SECURITIES AND EXCHANGE COMMISSION

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Unless otherwise noted, each of the following individual Members of the Commission voted affirmatively upon each action of the Commission shown in the file:

MARY L. SCHAPIRO, CHAIRMAN

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

DANIEL M. GALLAGHER, COMMISSIONER

(39 Documents)

Commissioner Walter
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67969 / October 3, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15058

In the Matter of eBX, LLC Respondent.	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against eBX, LLC ("eBX" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-And-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

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A. SUMMARY

1. eBX is a broker-dealer registered with the Commission that operates LeveL ATS ("LeveL"), an alternative trading system ("ATS"), which began operation on October 16, 2006. LeveL is an ATS subject to Regulation ATS under the Exchange Act. eBX marketed LeveL as a "dark pool" trading system and stated that it "maximizes liquidity and provides best execution while minimizing information leakage and market impact."

2. LeveL outsourced its operation to a third party technology service provider (the "Service Provider"), which signed a contract to build, host, and operate LeveL. The Service Provider also had a separate order routing business unit (the "Order Routing Business"), through which it sold order routing services to its own customers. The Service Provider and its Order Routing Business were distinct from LeveL.

3. Regulation ATS requires an ATS, among other things, to establish adequate safeguards and procedures to protect subscribers' confidential trading information. Despite this requirement, from at least 2008 through early 2011, LeveL failed to protect the confidential trading information of its subscribers and failed to disclose to all of its subscribers the uses that it allowed an entity outside of the ATS to make of that confidential trading information. In particular, LeveL allowed the Order Routing Business to remember LeveL subscribers' unexecuted order information and use that information for its own benefit. LeveL did not disclose to all of its subscribers that their confidential order information was being used by the Order Routing Business. There is no evidence that information about LeveL's unexecuted orders was displayed, or otherwise communicated to, clients of the Order Routing Business or other third parties.

4. From at least 2008 through early 2011, LeveL violated Regulation ATS by permitting the Order Routing Business's smart order router (the "Router") to remember information about LeveL subscribers' unexecuted orders residing within LeveL. The Router then used LeveL subscribers' order information to make routing decisions for the benefit of its own Order Routing Business. For example, if the Router knew that a buy order had been routed to LeveL, the Service Provider would use that information to route a sell order to LeveL to obtain an execution. Conversely, if the Service Provider knew that no buy order had been routed to LeveL, it would likely route any sell order it subsequently received to another destination. In addition, the Router was aware of the prices and pricing attributes of orders resting in LeveL, and was programmed to use that information in determining whether to send an order to LeveL as opposed to another venue based on where it knew it might get a better price for its own customers' orders.

5. LeveL did not inform most of its subscribers that their order information was used in this way – outside of the ATS –by the Order Routing Business. Instead, LeveL informed subscribers, in its subscriber agreements and elsewhere, that their order flow would be kept confidential and would not be shared outside of LeveL. These statements were inaccurate. LeveL subscribers other than the Service Provider did not have access to the same type of order information that would have assisted them in making their own routing decisions.

6. Moreover, LeveL was required to file a Form ATS with the Commission that accurately described how it operated. LeveL's Form ATS failed to disclose that it authorized the Service Provider to use data relating to orders routed to LeveL for the benefit of the Order Routing Business.

B. RESPONDENT

7. eBX registered with the Commission as a broker-dealer in or around July 2006 (SEC File No. 8-67145), and is a member of the Financial Industry Regulatory Authority. Since October 16, 2006, eBX has been the registered broker-dealer operating LeveL. eBX is a Delaware limited liability company that is a joint venture among five major registered broker-dealers. Its principal place of business is Boston, Massachusetts. LeveL's subscribers are limited to other registered broker-dealers.

C. FACTS

8. LeveL is an ATS that electronically matches undisplayed buy and sell orders for various equity securities, including NMS stocks and certain OTCBB and Pink Sheet securities.

9. LeveL operates pursuant to Regulation ATS, which was promulgated under the Exchange Act. An ATS is "any organization, association, person, group of persons, or system: (1) [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Exchange Act Rule 3b-16; and (2) [t]hat does not: (i) [s]et rules governing the conduct of subscribers other than the conduct of subscribers' trading on such [ATS]; or (ii) [d]iscipline subscribers other than by exclusion from trading." Regulation ATS, Rule 300(a).

10. Before beginning operation, an ATS is required to file Form ATS with the Commission. *See* Regulation ATS, Rule 301(b)(2). Form ATS requires the registrant to disclose basic information about the ATS, including the type of subscribers to the ATS, the type of securities that trade on the ATS, other entities that are involved with the ATS, and how the ATS operates. An ATS must file amendments to Form ATS before making material changes to the operation of its system and when information previously filed on Form ATS becomes inaccurate.

How LeveL Worked – From Initial Operation to March 2008

11. Since its inception, LeveL has outsourced its operation to the Service Provider. Under a contract signed in May 2006 (the "Original Hosting Agreement"), the Service Provider agreed to operate, host, and maintain LeveL. LeveL's systems were owned and operated by the Service Provider, the personnel involved in the day to day operation of LeveL were employees of the Service Provider, and LeveL employees were not able to access LeveL directly.

12. In addition to, and distinct from, its business of operating LeveL, the Service Provider had an Order Routing Business. The Order Routing Business had its own customers (some of which were also LeveL subscribers, but some of which were not LeveL subscribers). The Order Routing Business used its proprietary technology to send its customers' orders to various market centers. Until certain changes to the parties' agreements that will be described below (*see* ¶¶19-33), the Order Routing Business did not send its customers' orders into LeveL. The Order Routing Business provided its services through the use of the Router – which could adjust its routing strategies to attempt to maximize its customers' executions.

13. When it began to provide technology services to LeveL in 2006, the Service Provider decided to use the Router as the Financial Information eXchange ("FIX") gateway through which LeveL subscribers were instructed to send their orders into LeveL.[1]

14. LeveL had two principal order types: (1) resting orders ("Intents"), which remained in the system for a subscriber-determined period of time and (2) immediate-or-cancel ("IOC") orders. LeveL subscribers sent both types of orders into LeveL through the Router.

15. On July 6, 2006, LeveL filed with the Commission an initial operation report on Form ATS. That filing disclosed that the Service Provider would "build and host" LeveL and integrate it with the Router, and that the Router would "sit in front of" LeveL and route orders to LeveL. LeveL also told its subscribers that: LeveL was hosted and operated by the Service Provider; the Router operated by the Service Provider was used as a FIX router to access LeveL; and, for certain purposes, subscribers would communicate with the Service Provider's support personnel.

16. During this initial phase of LeveL's operations, eBX did not permit the Service Provider's Router to remember and utilize LeveL subscribers' confidential trading information.

The Service Provider's Order Routing Business and the Router's Memory Feature

17. In addition to functioning as a FIX gateway for LeveL, the Router also had a memory functionality (the "Memory Feature") that enabled it to retain a record of any order that the Router had submitted to various market centers, and to use that information to make automated routing decisions. The Memory Feature retained the symbol, side, source, quantity, and received time for these orders. For certain orders, the Memory Feature also remembered pricing information and order attributes. The Router would know if an order it had sent to a market center remained unexecuted, because if it had been executed, the market center would have reported the fill back to the Router. Thus, the Memory Feature maintained a catalog of the orders the Router had sent to all venues.

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[1] The FIX protocol is a series of messaging specifications widely used in the industry for the electronic communication of trade-related messages.

When the Router received a new order, it could consult the Memory Feature to determine the best venue to send the new order to. If the Router knew it had previously sent a contraside order to a particular market center and that order remained unexecuted, the Router could send the new order to that same market center, knowing that there was a high probability that the two orders would execute. The Memory Feature was outside of LeveL and was not necessary to LeveL's functioning.

18. The Service Provider was affiliated with a broker-dealer (the "Routing Broker") that operated an electronic communications network (an "ECN"). As part of its Order Routing Business, the Service Provider used the Router, and in particular, the Router's Memory Feature, to route order flow for its own customers, including the Routing Broker's ECN when contraside interest was not present in the ECN.

Negotiations to Permit the Router to Utilize the Memory Feature to Make Routing Decisions And Changes After March 2008

19. In fall 2007, LeveL began negotiating a new hosting agreement with the Service Provider. At around the same time the Order Routing Business also sought to have the Routing Broker become a subscriber to LeveL. During the negotiations, the Service Provider proposed that (1) as part of its Order Routing Business, the Router could send orders to LeveL, and (2) the Order Routing Business could use the Memory Feature and its information about LeveL subscribers' unexecuted orders for the purpose of routing or not routing orders to LeveL. In practice, this would allow the Router to read the LeveL order book by "turning on" the Memory Feature for LeveL. This arrangement would benefit the Service Provider because the Router would know LeveL's order book before it routed orders to LeveL. This arrangement would then increase the Order Routing Business' fill rate significantly, in part because it could route additional orders to LeveL in situations where there was more likely to be a contraside Intent in LeveL.

20. During the negotiations, the Service Provider emphasized to LeveL the importance of the Routing Broker becoming a LeveL subscriber. An executive from the Service Provider emailed a LeveL executive stating that the negotiations needed "to get resolved ASAP" because "if we do not get this agreement done, then [the Order Routing Business]'s flow will not be able to access LeveL." The Service Provider also later wrote the LeveL executive that the Routing Broker wants to "send orders to LeveL. That is all." The LeveL executive replied, "Absolutely. I will make sure it goes through."

21. During the negotiations, the issue was raised internally at LeveL as to whether its user agreements with its subscribers would prohibit the Memory Feature from using those subscribers' unexecuted order information for the Order Routing Business' benefit. A LeveL executive acknowledged that several LeveL subscribers had agreements that explicitly prohibited such use. Though that executive told another LeveL official that he would obtain the consent of those LeveL subscribers whose existing user agreements explicitly would prohibit such information access by the Memory Feature, he failed to do so.

22. Effective February 25, 2008, the Routing Broker signed a user agreement under which it became a subscriber to LeveL (the "Routing Broker User Agreement"). The Routing Broker User Agreement contained specially-negotiated language in the section entitled "restrictions on use: security" that stated it could "use information and or data relating to order entry, order execution, or indications of interest." This language was not present in LeveL's standard user agreements. In March 2008, the Memory Feature was turned on for orders submitted to LeveL by entities who were subscribers to both LeveL and to services offered by the Order Routing Business. From that point, the Order Routing Business benefitted from information concerning other LeveL subscribers' order information. At that time, the Memory Feature was not turned on for the order flow of LeveL subscribers who were not also customers of the Order Routing Business. LeveL did not inform its subscribers of this change in the use of their unexecuted order information.

23. Contemporaneously, the Service Provider was seeking to revise its Original Hosting Agreement with LeveL so that the Memory Feature could be turned on for all LeveL Intent orders. The Original Hosting Agreement required the Service Provider to maintain the confidentiality of all LeveL subscriber information. The Service Provider proposed edits to these confidentiality provisions that permitted it to use LeveL order information "related to unexecuted orders to enable the [Router] application to make routing decisions."

24. In November 2008, eBX entered into the new hosting agreement with the Service Provider (the "Revised Hosting Agreement") that expressly authorized the Service Provider to "use that portion of eBX Data that is information related to unexecuted orders to enable the [Router] application to make routing decisions" (the "Information Sharing provision"). Shortly after the Revised Hosting Agreement was signed, the Memory Feature was turned on for all LeveL subscribers. LeveL never advised most of its subscribers about this new use of their order information by the Service Provider and its Order Routing Business.

25. Although LeveL was advised by counsel in connection with negotiating the Revised Hosting Agreement, there is no evidence that LeveL obtained specific legal advice about whether the Information Sharing provision complied with Regulation ATS.

26. On or about December 31, 2009 and unrelated to the execution of the Revised Hosting Agreement, the Service Provider and many of its assets were sold to a third party. As part of this transaction, the Revised Hosting Agreement and certain assets of the Service Provider were assigned to the Routing Broker, which continues to act as LeveL's technology service provider and to operate the Order Routing Business.

Advantages of the Memory Feature to the Order Routing Business

27. The Memory Feature benefitted the Order Routing Business because it allowed the Router to know the likely result before routing an order to LeveL, increasing the Order Routing Business' fill rate by enabling the Router to route orders to LeveL in situations where it knew there would be a contraside Intent in LeveL and avoiding routing to LeveL when no contraside was available. In addition, the Router knew the way that

Intents in LeveL were priced and could make routing decisions for its own customers based on that pricing information. While the record shows that the actual execution price received by the LeveL subscriber and the Order Routing Business would be identical to the execution price that would have resulted had the Order Routing Business sent the same orders to LeveL without the benefit of the Memory Feature, knowledge of the pricing information of orders resting in LeveL gave the Order Routing Business the ability to route orders to LeveL in situations where the resulting price could have been better for the Order Routing Business' customer than prices available in other market centers.

28. The Information Sharing provision was significant to the Order Routing Business because it improved the efficiency of that business. In marketing materials, the Order Routing Business touted the advantages of the Memory Feature, noting that it:

- was a "virtual order book" of known dark orders from various liquidity sources, including other dark pools;
- provided a private market data source, which was known only to the Router;
- allowed the Router to route against a "known contra order"; and
- allowed the Router to use information provided by the Memory Feature for special orders, creating opportunities for price improvement and liquidity enhancement.

29. Internal documents from the Service Provider indicate that it perceived an advantage to the Order Routing Business from being able to "see the LeveL order flow in [the Memory Feature] and be able to efficiently interact with it." The Service Provider also reacted with enthusiasm to the signing of the Revised Hosting Agreement that allowed it to turn on the Memory Feature for all LeveL orders, stating in internal email, "Yeah! Finally. I will configure key LeveL-only clients for [the Memory Feature] tonight so we can start getting the benefits ASAP."

30. This arrangement provided the Order Routing Business with an information advantage over other LeveL subscribers, as the Order Routing Business was able to use the knowledge of other LeveL subscribers' orders to increase its execution rate within LeveL, as well as to decide whether to route to LeveL or elsewhere.

31. As a result of its privileged access to information about the orders that were submitted to, and executed in, LeveL, the Order Routing Business was able to obtain a much higher fill rate for its IOC orders than any other LeveL subscriber's IOC orders by increasing orders submitted to LeveL in circumstances where they were likely to be executed and decreasing orders submitted to LeveL in circumstances where they were less likely to be executed. For example, from about May 2008 through June 2009, the Order Routing Business's LeveL IOC orders had a fill rate ranging from about 30 to 70%, while the fill rate for other LeveL subscribers' IOC orders was about 1 to 2%. During this period, the Order Routing Business accounted for approximately 1 to 2 % of all IOC shares directed to LeveL while its executed IOC shares were between 16 and 39% of all IOC shares executed at LeveL, which accounted for between 4 and 11 % of all shares executed in LeveL.

32. In April 2011, after an examination by the Commission, LeveL caused the Order Routing Business to disable the Memory Feature. As a result of disabling the Memory Feature, the Order Routing Business' fill-rate decreased substantially, as it no longer had the benefit of the Memory Feature's knowledge of orders routed to LeveL.

LeveL Did Not Have Adequate Policies Concerning Regulation ATS

33. Rule 301(b)(10) of Regulation ATS requires an ATS to establish adequate safeguards and procedures to protect subscribers' confidential trading information, and to adopt and implement adequate oversight procedures to ensure that the safeguards and procedures adopted under Rule 301(b)(10) are followed. LeveL violated this Rule by entering into the Information Sharing arrangements that allowed the Order Routing Business to remember subscribers' unexecuted order information and to use that information for its own benefit. The subscriber information that was shared with the Order Routing Business is "confidential trading information" where such use was not authorized by, or disclosed to, LeveL subscribers.

34. LeveL also failed to have safeguards and procedures to ensure that its subscribers were informed about how the Router and its Memory Feature were accessing and using their confidential order information.

35. Despite outsourcing its operations, LeveL nonetheless retained the responsibility for ensuring LeveL's compliance with all applicable laws and regulations, including Rule 301(b)(10) of Regulation ATS. Despite these obligations, LeveL failed to adopt or implement adequate oversight procedures to make sure that the Service Provider, and after 2009, the Routing Broker, protected LeveL subscribers' confidential trading information.

LeveL Did Not Inform, and Otherwise Failed to Notify, Its Subscribers Concerning the Use of Their Confidential Order Information by the Service Provider and Routing Broker

36. Before the Commission's investigation into its conduct, LeveL did not disclose to most of its subscribers that the Memory Feature had access to, and used, information about unexecuted orders sent to LeveL to make routing decisions for the benefit of the Order Routing Business.

37. LeveL expressly represented to certain subscribers in their user agreements that their order information would not be shared with other users. For example, one subscriber's user agreement stated that "eBX acknowledges that the trades, trade related data, trading strategies and other information provided" by that subscriber were proprietary, and that LeveL agreed to keep such information "confidential" and not share it with any other LeveL subscriber. However, LeveL permitted the Router and its Memory Feature to access such order information for routing purposes.

38. From at least 2008 through early 2011, though LeveL disclosed to its subscribers that it obtained technology services from the Service Provider, most LeveL

subscribers were not provided with the additional information that their unexecuted order data was being remembered by the Memory Feature and was being used to make order routing decisions for customers of the Order Routing Business.

LeveL Failed To Amend Its Form ATS To Disclose the Information Sharing Arrangements Until 2011 And Did Not Timely Correct Other Inaccuracies In Its Form ATS

39. LeveL filed its initial operation report with the Commission on Form ATS in July 2006. In Exhibit E to that Form, which requires the disclosure of "the name of any entity, other than the [ATS], that will be involved in operation of the [ATS]," LeveL did not disclose that the Service Provider would be involved in providing technology and support services. In Exhibit F to its July 2006 Form ATS, which described the operation of the ATS, LeveL stated that the Service Provider would "build and host" LeveL and that customers would use the Router to submit orders to LeveL. Exhibit F also stated that "Intents are only viewable by the user that submitted that Intent. The ATS will not provide a data feed that will show in detail or in aggregate, the trading interest of all the Intents resting on the ATS book." At the time that statement was filed with the Commission, it was accurate because the Router's Memory Feature had not yet been enabled.

40. Between June 2007 and June 2009, eBX did not file any amendments to its Form ATS. During this time period two relevant events took place. First, in February 2008, LeveL entered into the Routing Broker User Agreement. In March 2008, the Routing Broker began to use the Memory Feature to remember and use certain LeveL subscribers' unexecuted order information for routing purposes. This was a material change to the operation of LeveL and should have been disclosed in a Form ATS amendment at least 20 days before the change was implemented.

41. In November 2008, LeveL entered into the Revised Hosting Agreement with the Service Provider that permitted the Memory Feature to use all LeveL subscribers' unexecuted order information to make routing decisions. This was a material change to the operation of LeveL and should have been disclosed in a Form ATS amendment at least 20 days before the change was implemented. This change also rendered inaccurate the Form ATS statement that "[i]ntents are only viewable by the user that submitted that Intent. The ATS will not provide a data feed that will show in detail or in aggregate, the trading interest of all the Intents resting on the ATS book."

42. In the Form ATS amendment filed on June 10, 2009, LeveL amended Exhibit E to disclose that the Service Provider provided "Technology Services" to LeveL, including the "technology related to the ATS matching system" and "all implementation, hosting, maintenance services" that are "necessary to access and use the Matching Application for eBX's operations and maintain the operating capability of the Matching Application." LeveL did not, however, make any relevant changes to Exhibit F. In particular, it did not add a disclosure describing the Information Sharing provision with the Service Provider, and it did not explain how its prior statements about Intents only being viewable by the user that submitted them had been rendered inaccurate.

43. On or about December 31, 2009, the Service Provider assigned its rights and obligations under the Revised Hosting Agreement to the Routing Broker. This change in the identity of LeveL's service provider was not reported in a timely Form ATS amendment.

D. VIOLATIONS

44. As a result of the conduct described above, eBX willfully[2] violated Rule 301(b)(10) of Regulation ATS which requires an ATS to establish adequate safeguards and procedures to protect subscribers' confidential trading information.

45. As a result of the conduct described above, eBX willfully violated Rule 301(b)(2) of Regulation ATS which requires an ATS to amend its Form ATS before implementing material changes to its operation or when the Form ATS becomes inaccurate.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

A. eBX shall cease and desist from committing or causing any violation and any future violation of Rules 301(b)(2) and 301(b)(10) of Regulation ATS;

B. eBX is censured;

C. eBX shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $800,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways: (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Boulevard, Oklahoma City, OK 73169. Payments by check or money order must be accompanied by a cover letter

[2] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

identifying eBX, LLC as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to John Dugan, Associate Director of Enforcement, Boston Regional Office, Securities and Exchange Commission, 33 Arch Street, Suite 2300, Boston, MA 02110.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 232

[Release Nos. 33-9364; 34-67978; 39-2486; IC-30227]

Adoption of Updated EDGAR Filer Manual

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the Commission) is adopting revisions to the Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) Filer Manual and related rules to reflect updates to the EDGAR system. The revisions are being made primarily to support public dissemination of previously submitted draft registration statements either under the JOBS Act or the Division of Corporation Finance's foreign private issuer policy; support PDF as an official filing format for submission type 40-33 and 40-33/A; support changes in the beneficiary account and receiver American Bank Association number and name for fee payments made for filings; and allow a future period date up to the next business date for Form 8-K. The EDGAR system is scheduled to be upgraded to support this functionality on October 1, 2012.

EFFECTIVE DATE: [Insert date of publication in the Federal Register.] The incorporation by reference of the EDGAR Filer Manual is approved by the Director of the Federal Register as of [Insert date of publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: In the Division of Corporation Finance, for questions on draft registration statements and Form 8-K, contact Jeffrey Thomas at (202) 551-3600; in the Division of Investment Management for questions concerning submission types 40-33 and 40-33/A, contact Barry Miller at (202) 551-6796; and in the Office of Information Technology, contact Rick Heroux at (202) 551-8800.

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SUPPLEMENTARY INFORMATION: We are adopting an updated EDGAR Filer Manual, Volume I and Volume II. The Filer Manual describes the technical formatting requirements for the preparation and submission of electronic filings through the EDGAR system.[1] It also describes the requirements for filing using EDGARLink Online and the Online Forms/XML website.

The revisions to the Filer Manual reflect changes within Volume I entitled EDGAR Filer Manual, Volume I: "General Information," Version 14 (October 2012) and Volume II entitled EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 21 (October 2012). The updated manual will be incorporated by reference into the Code of Federal Regulations.

The Filer Manual contains all the technical specifications for filers to submit filings using the EDGAR system. Filers must comply with the applicable provisions of the Filer Manual in order to assure the timely acceptance and processing of filings made in electronic format.[2] Filers may consult the Filer Manual in conjunction with our rules governing mandated electronic filing when preparing documents for electronic submission.[3]

The EDGAR system will be upgraded to Release 12.2 on October 1, 2012 and will introduce the following changes: EDGAR will be updated to support public dissemination of the confidential draft registration statements, submission types DRS and DRS/A. Issuers that submitted draft registrations either under the JOBS Act or the Division of Corporation Finance's foreign private issuer policy will be able to disseminate their previously submitted draft

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[1] We originally adopted the Filer Manual on April 1, 1993, with an effective date of April 26, 1993. Release No. 33-6986 (April 1, 1993) [58 FR 18638]. We implemented the most recent update to the Filer Manual on August 30, 2012. See Release No. 33-9353 (September 6, 2012) [77 FR 54806].

[2] See Rule 301 of Regulation S-T (17 CFR 232.301).

[3] See Release No. 33-9353 (September 6, 2012) [77 FR 54806] in which we implemented EDGAR Release 12.1. For additional history of Filer Manual rules, please see the cites therein.

registration statements. A new correspondence type, DRSLTR, will be available to submit any correspondences related to draft registration statements. The options to disseminate draft registration statements as well as to create DRSLTR submissions can be accessed by selecting the 'Draft Reg. Statement' link on the EDGAR Filing Website.

Form ID application will be updated with "JOBS Act §106" or "Foreign Private Issuer Policy" options to allow applicants to indicate that they are submitting an application for EDGAR access to file draft registration statements. These options will replace the "Access codes will be used to submit draft registration statement" check box.

Submission form types 8-K, 8-K/A, 8-K12B, 8-K12B/A, 8-K12G3, 8-K12G3/A, 8-K15D5, and 8-K15D5/A will allow a future period date up to the next business date from the date of submission, if the time of submission is between 05:31pm EST and 10:00pm EST.

EDGAR will be updated to allow filers to submit, on a voluntary basis, copies of litigation documents pursuant to Section 33 of the Investment Company Act of 1940 (submission types 40-33 and 40-33/A) in Portable Document Format (PDF) as an official filing format. EDGAR will continue to allow ASCII and HTML as official filing formats for submission types 40-33 and 40-33/A.

Starting October 1, 2012, filers initiating FEDWIRE transactions to make deposits to pay their filing fees will need to use a new US Treasury beneficiary account number (850000001001), as well as a new American Bank Association (ABA) number and bank name for the receiving bank (021030004/TREAS NYC). The current bank account number (152307768324) and receiving bank ABA number and name (081000210/US BANK) will be invalid from this date forward. Filer may obtain the new US Treasury account number and ABA number from the notice posted on the "Information for EDGAR Filers" web page prior to October 1, 2012 and by accessing the updated "Instructions for Wire Transfer (FEDWIRE) and Check Payment of SEC

Filing Fees" by logging onto the EDGAR Filing Website and accessing the 'Fees' link on the EDGAR menu thereafter.

The new online version of Form N-SAR, originally planned for deployment on July 9, 2012, has been delayed and will not go into production any sooner than January 14th 2013. The specific deployment date will be announced on the Commission's public web site's "Information for EDGAR Filers" page (http://www.sec.gov/info/edgar.shtml). Filers should continue to use the EDGAR Filer Manual, Volume III: N-SAR Supplement to file their N-SAR submissions. When the online version of Form N-SAR is deployed, EDGAR Filer Manual, Volume III: N-SAR Supplement will be retired. Instructions to file the online version of Form N-SAR addressed in Chapter 9 of EDGAR Filer Manual, Volume II: EDGAR Filing should then be followed.

Along with the adoption of the Filer Manual, we are amending Rule 301 of Regulation S-T to provide for the incorporation by reference into the Code of Federal Regulations of today's revisions. This incorporation by reference was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR Part 51.

You may obtain paper copies of the updated Filer Manual at the following address: Public Reference Room, U.S. Securities and Exchange Commission, 100 F Street, NE, Room 1543, Washington DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. We will post electronic format copies on the Commission's website; the address for the Filer Manual is http://www.sec.gov/info/edgar.shtml.

Since the Filer Manual and the corresponding rule changes relate solely to agency procedures or practice, publication for notice and comment is not required under the

Administrative Procedure Act (APA).[4] It follows that the requirements of the Regulatory Flexibility Act[5] do not apply.

The effective date for the updated Filer Manual and the rule amendments is [Insert date of publication in the Federal Register]. In accordance with the APA,[6] we find that there is good cause to establish an effective date less than 30 days after publication of these rules. The EDGAR system upgrade to Release 12.2 is scheduled to become available on October 1, 2012. The Commission believes that establishing an effective date less than 30 days after publication of these rules is necessary to coordinate the effectiveness of the updated Filer Manual with the system upgrade.

Statutory Basis

We are adopting the amendments to Regulation S-T under Sections 6, 7, 8, 10, and 19(a) of the Securities Act of 1933,[7] Sections 3, 12, 13, 14, 15, 23, and 35A of the Securities Exchange Act of 1934,[8] Section 319 of the Trust Indenture Act of 1939,[9] and Sections 8, 30, 31, and 38 of the Investment Company Act of 1940.[10]

List of Subjects in 17 CFR Part 232

Incorporation by reference, Reporting and recordkeeping requirements, Securities.

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4 5 U.S.C. 553(b).

5 5 U.S.C. 601-612.

6 5 U.S.C. 553(d)(3).

7 15 U.S.C. 77f, 77g, 77h, 77j, and 77s(a).

8 15 U.S.C. 78c, 78l, 78m, 78n, 78o, 78w, and 78ll.

9 15 U.S.C. 77sss.

10 15 U.S.C. 80a-8, 80a-29, 80a-30, and 80a-37.

TEXT OF THE AMENDMENT

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 232 - REGULATION S-T—GENERAL RULES AND REGULATIONS FOR ELECTRONIC FILINGS

1. The authority citation for Part 232 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 77z–3, 77sss(a), 78c(b), 78l, 78m, 78n, 78o(d), 78w(a), 78ll, 80a–6(c), 80a–8, 80a–29, 80a–30, 80a–37, and 7201 et seq.; and 18 U.S.C. 1350.

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2. Section 232.301 is revised to read as follows:

§232.301 EDGAR Filer Manual.

Filers must prepare electronic filings in the manner prescribed by the EDGAR Filer Manual, promulgated by the Commission, which sets out the technical formatting requirements for electronic submissions. The requirements for becoming an EDGAR Filer and updating company data are set forth in the updated EDGAR Filer Manual, Volume I: "General Information," Version 14 (October 2012). The requirements for filing on EDGAR are set forth in the updated EDGAR Filer Manual, Volume II: "EDGAR Filing," Version 21 (October 2012). All of these provisions have been incorporated by reference into the Code of Federal Regulations, which action was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR Part 51. You must comply with these requirements in order for documents to be timely received and accepted. You can obtain paper copies of the EDGAR Filer Manual from the following address: Public Reference Room, U.S. Securities and Exchange Commission, 100 F Street, NE, Room 1543, Washington, DC 20549, on official business days between the hours of

10:00 am and 3:00 pm. Electronic copies are available on the Commission's website. The address for the Filer Manual is http://www.sec.gov/info/edgar.shtml. You can also inspect the document at the National Archives and Records Administration (NARA). For information on the availability of this material at NARA, call 202–741–6030, or go to: http://www.archives.gov/federal_register/code_of_federal_regulations/ibr_locations.html.

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

October 04, 2012

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67988 / October 4, 2012

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3412 / October 4, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-12126

In the Matter of Gilbert Bergsman, CPA	ORDER GRANTING APPLICATION FOR REINSTATEMENT TO APPEAR AND PRACTICE BEFORE THE COMMISSION AS AN ACCOUNTANT

On December 15, 2005, Gilbert Bergsman, CPA ("Bergsman") was denied the privilege of appearing or practicing as an accountant before the Commission as a result of settled public administrative proceedings instituted by the Commission against Bergsman pursuant to Rule 102(e) of the Commission's Rules of Practice.[1] Bergsman consented to the entry of the December 15, 2005 order without admitting or denying the findings therein. This order is issued in response to Bergsman's application for reinstatement to appear and practice before the Commission as an accountant.

Bergsman was found to have engaged in improper professional conduct with respect to the audit of the financial statements of eSafetyworld, Inc. ("eSafety") for its fiscal year ended June 30, 2001 and the reviews of the financial statements for the quarters ended September 30, 2000, December 31, 2000, and March 31, 2001 by Eichler Bergsman & Co., LLP. Bergsman served as the engagement partner on the eSafety engagement. During this time, Bergsman engaged in improper professional conduct by repeatedly engaging in unreasonable conduct, resulting in a violation of applicable professional standards that indicated a lack of competence to practice before the Commission. Specifically, Bergsman (i) failed to make adequate inquiries into eSafety's new revenue stream and the valuation thereof during the first three quarters of 2001; (ii) allowed the reports on eSafety's quarterly financial statements to remain outstanding despite eSafety's failure to reverse certain consulting revenues recognized during the first three quarters of 2001; (iii) did not confirm accounts receivable from eSafety's consulting clients, and

[1] *See* Accounting and Auditing Enforcement Release No. 2354 dated December 15, 2005. Bergsman was permitted, pursuant to the order, to apply for reinstatement after one year upon making certain showings.

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did not note or require disclosure of eSafety's related party relationships with eSafety's consulting clients; (iv) did not appropriately audit or require correction of eSafety's deferral of certain administrative costs; and (v) did not obtain sufficient competent evidence to conclude that certain cash advances were loans or investments, which eSafety improperly recorded as assets rather than expenses.

Bergsman has met all of the conditions set forth in the December 15, 2005 order and, in his capacity as an independent accountant, has stated that he will comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to all requirements relating to registration, inspections, concurring partner reviews and quality control standards. In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Bergsman attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while practicing before the Commission in this capacity.

Rule 102(e)(5) of the Commission's Rules of Practice governs applications for reinstatement, and provides that the Commission may reinstate the privilege to appear and practice before the Commission "for good cause shown."[2] This "good cause" determination is necessarily highly fact specific.

On the basis of the information supplied, representations made, and undertakings agreed to by Bergsman, it appears that he has complied with the terms of the December 15, 2005 order denying him the privilege of appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Bergsman, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, and that Bergsman, by undertaking to comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards, in his practice before the Commission as an independent accountant has shown good cause for reinstatement. Therefore, it is accordingly,

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[2] Rule 102(e)(5)(i) provides:

"An application for reinstatement of a person permanently suspended or disqualified under paragraph (e)(1) or (e)(3) of this section may be made at any time, and the applicant may, in the Commission's discretion, be afforded a hearing; however, the suspension or disqualification shall continue unless and until the applicant has been reinstated by the Commission for good cause shown." 17 C.F.R. § 201.102(e)(5)(i).

ORDERED pursuant to Rule 102(e)(5)(i) of the Commission's Rules of Practice that Gilbert Bergsman, CPA is hereby reinstated to appear and practice before the Commission as an accountant.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68002; File No. AN-OCC-2012-03)

October 5, 2012

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Advance Notice and Notice of No Objection to Replace The Options Clearing Corporation's Credit Facility

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] and Rule 19b-4(n)(1)(i),[2] notice is hereby given that on September 26, 2012, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") an advance notice as described in Items I, II and III below, which Items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed change from interested persons.

I. Clearing Agency's Statement of the Terms of Substance for the Advance Notice

In connection with a change to its operations (the "Change"), OCC proposes to replace its credit facility designed to be used to meet obligations of OCC arising out of the default or suspension of a clearing member of OCC or the insolvency of any bank or clearing organization doing business with OCC.

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed change and discussed any comments it received on the proposed change. The text of these statements may be examined at the places specified in Item IV

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4(n)(i).

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below. OCC has prepared a summary, set forth in section (A) below, of the most significant aspects of such statements.[3]

Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act")

Description of Change

The Change involves the replacement of a credit facility that OCC maintains for the purposes of meeting obligations arising out of the default or suspension of a clearing member or the failure of a bank or securities or commodities clearing organization to perform its obligations due to its bankruptcy, insolvency, receivership or suspension of operations. OCC's existing credit facility (the "Existing Facility") was implemented on October 13, 2011 through the execution of a Credit Agreement among OCC, JPMorgan Chase Bank, N.A. ("JPMorgan"), as administrative agent, and the lenders that are parties to the agreement from time to time, which provides short-term secured borrowings in an aggregate principal amount of up to $2 billion.

The Existing Facility is set to expire on October 11, 2012, and OCC is therefore currently negotiating the terms of a new credit facility (the "New Facility") on substantially similar terms as the Existing Facility. On September 4, 2012, OCC received a commitment letter with regard to the New Facility from: JPMorgan, the administrative agent, euro administrative agent and collateral agent, and a lender, for the New Facility; JPMorgan Securities LLC ("JPMorgan Securities"), the joint lead arranger for the New Facility; Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S"), the joint lead arranger for the New Facility; and Bank of America, N.A. ("BANA"), the syndication agent and a lender for the New Facility. The terms and conditions applicable to the New Facility are

3 The Commission has modified the text of the summaries prepared by OCC.

set forth in the commitment letter and a Summary of Terms and Conditions attached as an exhibit to the commitment letter. One of the conditions to the availability of the New Facility is the execution and delivery of a credit agreement and pledge agreement between OCC, JPMorgan, JPMorgan Securities, MLPF&S, BANA and the various lenders under the New Facility, which OCC anticipates will occur on or before October 11, 2012. Another condition is the successful syndication of the facility to a group of lenders who will in the aggregate provide commitments of at least $2 billion.

Under the New Facility, a syndicate of banks, financial institutions and other entities will make loans to OCC on request. The New Facility includes a tranche that may be drawn in dollars or euros and a dollar-only tranche. The aggregate amount of loans available under the facility, subject to the value of eligible collateral, is up to $2 billion. The dollar equivalent of the total loans denominated in euros under the euro/dollar tranche of the New Facility may not exceed $100 million. During the term of the New Facility, the amount of the New Facility may be increased to up to $3 billion if OCC so requests and if sufficient commitments from lenders are received and accepted.

The New Facility is available on a revolving basis for a 364-day term. OCC may request a loan under the New Facility on any business day by providing a notice to JPMorgan, as administrative agent, which will then notify the lenders, who will be required to fund their *pro rata* share of any requested loan within a specified period of time after receiving notice from JPMorgan. The funding deadline is designed to permit OCC to obtain funds on the date of the request, subject to a cutoff time after which funding will occur on the next business day. Each loan issued pursuant to the New Facility matures and is payable 30 days after the borrowing date. Proceeds of these loans must be used to meet the obligations of OCC arising out of the default or suspension of a clearing member or the failure of a bank or securities or commodities clearing organization to perform its obligations to OCC. In order to obtain a loan under the facility, OCC must pledge as collateral cash or government securities that are margin deposits of suspended members or that are held in OCC's clearing fund, and that in either case are not otherwise subject to liens, security interests or other encumbrances. OCC has the authority to pledge these assets in connection with borrowings under Section 5(e) of Article VIII of its By-Laws and Rule 1104(b).

The amount available under the New Facility at any given point in time is equal to the lesser of (i) $2 billion, or the increased size of the facility, if applicable, and (ii) the sum of (A) 90% of the value of OCC's clearing fund that is not subject to liens or encumbrances granted by OCC other than in connection with the New Facility and (B) 90% of the value of unencumbered margin deposits of suspended clearing members that are not subject to liens or encumbrances granted by OCC other than in connection with the New Facility. If the aggregate principal amount of loans under the New Facility exceeds the amount available under this formula, OCC must prepay loans, obtain the release of liens and/or require additional margin and/or clearing fund deposits to cure the deficiency. A condition to the making of any loan under the New Facility is that, after giving effect to the loan, the sum of 100% of the dollar-denominated loans and 105% of the euro-denominated loans under the New Facility may not exceed the "borrowing base." The borrowing base is determined by adding the value of all collateral pledged in connection with all loans under the New Facility, after applying "haircuts" to government securities based on their remaining maturity. If the borrowing base is less than the sum of 100% of the dollar-denominated loans and 105% of the euro-denominated loans under the New Facility, OCC must repay loans or pledge additional collateral to cure the deficiency. There are additional customary conditions to the making of any loan under the New Facility, including that OCC is not in default. Importantly, however, the absence of a material adverse change affecting OCC is not a condition to the making of a loan. Loans may be prepaid at any time without penalty.

Events of default by OCC under the New Facility include, but are not limited to, non-payment of principal, interest, fees or other amounts when due; non-compliance with a daily borrowing base when loans are outstanding; material inaccuracy of representations and warranties; bankruptcy events; fundamental changes; and failure to maintain a first priority perfected security interest in collateral. In the event of a default, the interest rate applicable to outstanding loans would increase by 2.00%. The New Facility also includes customary defaulting lender provisions, including provisions that restrict the defaulting lender's voting rights, permit set-offs of payments against the defaulting lender and suspend the defaulting lender's right to receive commitment fees.

The New Facility involves a variety of customary fees payable by OCC, including: (1) a one-time arrangement fee payable to JPMorgan Securities and MLPF&S; (2) a one-time administrative and collateral agent fee payable to JPMorgan if the New Facility closes; (3) a one-time euro administrative fee payable to JPMorgan if the New Facility closes; (4) upfront commitment fees payable to the lenders based on the amount of their commitments; and (5) an ongoing quarterly commitment fee based on the unused amount of the New Facility.

Anticipated Effect on and Management of Risk

Overall, the New Facility reduces the risks to OCC, its clearing members and the options market in general because it will allow OCC to obtain short-term funds to address liquidity demands arising in connection with the default or suspension of clearing members or the insolvency of a bank or another securities or commodities clearing organization. The existence of the New Facility could enable OCC to minimize losses in the event such a default, suspension or insolvency, by allowing it to obtain funds on extremely short notice to ensure that the clearance of transactions in options and other contracts occurs without interruption. By drawing on the facility OCC would be able to avoid liquidating margin or clearing fund assets in what would likely be volatile market conditions, which would preserve funds available to cover any losses resulting from the failure of a clearing member, bank or another clearing organization. OCC's entering into the New Facility will not increase the risks associated with its clearing function because it is entered into on substantially the same terms as the Existing Facility.

While the New Facility will, in general, reduce the risks associated with OCC's clearing function, like any lending arrangement the New Facility involves risks. One of the primary risks to OCC and its clearing function associated with the New Facility is the risk that a lender fails to fund when OCC requests a loan, because of the lender's insolvency or otherwise. This risk is mitigated through the use of a syndicated facility, which does not depend on the creditworthiness of a small number of lenders. In addition, the New Facility has lender default provisions designed to discourage lenders from failing to fund loans. Moreover, OCC has the ability under the New Facility to replace a defaulting lender. Finally, in the event a particular lender fails to fund its portion of the requested loan, the

New Facility includes provisions pursuant to which OCC may request "covering" loans from non-defaulting lenders to make up the shortfall, or OCC may simply make a second borrowing request for the shortfall amount that lenders are committed to make, subject to OCC's satisfying the borrowing conditions for the second loan, although in either case the total amount available for borrowing under the New Facility would be reduced by the unfunded commitment of the defaulting lender. The failure by one or more lenders to fund the first loan does not relieve the lenders of their commitment to fund the second loan.

A second risk associated with the New Facility is the risk that OCC is unable to repay a loan within 30 days, which would allow the lenders to seize the pledged collateral and liquidate it, potentially at depressed prices that would result in losses to OCC. OCC believes that this risk is at a manageable level, because 30 days should be an adequate period of time to allow OCC to generate funds to repay the loans under the New Facility, such as by liquidating clearing fund assets other than those pledged to secure the loans. As provided in Section 5(e) of Article VIII of its By-Laws, if the loans have not been repaid within 30 days, the amount of clearing fund assets used to secure the loans will be considered to be an actual loss to the clearing fund, which will be allocated in accordance with Section 5 of Article VIII, and the proceeds of such allocation can be used to repay the loans.

III. <u>Date of Effectiveness of the Advance Notice and Timing for Commission Action</u>

The proposed change may be implemented if the Commission does not object to the proposed change within 60 days of the later of (i) the date that the proposed change was filed with the Commission or (ii) the date that any additional information requested by the

Commission is received. The clearing agency shall not implement the proposed change if the Commission has any objection to the proposed change.

The Commission may extend period for review by an additional 60 days if the proposed change raises novel or complex issues, subject to the Commission or the Board of Governors of the Federal Reserve System providing the clearing agency with prompt written notice of the extension. A proposed change may be implemented in less than 60 days from the date the advance notice is filed, or the date further information requested by the Commission is received, if the Commission notifies the clearing agency in writing that it does not object to the proposed change and authorizes the clearing agency to implement the proposed change on an earlier date, subject to any conditions imposed by the Commission.

The clearing agency shall post notice on its website of proposed changes that are implemented.

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed change is consistent with the Exchange Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml) or
- Send an e-mail to rule-comments@sec.gov. Please include File Number AN-OCC-2012-03 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-1090.

All submissions should refer to File Number AN-OCC-2012-03. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed change that are filed with the Commission, and all written communications relating to the proposed change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Section, 100 F Street, N.E., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filings will also be available for inspection and copying at the principal office of OCC and on OCC's website: (http://www.optionsclearing.com/components/docs/legal/rules_and_bylaws/an_occ_12_03.pdf).

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number AN-OCC-2012-03 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. <u>Commission's Findings and Notice of No Objection</u>

Section 806(e)(1)(G) of the Clearing Supervision Act provides that a designated financial market utility may implement a change if it has not received an objection by the Commission within 60 days of an advanced notice.[4] Section 806(e) of the Clearing Supervision Act allows the Commission to act prior to the 60th day.[5] If the Commission chooses to not object prior to the 60th day, it must notify the designated financial market utility in writing that it does not object and authorize implementation of the change on an earlier date.[6] If the Commission chooses to object prior to the 60th day, it must similarly notify the designated financial market utility.[7]

In its filing with the Commission, OCC requested that the Commission notify OCC that it has no objection to the Change no later than October 9, 2012, which is two days prior to the October 11, 2012 effective date of the New Facility. OCC requested Commission action two days in advance of the effective date to ensure that there is no

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4 12 U.S.C. 5465(e)(1)(G).

5 12 U.S.C. 5465(e).

6 12. U.S.C. 5465(e)(1)(I).

7 12. U.S.C. 5465(e)(1)(E).

period of time that OCC operates without a credit facility, given the importance of the borrowing capacity in connection with OCC's risk management.

For the reasons set forth above, the Commission does not object to the proposed change.

VI. Conclusion

Pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act, the Commission does not object to the proposed change and authorizes OCC to implement the change (AN-OCC-2012-03) as of the date of this notice.[8]

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

[8] 12 U.S.C. 5465(e)(1)(I).

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-3483; File No. S7-23-07

RIN 3235-AJ96

Temporary Rule Regarding Principal Trades with Certain Advisory Clients

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is proposing to amend rule 206(3)-3T under the Investment Advisers Act of 1940, a temporary rule that establishes an alternative means for investment advisers that are registered with the Commission as broker-dealers to meet the requirements of section 206(3) of the Investment Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. The amendment would extend the date on which rule 206(3)-3T will sunset from December 31, 2012 to December 31, 2014.

DATES: Comments must be received on or before [30 days after the date of publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-23-07 on the subject line; or

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- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-23-07. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Melissa S. Gainor, Attorney-Adviser, Vanessa M. Meeks, Attorney-Adviser, Sarah A. Buescher, Branch Chief, or Daniel S. Kahl, Assistant Director, at (202) 551-6787 or *IArules@sec.gov*, Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is proposing an amendment to temporary rule 206(3)-3T [17 CFR 275.206(3)-3T] under the

Investment Advisers Act of 1940 [15 U.S.C. 80b] that would extend the date on which the rule will sunset from December 31, 2012 to December 31, 2014.

I. Background

On September 24, 2007, we adopted, on an interim final basis, rule 206(3)-3T, a temporary rule under the Investment Advisers Act of 1940 (the "Advisers Act") that provides an alternative means for investment advisers that are registered with us as broker-dealers to meet the requirements of section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients.[1] The purpose of the rule was to permit broker-dealers to sell to their advisory clients, in the wake of *Financial Planning Association v. SEC* (the "FPA Decision"),[2] certain securities held in the proprietary accounts of their firms that might not be available on an agency basis — or might be available on an agency basis only on less attractive terms[3] — while protecting clients from conflicts of interest as a result of such transactions.[4]

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1 Rule 206(3)-3T [17 CFR 275.206(3)-3T]. All references to rule 206(3)-3T and the various sections thereof in this release are to 17 CFR 275.206(3)-3T and its corresponding sections. *See also Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2653 (Sep. 24, 2007) [72 FR 55022 (Sep. 28, 2007)] ("2007 Principal Trade Rule Release").

2 482 F.3d 481 (D.C. Cir. 2007). In the FPA Decision, handed down on March 30, 2007, the Court of Appeals for the D.C. Circuit vacated (subject to a subsequent stay until October 1, 2007) rule 202(a)(11)-1 under the Advisers Act. Rule 202(a)(11)-1 provided, among other things, that fee-based brokerage accounts were not advisory accounts and were thus not subject to the Advisers Act. For further discussion of fee-based brokerage accounts, *see* 2007 Principal Trade Rule Release, Section I.

3 *See* 2007 Principal Trade Rule Release at nn.19-20 and Section VI.C.

4 As a consequence of the FPA Decision, broker-dealers offering fee-based brokerage accounts with an advisory component became subject to the Advisers Act with respect to those accounts, and the client relationship became fully subject to the Advisers Act. These broker-dealers — to the extent they wanted to continue to offer fee-based accounts and met the requirements for registration — had to: register as investment advisers, if they had not done so already; act as fiduciaries with respect to those clients; disclose all material conflicts of interest; and otherwise fully comply with the Advisers Act,

As initially adopted on an interim final basis, rule 206(3)-3T was set to sunset on December 31, 2009. In December 2009, however, we adopted rule 206(3)-3T as a final rule in the same form in which it was adopted on an interim final basis in 2007, except that we extended the rule's sunset date by one year to December 31, 2010.[5] We deferred final action on rule 206(3)-3T in December 2009 because we needed additional time to understand how, and in what situations, the rule was being used.[6]

In December 2010, we further extended the rule's sunset date by two years to December 31, 2012.[7] We deferred final action on rule 206(3)-3T at that time in order to complete a study required by section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[8] and to consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers, including

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including the restrictions on principal trading contained in section 206(3) of the Act. *See* 2007 Principal Trade Rule Release, Section I.

5 *See Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2965 (Dec. 23, 2009) [74 FR 69009 (Dec. 30, 2009)] ("2009 Extension Release"); *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2965A (Dec. 31, 2009) [75 FR 742 (Jan. 6, 2010)] (making a technical correction to the 2009 Extension Release).

6 *See* 2009 Extension Release, Section II.c.

7 *See Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3118 (Dec. 1, 2010) [75 FR 75650 (Dec. 6, 2010)] (proposing a two-year extension of rule 206(3)-3T's sunset provision) ("2010 Extension Proposing Release"); *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3128 (Dec. 28, 2010) [75 FR 82236 (Dec. 30, 2010)] ("2010 Extension Release").

8 Pub. L. No. 111-203, 124 Stat. 1376 (2010). Under section 913 of the Dodd-Frank Act, we were required to conduct a study and provide a report to Congress concerning the obligations of broker-dealers and investment advisers, including standards of care applicable to those intermediaries and their associated persons. Section 913 also authorizes us to promulgate rules concerning the legal or regulatory standards of care for broker-dealers, investment advisers, and persons associated with these intermediaries for providing personalized investment advice about securities to retail customers, taking into account the findings, conclusions, and recommendations of the study.

whether rule 206(3)-3T should be substantively modified, supplanted, or permitted to sunset.[9]

The study mandated by section 913 of the Dodd-Frank Act was prepared by the staff and delivered to Congress on January 21, 2011.[10] Since that time, we have considered the findings, conclusions, and recommendations of the 913 Study in order to determine whether to promulgate rules concerning the legal or regulatory standards of care for broker-dealers and investment advisers. In addition, since issuing the 913 Study, Commissioners and the staff have held numerous meetings with interested parties on the study and related matters.[11]

II. Discussion

We are proposing to amend rule 206(3)-3T only to extend the rule's sunset date by two additional years.[12] Absent further action by the Commission, the rule will sunset

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9 *See* 2010 Extension Release, Section II.

10 *See Study on Investment Advisers and Broker-Dealers* ("913 Study") (Jan. 21, 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf. For a discussion regarding principal trading, *see* section IV.C.1.(b) of the 913 Study. *See also* Commissioners Kathleen L. Casey and Troy A. Paredes, *Statement by SEC Commissioners: Statement Regarding Study on Investment Advisers and Broker-Dealers* (Jan. 21, 2011), available at http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

11 *See Comments on Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, File No. 4-606, available at http://sec.gov/comments/4-606/4-606.shtml.

12 The rule includes a reference to an "investment grade debt security," which is defined as "a non-convertible debt security that, at the time of sale, is rated in one of the four highest rating categories of at least two nationally recognized statistical rating organizations (as defined in section 3(a)(62) of the Exchange Act)." Rule 206(3)-3T(a)(2) and (c). Section 939A of the Dodd-Frank Act requires that we "review any regulation issued by [us] that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and any references to or requirements in such regulations regarding credit ratings." Once we have completed that review, the statute provides that we modify any regulations identified in our review to "remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness" as we determine to be appropriate. We believe that the credit rating requirement in the temporary rule would be better addressed after the Commission

on December 31, 2012. We are proposing this extension because we continue to believe that the issues raised by principal trading, including the restrictions in section 206(3) of the Advisers Act and our experiences with, and observations regarding, the operation of rule 206(3)-3T, should be considered as part of our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers in connection with the Dodd-Frank Act.[13]

As discussed in the 2010 Extension Release, section 913 of the Dodd-Frank Act authorizes us to promulgate rules concerning, among other things, the legal or regulatory standards of care for broker-dealers, investment advisers, and persons associated with these intermediaries when providing personalized investment advice about securities to retail customers. Since the completion of the 913 Study in 2011, we have been

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completes its review of the regulatory standards of care that apply to broker-dealers and investment advisers. Therefore, we are not proposing any substantive amendments to the rule at this time. *See generally Report on Review of Reliance on Credit Ratings* (July 21, 2011), available at http://www.sec.gov/news/studies/2011/939astudy.pdf (staff study reviewing the use of credit ratings in Commission regulations).

13 The 913 Study is one of several studies relevant to the regulation of broker-dealers and investment advisers mandated by the Dodd-Frank Act. *See, e.g., Study on Enhancing Investment Adviser Examinations* (Jan. 19, 2011), available at http://sec.gov/news/studies/2011/914studyfinal.pdf (staff study required by section 914 of the Dodd-Frank Act, which directed the Commission to review and analyze the need for enhanced examination and enforcement resources for investment advisers); Commissioner Elisse B. Walter, *Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act)* (Jan. 19, 2011), available at http://sec.gov/news/speech/2011/spch011911ebw.pdf. *See also Study and Recommendations on Improved Investor Access to Registration Information About Investment Advisers and Broker-Dealers* (Jan. 26, 2011), available at http://sec.gov/news/studies/2011/919bstudy.pdf (staff study required by section 919B of the Dodd-Frank Act, that directed the Commission to complete a study, including recommendations (some of which have been implemented) of ways to improve investor access to registration information about investment advisers and broker dealers, and their associated persons); *United States Government Accountability Office Report to Congressional Committees on Private Fund Advisers* (July 11, 2011), available at http://www.gao.gov/new.items/d11623.pdf (study required by section 416 of the Dodd-Frank Act, which directed the Comptroller General of the United States to study the feasibility of forming an self-regulatory organization to oversee private funds).

considering the findings, conclusions, and recommendations of the study and the comments we have received from interested parties.[14] In addition, our staff has been working to obtain data and economic analysis related to standards of conduct and enhanced regulatory harmonization of broker-dealers and investment advisers to inform the Commission as it considers any future rulemaking. At this time, our consideration of the regulatory requirements applicable to broker-dealers and investment advisers and the recommendations from the 913 Study is ongoing. We will not complete our consideration of these issues before December 31, 2012, the current sunset date for rule 206(3)-3T.

If we permit rule 206(3)-3T to sunset on December 31, 2012, after that date investment advisers registered with us as broker-dealers that currently rely on rule 206(3)-3T would be required to comply with section 206(3)'s transaction-by-transaction written disclosure and consent requirements without the benefit of the alternative means of complying with these requirements currently provided by rule 206(3)-3T. This could limit the access of non-discretionary advisory clients of advisory firms that are registered with us as broker-dealers to certain securities.[15] In addition, firms may be required to make substantial changes to their disclosure documents, client agreements, procedures, and systems.

We believe that the requirements of rule 206(3)-3T, coupled with regulatory oversight, will adequately protect advisory clients for an additional limited period of time

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14 Section 913(f) of the Dodd-Frank Act requires us to consider the 913 Study in any rulemaking authorized by that section of the Dodd-Frank Act. *See also Comments on Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, File No. 4-606, available at http://sec.gov/comments/4-606/4-606.shtml.

15 For a discussion of the costs and benefits underlying rule 206(3)-3T, *see* 2007 Principal Trade Rule Release, Section VI.C.

while we consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers.[16] In the 2010 Extension Proposing Release, we discussed certain compliance issues identified by the Office of Compliance, Inspections and Examinations.[17] One matter identified in the staff's review resulted in a settlement of an enforcement proceeding and other matters continue to be reviewed by the staff.[18] Since 2010 and throughout the period of the proposed extension, the staff has and would continue to examine firms that engage in principal transactions and will take appropriate action to help ensure that firms are complying with section 206(3) or rule 206(3)-3T (as applicable), including possible enforcement action.

In light of these considerations, we believe that it would be premature to require firms currently relying on the rule to restructure their operations and client relationships before we complete our consideration of the standards of conduct and regulatory requirements applicable to broker-dealers and investment advisers. To the extent our consideration of these issues leads to new rules concerning principal trading, these firms would be required to restructure their operations and client relationships, potentially at substantial expense.

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16 In addition, rule 206(3)-3T(b) provides that the rule does not relieve an investment adviser from acting in the best interests of its clients, or from any obligation that may be imposed by sections 206(1) or (2) of the Advisers Act or any other applicable provisions of the federal securities laws.

17 *See* 2010 Extension Proposing Release, Section II (discussing certain compliance issues identified by the Office of Compliance Inspections and Examinations with respect to the requirements of section 206(3) or rule 206(3)-3T and noting that the staff did not identify any instances of "dumping" as part of its review).

18 *See In the Matter of Feltl & Company, Inc.*, Investment Advisers Act Release No. 3325 (Nov. 28, 2011) (settled order finding, among other things, violations of section 206(3) of the Advisers Act for certain principal transactions and section 206(4) of the Advisers Act and rule 206(4)-7 thereunder for failure to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules).

As part of our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers, we intend to carefully consider principal trading by advisers, including whether rule 206(3)-3T should be substantively modified, supplanted, or permitted to sunset. In making these determinations, we will consider, among other things, the 913 Study, relevant comments received in connection with the 913 Study and any rulemaking that may follow, the results of our staff's evaluation of the operation of rule 206(3)-3T, and comments we receive on rule 206(3)-3T in connection with this proposed extension.

III. Request for Comment

We request comment on our proposal to extend rule 206(3)-3T's sunset date for two additional years.

- Should we allow the rule to sunset?
- If so, what costs would advisers that currently rely on the rule incur? What would be the impact on their clients?
- If we allow the rule to sunset, should we consider requests from investment advisers that are registered with us as broker-dealers for exemptive orders providing an alternative means of compliance with section 206(3)?
- If we extend the rule's sunset date, is two years an appropriate period of time to extend the sunset date? Or should we extend the rule's sunset date for a different period of time? If so, for how long?
- Is it appropriate to extend rule 206(3)-3T's sunset date for a limited period of time in its current form while we complete our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers?

- Should we consider changing the requirements for adviser disclosures to have registered advisers provide more information to us and their clients about whether they are relying on the rule? For example, should we amend Part 1A of Form ADV to require advisers to disclose whether they rely on rule 206(3)-3T for certain principal transactions? Should we amend Part 2A of Form ADV to require advisers who rely on rule 206(3)-3T to provide a description to clients of the policies and procedures they have adopted to ensure compliance with the rule?
- Why do advisers eligible to rely on the temporary rule not rely on it?

IV. Paperwork Reduction Act

Rule 206(3)-3T contains "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[19] The Office of Management and Budget ("OMB") last approved the collection of information with an expiration date of May 31, 2014. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The title for the collection of information is: "Temporary rule for principal trades with certain advisory clients, rule 206(3)-3T" and the OMB control number for the collection of information is 3235-0630.

The amendment to the rule we are proposing today – to extend rule 206(3)-3T's sunset date for two years – does not affect the current annual aggregate estimated hour burden of 378,992 hours.[20] Therefore, we are not revising the Paperwork Reduction Act burden and cost estimates submitted to OMB as a result of this proposed amendment.

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19 44 U.S.C. 3501 *et seq.*

20 *See Proposed Collection; Comment Request*, 75 FR 82416 (Dec. 30, 2010); *Submission for OMB Review; Comment Request*, 76 FR 13002 (Mar. 9, 2011).

We request comment on whether the estimates continue to be reasonable. Have circumstances changed such that these estimates (or the underlying assumptions embedded in these estimates) should be modified or revised? Persons submitting comments should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-23-07.

V. Economic Analysis

A. Introduction

The Commission is sensitive to the costs and benefits of its rules. The discussion below addresses the costs and benefits of extending rule 206(3)-3T's sunset date for two years, as well as the effect of the proposed extension on the promotion of efficiency, competition, and capital formation as required by section 202(c) of the Advisers Act.[21]

Rule 206(3)-3T provides an alternative means for investment advisers that are registered with the Commission as broker-dealers to meet the requirements of section 206(3) of the Advisers Act when they act in a principal capacity in transactions with their non-discretionary advisory clients. Other than proposing to extend rule 206(3)-3T's sunset date for two years, we are not otherwise proposing to modify the rule from its current form. We previously considered and discussed the economic analysis of rule

[21] 15 U.S.C. 80b-2(c). Section 202(c) of the Advisers Act mandates that the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

206(3)-3T in its current form in the 2007 Principal Trade Rule Release, the 2009 Extension Release, and the 2010 Extension Release.[22]

The baseline for the following analysis of the benefits and costs of the proposed rule is the situation in existence today, in which investment advisers that are registered with us as broker-dealers can choose to use rule 206(3)-3T as an alternative means to comply with section 206(3) of the Advisers Act when engaging in principal transactions with their non-discretionary advisory clients. The proposed amendment, which will extend rule 206(3)-3T's sunset date by an additional two years, will affect investment advisers that are registered with us as broker-dealers and engage in, or may consider engaging in, principal transactions with non-discretionary advisory clients, as well as the non-discretionary advisory clients of these firms that engage in, or may consider engaging in, principal transactions. The extent to which firms currently rely on the rule is unknown.[23] Past comment letters have indicated that since its implementation in 2007, both large and small advisers have relied upon the rule.[24]

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22 *See* 2007 Principal Trade Rule Release, Sections VI-VII; 2009 Extension Release, Sections V-VI; 2010 Extension Release, Sections V-VI.

23 Based on IARD data as of August 1, 2012, we estimate that there are less than 100 registered advisers that are also registered as broker-dealers that have non-discretionary advisory accounts and that engage in principal transactions.

24 *See* Comment Letter of Securities Industry and Financial Markets Association (Dec. 20, 2010); Comment Letter of Winslow, Evans & Crocker (Dec. 8, 2009) ("Winslow, Evans & Crocker Letter"); Comment Letter of Bank of America Corporation (Dec. 20, 2010) ("Bank of America Letter").

B. Benefits and Costs of Rule 206(3)-3T

As stated in previous releases, we believe the principal benefit of rule 206(3)-3T is that it maintains investor choice and protects the interests of investors. Rule 206(3)-3T also provides non-discretionary advisory clients easier access to a wider range of securities by providing a lower cost and more efficient alternative for an adviser that is registered with us as a broker-dealer to comply with the requirements of section 206(3) of the Advisers Act. Non-discretionary advisory clients also benefit from the protections of the sales practice rules of the Exchange Act and the relevant self-regulatory organization(s), and the fiduciary duties and other obligations imposed by the Advisers Act. The rule also may promote a more efficient allocation of capital by increasing access of non-discretionary advisory clients to a wider range of securities. In the long term, the more efficient allocation of capital may lead to an increase in capital formation.

A commenter disagreed with a number of the benefits of rule 206(3)-3T described above in connection with the 2010 extension of the rule, but did not provide any specific data, analysis, or other information in support of its comment.[25] This commenter also argued that rule 206(3)-3T would impede, rather than promote, capital formation because it would lead to "more numerous and more severe violations…of the trust placed by individual investors in their trusted investment adviser."[26] While we understand the view that numerous and severe violations of trust could impede capital formation, we have not

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[25] *See* Comment Letter of the National Association of Personal Financial Advisors (Dec. 20, 2010) ("NAPFA Letter") (questioning the benefits of the rule in: (1) providing protections of the sales practice rules of the Exchange Act and the relevant self-regulatory organizations; (2) allowing non-discretionary advisory clients of advisory firms that are also registered as broker-dealers to have easier access to a wider range of securities which, in turn, should continue to lead to increased liquidity in the markets for these securities; (3) maintaining investor choice; and (4) promoting capital formation).

[26] *See id.*

seen any evidence that rule 206(3)-3T has caused this result. The staff has not identified instances where an adviser has used the temporary rule to "dump" unmarketable securities or securities that the adviser believes may decline in value into an advisory account, a harm that section 206(3) and the conditions and limitations of rule 206(3)-3T are designed to redress.[27] No commenter provided any substantive or specific evidence to contradict the Commission's previous conclusion that the rule benefits investors, and the Commission continues to believe that the rule provides those benefits.[28]

We also received comments on the 2007 Principal Trade Rule Release from commenters who opposed the limitation of the temporary rule to investment advisers that are registered with us as broker-dealers, as well as to accounts that are subject to both the Advisers Act and Exchange Act as providing a competitive advantage to investment advisers that are registered with us as broker-dealers.[29] Based on our experience with the rule to date, and as we noted in previous releases, we have no reason to believe that broker-dealers (or affiliated but separate investment advisers and broker-dealers) are put at a competitive disadvantage to advisers that are themselves also registered as broker-dealers.[30] We intend to continue to evaluate the effects of the rule on efficiency, competition, and capital formation in connection with our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers.

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27 *See supra* n.17.

28 *See* 2007 Principal Trade Rule Release, Section VI.C; 2009 Extension Release, Section V; 2010 Extension Release, Section V.

29 *See* Comment Letter of the Financial Planning Association (Nov. 30, 2007); Comment Letter of the American Bar Association, section of Business Law's Committee on Federal Regulation of Securities (Apr. 18, 2008). *See also* 2009 Extension Release, Section VI.

30 *See* 2009 Extension Release, Section VI; 2010 Extension Release, Section VI.

As we discussed in previous releases, there are also several costs associated with rule 206(3)-3T, including the operational costs associated with complying with the rule.[31] In the 2007 Principal Trade Rule Release, we presented estimates of the costs of each of the rule's disclosure elements, including: prospective disclosure and consent; transaction-by-transaction disclosure and consent; transaction-by-transaction confirmations; and the annual report of principal transactions. We also provided estimates for the following related costs of compliance with rule 206(3)-3T: (i) the initial distribution of prospective disclosure and collection of consents; (ii) systems programming costs to ensure that trade confirmations contain all of the information required by the rule; and (iii) systems programming costs to aggregate already-collected information to generate compliant principal transactions reports. We did not receive comments directly addressing with supporting data the cost analysis we presented in the 2007 Principal Trade Rule Release. We do not believe the extension we are proposing today would materially affect the cost estimates associated with the rule.[32] We request comment on whether the proposed extension would impact our previous estimates.

C. Benefits and Costs of the Proposed Extension

In addition to the benefits of rule 206(3)-3T described above and in previous releases, we believe there are benefits to extending the rule's sunset date for an additional two years. A temporary extension of rule 206(3)-3T would have the benefit of providing the Commission with additional time to consider principal trading as part of the broader

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[31] *See supra* n. 22.

[32] In the 2007 Principal Trade Rule Release, we estimated the total overall costs, including estimated costs for all eligible advisers and eligible accounts, relating to compliance with rule 206(3)-3T to be $37,205,569. *See* 2007 Principal Trade Rule Release, Section VI.D.

consideration of the regulatory requirements applicable to broker-dealers and investment advisers without causing disruption to the firms and clients relying on the rule.

One alternative to the proposed extension of the rule's sunset date would be to let the temporary rule sunset on its current sunset date, and so preclude investment advisers from engaging in principal transactions with their advisory clients unless in compliance with the requirements of section 206(3) of the Advisers Act. As explained in the 2010 Extension Release, if we do not extend rule 206(3)-3T's sunset date, firms currently relying on the rule would be required to restructure their operations and client relationships on or before the rule's current expiration date — potentially only to have to do so again later (first when the rule sunsets or is modified, and again if we adopt a new approach in connection with our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers).[33] On the other hand, if the rule's sunset date is extended for two years, firms relying on the rule would continue to be able to offer clients and prospective clients access to certain securities on a principal basis and would not need to incur the cost of adjusting to a new set of rules or abandoning the systems established to comply with the current rule during this two-year period. An extension of the rule would also permit non-discretionary advisory clients who have had access to certain securities because of their advisers' reliance on the rule to trade on a principal basis to continue to have access to those securities without disruption.

We recognize that if this proposal is adopted, firms relying on the rule would continue to incur the costs associated with complying with the rule for two additional years. We also recognize that a temporary rule, by nature, creates long-term uncertainty,

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33 *See* 2010 Extension Release, Section V.

which in turn, may result in a reduced ability of firms to coordinate and plan future business activities.[34] However, we believe that it would be premature to allow the rule to sunset or to adopt the rule on a permanent basis while consideration of the regulatory requirements applicable to broker-dealers and investment advisers is ongoing. The Commission also considered extending the rule's sunset date for a period other than two years. Should our consideration of the fiduciary obligations and other regulatory requirements applicable to broker-dealers and investment advisers extend beyond the proposed sunset date of the temporary rule, a longer period may be appropriate. On balance, however, we believe that the proposed two-year extension of rule 206(3)-3T appropriately addresses the concerns of firms and clients relying on the rule while preserving the Commission's ability to address principal trading as part of its broader-consideration of the standards applicable to investment advisers and broker-dealers. We will continue to assess the rule's operation and impact along with intervening developments during the period of the extension.

D. Request for Comment

We request comment on all aspects of the economic analysis, including the accuracy of the potential costs and benefits identified and assessed in this Release and the prior releases, any other costs or benefits that may result from the proposal, and whether the proposal, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data to support their views.

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34 We received several comments in connection with prior extensions of the rule urging us to make the rule permanent to avoid such uncertainty. *See e.g.*, Winslow, Evans & Crocker Letter; Bank of America Letter.

VII. Initial Regulatory Flexibility Act Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis ("IRFA") regarding the proposed amendment to rule 206(3)-3T in accordance with section 3(a) of the Regulatory Flexibility Act.[35]

A. Reasons for Proposed Action

We are proposing to extend rule 206(3)-3T's sunset date for two years because we believe that it would be premature to require firms relying on the rule to restructure their operations and client relationships before we complete our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers.

B. Objectives and Legal Basis

The objective of the proposed amendment to rule 206(3)-3T, as discussed above, is to permit firms currently relying on rule 206(3)-3T to limit the need to modify their operations and relationships on multiple occasions, both before and potentially after we complete any regulatory actions stemming from the 913 Study.

We are proposing to amend rule 206(3)-3T pursuant to sections 206A and 211(a) of the Advisers Act [15 U.S.C. 80b-6a and 15 U.S.C. 80b-11(a)].

C. Small Entities Subject to the Rule

Rule 206(3)-3T is an alternative method of complying with Advisers Act section 206(3) and is available to all investment advisers that: (i) are registered as broker-dealers under the Exchange Act; and (ii) effect trades with clients directly or indirectly through a broker-dealer controlling, controlled by or under common control with the investment adviser, including small entities. Under Advisers Act rule 0-7, for purposes of the

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[35] 5 U.S.C. 603(a).

Regulatory Flexibility Act an investment adviser generally is a small entity if it: (i) has assets under management of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year.[36]

We estimate that as of August 1, 2012, 547 SEC-registered investment advisers were small entities.[37] As discussed in the 2007 Principal Trade Rule Release, we opted not to make the relief provided by rule 206(3)-3T available to all investment advisers, and instead have restricted it to investment advisers that are registered as broker-dealers under the Exchange Act.[38] We therefore estimate for purposes of this IRFA that 7 of these small entities (those that are both investment advisers and registered broker-dealers) could rely on rule 206(3)-3T.[39]

D. Reporting, Recordkeeping, and other Compliance Requirements

The provisions of rule 206(3)-3T impose certain reporting or recordkeeping requirements, and our proposal, if adopted, would extend the imposition of these requirements for an additional two years. We do not, however, expect that the proposed two-year extension of the rule's sunset date would alter these requirements.

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36 *See* 17 CFR 275.0-7.

37 IARD data as of August 1, 2012.

38 *See* 2007 Principal Trade Rule Release, Section VIII.B.

39 IARD data as of August 1, 2012.

Rule 206(3)-3T is designed to provide an alternative means of compliance with the requirements of section 206(3) of the Advisers Act. Investment advisers taking advantage of the rule with respect to non-discretionary advisory accounts would be required to make certain disclosures to clients on a prospective, transaction-by-transaction and annual basis.

Specifically, rule 206(3)-3T permits an adviser, with respect to a non-discretionary advisory account, to comply with section 206(3) of the Advisers Act by, among other things: (i) making certain written disclosures; (ii) obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal trades; (iii) making oral or written disclosure and obtaining the client's consent orally or in writing prior to the execution of each principal transaction; (iv) sending to the client a confirmation statement for each principal trade that discloses the capacity in which the adviser has acted and indicating that the client consented to the transaction; and (v) delivering to the client an annual report itemizing the principal transactions. Advisers are already required to communicate the content of many of the disclosures pursuant to their fiduciary obligations to clients. Other disclosures are already required by rules applicable to broker-dealers.

Our proposed amendment, if adopted, only would extend the rule's sunset date for two years. Advisers currently relying on the rule already should be making the disclosures described above.

E. Duplicative, Overlapping, or Conflicting Federal Rules

We believe that there are no rules that duplicate or conflict with rule 206(3)-3T, which presents an alternative means of compliance with the procedural requirements of section 206(3) of the Advisers Act that relate to principal transactions.

We note, however, that rule 10b-10 under the Exchange Act is a separate confirmation rule that requires broker-dealers to provide certain information to their customers regarding the transactions they effect, including whether the broker or dealer is acting as an agent or as a principal for its own account in a given transaction. Furthermore, FINRA rule 2232 requires broker-dealers that are members of FINRA to deliver a written notification in conformity with rule 10b-10 under the Exchange Act containing certain information. Rule G-15 of the Municipal Securities Rulemaking Board also contains a separate confirmation rule that governs transactions in municipal securities, and requires brokers, dealers and municipal securities dealers to disclose, among other things, the capacity in which the firm effected a transaction (*i.e.*, as an agent or principal). In addition, investment advisers that are qualified custodians for purposes of rule 206(4)-2 under the Advisers Act and that maintain custody of their advisory clients' assets must send quarterly account statements to their clients pursuant to rule 206(4)-2(a)(3) under the Advisers Act.

These rules overlap with certain elements of rule 206(3)-3T, but we designed the temporary rule to work efficiently together with existing rules by permitting firms to incorporate the required disclosure into one confirmation statement.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small entities.[40] Alternatives in this category would include: (i) establishing different

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[40] *See* 5 U.S.C. 603(c).

compliance or reporting standards or timetables that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying compliance requirements under the rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the rule, or any part of the rule.

We believe that special compliance or reporting requirements or timetables for small entities, or an exemption from coverage for small entities, may create the risk that the investors who are advised by and effect securities transactions through such small entities would not receive adequate disclosure. Moreover, different disclosure requirements could create investor confusion if it creates the impression that small investment advisers have different conflicts of interest with their advisory clients in connection with principal trading than larger investment advisers. We believe, therefore, that it is important for the disclosure protections required by the rule to be provided to advisory clients by all advisers, not just those that are not considered small entities. Further consolidation or simplification of the proposals for investment advisers that are small entities would be inconsistent with the Commission's goals of fostering investor protection.

We have endeavored through rule 206(3)-3T to minimize the regulatory burden on all investment advisers eligible to rely on the rule, including small entities, while meeting our regulatory objectives. It was our goal to ensure that eligible small entities may benefit from the Commission's approach to the rule to the same degree as other eligible advisers. The condition that advisers seeking to rely on the rule must also be registered with us as broker-dealers and that each account with respect to which an adviser seeks to rely on the rule must be a brokerage account subject to the Exchange Act, and the rules thereunder, and the rules of the self-regulatory organization(s) of which the broker-dealer is a member, reflect what we believe is an important element of our balancing between easing regulatory burdens (by affording advisers an alternative means of compliance with section 206(3) of the Act) and meeting our investor protection objectives.[41] Finally, we do not consider using performance rather than design standards to be consistent with our statutory mandate of investor protection in the present context.

G. Solicitation of Comments

We solicit written comments regarding our analysis. We request comment on whether the rule will have any effects that we have not discussed. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

Do small investment advisers believe an alternative means of compliance with section 206(3) should be available to more of them?

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[42] we must advise OMB whether a proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results in or is likely to result in: (1) an annual effect on the economy of $100 million or more;

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41 *See* 2007 Principal Trade Rule Release, Section II.B.7 (noting commenters that objected to this condition as disadvantaging small broker-dealers (or affiliated but separate investment advisers and broker-dealers)).

42 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

(2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment or innovation.

We request comment on the potential impact of the proposed amendment on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

IX. Statutory Authority

The Commission is proposing to amend rule 206(3)-3T pursuant to sections 206A and 211(a) of the Advisers Act [15 U.S.C. 80b-6a and 80b-11(a)].

List of Subjects in 17 CFR Part 275

Investment advisers, Reporting and recordkeeping requirements.

Text of Proposed Rule Amendment

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows.

PART 275 -- RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 continues to read in part as follows:

Authority: 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(11)(H), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

*   *   *   *   *

§275.206(3)-3T [Amended]

2. In § 275.206(3)-3T, amend paragraph (d) by removing the words "December 31, 2012" and adding in their place "December 31, 2014."

By the Commission. Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: October 9, 2012

Chairman Schapiro
Commissioner Walter
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68023 / October 9, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-12591

In the Matter of Banc of America Securities LLC with Merrill Lynch, Pierce, Fenner & Smith Incorporated as Successor, Respondent.	ORDER AMENDING ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 15(b)(4) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

On March 14, 2007 the U. S. Securities and Exchange Commission ("Commission") issued an Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 against Banc of America Securities LLC (the "2007 BAS Order"). The 2007 BAS Order found that, from January 1999 through December 2001, BAS issued materially false and misleading research on three different companies. The 2007 BAS Order also found that BAS lacked policies and procedures to prevent the misuse by the firm and its employees of material nonpublic information concerning the content and timing of its research reports.

The 2007 BAS Order censured BAS and ordered BAS to: (i) cease and desist from committing or causing any violations or future violations of Sections 15(c) and 15(f) of the Securities Exchange Act of 1934, and Rule 15c1-2(a) promulgated thereunder; (ii) pay $26 million in disgorgement and penalties into a fair fund for distribution to its affected customers; (iii) retain an independent consultant to conduct a comprehensive review of the firm's internal controls to prevent the misuse of material nonpublic information concerning BAS research; (iv) certify to the Commission's staff in the second year following the issuance of the 2007 BAS Order that BAS had established and continued to maintain Exchange Act Section 15(f) policies, practices, and procedures consistent with the findings of the 2007 BAS Order; and (v) comply with Addendum A to the 2007 BAS Order, which

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implemented certain structural changes to the operations of the firm's equity research and investment banking departments. Section 1.1.a. of Addendum A to the 2007 BAS Order specifies that it applies to successors and assigns of BAS's investment banking and research operations.

II.

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPFS"), as the successor to BAS, has submitted an Amended Offer of Settlement (the "Amended Offer") in which it consents to the entry of an Order amending the 2007 BAS Order. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which MLPFS, as the successor to BAS, admits, MLPFS consents to the issuance of this Order Amending Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Amended Order").

On the basis of this Amended Order and the Amended Offer of MLPFS, as the successor to BAS, the Commission finds that:

A. Respondent

Banc of America Securities LLC ("BAS") was a Delaware corporation with its principal place of business in New York City, New York. It was a subsidiary of Bank of America Corporation. BAS was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act and as an investment adviser pursuant to Sections 203(c) and 15(f) of the Investment Advisers Act of 1940 until it filed Form BDW on November 29, 2010 and was terminated by the Commission on January 27, 2011 and by the Financial Industry Regulatory Authority ("FINRA") on January 31, 2011. BAS was the successor-in-interest to NationsBanc Montgomery Securities. BAS was a member of the New York Stock Exchange ("NYSE"), the National Association of Securities Dealers and other national securities exchanges. On November 1, 2010, BAS was merged into MLPFS. BAS no longer exists as an entity, and MLPFS is the surviving entity.

B. Related Entities

1. **Bank of America Corporation**, ("BAC") is a Delaware corporation, a bank holding company and a financial holding company under the Gramm-Leach-Bliley Act. BAC's principal offices are located in Charlotte, North Carolina. BAC's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the NYSE. BAC was the ultimate parent company of BAS.

2. **Merrill Lynch & Co., Inc.**, ("Merrill") is a Delaware corporation, and is now a wholly-owned subsidiary of BAC. Prior to its acquisition by BAC on January 1, 2009,

Merrill's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the NYSE. Merrill is the parent company of MLPFS.

3. **Merrill Lynch, Pierce, Fenner & Smith Incorporated** ("MLPFS") is a Delaware corporation with its principal executive offices in New York, New York. MLPFS is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. MLPFS is a wholly-owned subsidiary of Merrill, and, since January 1, 2009, an indirect wholly-owned subsidiary of BAC. On November 1, 2010, BAS was merged into MLPFS, and MLPFS is the surviving entity.

C. Facts

On April 28, 2003, the Commission filed a complaint against MLPFS in the U.S. District Court for the Southern District of New York, entitled, inter alia, Securities and Exchange Commission v. Merrill Lynch, Pierce, Fenner & Smith Inc., 03 Civ. 2941 (WHP) (S.D.N.Y. April 28, 2003), alleging that the investment banking interests of MLPFS exercised undue influence over its securities research operations and that MLPFS issued fraudulent and inconsistent research reports in violation of Section 15(c) of the Exchange Act and Rule 15c1-2 thereunder, as well as various related SRO rules (the "MLPFS action"). On October 31, 2003, the Court issued a Final Judgment as to Defendant Merrill Lynch, Pierce, Fenner & Smith Incorporated (the "2003 MLPFS Final Judgment"), wherein the Court ordered MLPFS, inter alia, to "comply with the undertakings set forth in Addendum A hereto." (Section VIII of the 2003 MLPFS Final Judgment). BAS was not involved in the district court action.

On March 14, 2007, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 against BAS (the "2007 BAS Order"). The 2007 BAS Order found that from January 1999 through December 2001, BAS investment bankers inappropriately influenced equity research analysts, resulting in the publication of materially false and misleading research reports on at least three companies in violation of Sections 15(c) and 15(f) of the Exchange Act and Rule 15c1-2(a) thereunder. The 2007 BAS Order, among other things, ordered BAS to comply with Addendum A to the 2007 BAS Order. Addendum A by its terms applies to successors and assigns of BAS' investment banking and research operations. At that time, the language of Addendum A to the 2007 BAS Order was, in all material respects, essentially identical to Addendum A to the 2003 MLPFS Final Judgment.

On January 1, 2009, BAC, the parent company of BAS, acquired Merrill, the parent company of MLPFS. Following that acquisition, BAC transferred legacy BAS equity research operations from BAS to MLPFS. In that regard, the registrations of the legacy BAS equity research analysts were transferred to MLPFS, and MLPFS assumed supervisory responsibility for these analysts.

On November 1, 2010, BAS was merged into MLPFS, and BAS ceased to exist. A Form BDW for BAS was filed on November 29, 2010. BAS' registration was terminated by the Commission on January 27, 2011 and FINRA on January 31, 2011. As the successor to

BAS, MLPFS became subject to Addendum A of the 2007 BAS Order. At the same time, MLPFS remains subject to Addendum A to the 2003 MLPFS Final Judgment.

On March 15, 2010, in the MLPFS action, the District Court modified Addendum A to the 2003 MLPFS Final Judgment by, inter alia, removing certain provisions that remain in Addendum A to the 2007 BAS Order. Since that date, MLPFS has been subject to two differing Addenda concerning substantially identical subjects.

VI.

In view of the foregoing, the Commission deems it appropriate and in the public interest to amend the 2007 BAS Order as agreed to in the Amended Offer of MLFPS as successor to BAS.

Accordingly, IT IS HEREBY ORDERED that the 2007 BAS Order is amended to:

(1) Strike Addendum A to the 2007 BAS Order;

(2) Order that henceforth the successors and assigns of BAS shall comply with all orders, addenda and undertakings in SEC v. Merrill Lynch, Pierce, Fenner & Smith Inc., 03 Civ. 2941 (WHP) (S.D.N.Y. April 28, 2003), as modified on March 15, 2010; and

(3) Order that in all other respects, aside from Addendum A, the 2007 BAS Order remains in effect and binding on Respondent's successors and assigns.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68040 / October 11, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15062

In the Matter of **CHINA MEDICAL TECHNOLOGIES, INC.,** **Respondent.**	**ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934 AND NOTICE OF HEARING**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against China Medical Technologies, Inc. ("China Medical" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. China Medical is a Cayman Islands corporation located in the People's Republic of China that purports to develop, manufacture and market medical devices. In 2005, China Medical registered its ordinary shares pursuant to Section 12(g) of the Exchange Act and registered an initial public offering of American Depositary Shares ("ADSs") (each of which represented ten ordinary shares), which were quoted on the Nasdaq National Market. In 2006, after Nasdaq Stock Market LLC became a registered national securities exchange, the ordinary shares became registered pursuant to Section 12(b) of the Exchange Act, and the ADSs became listed on the Nasdaq Global Select Market ("Nasdaq"). On March 14, 2012, Nasdaq filed a Form 25, pursuant to which the China Medical ADSs were delisted effective March 26, 2012, and the ordinary shares were deregistered from Section 12(b) effective June 12, 2012. At that point, the ordinary shares reverted to their previous Section 12(g) registration. China Medical ADSs are currently quoted on OTC Link (f.k.a. "the Pink Sheets") operated by OTC Markets Group Inc. and quote under the ticker symbol "CMEDY." China Medical identifies itself as a foreign private issuer under the

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Exchange Act and has filed and furnished reports with the Commission on Forms 20-F and 6-K. As of July 27, 2012, pursuant to an Order by the Grand Court of the Cayman Islands, China Medical has been under the control of Joint Official Liquidators.

B. DELINQUENT PERIODIC FILING

2. Section 13(a) of the Exchange Act and Rule 13a-1 thereunder require issuers with classes of securities registered pursuant to Section 12 of the Exchange Act to file annual reports with the Commission.

3. China Medical has failed to comply with Section 13(a) of the Exchange Act and Rule 13a-1 thereunder, while its securities were registered with the Commission pursuant to Section 12 of the Exchange Act, in that it has not filed an Annual Report on Form 20-F since July 18, 2011.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondent identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate name of the Respondent.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice [17 C.F.R. § 201.220].

If Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of Respondent, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondent personally or by certified, registered or Express Mail, or by other means permitted by the Commission's Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68038 / October 11, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3484 / October 11, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15061

In the Matter of **STEPHEN B. BLANKENSHIP,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Stephen B. Blankenship ("Blankenship" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of

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1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Blankenship, age 63, is a resident of New Fairfield, Connecticut and former registered representative of Vanderbilt Financial Services, Inc., a broker-dealer registered with the Commission.

2. On September 12, 2012, Blankenship pled guilty to one count of Mail Fraud in violation of Title 18 of the United States Code, Section 1341 and one count of Securities Fraud in violation of Title 15 of the United States Code, Section 78j(b) and Title 17, Code of Federal Regulations, Section 240.10b-5 before the United States District Court for the District of Connecticut, in United States of America v. Stephen B. Blankenship, Criminal No. 12-197 (VLB).

3. The two counts of the criminal Information to which Blankenship pled alleged, *inter alia*, that while acting as a registered representative of a broker-dealer and an investment adviser, Blankenship knowingly, willfully, and with the intent to defraud participated in a scheme to defraud his customers of Deer Hill Financial Group, LLC, an unregistered entity that Blankenship owned and operated in Danbury, Connecticut. For the Mail Fraud count and the Securities Fraud count, the Information alleges that from in or about 2002 and continuing until in or about March 2012, Blankenship enriched himself and Deer Hill by fraudulently obtaining money from Deer Hill customers through the sale of securities that would purportedly pay a safe return and by falsely representing that funds placed with Blankenship had been and would be used to purchase such securities. In furtherance of the scheme, Blankenship caused Deer Hill customers to provide him, by way of wire transfers and checks, approximately $800,000 in funds and diverted those funds for his own personal use and benefit, including to pay for personal expenses such as travel expenses, shopping, credit card payments, mortgage payments, improvements on his home, and for business expenses of Deer Hill. To corroborate the fraudulent misrepresentations that Blankenship made to Deer Hill customers, Blankenship sent his customers official-looking documents that contained false and misleading representations. The fraudulent documents that Blankenship sent included fraudulent "account statements" that reflected, among other things, fictitious holdings, fictitious transactions, fictitious prices for the securities, and fictitious balances. These account statements were sent to the Deer Hill customers for the purpose of lulling them into believing that their funds had been invested as represented, were secure, and were appreciating in value.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Blankenship's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act that Respondent Blankenship be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68048 / October 12, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15063

In the Matter of JODY DUNN, Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Jody Dunn ("Dunn" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Dunn, who is deaf, on behalf of Imperia Invest IBC ("Imperia"), a foreign internet-based entity that purported to invest in Traded Endowment Policies ("TEP"), solicited investments from approximately 7,133 investors, most of whom are deaf, in unregistered transactions. Dunn was the president, sole shareholder and a director of Global Wealth Lifepath, Inc. ("GWL") and Dunn World Investments ("DWI"), companies Dunn used to open bank accounts into which investor funds were deposited and from which the funds were wired to offshore bank accounts and Paypal-type accounts controlled by Imperia. Dunn purported to charge investors a fee for each transaction. Dunn has never been registered with the Commission or held any securities licenses. Dunn, 43 years old, is a resident of Corinth, Texas.

2. On September 29, 2012, a final judgment was entered by consent against Dunn, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Jody Dunn, et al., Civil Action Number 4:11-cv-00577, in the United States District Court for the Eastern District of Texas.

3. The Commission's complaint alleged that, in connection with the sale of TEPs through Imperia, Dunn misused and misappropriated investor funds; made material misrepresentations to investors; omitted material facts that would have been useful in investors' decisions to invest; transferred investor funds to his personal bank accounts; used the mail or other means or instrumentality of interstate commerce to effect the transactions in, or to induce the purchase and sale of securities while not registered as a broker-dealer or associated with a registered broker-dealer; failed to conduct any due diligence on Imperia prior to soliciting investors; and otherwise engaged in a variety of conduct which operated as a fraud and deceit on investors. The complaint also alleged that Dunn sold unregistered securities.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Dunn's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Dunn be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68050 / October 12, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15064

In the Matter of **Derek F.C. Elliott,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Derek F.C. Elliott ("Elliott" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that

1. Elliott, 41 was the President and CEO of numerous entities under the Elliott name. He was born in Ontario, Canada and is a Canadian citizen. Prior to developing real estate in the Dominican Republic ("DR"), Elliott managed an inn in the Toronto area. He has never been registered to sell securities under U.S. laws. Respondent participated in an offering of Net Worth securities, which is a penny stock.

2. On October 5, 2012, a final judgment was entered by consent against Elliott, permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, and Section 15(a) of the Exchange Act, in the civil action entitled Securities and Exchange Commission v. James B. Catledge, et al., Civil Action Number 2:12-cv-00887-JCM-RJJ, in the United States District Court for the District of Nevada.

3. The Commission's complaint alleged that, from approximately the fall of 2004 until early 2009, Elliott solicited investments, through the marketing entity known as Net Worth Solutions, involving the offer and sale of over $163 million of investment contracts in unregistered transactions to approximately 1,200 investors. It is alleged Elliott sold two types of securities, called "Residence" and Passport" investments, represented timeshare and ownership interests, respectively, in two resorts in the Dominican Republic. The Commission's complaint further alleged that Elliott developed and constructed the resorts, while Catledge was directing the sales force. It is further alleged that Elliott marketed and sold investments in these resorts in partnership with Net Worth Solutions, a multilevel marketing entity controlled by James B. Catledge. The complaint also alleged, among other things, that material misrepresentations were made to investors in order to induce them to purchase the Residence and Passport investments. It also alleged that Elliott acted as an unregistered broker-dealer.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Elliott's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Elliott be, and hereby is:

(i) barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

(ii) barred from participating in any offering of penny stock, including; acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68054 / October 15, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15066

In the Matter of Andre J. Hayden, Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Andre J. Hayden ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Respondent, age 41, is a resident of Spring Hill, Tennessee. From September 2007 through approximately June 2008, Respondent was acting as an unregistered broker by soliciting prospective investors to purchase interests in a real estate joint venture operated by Titan Investment Partners Corp. ("Titan").

2. On July 23, 2012, a judgment was entered by consent against Respondent, permanently enjoining him from, among other things, future violations of Section 15(a) of the Exchange Act, in the civil action entitled United States Securities and Exchange Commission v. Amella, et al., Civil Action Number 1:11-CV-6849, in the United States District Court for the Northern District of Illinois.

3. The Commission's complaint alleged that, in connection with the sale of interests in the Titan joint venture for which Respondent was paid commissions, Respondent falsely stated to investors that the Titan joint venture used investor money to purchase and develop real estate and that investors would receive a guaranteed 10% monthly return on their investments. The complaint also alleged that Respondent failed to conduct a reasonable investigation into the legitimacy of the joint venture and the accuracy of his representations. The complaint alleged that the joint venture interests Respondent sold and offered to sell were securities.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Hayden's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Hayden be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and
>
> barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3487 / October 15, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15065

In the Matter of Scott E. Johnson, Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Scott E. Johnson ("Johnson" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

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1. Scott Johnson, 53 years old, is a resident of Lake Forest, Minnesota. Between January 2006 and June 2010, Johnson acted as an unregistered investment adviser pursuant to Section 202(a)(11) of the Advisers Act.

2. On December 6, 2011, Johnson pleaded guilty to one count of unlawful securities transactions and six counts of theft before the District Court for the Fourth Judicial District in Hennepin County, Minnesota, in State of Minnesota v. Scott Ernest Johnson, 27-CR-11-23635. On February 9, 2012, a judgment in the criminal case was entered against Johnson. He was sentenced to a prison term of 18 months and ordered to make restitution in the amount of $631,121.61.

3. The counts of the criminal information to which Johnson pleaded guilty alleged, inter alia, that Johnson committed several acts of felonious theft, while transacting business as a securities broker without having registered to conduct such business under the Minnesota Securities Act.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Johnson's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act that Respondent Johnson be, and hereby is, barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3488 / October 15, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15067

In the Matter of **RICK CHO,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Rick Cho ("Cho" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Cho was the managing member, president, and chief compliance officer of Jupiter Group Capital Advisors, LLC ("Jupiter Group"), an investment adviser formerly registered with the Commission. Cho, 39 years old, is a resident of Honolulu, Hawaii.

2. On September 27, 2012, a final judgment was entered by consent against Cho, permanently enjoining him from future violations of Sections 203A, 204, and 207 of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. Jupiter Group Capital Advisors, LLC, et al., Civil Action Number CV11-00291 LEK (RLP), in the United States District Court for the District of Hawaii.

3. The Commission's complaint alleged that Cho caused Jupiter Group to file a false Form ADV submission with the Commission specifying the number of clients and assets under management of Jupiter Group, improperly registered Jupiter Group as an investment adviser with the Commission although it was ineligible to register because it had less than $25 million in assets under management, and unlawfully refused to allow the Commission's staff to review Jupiter Group's books and records.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Cho's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act that Respondent Cho be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; with the right to apply for reentry after one year to the appropriate self-regulatory organization, or if there is none, to the Commission.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order;

and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68060 / October 17, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15069

In the Matter of China Agritech, Inc., Respondent.	ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 12(j) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, IMPOSING A CEASE-AND-DESIST ORDER, AND REVOKING REGISTRATION OF SECURITIES

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 12(j) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against China Agritech, Inc. ("China Agritech" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 12(j) and 21C of the

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Securities Exchange Act of 1934, Making Findings, Imposing a Cease-and-Desist Order, and Revoking Registration of Securities (the"Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

FACTS

A. China Agritech is a Delaware corporation with headquarters in Beijing, China. China Agritech's filings with the Commission reported that China Agritech has operations in several locations in China, from which it manufactures and distributes organic fertilizers for sale throughout China. In September 2009, China Agritech registered its securities under Section 12(b) of the Exchange Act and listed on the NASDAQ Global Select Market ("NASDAQ"). On July 13, 2011, NASDAQ filed a Form 25 with the Commission removing China Agritech's securities from listing on NASDAQ and from registration under Section 12(b) of the Exchange Act. Since effectiveness of the deregistration from Section 12(b) of the Exchange Act, China Agritech's securities have been registered under Section 12(g) of the Exchange Act and quoted on OTC Pink under the symbol "CAGC."

B. China Agritech last filed a periodic report on November 10, 2010, when it filed a quarterly report on Form 10-Q for the quarter ended September 30, 2010. Since that time, China Agritech has failed to file annual reports on Form 10-K for the fiscal years ended December 31, 2010 and December 31, 2011, and has failed to file quarterly reports on Form 10-Q for the quarters ended March 31, 2011; June 30, 2011; September 30, 2011; March 31, 2012; and June 30, 2012.

C. On March 16, 2011, China Agritech filed a Form NT 10-K as required under Exchange Act Rule 12b-25, formally notifying the Commission that its 2010 Form 10-K would be delayed "due to a delay in obtaining and compiling information required to be included in the Company's Form 10-K." China Agritech has failed to file Forms NT 10-K or NT 10-Q for its delinquent annual report on Form 10-K for the fiscal year ended December 31, 2011 and its quarterly reports on Form 10-Q for the quarters ended March 31, 2011; June 30, 2011; September 30, 2011; March 31, 2012; and June 30, 2012, or provided the reasons for those delinquencies.

D. China Agritech belatedly disclosed in a Form 8-K filed on June 14, 2012, that one of the independent members of its Board of Directors had resigned effective January 25, 2012 and that two other independent directors had resigned effective March 15, 2012.

VIOLATIONS

E. As a result of the conduct described in paragraphs A and B, above, China Agritech has

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1 The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

failed to comply with, and committed violations of, Section 13(a) of the Exchange Act and Rules 13a-1, and 13a-13 thereunder, which require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current financial information in annual and quarterly reports.

F. As a result of the conduct described in paragraph C, above, China Agritech has also failed to comply with, and committed violations of, Section 13(a) of the Exchange Act and Rule 12b-25 thereunder, which require any reporting issuer that will be unable to meet the filing deadline for a required periodic report to file, within one business day of the missed deadline, a formal notification declaring its inability to file and the reasons therefor in reasonable detail.

G. Finally, as a result of the conduct described in paragraph D, above, China Agritech has failed to comply with, and committed violations of, Section 13(a) of the Exchange Act and Rule 13a-11 thereunder, which require every reporting issuer to file current reports disclosing certain events within the time period specified on Form 8-K; Item 5.02(b) of Form 8-K requires registrants to report the fact that a director has resigned and the date of the resignation within four business days of the occurrence of the event.

IV.

Section 21C(a) of the Exchange Act provides as follows:

> If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this title, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation.

Section 12(j) of the Exchange Act provides as follows:

> The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that Respondent cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 12b-25, 13a-1, 13a-11, and 13a-13 thereunder.

IT IS FURTHER ORDERED, pursuant to Section 12(j) of the Exchange Act, that registration of each class of Respondent's securities registered pursuant to Section 12 of the Exchange Act be, and hereby is, revoked.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68061 / October 17, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15070

In the Matter of **Lindsay R. Sayer,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Lindsay R. Sayer ("Sayer" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. From at least March 2010 to October 2011, Sayer acted as an unregistered broker. Sayer, 32 years old, is a resident of Longmont, Colorado.

2. On September 25, 2012, a judgment was entered by consent against Sayer, permanently enjoining her from future violations of Section 17(a) of the Securities Act of 1933, and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action titled Securities and Exchange Commission v. Rudolf D. Pameijer, et al., Civil Action Number 1:12-CV-01364, in the United States District Court for the Southern District of Indiana.

3. The Commission's complaint alleges the following: From at least March 2010 through October 2011, in connection with the sale of securities, Sayer and her father, Rudolf D. Pameijer, and Ryan W. Koester, operating through their entities Plan America and Rykoworks Capital Group, LLC, misappropriated nearly $1.7 million of investor money. Koester purported to be an expert foreign currency trader and falsely represented that his trading strategy offered investors a principal guaranteed investment opportunity. Sayer and Pameijer, operating as unlicensed brokers, solicited clients to invest in Koester's trading system, and misappropriated the majority of investor funds for their own personal use. The remaining investor funds transferred by Sayer and Pameijer to Koester and his entity Rykoworks were depleted through trading losses and Koester's misappropriation of funds for his own personal use. Sayer misled investors regarding how their money was being used, sent out false account statements, and otherwise engaged in conduct which operated as a fraud and deceit on investors.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Sayer's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Sayer be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and
>
> barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

Commissioner Aguilar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68062 / October 17, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15071

In the Matter of **Rudolf Pameijer,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Rudolf Pameijer ("Pameijer" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of ther Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of ther Order and Respondent's Offer, the Commission finds that:

1. From at least March 2010 to October 2011, Pameijer acted as an unregistered broker. Pameijer, 62 years old, is a resident of Trafalgar, Indiana.

2. On September 25, 2012, a judgment was entered by consent against Pameijer, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933, and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder, in the civil action titled Securities and Exchange Commission v. Rudolf D. Pameijer, et al., Civil Action Number 1:12-CV-01364, in the United States District Court for the Southern District of Indiana.

3. The Commission's complaint alleges that: From at least March 2010 through October 2011, in connection with the sale of securities, Pameijier and his daughter, Lindsay R. Sayer, and Ryan W. Koester, operating through their entities Plan America and Rykoworks Capital Group, LLC, misappropriated nearly $1.7 million of investor money. Koester purported to be an expert foreign currency trader and falsely represented that his trading strategy offered investors a principal guaranteed investment opportunity. Pameijer and Sayer, operating as unlicensed brokers, solicited clients to invest in Koester's trading system, and misappropriated the majority of investor funds for their own personal use. The remaining investor funds transferred by Pameijer and Sayer to Koester and his entity Rykoworks were depleted through trading losses and Koester's misappropriation of funds for his own personal use. Pameijer misled investors regarding how their money was being used, sent out false account statements, and otherwise engaged in conduct which operated as a fraud and deceit on investors.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Pameijer's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Pameijer be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and
>
> barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68064 / October 18, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15072

In the Matter of **CARLTON L. WILLIAMS,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Carlton L. Williams ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Williams, age 52, resides in Lake Forest, California. Williams was previously registered with the Commission as a registered representative, but he was not registered with the Commission at the times of the conduct alleged in the Commission's complaint.

2. On February 15, 2012, a judgment was entered by consent against Williams, permanently enjoining him from future violations of Sections 5(a) and 5(c) of the Securities Act of 1933 ("Securities Act"), and Section 15(a) of the Exchange Act, in the civil action entitled Securities and Exchange Commission v. Joseph R. Porche, et al., Civil Action Number SACV 10-01165 DOC (RNBx), in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that Williams was a member of the sales staff of Kensington Resources, Inc. ("Kensington"), an entity through which Williams and others solicited investors in American Environmental Energy, Inc. ("AEEI"), the purported "green energy" company to which investor funds were to be sent. The complaint further alleged that Williams participated in an offering of AEEI stock, which is a penny stock, and was a member of its sales staff and that, through the offering, Kensington raised over $11 million from approximately 200 investors nationwide. The complaint also alleged that Williams received commissions for his sales of AEEI stock and was not registered with the Commission at the time of the sales.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Williams' Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Williams be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the

Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 68072 / October 18, 2012

Admin. Proc. File No. 3-14871

In the Matter of

ONE VOICE TECHNOLOGIES, INC., *et al.*

ORDER DISMISSING PROCEEDING WITH RESPECT TO RESPONDENT PINE VALLEY MINING CORP.

On May 8, 2012, the Commission instituted an administrative proceeding against Pine Valley Mining Corp. and seven other respondents under § 12(j) of the Securities Exchange Act of 1934.[1] The Order Instituting Proceedings alleged, among other things, that Pine Valley violated periodic reporting requirements under Exchange Act § 13(a),[2] and sought to determine, based on those allegations, whether it was "necessary and appropriate for the protection of investors to suspend . . . or revoke" the registration of its securities.

On June 7, 2012, Pine Valley filed with the Commission a Form 15, pursuant to Exchange Act Rule 12g-4(a),[3] to voluntarily terminate the registration of its securities under Exchange Act § 12(g). Under Rule 12g-4(a), an issuer's registration is terminated ninety days after filing, which in this case was September 5, 2012. On September 5, 2012, the Division of Enforcement filed a motion to dismiss the proceeding against Pine Valley, based on the deregistration of its securities. Pine Valley did not respond.

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1 15 U.S.C. ' 78l(j).

2 15 U.S.C. ' 78m(a).

3 17 C.F.R. ' 240.12g-4(a) (certification of termination of registration under § 12(g)).

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It is appropriate to grant the Division's motion because the respondent does not now have a class of registered securities and because revocation or suspension of registration is the only remedy available in a proceeding instituted under Exchange Act § 12(j).[4]

Accordingly, IT IS ORDERED that this proceeding be, and it hereby is, dismissed with respect to Pine Valley Mining Corp.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[4] *See, e.g.*, *Sharon Energy, Ltd.*, Securities Exchange Act Release No. 66361, 2012 WL 401598, at *1 (Feb. 8, 2012).

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-68071; File No. S7-08-12

RIN 3235-AL12

Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: In accordance with sections 763 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), the Securities and Exchange Commission ("Commission"), pursuant to the Securities Exchange Act of 1934 ("Exchange Act"), is proposing capital and margin requirements for security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs"), segregation requirements for SBSDs, and notification requirements with respect to segregation for SBSDs and MSBSPs. The Commission also is proposing to increase the minimum net capital requirements for broker-dealers permitted to use the alternative internal model-based method for computing net capital ("ANC broker-dealers").

DATES: Comments should be received on or before [**insert date 60 days after publication in the Federal Register**].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

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- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-08-12 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, D.C. 20549-1090.

All submissions should refer to File Number S7-08-12. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, D.C. 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Deputy Associate Director, at (202) 551-5521; Randall W. Roy, Assistant Director, at (202) 551-5522; Mark M. Attar, Branch Chief, at (202) 551-5889; Sheila Dombal Swartz, Special Counsel, at (202) 551-5545; Valentina M. Deng, Attorney, at (202) 551-5778; or Teen I. Sheng, Attorney, at 202-551-5511, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, D.C. 20549-7010.

SUPPLEMENTARY INFORMATION:

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I. BACKGROUND

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.[1] Title VII of the Dodd-Frank Act ("Title VII") established a new regulatory framework for OTC derivatives.[2] In this regard, Title VII was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (i) providing for the registration and regulation of SBSDs and MSBSPs; (ii) imposing clearing and trade execution requirements on standardized derivative products; (iii) creating recordkeeping and real-time reporting regimes; and (iv) enhancing the Commission's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commission's oversight.[3]

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1 See Pub. L. 111-203, 124 Stat. 1376 (2010).

2 Pursuant to section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010." See Pub. L. 111-203 § 701. The Dodd-Frank Act assigns responsibility for the oversight of the U.S. OTC derivatives markets to the Commission, the Commodity Futures Trading Commission ("CFTC"), and certain "prudential regulators," discussed below. The Commission has oversight authority with respect to a security-based swap as defined in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68)), including to implement a registration and oversight program for a security-based swap dealer as defined in section 3(a)(71) of the Exchange Act (15 U.S.C. 78c(a)(71)) and a major security-based swap participant as defined in section 3(a)(67) of the Exchange Act (15 U.S.C. 78c(a)(67)). The CFTC has oversight authority with respect to a swap as defined in section 1(a)(47) of the Commodity Exchange Act ("CEA") (7 U.S.C. 1(a)(47)), including to implement a registration and oversight program for a swap dealer as defined in section 1(a)(49) of the CEA (7 U.S.C. 1(a)(49)) and a major swap participant as defined in section 1(a)(33) of the CEA (7 U.S.C. 1(a)(33)). The Commission and the CFTC jointly have adopted rules to further define, among other things, those terms and the terms swap, security-based swap, swap dealer, major swap participant, security-based swap dealer, and major security-based swap participant. See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Exchange Act Release No. 64372 (Apr. 29, 2011), 76 FR 29818 (May 23, 2011) ("Product Definitions Proposing Release"); Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Exchange Act Release No. 67453 (July 18, 2012), 77 FR 48208 (Aug. 13, 2012) (Joint final rule with the CFTC) ("Product Definitions Adopting Release"); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", Exchange Act Release No. 63452 (Dec. 7, 2010), 75 FR 80174 (Dec. 21, 2010) (Joint proposal with the CFTC) ("Entity Definitions Proposing Release"); and Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", Exchange Act Release No. 66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012) (Joint final rule with the CFTC) ("Entity Definitions Adopting Release").

3 See Pub. L. 111-203 §§ 701-774.

Section 764 of the Dodd-Frank Act added section 15F to the Exchange Act.[4] Section 15F(e)(1)(B) of the Exchange Act provides that the Commission shall prescribe capital and margin requirements for SBSDs and nonbank MSBSPs that do not have a prudential regulator (respectively, "nonbank SBSDs" and "nonbank MSBSPs").[5] Section 763 of the Dodd-Frank Act added section 3E to the Exchange Act.[6] Section 3E provides the Commission with authority to establish segregation requirements for SBSDs and MSBSPs.[7]

Section 4s(e)(1)(B) of the CEA provides that the CFTC shall prescribe capital and margin requirements for swap dealers and major swap participants for which there is not a prudential regulator ("nonbank swap dealers" and "nonbank swap participants").[8] Section 15F(e)(1)(A) of the Exchange Act provides that the prudential regulators shall prescribe capital and margin requirements for bank SBSDs and bank MSBSPs, and section 4s(e)(1)(A) of the CEA provides that the prudential regulators shall prescribe capital and margin requirements for swap dealers and major swap participants for which there is a prudential regulator ("bank swap dealers" and "bank swap participants").[9] The prudential regulators have proposed capital and margin

4 See id. § 764; 15 U.S.C. 78o-10.

5 See 15 U.S.C. 78o-10(e)(1)(B). Specifically, section 15F(e)(1)(B) of the Exchange Act provides that each registered SBSD and MSBSP for which there is not a prudential regulator shall meet such minimum capital requirements and minimum initial and variation margin requirements as the Commission shall by rule or regulation prescribe. The term "prudential regulator" is defined in section 1(a)(39) of the CEA (7 U.S.C. 1(a)(39)) and that definition is incorporated by reference in section 3(a)(74) of the Exchange Act (15 U.S.C. 78c(a)(74)). Pursuant to the definition, the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Farm Credit Administration, or the Federal Housing Finance Agency (collectively, the "prudential regulators") is the "prudential regulator" of an SBSD, MSBSP, swap participant, or major swap participant if the entity is directly supervised by that agency.

6 See Pub. L. 111-203 § 763; 15 U.S.C. 78c-5.

7 See 15 U.S.C. 78c-5(a)-(g). Section 3E of the Exchange Act does not distinguish between bank and nonbank SBSDs and bank and nonbank MSBSPs, and, consequently, provides the Commission with the authority to establish segregation requirements for SBSDs and MSBSPs, whether or not they have a prudential regulator. Id.

8 See 7 U.S.C. 6s(e)(1)(B).

9 See 15 U.S.C. 78o-10(e)(1)(A); 7 U.S.C. 6s(e)(1)(A).

requirements for bank swap dealers, bank SBSDs, bank swap participants, and bank MSBSPs.[10] The CFTC has proposed capital and margin requirements for nonbank swap dealers and nonbank major swap participants.[11] The CFTC also has adopted segregation requirements for cleared swaps and proposed segregation requirements for non-cleared swaps.[12]

Pursuant to sections 763 and 764 of the Dodd-Frank Act, the Commission is proposing to amend Rule 15c3-1 and Rule 15c3-3 and propose new Rules 18a-1 (including appendices to Rule 18a-1), 18a-2, 18a-3, and 18a-4 (including an exhibit to Rule 18a-4).[13] The proposed amendments and new rules would establish capital and margin requirements for nonbank SBSDs, including broker-dealers that are registered as SBSDs ("broker-dealer SBSDs"), and nonbank MSBSPs. They also would establish segregation requirements for SBSDs and notification requirements with respect to segregation for SBSDs and MSBSPs.

Further, the proposals also would increase the minimum net capital requirements and establish liquidity requirements for ANC broker-dealers.[14] An ANC broker-dealer is a broker-dealer that has been approved by the Commission to use internal value-at-risk ("VaR") models to determine market risk charges for proprietary securities and derivatives positions and to take a

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10 See Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564 (May 11, 2011) ("Prudential Regulator Margin and Capital Proposing Release"). The prudential regulators, as part of their proposed margin requirements for non-cleared security-based swaps, proposed a segregation requirement for collateral received as margin. Id.

11 See Capital Requirements of Swap Dealers and Major Swap Participants, 76 FR 27802 (May 12, 2011) ("CFTC Capital Proposing Release"); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011) ("CFTC Margin Proposing Release"). The CFTC reopened the comment period for the CFTC Margin Proposing Release to allow interested parties to comment on the CFTC proposed rules in light of the proposals discussed in the international consultative paper. See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 77 FR 41109 (July 12, 2012).

12 See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 FR 6336 (Feb. 7, 2012) and Protection of Collateral of Counterparties to Non-cleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 FR 75432 (Dec. 3, 2010).

13 See 17 CFR 240.15c3-1; 17 CFR 240.15c3-3.

14 See 17 CFR 240.15c3-1(a)(7); 17 CFR 240.15c3-1e.

credit risk charge in lieu of a 100% charge for unsecured receivables related to OTC derivatives transactions (hereinafter, collectively "internal models"). The proposed amendments applicable to ANC broker-dealers are designed to account for their large size, the scale of their custodial activities, and the potential substantial leverage they may take on if they become more active in the security-based swap markets under the Dodd-Frank Act reforms, which, among other things, require dealers in security-based swaps to register with the Commission.[15] Finally, some of the proposed amendments to Rule 15c3-1 would apply to broker-dealers that are not registered as SBSDs. These proposed amendments are designed to maintain a consistent capital treatment for security-based swaps and swaps under Rule 15c3-1 and proposed new Rule 18a-1.

As discussed in detail below, the proposals for capital, margin, and segregation requirements for SBSDs and MSBSPs are based in large part on existing capital, margin, and segregation requirements for broker-dealers ("broker-dealer financial responsibility requirements").[16] The broker-dealer financial responsibility requirements served as the model for the proposals because the financial markets in which SBSDs and MSBSPs are expected to operate are similar to the financial markets in which broker-dealers operate. In addition, as discussed below, the objectives of the broker-dealer financial responsibility requirements are similar to the objectives underlying the proposals. Moreover, the broker-dealer financial responsibility requirements have existed for many years and have facilitated the prudent operation of broker-dealers.[17] Consequently, they provide a reasonable template for building a

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15 See, e.g., 15 U.S.C. 78o-10(a)(1) ("It shall be unlawful for any person to act as a security-based swap dealer unless the person is registered as a security-based swap dealer with the Commission.").

16 See infra section II.A.1. of this release (describing generally the broker-dealer capital standards); section II.B.1. of this release (describing generally the broker-dealer margin standards); section II.C.1. of this release (describing generally the broker-dealer segregation requirements).

17 For example, one of the objectives of the broker-dealer financial responsibility requirements is to protect customers from the consequences of the financial failure of a broker-dealer in terms of safeguarding customer securities and funds held by the broker-dealer. It should be noted that the Securities Investor

financial responsibility program for SBSDs and MSBSPs. Furthermore, it is expected that some nonbank SBSDs also will register as broker-dealers in order to be able to offer customers a broader range of services than a nonbank SBSD not registered as a broker-dealer ("stand-alone SBSD") would be permitted to engage in. Therefore, establishing consistent financial responsibility requirements would avoid potential competitive disparities between stand-alone SBSDs and broker-dealer SBSDs.

However, the Commission recognizes that there may be other approaches to establishing financial responsibility requirements that may be appropriate – including, for example, applying a standard based on the international capital standard for banks ("Basel Standard")[18] in the case of entities that are part of a bank holding company, as has been proposed by the CFTC.[19] In general, the bank capital model requires the holding of specified levels of capital as a percentage of "risk weighted assets."[20] It does not require generally a full capital deduction for unsecured receivables, given that banks, as lending entities, are in the business of extending credit to a range of counterparties.

Protection Corporation ("SIPC"), since its inception in 1971, has initiated customer protection proceedings for only 324 broker-dealers, which is less than 1% of the approximately 39,200 broker-dealers that have been members of SIPC during that timeframe. From 1971 through December 31, 2011, approximately 1% of the $117.5 billion of cash and securities distributed for accounts of customers came from the SIPC fund rather than debtors' estates. See SIPC, Annual Report 2011, available at http://www.sipc.org/Portals/0/PDF/2011_Annual_Report.pdf ("SIPC 2011 Annual Report").

18 The Basel Standard was developed by the Basel Committee on Banking Supervision of the Bank for International Settlements ("BCBS"). More information about the Basel Standard is available at the website of the Bank for International Settlements ("BIS") at http://www.bis.org/bcbs/index.htm.

19 CFTC Capital Proposing Release, 76 FR 27802.

20 The prudential regulators also have proposed capital rules that would require a covered swap entity to comply with the regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime. Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27568. The prudential regulators note that they have "had risk-based capital rules in place for banks to address over-the-counter derivatives since 1989 when the banking agencies implemented their risk-based capital adequacy standards…based on the first Basel Accord." Id.

This approach could promote a consistent view and management of capital within a bank holding company structure. The Commission is not proposing this approach, however, both because of the distinctions between bank and nonbank dealer business models and access to backstop liquidity, as well as uncertainties as to how a bank capital standard would in practice affect valuations and the conduct of business in a nonbank entity; but the Commission is specifically seeking comment on this approach. In addition, detailed comment is requested below on alternative financial responsibility frameworks that could serve as a model for establishing financial responsibility requirements for SBSDs and MSBSPs.

The minimum financial and customer protection requirements proposed today – like other financial tests that market participants use in the ordinary course of business to manage risk or to comply with applicable regulations – incorporate many specific numerical thresholds, limits, deductions, and ratios.[21] The Commission recognizes that each such quantitative requirement could be read by some to imply a definitive conclusion based on quantitative analysis of that requirement and its alternatives.

The Commission notes in this regard that the specific quantitative requirements included in this proposal have not been derived directly from econometric or mathematical models, nor has the Commission performed a detailed quantitative analysis of the likely economic consequences of the specific quantitative requirements being included in this proposal. As discussed in the economic analysis below, there are a number of challenges presented in conducting such a quantitative analysis in a robust fashion. Accordingly, the selection of a particular quantitative requirement proposed below reflects a qualitative assessment by the

21 For example, the proposed capital requirements would include in the formula that determines minimum net capital an amount generally equal to 8% of the amount of margin that nonbank SBSDs would be required to collect from counterparties. Similarly, the capital and margin proposals, in setting "haircut" requirements to reflect market risk for certain types of security-based swaps, propose to use a numerical grid that establishes specific deductions depending on spread and tenor, among other factors.

Commission regarding the appropriate financial standard for an identified issue. In making such assessments and in turn selecting proposed quantitative requirements, the Commission has drawn from its experiences in regulating broker-dealers and has frequently looked to comparable quantitative elements in the existing broker-dealer financial responsibility regime (e.g., the current capital charges in the existing broker-dealer net capital rule) or, where appropriate, the existing or proposed regulations of the prudential regulators, FINRA, or the CFTC with respect to similar activities. For example, the Commission may propose using a specified haircut percentage (e.g., 15%, as opposed to a percentage that is higher or lower) because it believes, based on is experience regulating markets, that such percentage should be sufficient to cover a severe market movement. The Commission has used these comparable quantitative requirements as a reasonable starting point for purposes of the various proposals because, as noted above, there are substantial similarities between the proposed rules and those other regimes in terms of the relevant markets, entities, and regulatory objectives, and because many nonbank SBSDs may also be subject to the existing broker-dealer financial responsibility requirements.

The Commission invites comment, including relevant data and analysis, regarding all aspects of the various quantitative requirements reflected in the proposed rules. In particular, data and comment from market participants and other interested parties regarding the likely effect of each proposed quantitative requirement, the effect of such requirements in the aggregate, and potential alternative requirements will be particularly useful to the Commission in evaluating modifications to the proposals. Commenters are also requested to describe in detail any econometric or mathematical models or economic analyses of data, to the extent they exist, that they believe would be relevant for evaluating or modifying any quantitative provisions contained in the proposals.

The Commission staff consulted with the prudential regulators and the CFTC in drafting the proposals discussed in this release.[22] In addition, the proposals of the prudential regulators and the CFTC were considered in developing the Commission's proposed capital, margin, and segregation requirements for SBSDs and MSBSPs. The Commission's proposals differ in some respects from proposals of the prudential regulators and the CFTC, and such differences are described below in connection with the relevant proposals. While some differences are based on differences in the activities of securities firms, banks, and commodities firms, or differences in the products at issue, other differences may reflect an alternative approach to balancing the relevant policy choices and considerations. Where these differences exist, comment is sought on the advantages and disadvantages of each proposal and whether a given proposal is appropriate based on differences in the business models of the types of entities that would be subject to the respective proposal, the risks of these entities, and any other factors commenters believe relevant.[23]

The capital, margin, and segregation requirements ultimately adopted, like other requirements established under the Dodd-Frank Act, could have a substantial impact on international commerce and the relative competitive position of intermediaries operating in various, or multiple, jurisdictions. In particular, intermediaries operating in the U.S. and in other jurisdictions could be advantaged or disadvantaged if corresponding requirements are not established in other jurisdictions or if the Commission's rules are substantially more or less stringent than corresponding requirements in other jurisdictions. This could, among other

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22 See 15 U.S.C. 78o-10(e)(3)(D)(i) ("The prudential regulators, the [CFTC], and the [Commission] shall periodically (but not less frequently than annually) consult on the minimum capital requirements and minimum initial and variation margin requirements.").

23 See 15 U.S.C. 78o-10(e)(3)(D)(ii) (providing that the prudential regulators, the CFTC, and the Commission "shall, to the maximum extent practicable establish and maintain comparable minimum capital requirements and minimum initial and variation margin requirements, including the use of noncash collateral," for SBSDs and swap dealers).

potential impacts, affect the ability of intermediaries and other market participants based in the U.S. to participate in non-U.S. markets, the ability of non-U.S.-based intermediaries and other market participants to participate in U.S. markets, and whether and how international firms make use of global "booking entities" to centralize risks related to security-based swaps. These issues have been the focus of numerous comments to the Commission and other regulators, Congressional inquiries, and other public dialogue.[24]

The potential international implications of the proposed capital, margin, and segregation requirements warrant further consideration. However, consistent with the Commission's general approach with respect to its other proposals under Title VII, these implications are recognized here but not fully addressed. Instead, the Commission intends to publish a comprehensive release seeking public comment on the full spectrum of issues relating to the application of Title VII to cross-border security-based swap transactions and non-U.S. persons that act in capacities regulated under the Dodd-Frank Act. This approach will provide market participants, foreign regulators, and other interested parties with an opportunity to consider, as an integrated whole,

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24 See, e.g., letter from Senator Tim Johnson, Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, and Congressman Barney Frank, Ranking Member of the U.S. House Committee on Financial Services, to the CFTC, Commission, Federal Reserve, and FDIC (Oct. 4, 2011), available at http://www.sec.gov/comments/s7-25-11/s72511-34.pdf ("Given the global nature of this market, U.S. regulators should avoid creating opportunities for international regulatory arbitrage that could increase systemic risk and reduce the competitiveness of U.S. firms abroad"); letter from Barclays Bank PLC, BNP Paribas S.A., Credit Suisse AG, Deutsche Bank AG, HSBC, Nomura Securities International, Inc., Rabobank Nederland, Royal Bank of Canada, The Royal Bank of Scotland Group PLC, Societe Generale, The Toronto-Dominion Bank, and UBS AG, to the CFTC, Commission, and Federal Reserve (Feb. 17, 2011), available at http://www.sec.gov/comments/s7-39-10/s73910-25.pdf ("[T]he home country regulator has the greatest interest in and is in the best position to protect a foreign bank swap dealer under its primary supervision by setting appropriate margin requirements or functionally equivalent capital charges for non-cleared swaps"); letter from Carlos Tavares, Vice-Chairman of European Securities and Markets Authority, to the Commission (Jan. 17, 2011), available at http://www.sec.gov/comments/s7-35-10/s73510-19.pdf ("if the foreign supervision were not taken into account…a foreign [entity would] be subject to multiple regimes…[which would be] very challenging for regulated entities and would significantly raise the costs for both the industry and supervisors"); BCBS, Board of the International Organization of Securities Commissions ("IOCSO"), Consultative Document, Margin Requirements for Non-centrally-cleared Derivatives (July 2012), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf (consultative document seeking comment on margin requirements for non-centrally-cleared derivatives).

the proposed approach to the cross-border application of Title VII, including capital, margin, and segregation requirements.

II. PROPOSED RULES AND RULE AMENDMENTS

A. CAPITAL

1. Introduction

Section 15F(e)(1)(B) of the Exchange Act requires that the Commission prescribe capital requirements for nonbank SBSDs and nonbank MSBSPs.[25] The Commission also has concurrent authority under section 15(c)(3) of the Exchange Act to prescribe capital requirements for broker-dealers.[26] The existing broker-dealer capital requirements are contained in Rule 15c3-1,[27] including seven appendices to Rule 15c3-1.[28] The minimum capital requirements for stand-alone SBSDs would be contained in proposed new Rule 18a-1,[29] and the minimum capital requirements for broker-dealer SBSDs would be contained in Rule 15c3-1, as proposed to be

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25 15 U.S.C. 78o-10(e)(1)(B).

26 15 U.S.C. 78o(c)(3). Section 771 of the Dodd-Frank Act states that unless otherwise provided by its terms, its provisions relating to the regulation of the security-based swap markets do not divest any appropriate Federal banking agency, the Commission, the CFTC, or any other Federal or State agency, of any authority derived from any other provision of applicable law. See Pub. L. 111-203 § 771. In addition, section 15F(e)(3)(B) of the Exchange Act provides that nothing in section 15F "shall limit, or be construed to limit, the authority" of the Commission "to set financial responsibility rules for a broker or dealer…in accordance with Section 15(c)(3)." 15 U.S.C. 78o-8(e)(3)(B).

27 17 CFR 240.15c3-1.

28 17 CFR 240.15c3-1a (Options); 17 CFR 240.15c3-1b (Adjustments to net worth and aggregate indebtedness for certain commodities transactions); 17 CFR 240.15c3-1c (Consolidated computations of net capital and aggregate indebtedness for certain subsidiaries and affiliates); 17 CFR 240.15c3-1d (Satisfactory subordination agreements); 17 CFR 240.15c3-1e (Deductions for market and credit risk for certain brokers or dealers); 17 CFR 240.15c3-1f (Optional market and credit risk requirements for OTC derivatives dealers); 17 CFR 240.15c3-1g (Conditions for ultimate holding companies of certain brokers or dealers).

29 See proposed new Rule 18a-1.

amended. Proposed Rule 18a-1 would be structured similarly to Rule 15c3-1 and would contain many provisions that correspond to those in Rule 15c3-1.[30]

As described above, the capital and other financial responsibility requirements for broker-dealers generally provide a reasonable template for crafting the corresponding requirements for nonbank SBSDs. For example, among other considerations, the objectives of capital standards for both types of entities are similar. Rule 15c3-1, described in detail below, is a net liquid assets test that is designed to require a broker-dealer to maintain sufficient liquid assets to meet all obligations to customers and counterparties and have adequate additional resources to wind-down its business in an orderly manner without the need for a formal proceeding if it fails financially.[31] In turn, the objective of the proposed capital standards for nonbank SBSDs is to protect customer assets and mitigate the consequences of a firm failure, while allowing these firms the flexibility in how they conduct a security-based swaps business.

In addition, the Dodd-Frank Act divided responsibility for SBSDs by providing the prudential regulators with authority to prescribe the capital and margin requirements for bank SBSDs and the Commission with authority to prescribe capital and margin requirements for

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30 For example, proposed new Rule 18a-1 would include four appendices: Appendix A (proposed new Rule 18a-1a); Appendix B (proposed new Rule18a-1b); Appendix C (proposed new Rule 18a-1c); and Appendix D (proposed new Rule 18a-1d). The appendices would correspond to the following appendices to Rule 15c3-1: Appendix A (Options) (17 CFR 240.15c3-1a); Appendix B (Adjustments to net worth and aggregate indebtedness for certain commodities transactions) (17 CFR 240.15c3-1b); Appendix C (Consolidated computations of net capital and aggregate indebtedness for certain subsidiaries and affiliates) (17 CFR 240.15c3-1c); and Appendix D (Satisfactory subordination agreements) (17 CFR 240.15c3-1d).

31 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997) ("Rule 15c3-1 requires registered broker-dealers to maintain sufficient liquid assets to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding."). As indicated, the goal of the rule is to require a broker-dealer to hold sufficient liquid net capital to meet all obligations to creditors, except for creditors who agree to subordinate their claims to all other creditors. As discussed in more detail below, Rule 15c3-1d (Appendix D to Rule 15c3-1) sets forth minimum requirements for a subordinated loan agreement. See 17 CFR 240.15c3-1d. Typically, affiliates of the broker-dealer (e.g., the firm's holding company) or individual owners of the broker-dealer make subordinated loans to the broker-dealer. If the broker-dealer fails financially and is liquidated, the obligations of the broker-dealer to all other creditors would need to be paid in full before the obligations of the broker-dealer to a subordinated lender are paid.

nonbank SBSDs.[32] This division also suggests it may be appropriate to model the capital requirements for nonbank SBSDs on the capital standards for broker-dealers, while the capital requirements for bank SBSDs are modeled on capital standards for banks (as reflected in the proposal by the prudential regulators).[33] Certain operational, policy, and legal differences appear to support this distinction between nonbank SBSDs and bank SBSDs. First, based on the Commission staff's understanding of the activities of nonbank dealers in over-the counter ("OTC") derivatives, nonbank SBSDs are expected to engage in a securities business with respect to security-based swaps that is more similar to the dealer activities of broker-dealers than to the activities of banks; indeed, some broker-dealers likely will be registered as nonbank SBSDs.[34] Second, existing capital standards for banks and broker-dealers reflect, in part, differences in their funding models and access to certain types of financial support, and those same differences also will exist between bank SBSDs and nonbank SBSDs. For example, banks obtain funding through customer deposits and can obtain liquidity through the Federal Reserve's discount window, whereas broker-dealers do not – and nonbank SBSDs will not – have access to these sources of funding and liquidity. Third, Rule 15c3-1 currently contains provisions designed to address dealing in OTC derivatives by broker-dealers and, therefore, to some extent already can accommodate this type of activity (although, as discussed below, proposed amendments to Rule 15c3-1 would be designed to more specifically address the risks of security-based swaps and the potential for increased involvement of broker-dealers in the security-based

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32 See 15 U.S.C. 78o-10, in general; 15 U.S.C. 78o-10(e)(2)(A)-(B), in particular.

33 The prudential regulators have proposed capital requirements for bank SBSDs and bank swap dealers that are based on the capital requirements for banks. See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27582.

34 Id.

swaps markets).[35]

For these reasons, the proposed capital standard for nonbank SBSDs is a net liquid assets test modeled on the broker-dealer capital standard in Rule 15c3-1.[36] However, the Commission recognizes that there may be alternative approaches to financial responsibility requirements that may be appropriate.[37] Accordingly, in the requests for comment below on the various capital standards, commenters are encouraged: (1) to consider alternative approaches to capital for nonbank SBSDs generally; (2) for nonbank SBSDs that are broker-dealers, to identify what, if

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35 See 17 CFR 240.15c3-1f and 17 CFR 240.15c3-1e. See also Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Exchange Act Release No. 49830 (June 8, 2004), 69 FR 34428 (June 21, 2004) ("Alternative Net Capital Requirements Adopting Release"); OTC Derivatives Dealers, Exchange Act Release No. 40594 (Oct. 23, 1998), 63 FR 59362 (Nov. 3, 1998).

36 As noted above, the prudential regulators similarly proposed capital standards for bank SBSDs based on the capital standards for banks. See Prudential Regulator Margin and Capital Proposing Release 76 FR 27564. The CFTC has proposed three different capital standards for nonbank swap dealers. First, a futures commission merchant ("FCM") that is registered as a swap dealer would be subject to the CFTC's net capital rule for FCMs, which is similar to the Commission's net capital rule for broker-dealers in that it imposes a net liquid assets test. See CFTC Capital Proposing Release, 76 FR 27802. Second, a swap dealer that is not an FCM and not affiliated with a U.S. bank holding company would be subject to a "tangible net equity" capital standard (the CFTC proposal defines tangible net equity as equity determined under U.S. generally accepted accounting principles ("GAAP"), and excludes goodwill and other intangible assets). Third, a swap dealer that is not an FCM and is affiliated with a U.S. bank holding company would be subject to the capital standard that applies to U.S. banking institutions. Id. The proposed capital standard for nonbank SBSDs would not make such distinctions and, therefore, all nonbank SBSDs would be subject to the net liquid assets test embodied in Rule 15c3-1 (i.e., regardless of whether they are registered as broker-dealers or affiliates of U.S. bank holding companies). The CFTC proposed a tangible net equity requirement for certain swap dealers to address the probability that commercial entities (e.g., entities engaged in agricultural or energy businesses) may need to register as swap dealers and that imposing a net liquid assets test could require them to engage in significant corporate restructuring and potentially cause undue costs because their equity is comprised of physical and other non-current assets. Differences between the swaps markets and the security-based swaps markets may make a single capital standard more workable for nonbank SBSDs. The swaps market is significantly larger than the security-based swaps market and has many more active participants that are commercial entities. See BIS, OTC Derivatives Market Activity in the Second Half of 2010, Monetary and Economic Department, (May 2011), available at http://www.bis.org/publ/otc_hy1105.pdf. It is expected that financial institutions will comprise a large segment of the security-based swaps market as is currently the case and that these entities are more likely to have affiliates dedicated to OTC derivatives trading and affiliates that are broker-dealers registered with the Commission. See infra section V.A. of this release (providing an overview of the security-based swaps markets). Consequently, these affiliates – because their capital structures are geared towards securities trading or because they already are broker-dealers – would be able to more readily adhere to a net liquid assets test. In addition, many broker-dealers currently are affiliates within bank holding companies. Consequently, these broker-dealers are subject to Rule 15c3-1, while their bank affiliates are subject to bank capital standards.

37 CFTC Capital Proposing Release, 76 FR 27802.

any, specific amendments to Rule 15c3-1 and its appendices they believe would not be appropriate for broker-dealers; and (3) for stand-alone SBSDs, to identify what, if any, specific provisions in proposed new Rule 18a-1 and its appendices (including those modeled on provisions in Rule 15c3-1 and its appendices) they believe would not be appropriate for stand-alone SBSDs.

The capital standard in Rule 15c3-1 – that serves as a model for the proposed capital standard for nonbank SBSDs – is a net liquid assets test. This standard is designed to promote liquidity; the rule allows a broker-dealer to engage in activities that are part of conducting a securities business (e.g., taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors).[38] For example, Rule 15c3-1 allows securities positions to count as allowable net capital, subject to standardized or internal model-based haircuts.[39] The rule, however, does not permit most

38 See, e.g., Interpretation Guide to Net Capital Computation for Brokers and Dealers, Exchange Act Release No. 8024 (Jan. 18, 1967), 32 FR 856 (Jan. 25, 1967) ("Rule 15c3-1 (17 CFR 240.15c3-1) was adopted to provide safeguards for public investors by setting standards of financial responsibility to be met by brokers and dealers. The basic concept of the rule is liquidity; its object being to require a broker-dealer to have at all times sufficient liquid assets to cover his current indebtedness.") (footnotes omitted); Net Capital Treatment of Securities Positions, Obligations and Transactions in Suspended Securities, Exchange Act Release No. 10209 (June 8, 1973), 38 FR 16774 (June 26, 1973) (Commission release of a letter from the Division of Market Regulation) ("The purpose of the net capital rule is to require a broker or dealer to have at all times sufficient liquid assets to cover its current indebtedness. The need for liquidity has long been recognized as vital to the public interest and for the protection of investors and is predicated on the belief that accounts are not opened and maintained with broker-dealers in anticipation of relying upon suit, judgment and execution to collect claims but rather on a reasonable demand one can liquidate his cash or securities positions."); Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 15426 (Dec. 21, 1978), 44 FR 1754 (Jan. 8, 1979) ("The rule requires brokers or dealers to have sufficient cash or liquid assets to protect the cash or securities positions carried in their customers' accounts. The thrust of the rule is to insure that a broker or dealer has sufficient liquid assets to cover current indebtedness."); Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 26402 (Dec. 28, 1989), 54 FR 315 (Jan. 5, 1989) ("The rule's design is that broker-dealers maintain liquid assets in sufficient amounts to enable them to satisfy promptly their liabilities. The rule accomplishes this by requiring broker-dealers to maintain liquid assets in excess of their liabilities to protect against potential market and credit risks.") (footnote omitted).

39 See 17 CFR 240.15c3-1(c)(2)(vi); 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f.

unsecured receivables to count as allowable net capital.[40] This aspect of the rule severely limits the ability of broker-dealers to engage in activities, such as unsecured lending, that generate unsecured receivables. The rule also does not permit fixed assets or other illiquid assets to count as allowable net capital, which creates disincentives for broker-dealers to own real estate and other fixed assets that cannot be readily converted into cash. For these reasons, Rule 15c3-1 incentivizes broker-dealers to confine their business activities and devote capital to activities such as underwriting, market making, and advising on and facilitating customer securities transactions.

Rule 15c3-1 requires broker-dealers to maintain a minimum level of net capital (meaning highly liquid capital) at all times.[41] The rule requires that a broker-dealer perform two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain;[42] and (2) a computation of the amount of net capital the broker-dealer is maintaining.[43] The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of aggregate debit items ratio.[44]

In computing net capital, the broker-dealer must, among other things, make certain adjustments to net worth such as deducting illiquid assets and taking other capital charges and adding qualifying subordinated loans.[45] The amount remaining after these deductions is defined

40 See 17 CFR 240.15c3-1(c)(2)(iv).

41 See 17 CFR 240.15c3-1.

42 See 17 CFR 240.15c3-1(a).

43 See 17 CFR 240.15c3-1(c)(2). The computation of net capital is based on the definition of net capital in paragraph (c)(2) of Rule 15c3-1. Id.

44 See 17 CFR 240.15c3-1(a).

45 See 17 CFR 240.15c3-1(c)(2)(i)-(xiii).

as "tentative net capital."[46] The final step in computing net capital is to take prescribed percentage deductions ("standardized haircuts") from the mark-to-market value of the proprietary positions (e.g., securities, money market instruments, and commodities) that are included in its tentative net capital.[47] The standardized haircuts are designed to account for the market risk inherent in these positions and to create a buffer of liquidity to protect against other risks associated with the securities business.[48] ANC broker-dealers and a type of limited purpose broker-dealer that deals solely in OTC derivatives ("OTC derivative dealers") are permitted, with Commission approval, to calculate net capital using internal models as the basis for taking market risk and credit risk charges in lieu of the standardized haircuts for classes of positions for which they have been approved to use models.[49] Rule 15c3-1 imposes substantially higher minimum capital requirements for ANC broker-dealers and OTC derivatives dealers, as compared to other types of broker-dealers, because, among other reasons, the use of internal models to compute net capital can substantially reduce the deductions for securities and money market positions as compared with the standardized haircuts.[50] Consequently, the higher

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46 See 17 CFR 240.15c3-1(c)(15).

47 See 17 CFR 240.15c3-1(c)(2)(vi).

48 See, e.g., Uniform Net Capital Rule, Exchange Act Release No. 13635 (June 16, 1977), 42 FR 31778 (June 23, 1977) ("[Haircuts] are intended to enable net capital computations to reflect the market risk inherent in the positioning of the particular types of securities enumerated in [the rule]"); Net Capital Rule, Exchange Act Release No. 22532 (Oct. 15, 1985), 50 FR 42961 (Oct. 23, 1985) ("These percentage deductions, or 'haircuts', take into account elements of market and credit risk that the broker-dealer is exposed to when holding a particular position."); Net Capital Rule, Exchange Act Release No. 39455 (Dec. 17, 1997), 62 FR 67996 (Dec. 30, 1997) ("Reducing the value of securities owned by broker-dealers for net capital purposes provides a capital cushion against adverse market movements and other risks faced by the firms, including liquidity and operational risks.") (footnote omitted).

49 See 17 CFR 240.15c3-1(a)(5) and (a)(7); 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f. As part of the application to use internal models, an entity seeking to become an ANC broker-dealer or an OTC derivatives dealer must identify the types of positions it intends to include in its model calculation. See 17 CFR 240.15c3-3e(a)(1)(iii); 17 CFR 240.15c3-1f(a)(1)(ii). After approval, an ANC broker-dealer and OTC derivatives dealer must obtain Commission approval to make a material change to the model, including a change to the types of positions included in the model. See 17 CFR 240.15c3-1e(a)(8); 17 CFR 240.15c3-f(a)(3).

50 See 17 CFR 240.15c3-1(a)(5) and (a)(7).

minimum capital requirements are designed to account for risks that may not be addressed by the internal models. A broker-dealer must ensure that its net capital exceeds its minimum net capital requirement at all times.[51]

A different capital standard than the net liquid assets test is proposed for nonbank MSBSPs. As discussed in more detail below, proposed Rule 18a-2 would require nonbank MSBSPs to maintain positive tangible net worth.[52] The Commission preliminarily believes that a tangible net worth standard – as opposed to the net liquid assets test – is more workable for nonbank MSBSPs because these entities may engage in a diverse range of business activities different from, and broader than, the securities activities conducted by broker-dealers or SBSDs (and, to the extent they did not, they likely would be required to register as an SBSD and/or broker-dealer).[53] Consequently, requiring nonbank MSBSPs to adhere to a capital standard based on a net liquid assets test could restrict these entities from engaging in commercial activities that are part of their core business models. For example, some of these entities may engage in manufacturing and supply activities that generate large amounts of unsecured receivables and require substantial fixed assets.[54] Accordingly, as discussed below, proposed Rule 18a-2 is not modeled on Rule 15c3-1 because of the expected differences between nonbank SBSDs and broker-dealers, on the one hand, and the entities that may register as nonbank

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51 17 CFR 240.15c3-1(a).

52 See proposed new Rule 18a-2.

53 An entity will need to register with the Commission as an MSBSP and, consequently, be subject to proposed new Rule 18a-2 if it falls within the definition of major security-based swap participant in section 3(a)(67) of the Exchange Act (15 U.S.C. 78c(a)(67)) as further defined by the Commission by rule. See Entity Definitions Adopting Release, 77 FR 30596.

54 See CFTC Capital Proposing Release, 76 FR at 27807 (proposing a tangible net equity test for major swap participants that are not part of bank holding companies noting that although these firms "may have significant amounts of balance sheet equity, it may also be the case that significant portions of their equity is comprised of physical and other noncurrent assets, which would preclude the firms from meeting FCM capital requirements without engaging insignificant corporate restructuring and incurring potentially undue costs.").

MSBSPs, on the other hand.

Request for Comment

The Commission generally requests comment on the proposals to impose a net liquid assets test capital standard for nonbank SBSDs and a tangible net worth standard for nonbank MSBSPs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Will the entities that register as nonbank SBSDs engage in a securities business with respect to security-based swaps that is similar to the securities business conducted by broker-dealers? If not, describe how the securities activities of nonbank SBSDs will differ from the securities activities of broker-dealers.
2. Will some broker-dealers register as nonbank SBSDs? If so, which types of broker-dealers and which types of activities do these broker-dealers currently engage in?
3. Should there be different capital standards for nonbank SBSDs depending on whether they are registered as broker-dealers or affiliated with bank holding companies, or not registered as broker-dealers and not affiliated with bank holding companies? If so, explain why. If not, explain why not. For example, should stand-alone SBSDs be subject to a tangible net worth standard or, if affiliated with a bank holding company, the bank capital standard? Would different standards create competitive advantages? If so, explain why. If different capital standards would be appropriate, explain the appropriate capital standard that should apply to each of these classes of nonbank SBSDs.
4. Generally, is there a level of capital under which counterparties will not transact with a dealer in OTC derivatives because the counterparty credit risk is too great? If so, identify that level of capital.

5. Will stand-alone SBSDs seek to effect transactions in securities OTC derivatives products other than security-based swaps, such as OTC options, that would necessitate registration as a broker-dealer? If so, would registering as a limited purpose broker-dealer under the provisions applicable to OTC derivatives dealers provide a workable alternative to registering as a full-service broker-dealer? For example, would there be conflicts between the proposed capital, margin, and segregation requirements for SBSDs and the existing requirements for OTC derivatives dealers? If so, identify the conflicts.
6. Should the requirements for OTC derivatives dealers be amended (by exemptive relief or otherwise) to accommodate firms that want to deal in security-based swaps? If so, explain how the requirements should be amended and why.
7. Should the Commission exempt nonbank SBSDs engaged in activities with respect to securities OTC derivatives products other than security-based swaps from any requirements applicable to OTC derivatives dealers? Please identify which requirements and explain why.
8. As discussed below, the proposed minimum net capital requirements would differ substantially for stand-alone SBSDs that are approved to use models in computing net capital (i.e., a $20 million fixed-dollar minimum net capital requirement and $100 million tentative net capital requirement) compared to broker-dealer SBSDs approved to use models (i.e., a $1 billion fixed-dollar minimum net capital requirement and $5 billion tentative net capital requirement). In general, because the definition of "security-based swap dealer" in the Dodd-Frank Act does not include acting as a broker or agent in security-based swaps, entities engaging in brokerage activities with respect to security-based swaps could be required to register as broker-dealers. To the extent these broker-

dealer SBSDs wanted to use models to compute net capital, they would be subject to the higher minimum net capital requirements. Accordingly, in order to avoid being subject to higher minimum net capital requirements applicable to broker-dealer SBSDs approved to use models to compute net capital, a stand-alone SBSD may need to limit the activity it could conduct on behalf of customers so that it does not fall within the definition of a "broker" under the Exchange Act and, thereby, need to register as a broker-dealer. Commenters are requested to address this issue, including any potential changes to the proposed capital requirements for stand-alone SBSDs and broker-dealer SBSDs discussed below. For example, should broker-dealer SBSDs approved to use internal models to compute net capital and that register as broker-dealers only in order to conduct brokerage activities with respect to security-based swaps, and that do not conduct a general business in securities with customers, be subject to the minimum net capital requirements applicable to stand-alone SBSDs approved to use internal models? If so, explain why. If not, explain why not. If different capital standards would be appropriate, explain the appropriate capital standard that should apply to this class of broker-dealer SBSDs and whether any limitations should apply, including with respect to the types of broker activities in which the nonbank SBSD may engage in order to qualify for a particular capital treatment. Alternatively, or in addition, should the Commission allow OTC derivatives dealers (which are subject to a $20 million fixed-dollar minimum net capital requirement and $100 million tentative net capital requirement) to be dually registered as nonbank SBSDs and/or amend the rules for OTC derivatives dealers to conduct a broader range of activities than are currently permitted? If the Commission took this action, should it also remove the exemption for OTC derivatives dealers from membership in a self-regulatory organization ("SRO")?

9. Describe the types of entities that may need to register as MSBSPs and how the activities that these entities engage in would impact the entity's capital position.

10. Should nonbank MSBSPs be subject to a net liquid assets test capital standard (in contrast to a tangible net worth test)? If so, explain why. If not, explain why not.

2. Proposed Capital Rules for Nonbank SBSDs

As discussed in detail below, proposed new Rule 18a-1 would prescribe capital requirements for stand-alone SBSDs and amendments to Rule 15c3-1 would prescribe capital requirements for broker-dealer SBSDs. Proposed new Rule 18a-1 would require a stand-alone SBSD to compute net capital using standardized haircuts prescribed in the rule (including standardized haircuts specifically for security-based swaps and swaps) or, alternatively, with Commission approval, to use internal models for positions for which the stand-alone SBSD has been approved to use internal models. Under the proposed amendments to Rule 15c3-1, a broker-dealer SBSD would be required to use the existing standardized haircuts in the rule plus proposed new additional standardized haircuts specifically for security-based swaps and swaps. A broker-dealer SBSD that seeks to compute net capital using internal models would need to apply to the Commission for approval to operate as an ANC broker-dealer. A nonbank SBSD permitted to use internal models to compute net capital (whether a stand-alone SBSD subject to proposed new Rule 18a-1 or an ANC broker-dealer subject to Rule 15c3-1, as amended) would need to comply with additional requirements as compared to a nonbank SBSD that is not approved to use internal models. This would be consistent with the existing requirements in Rule 15c3-1, which impose additional requirements on ANC broker-dealers and OTC derivatives dealers as compared with other broker-dealers.[55] Finally, the amendments to Rule 15c3-1 would apply to broker-dealers that are not registered as SBSDs to the extent they hold positions in security-based swaps and swaps.

a. Computing Required Minimum Net Capital

Rule 15c3-1 prescribes the minimum net capital requirement for a broker-dealer as the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of aggregate debit items ratio.[56] The proposed capital requirements for nonbank SBSDs would use a similar framework. Under the proposals, there would be different minimum net capital requirements for stand-alone SBSDs that are not approved to use internal models, broker-dealer SBSDs that are not approved to use internal models, stand-alone SBSDs that are approved to use internal models, and broker-dealer SBSDs that are approved to use internal models (i.e., ANC broker-dealers). The following table provides a summary of the proposed minimum net capital requirements, which are discussed in the following sections.

Proposed Minimum Capital Requirements

Type of Registrant	Tentative Net Capital	Net Capital	
		Fixed Dollar	Financial Ratio
Stand-alone SBSD (not using internal models)	N/A	$20 million	8% margin factor
Stand-alone SBSD (using internal models)	$100 million	$20 million	8% margin factor
Broker-dealer SBSD (not using internal models)	N/A	$20 million	8% margin factor + Rule 15c3-1 ratio
Broker-dealer SBSD (using internal models)	$5 billion	$1 billion	8% margin factor + Rule 15c3-1 ratio

55 See, e.g., 17 CFR 240.15c3-1(a)(5) and (a)(7); 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f; 17 CFR 240.15c3-4.

56 See 17 CFR 240.15c3-1(a).

i. Stand-alone SBSDs Not Using Internal Models

A stand-alone SBSD would be subject to the capital requirements set forth in proposed new Rule 18a-1. Under this proposed new rule, a stand-alone SBSD that is not approved to use internal models to compute haircuts would be required to maintain minimum net capital of not less than the greater of $20 million or 8% of the firm's risk margin amount ("8% margin factor").[57] The term risk margin amount would be defined as the sum of: (1) the greater of the total margin required to be delivered by the nonbank SBSD with respect to security-based swap transactions cleared for security-based swap customers at a clearing agency or the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to paragraph (c)(1)(vi) of Rule 18a-1; and (2) the total margin amount calculated by the stand-alone SBSD with respect to non-cleared security-based swaps pursuant to proposed new Rule 18a-3.[58] Accordingly, to determine its minimum net capital requirement, a stand-alone SBSD would need to calculate the amount equal to the 8% margin factor.[59] The firm's minimum net capital requirement would be the greater of $20 million or the amount equal to the 8% margin factor.[60]

The proposed $20 million fixed-dollar minimum requirement would be the same as the fixed-dollar minimum requirement applicable to OTC derivatives dealers and already familiar to existing market participants.[61] OTC derivatives dealers are limited purpose broker-dealers that

57 See paragraph (a)(1) of proposed new Rule 18a-1. The rationales for these minimum requirements are discussed below.

58 See paragraph (c)(6) of proposed new Rule 18a-1. The components of the risk margin amount are discussed in detail below.

59 See paragraphs (a)(1) and (c)(6) of proposed new Rule 18a-1.

60 See paragraph (a)(1) of proposed new Rule 18a-1.

61 See 17 CFR 240.15c3-1(a)(5). The CFTC proposed a $20 million fixed-dollar minimum net capital requirement for FCMs that are registered as swap dealers, regardless of whether the firm is approved to use internal models to compute regulatory capital. See CFTC Capital Proposing Release, 76 FR 27802.

are authorized to trade in certain derivatives, including security-based swaps, and to use internal models to calculate net capital. They are required to maintain minimum tentative net capital of $100 million and minimum net capital of $20 million.[62] These current fixed-dollar minimums have been the minimum capital standards for OTC derivative dealers for over a decade, and are substantially lower than the fixed-dollar minimums in Rule 15c3-1 currently applicable to ANC broker-dealers, which use internal models to calculate net capital.[63] In addition, available data regarding the current population of broker-dealers suggests that these minimums would not prevent new entrants in the security-based swap market.[64] To date, there have been no indications that these minimums are not adequately meeting the objective of requiring OTC derivatives dealers to maintain sufficient levels of regulatory capital to account for the risks inherent in their activities.

At the same time, the proposed $20 million fixed-dollar minimum requirement for stand-alone SBSDs that do not use internal models to calculate net capital would be substantially higher than the fixed-dollar minimums in Rule 15c3-1 currently applicable to broker-dealers that

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Further, the CFTC proposed a $20 million fixed-dollar "tangible net equity" minimum requirement for swap dealers and major swap participants that are not FCMs <u>and are not</u> affiliated with a U.S. bank holding company. Finally, the CFTC proposed a $20 million fixed-dollar Tier 1 capital minimum requirement for swap dealers and major swap participants that are not FCMs <u>and are</u> affiliated with a U.S. bank holding company (the term "Tier 1 capital" refers to the regulatory capital requirement for U.S. banking institutions). Id.

62 See 17 CFR 240.15c3-1(a)(5). When adopting the capital requirements for OTC derivatives dealers, the Commission stated "[t]he minimum tentative net capital and net capital requirements are necessary to ensure against excessive leverage and risks other than credit or market risk, all of which are now factored into the current haircuts. Further, while the mathematical assumptions underlying VaR may be useful in projecting possible daily trading losses under 'normal' market conditions, VaR may not help firms measure losses that fall outside of normal conditions, such as during steep market declines. Accordingly, the minimum capital requirements provide additional safeguards to account for possible extraordinary losses or decreases in liquidity during times of stress which are not incorporated into VaR calculations." See OTC Derivatives Dealers, 63 FR 59362.

63 Paragraph (a)(7) of Rule 15c3-1 currently requires that ANC broker-dealers at all times maintain tentative net capital of not less than $1 billion and net capital of not less than $500 million. 17 CFR 240.15c3-1(a)(7).

64 See infra section V.B.2.a.i. of this release (economic analysis discussion based on year-end 2011 data showing that approximately 270 broker-dealers maintain net capital of $20 million or more).

do not use internal models (i.e., that are not ANC broker-dealers or OTC derivatives dealers).[65] Under the proposals, stand-alone SBSDs that do not use models would not be able to avail themselves of such minimums and would be subject to the same $20 million minimum net capital requirement as OTC derivatives dealers, even though they would not be using models like such derivatives dealers. In other words, the same minimum net capital requirement will apply to stand-alone SBSDs regardless of whether or not they use models.

This level of minimum capital may be appropriate because of the nature of the business of a stand-alone SBSD and the differences from the business of a broker-dealer or OTC derivatives dealer. Generally, OTC derivatives, such as security-based swaps, are contracts between a dealer and its counterparty. Consequently, the counterparty's ability to collect amounts owed to it under the contract depends on the financial wherewithal of the dealer. In contrast, the returns on financial instruments held by a broker-dealer for an investor (other than a derivative issued by the broker-dealer) are not linked to the financial wherewithal of the broker-dealer holding the instrument for the customer. Accordingly, if a stand-alone SBSD fails, the counterparty may not be able to liquidate the contract or replace the contract with a new counterparty without incurring a loss on the position. The entities that will register and operate as nonbank SBSDs should be sufficiently capitalized to minimize the risk that they cannot meet their obligations to counterparties, particularly given that the counterparties will not be limited to other dealers but will include customers and other counterparties as well.

In addition, stand-alone SBSDs will not be subject to the same limitations that apply to

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65 For example, a broker-dealer that carries customer accounts has a fixed-dollar minimum requirement of $250,000; a broker-dealer that does not carry customer accounts but engages in proprietary securities trading (defined as more than ten trades a year) has a fixed-dollar minimum requirement of $100,000; and a broker-dealer that does not carry accounts for customers or otherwise does not receive or hold securities and cash for customers, and does not engage in proprietary trading activities, has a fixed-dollar minimum requirement of $5,000. See 17 CFR 240.15c3-1(a)(2).

OTC derivative dealers in effecting transactions with customers and engaging in dealing activities.[66] Therefore, the failure of a stand-alone SBSD could have a broader adverse impact on a larger number of market participants, including customers and counterparties.[67] The proposed capital requirements for this group of firms, in part, are meant to account for this potential broader impact on market participants.[68]

Consequently, stand-alone SBSDs that do not use internal models would be subject to the same $20 million fixed-dollar minimum net capital requirement that applies to OTC derivatives dealers. The same firms would not, however, be subject to a minimum tentative net capital requirement, which is applied to firms that use internal models to account for risks that may not be fully captured by the models.[69]

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66 See 17 CFR 240.3b-12; 17 CFR 240.15a-1. Rule 3b-12, defining the term OTC derivatives dealer, provides, among other things, that an OTC derivatives dealer's securities activities must be limited to: (1) engaging in dealer activities in eligible OTC derivative instruments (as defined in the rule) that are securities; (2) issuing and reacquiring securities that are issued by the dealer, including warrants on securities, hybrid securities, and structured notes; (3) engaging in cash management securities activities (as defined in Rule 3b-14 (17 CFR 240.3b-14)); (4) engaging in ancillary portfolio management securities activities (as defined in the rule); and (5) engaging in such other securities activities that the Commission designates by order. See 17 CFR 240.3b-12. Rule 15a-1, governing the securities activities of OTC derivatives dealers, provides that an OTC derivatives dealer must effect transactions in OTC derivatives with most types of counterparties through an affiliated Commission-registered broker-dealer that is not an OTC derivatives dealer. See 17 CFR 240.15a-1.

67 The proposal is consistent with the CFTC's proposed capital requirements for nonbank swap dealers, which impose $20 million fixed-dollar minimum requirements regardless of whether the firm is approved to use internal models to compute regulatory capital. See CFTC Capital Proposing Release, 76 FR 27802.

68 As discussed above, stand-alone SBSDs would be subject to a minimum ratio amount based on the 8% margin factor. OTC derivatives dealers are not subject to a minimum ratio amount.

69 OTC derivatives dealers are subject to a $100 million minimum tentative net capital requirement. ANC broker-dealers are currently subject to a $1 billion minimum tentative net capital requirement. The minimum tentative net capital requirements are designed to address risks that may not be captured when using internal models rather than standardized haircuts to compute net capital. See OTC Derivatives Dealers, 63 FR at 59384; Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities; Proposed Rule, Exchange Act Release No. 48690 (Oct. 24, 2003), 68 FR 62872, 62875 (Nov. 6, 2003) ("We expect that net capital charges will be reduced for broker-dealers that use the proposed alternative net capital computation. The present haircut structure is designed so that firms will have a sufficient capital base to account for, in addition to market and credit risk, other types of risk, such as operational risk, leverage risk, and liquidity risk. Raising the minimum tentative net capital requirement to $1 billion and net capital requirement to $500 million is one way to ensure that firms that use the alternative capital computation maintain sufficient capital reserves to account for these other risks.

The proposed 8% margin factor would be part of determining the stand-alone SBSD's minimum net capital requirement. As noted above, the stand-alone SBSD would determine this amount by adding:

- The greater of the total margin required to be delivered by the stand-alone SBSD with respect to security-based swap transactions cleared for security-based swap customers at a clearing agency or the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to paragraph (c)(1)(vi) of Rule 18a-1;[70] and

- The total margin amount calculated by the stand-alone SBSD with respect to non-cleared security-based swaps pursuant to paragraph (c)(1)(i)(B) of proposed new Rule 18a-3.[71]

The total of these two amounts – i.e., the risk margin amount – would be multiplied by 8% to determine the amount of the 8% margin factor, which, if greater than the $20 million fixed-dollar amount, would be the stand-alone SBSD's minimum net capital requirement.[72] This

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In addition, based on our experience, firms must have this scale of operations in order to have developed internal risk management control systems necessary to support reliable VaR computations.").

70 See paragraph (c)(6) of proposed new Rule 18a-1. As discussed below in section II.B. of this release, nonbank SBSDs will be subject to margin requirements imposed by clearing agencies pursuant to which nonbank SBSDs will be required to collect collateral from customers relating to the customers' cleared security-based swap transactions. The amount of collateral required to be collected as a result of customers' cleared security-based swap transactions would be used to determine the first component of the risk margin amount. This amount would be added to the second component of the risk margin amount relating to non-cleared security-based swaps and that amount would be multiplied by 8% to determine the 8% margin factor. However, if the margin requirements of the clearing agencies require the stand-alone SBSD to collect total collateral in an amount that is less than the deductions the firm would apply to the customers' cleared security-based swap positions under proposed new Rule 18a-1, the stand-alone SBSD would need to add the amount of the deductions to the second component of the risk margin amount relating to non-cleared security-based swaps and multiply that amount by 8% to determine the 8% margin factor.

71 See paragraph (c)(6) of proposed new Rule 18a-1. As discussed below in section II.B. of this release, proposed new Rule 18a-3 would establish margin requirements for nonbank SBSDs with respect to non-cleared security-based swaps. See proposed new Rule 18a-3. The proposed rule would define the term margin to mean the amount of positive equity in an account of a counterparty. See paragraph (b)(5) of proposed new Rule 18a-3. Under the proposed rule, a nonbank SBSD would be required to calculate daily a margin amount for the account of each counterparty to a non-cleared security-based swap. See paragraph (c)(1)(i)(B) of proposed new Rule 18a-3. These calculations of counterparty margin amounts for the purposes of proposed new Rule 18a-3 would be used to determine the component of the risk margin amount relating to non-cleared security-based swaps. This amount would be added to the first component relating to cleared security-based swaps, and the total amount would be multiplied by 8% to determine the 8% margin factor.

72 See paragraphs (a)(1) and (c)(6) of proposed new Rule 18a-1.

proposed 8% margin factor ratio requirement is similar to an existing requirement in the CFTC's net capital rule for FCMs.[73] Further, the CFTC has proposed a similar requirement for swap dealers and major swap participants registered as FCMs.[74] Under the CFTC's proposal, an FCM would be required to maintain adjusted net capital that is equal to or greater than 8% of the risk margin required for customer and non-customer exchange-traded futures and swaps positions that are cleared by a derivatives clearing organization ("DCO").[75] The CFTC's proposed 8% of margin, or risk-based capital rule, "is intended to require FCMs to maintain a minimum level of capital that is associated with the level of risk associated with the customer positions that the FCM carries."[76] Based on Commission staff experience with dually-registered broker-dealer/FCMs, the Commission preliminarily believes that the 8% margin factor would serve as a reasonable measure to ensure that a firm's minimum capital requirement increases or decreases in tandem with the level of risk arising from customer futures transactions. Consequently, the 8% margin factor is being proposed to provide a similar adjustable minimum net capital requirement for nonbank SBSDs with respect to their security-based swap activity.[77]

73 See 17 CFR 1.17(a)(1)(i)(B). See also Minimum Financial and Related Reporting Requirements for Futures Commission Merchants and Introducing Brokers, 69 FR 49784 (Aug. 12, 2004). The CFTC proposed the 8% risk margin requirement to establish a margin-based capital computation identical to the margin-based minimum net capital computation that several futures self-regulatory organizations, including one derivatives clearing organization, adopted for their respective member-FCMs. Id. at note 16.

74 See CFTC Capital Proposing Release, 76 FR 27802. The 8% risk margin calculation under the CFTC's proposal relates to cleared swaps or futures transactions, whereas the 8% margin factor proposed in new Rule 18a-1 would be based on cleared and non-cleared security-based swaps. As discussed below, the proposed minimum net capital requirement is based on a nonbank SBSD's cleared and non-cleared security-based swap activity in order to account for the risks of both types of positions.

75 See CFTC Capital Proposing Release, 76 FR 27802.

76 Id. at 27807.

77 As discussed below in section II.A.2.b.iv. of this release, an 8% multiplier is used for purposes of calculating credit risk charges under Appendix E to Rule 15c3-1. While this is a different calculation than the proposed 8% margin factor, using an 8% multiplier for purposes of computing regulatory capital requirements is an international standard. See Alternative Net Capital Requirements Adopting Release, 69 FR 34428, note 42 (describing the 8% multiplier in Appendix E to Rule 15c3-1 as being "consistent with the calculation of credit risk in the OTC derivatives dealers rules and with the Basel Standard" and as being "designed to dampen leverage to help ensure that the firm maintains a safe level of capital.").

Under the proposed rule, nonbank SBSDs – including stand-alone SBSDs that are not approved to use internal models to calculate net capital – would be subject to a minimum net capital requirement that increases in tandem with an increase in the risks associated with nonbank SBSD's security-based swap activities.[78] Without the 8% margin factor, the minimum net capital requirement for a nonbank SBSD would be the same (i.e., $20 million) regardless of the volume, size, and risk of its outstanding security-based swap transactions.

The amount computed under the 8% margin factor generally would increase as the stand-alone SBSD increased the volume, size, and risk of its security-based swap transactions. Specifically, the proposed definition of the term risk margin amount is designed to link the stand-alone SBSD's minimum net capital requirement to its cleared and non-cleared security-based swap activity. For example, the definition in proposed new Rule 18a-1 provides that, for cleared security-based swaps, the amount is the greater of the margin required to be collected or the amount of the deductions that would apply pursuant to proposed new Rule 18a-1 (i.e., the amount of the deductions using standardized haircuts).[79] The margin requirement for cleared security-based swap positions generally should increase with the volume, size, and risk of the positions as would the amount of the standardized haircuts applicable to the positions. Further, the "greater of" provision is designed to ensure that the 8% margin factor requirement is based on, at a minimum, the standardized haircuts as these provide a uniform approach for all cleared security-based swaps, whereas margin requirements for cleared security-based swaps will vary over time and across different clearing agencies.

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78 As discussed below in sections II.A.2.a.ii., II.A.2.a.iii., and II.A.2.a.iv. of this release, the 8% margin factor would be used to compute the minimum net capital requirement for all nonbank SBSDs.

79 For a stand-alone SBSD approved to use internal models and an ANC broker-dealer, it would be the amount of the deductions determined using a VaR model, except for types of positions for which the firm has not been approved to use a VaR model.

As proposed, the 8% margin factor is determined using the greater of required margin or standardized haircuts with respect to cleared security-based swaps plus the margin amount for non-cleared security-based swaps calculated under proposed new Rule 18a-3.[80] Thus, the 8% margin factor would be based on a stand-alone SBSD's activity in both cleared and non-cleared security-based swaps. As noted above, the goal of the provision is to require the stand-alone SBSD to increase its net capital in tandem with an increase in the risk of its security-based swap transactions. The proposal does not limit the computation to only cleared security-based swaps, as proposed by the CFTC, because such a limitation would allow the stand-alone SBSD to increase the amount of its non-cleared security-based swaps positions without a corresponding increase in net capital. This could create greater risk to the stand-alone SBSD's customers because – as discussed above – their ability to collect amounts owing on security-based swaps depends on the ability of the stand-alone SBSD to meets its obligations.

Request for Comment

The Commission generally requests comment on the proposed minimum net capital requirements in proposed new Rule 18a-1 for stand-alone SBSDs that are not approved to use internal models to compute net capital. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

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80 Proposed new Rule 18a-3 would require a nonbank SBSD to calculate daily a margin amount for the account of each counterparty to a non-cleared security-based swap. See paragraph (c)(1)(i)(B) of proposed new Rule 18a-3. As discussed below in section II.B. of this release, a nonbank SBSD would be required to perform this calculation even though proposed new Rule 18a-3 would not require the nonbank SBSD to collect collateral from all counterparties to collateralize the margin amount. For example, the Commission is proposing that collateral need not be collected from commercial end users. Nonetheless, the calculation of the margin amount for purposes of proposed new Rule 18a-3 would determine the non-cleared security-based swap component of the risk margin amount regardless of whether the nonbank SBSD would be required to collect collateral from the counterparty to collateralize the margin amount. In other words, the amount of the risk margin amount would be based on the calculation required by proposed new Rule 18a-3 for all counterparties to non-cleared security-based swaps and not on whether the stand-alone SBSD would be required to collect collateral from a counterparty to collateralize the margin amount. As discussed in section II.B. of this release, this is designed to ensure that the risk margin amount is based on all non-cleared security-based swap activity of the stand-alone SBSD and not just on security-based swap activity that would require the firm to collect collateral.

1. Is the proposed $20 million minimum net capital requirement for stand-alone SBSDs not using internal models appropriate? If not, explain why not. What minimum amount would be more appropriate? For example, should the minimum fixed-dollar amount be greater than $20 million to account for the broader range of activities that stand-alone SBSDs will be able to engage in as compared with OTC derivatives dealers? If so, explain why. If it should be a greater amount, how much greater should it be (e.g., $30 million, $50 million, $100 million, or some other amount)? Alternatively, should the minimum fixed-dollar amount be less than $20 million because these firms will not be using internal models to compute net capital? If so, explain why. If it should be a lower amount, how much lower (e.g., $15 million, $10 million, $5 million, or some other amount)? If a greater or lesser alternative amount is recommended, explain why it would be more appropriate for broker-dealer SBSDs that are not approved to use internal models.
2. Is the proposed definition of risk margin amount appropriate? If not, explain why and suggest modifications to the definition. For example, are there modifications that could make the definition more accurately reflect the nonbank SBSD's risk exposure from dealing in security-based swaps? If so, describe the modifications and explain why they would achieve this result.
3. Is the component of the risk margin amount definition addressing margin delivered for cleared swaps appropriate? If not, explain why not. Would the definition be more appropriate if this component was dropped so that the first prong of the definition only incorporated the haircuts for cleared security-based swaps?

4. Should the proposed definition of risk margin amount only address cleared security-based swaps, consistent with the CFTC's proposal? If so, explain why, including how the risk of non-cleared security-based swap activities could be addressed through other measures.
5. Is the component of the risk margin amount definition addressing margin collected for non-cleared security-based swaps appropriate? If not, explain why not.
6. Is the 8% margin factor an appropriate metric for determining a nonbank SBSD's minimum net capital requirement in terms of increasing a nonbank SBSD's minimum net capital requirement as the risk of its security-based swap activities increases? If not, explain why not. For example, should the percentage be greater than 8% (e.g., 10%, 12%, or some other percentage)? If so, identify the percentage and explain why it would be preferable. Should the percentage be less than 8% (e.g., 6%, 4%, or some other percentage)? If so, identify the percentage and explain why it would be preferable.
7. Should the 8% multiplier be tiered as the amount of the risk margin amount increases? If so, explain why. For example, should the multiplier decrease from 8% to 6% for the amount of the risk margin amount that exceeds a certain threshold, such as $1 billion or $5 billion? If so, explain why. Should the amount of the multiplier increase from 8% to 10% for the amount of the risk margin amount that exceeds a certain threshold such as $1 billion or $5 billion? If so, explain why.
8. Should the 8% margin factor be an adjustable ratio (e.g., increase to 10% or decrease to 6%)? For example, should the multiplier adjust periodically if certain conditions occur? If so, explain the conditions under which the 8% multiplier would adjust upward or downward and why having an adjustable ratio would be appropriate.
9. Would the 8% margin factor be a sufficient minimum net capital requirement without the

$20 million fixed-dollar minimum? If so, explain why.

10. Are there metrics other than a fixed-dollar minimum and the 8% margin factor for calculating required minimum capital that would more appropriately reflect the risk of nonbank SBSDs? If so, identify them and explain why they would be preferable. For example, instead of an absolute fixed-dollar minimum, should the minimum net capital requirement be linked to a scalable metric such as the size of the nonbank SBSD or the amount of the deductions taken by the nonbank SBSD when computing net capital? For any scalable minimum net capital requirements identified, explain how the computation would work in practice and how the minimum requirement would address the same objectives of a fixed-dollar minimum.

11. Would the 8% margin factor address the risk of extremely large nonbank SBSDs? If not, explain why not. For example, if the customer margin requirements for cleared and non-cleared security-based swaps carried by the nonbank SBSD were low because the positions were hedged or otherwise not high risk, the 8% margin factor may not increase in tandem with the level of the nonbank SBSD's security-based swap activity. In this case, would the 8% margin factor adequately address the risk of the nonbank SBSD, particularly if it carried substantial security-based swap positions? If not, explain why not. Would the 8% margin factor be necessary for small nonbank SBSDs? If not, explain why not.

12. Would the 8% margin factor provide an appropriate and workable restraint on the amount of leverage incurred by stand-alone SBSDs not using internal models because the amount of minimum net capital would increase as the risk margin amount increases? If not, explain why not. Is there another measure that would more accurately and effectively

address the leverage risk of these firms? If so, identify the measure and explain why it would be more accurate and effective.

13. Should the 8% margin factor be applied to margin related to cleared and non-cleared swap transactions in addition to security-based swap transactions? For example, the provision could require that 8% of the margin required for cleared and non-cleared swaps be added to the 8% of margin required for cleared and non-cleared security-based swaps in determining the minimum net capital requirement. Would this be a workable approach to address the fact that the CFTC's proposed 8% margin requirement would not apply to swap dealers that are not registered as FCMs and, with respect to dually-registered FCM swap dealers, it would apply only to cleared swaps? Including swaps in the 8% margin factor calculation would provide for equal treatment of security-based swaps and swaps in determining a minimum net capital requirement. Would this be a workable approach? If so, explain why. If not, explain why not.

14. Would the 8% margin factor be practical as applied to a portfolio margin account that contains security-based swaps and swaps? If so, explain why. If not, explain why not.

15. What will be the practical impacts of the 8% margin factor? For example, what will be the effect on transaction costs, liquidity in security-based swaps, availability of capital to support security-based swap transactions generally and/or for non-security-based swap-related uses, use of security-based swaps for hedging purposes, risk management at SBSDs, the costs for potential new SBSDs to participate in the security-based swap markets, etc.? How would these impacts increase or decrease if the 8% margin factor were set at a higher or lower percentage?

ii. Broker-Dealer SBSDs Not Using Internal Models

A broker-dealer that registers as an SBSD would continue to be subject to the capital requirements in Rule 15c3-1, as proposed to be amended to account for security-based swap activities. Proposed amendments to paragraph (a) of Rule 15c3-1 would establish minimum net capital requirements for a broker-dealer SBSD that is not approved to use internal models to compute net capital.[81] Under these proposed amendments, the broker-dealer SBSD would be subject to the same $20 million fixed-dollar minimum net capital requirement as a stand-alone SBSD that does not use internal models.[82] As discussed above in section II.A.2.a.i. of this release, the proposed $20 million fixed-dollar minimum would be consistent with the current fixed-dollar minimum that applies to OTC derivatives dealers, which has been used as a minimum capital standard for OTC derivative dealers for over a decade.

In addition, a broker-dealer SBSD that does not use internal models would be required to use the 8% margin factor to compute its minimum net capital amount. As discussed above in section II.A.2.a.i. of this release, the 8% margin factor is designed to adjust the broker-dealer SBSD's minimum net capital requirement in tandem with the risk associated with the broker-dealer SBSD's security-based swap activity. Without the 8% margin factor, the minimum net capital requirement for a broker-dealer SBSD would be the same (i.e., $20 million) regardless of the number, size, and risk of its outstanding security-based swap transactions. Consequently, the proposed rule would include the 8% margin factor in order to increase the broker-dealer SBSD's net capital requirement as the risk of its security-based swap activities increases.

Moreover, the broker-dealer SBSD – as a broker-dealer – would be subject to the existing financial ratio requirements in Rule 15c3-1 and, therefore, would need to include the applicable

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81 See proposed new paragraph (a)(10) of Rule 15c3-1.

82 Id.

financial ratio amount when determining the firm's minimum net capital requirement.[83] A broker-dealer's minimum net capital requirement is the greater of the applicable fixed-dollar amount and one of two alternative financial ratios. The first financial ratio requirement provides that a broker-dealer must not permit its aggregate indebtedness to all other persons to exceed 1500% of its net capital (i.e., a 15-to-1 aggregate indebtedness to net capital requirement).[84] This is the default financial ratio requirement that all broker-dealers must apply unless they affirmatively elect to be subject to the second financial ratio requirement by notifying their designated examining authority of the election.[85] The second financial ratio requirement provides that a broker-dealer must not permit its net capital to be less than 2% of aggregate debit items (i.e., customer-related obligations to the broker-dealer).[86]

The proposed amendments to Rule 15c3-1 would provide that a broker-dealer SBSD that is not approved to use internal models would be required to maintain a minimum net capital level of not less than the greater of: (1) $20 million or (2) the financial ratio amount required pursuant to paragraph (a)(1) of Rule 15c3-1 plus the 8% margin factor.[87] Thus, the proposed minimum net capital requirement for a broker-dealer SBSD would incorporate the requirement in Rule 15c3-1 that a broker-dealer maintain the greater of a fixed-dollar amount or one of the two

83 See 17 CFR 240.15c3-1(a)(1); proposed new paragraph (a)(10)(i) of Rule 15c3-1. Currently, all broker-dealers, including the ANC broker-dealers, are subject either to the aggregate indebtedness standard or the aggregate debit items (alternative standard) financial ratio requirements.

84 See 17 CFR 240.15c3-1(a)(1)(i). Stated another way, the broker-dealer must maintain, at a minimum, an amount of net capital equal to 1/15th (or 6.67%) of its aggregate indebtedness. This financial ratio generally is used by smaller broker-dealers that do not hold customer securities and cash.

85 See 17 CFR 240.15c3-1(a)(1)(i)-(ii).

86 See 17 CFR 240.15c3-1(a)(1)(ii). Customer debit items – computed pursuant to Rule 15c3-3 – consist of, among other things, margin loans to customers and securities borrowed by the broker-dealer to effectuate deliveries of securities sold short by customers. See 17 CFR 240.15c3-3; 17 CFR 240.15c3-3a. This ratio generally is used by larger broker-dealers that hold customer securities and cash.

87 See proposed new paragraph (a)(10)(i) of Rule 15c3-1.

financial ratio amounts, as applicable.[88] The financial ratio requirements in Rule 15c3-1 are designed to link the broker-dealer's minimum net capital requirement to the level of its securities activities. For example, the aggregate debit ratio requirement is designed for broker-dealers that carry customer securities and cash.[89] This provision increases the minimum net capital requirement for these broker-dealers as they increase their debit items by engaging in margin lending and facilitating of customer short-sale transactions.[90] The proposal to combine the Rule 15c3-1 financial ratios with the 8% margin factor in a broker-dealer SBSD's computation of its minimum net capital requirement is designed to require the broker-dealer SBSD to maintain a capital cushion to support its traditional securities activities (e.g., margin lending) and its security-based swap activities.

Request for Comment

The Commission generally requests comment on the proposed minimum net capital requirements for broker-dealer SBSDs that are not approved to use internal models. Commenters are referred to the general questions above in section II.A.2.a.i. of this release about the 8% margin factor as applied broadly to nonbank SBSDs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is the proposed $20 million minimum net capital requirement appropriate for broker-dealer SBSDs that are not approved to use internal models? If not, explain why not. What minimum amount would be more appropriate? For example, should the minimum fixed-dollar amount be greater than $20 million to account for the broader range of

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88 Id.

89 See Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 17208 (Oct. 9, 1980), 45 FR 69915 (Oct. 22, 1980).

90 See 17 CFR 240.15c3-1(a)(1)(ii); 17 CFR 240.15c3-3a.

activities that broker-dealer SBSDs will be able to engage in (e.g., traditional securities activities such as margin lending), as compared with stand-alone SBSDs and OTC derivatives dealers? If it should be a greater amount, how much greater should it be (e.g., \$30 million, \$50 million, \$100 million, or some other amount)? Alternatively, should the minimum fixed-dollar amount be less than \$20 million because these firms will not be using internal models to compute net capital? If it should be a lower amount, how much lower (e.g., \$15 million, \$10 million, \$5 million or some other amount)? If a greater or lesser alternative amount is recommended, explain why it would be preferable for broker-dealer SBSDs that are not approved to use internal models.

2. Is combining the 8% margin factor requirement with the applicable Rule 15c3-1 financial ratio requirement an appropriate way to determine a minimum net capital requirement for broker-dealer SBSDs that are not approved to use internal models? If not, explain why not.

3. Would the 8% margin factor combined with the Rule 15c3-1 financial ratio provide an appropriate and workable restraint on the amount of leverage incurred by broker-dealer SBSDs not using internal models? If not, explain why not. Is there another measure that would more accurately and effectively address the leverage risk of these firms? If so, identify the measure and explain why it would be more accurate and effective.

iii. Stand-alone SBSDs Using Internal Models

As discussed above, a stand-alone SBSD would be subject to the capital requirements in proposed new Rule 18a-1.[91] Rule 18a-1 would permit stand-alone SBSDs to apply to use

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91 See proposed new Rule 18a-1.

internal models to compute net capital.[92] In terms of minimum capital requirements, a stand-alone SBSD that has been approved to use internal models would be required to maintain: (1) a minimum tentative net capital level of not less than $100 million; and (2) a minimum net capital level of not less than the greater of $20 million or the 8% margin factor.[93] The proposed minimum net capital requirement for stand-alone SBSDs using internal models (i.e., the greater of $20 million or the 8% margin factor) is the same as the proposed minimum net capital requirement for stand-alone SBSDs and broker-dealer SBSDs not using internal models (though the latter would need to incorporate the Rule 15c3-1 financial ratio requirement into their minimum net capital computations).

A stand-alone SBSD approved to use internal models also would be subject to a minimum tentative net capital requirement of $100 million.[94] This proposed minimum tentative net capital requirement would be consistent with the current minimum tentative net capital requirement applicable to OTC derivatives dealers.[95] A minimum tentative net capital requirement is designed to operate as a prudential control on the use of internal models for regulatory capital purposes.[96] Tentative net capital is the amount of net capital maintained by a

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92 See paragraphs (a)(2) and (d) of proposed new Rule 18a-1; the discussion below in section II.A.2.b.iii. of this release.

93 See paragraph (a)(2) of proposed Rule 18a-1. As discussed above in section II.A.2.a.i. of this release, the 8% margin factor is designed to adjust the stand-alone SBSD's minimum net capital requirement in tandem with the risk associated with the broker-dealer firm's security-based swap activity.

94 See paragraph (a)(2) of proposed new Rule 18a-1.

95 Both ANC broker-dealers and OTC derivatives dealers – entities that use internal models – are subject to a minimum tentative net capital requirement. See 17 CFR 240.15c3-1(a)(5) and (a)(7).

96 OTC Derivatives Dealers, 63 FR at 59384 ("The final rule contains the minimum requirements of $100 million in tentative net capital and $20 million in net capital. The minimum tentative net capital and net capital requirements are necessary to ensure against excessive leverage and risks other than credit or market risk, all of which are now factored into the current haircuts. Further, while the mathematical assumptions underlying VaR may be useful in projecting possible daily trading losses under 'normal' market conditions, VaR may not help firms measure losses that fall outside of normal conditions, such as during steep market declines. Accordingly, the minimum capital requirements provide additional safeguards to account for possible extraordinary losses or decreases in liquidity during times of stress which are not incorporated into VaR calculations."). See also Alternative Net Capital Requirements Adopting Release, 69 FR at 34431

broker-dealer before applying the standardized haircuts or using internal models to determine deductions on the mark-to-market value of proprietary positions to arrive at the broker-dealer's amount of net capital.[97] OTC derivatives dealers, therefore, compute tentative net capital before using internal VaR models to take the market risk deductions. The minimum tentative net capital requirement is designed to account for the fact that VaR models, while more risk sensitive than standardized haircuts, tend to substantially reduce the amount of the deductions to tentative net capital in comparison to the standardized haircuts because the models recognize more offsets between related positions (i.e., positions that show historical correlations) than the standardized haircuts.[98] In addition, VaR models may not capture all risks and, therefore, having a minimum tentative net capital requirement (i.e., one that is not derived using the VaR model) is designed to require that capital be sufficient to withstand events that the model may not take into account (e.g., extraordinary losses or decreases in liquidity during times of stress that are not

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("The current haircut structure [use of the standardized haircuts] seeks to ensure that broker-dealers maintain a sufficient capital base to account for operational, leverage, and liquidity risk, in addition to market and credit risk. We expect that use of the alternative net capital computation [internal models] will reduce deductions for market and credit risk substantially for broker-dealers that use that method. Moreover, inclusion in net capital of unsecured receivables and securities that do not have a ready market under the current net capital rule will reduce the liquidity standards of Rule 15c3-1. Thus, the alternative method of computing net capital and, in particular, its requirements that broker-dealers using the alternative method of computing [sic] maintain minimum tentative net capital of at least $1 billion, maintain net capital of at least $500 million, notify the Commission that same day if their tentative net capital falls below $5 billion, and comply with Rule 15c3-4 are intended to provide broker-dealers with sufficient capital reserves to account for market, credit, operational, and other risks.") (Text in brackets added).

97 See 17 CFR 240.15c3-1(c)(10).

98 See OTC Derivatives Dealers, 63 FR 53962. See Net Capital Rule, Exchange Act Release No. 39456 (Dec. 17, 1997), 62 FR 68011 (Dec. 30, 1997) (concept release considering the extent to which statistical models should be used in setting the capital requirements for a broker-dealer's proprietary positions) ("For example, the current method of calculating net capital by deducting fixed percentages from the market value of securities can allow only limited types of hedges without becoming unreasonably complicated. Accordingly, the net capital rule recognizes only certain specified hedging activities, and the Rule does not account for historical correlations between foreign securities and U.S. securities or between equity securities and debt securities. By failing to recognize offsets from these correlations between and within asset classes, the fixed percentage haircut method may cause firms with large, diverse portfolios to reserve capital that actually overcompensates for market risk." Id. "The primary advantage of incorporating models into the net capital rule is that a firm would be able to recognize, to a greater extent, the correlations and hedges in its securities portfolio and have a comparatively smaller capital charge for market risk.").

incorporated into VaR calculations).[99] Consequently, the proposed $100 million minimum tentative net capital requirement is designed to provide a sufficient liquid capital cushion for stand-alone SBSDs that use models, just as it has done in practice for entities registered as OTC derivatives dealers.[100]

Request for Comment

The Commission generally requests comment on the proposed capital requirements for stand-alone SBSDs using internal models. Commenters are referred to the general questions above in section II.A.2.a.i. of this release about the 8% margin factor as applied broadly to nonbank SBSDs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is the proposed minimum net capital requirement of $20 million appropriate for stand-alone SBSDs that are approved to use internal models, in comparison to OTC derivatives dealers which are more limited by the activities they are permitted to conduct (such as being prohibited from effecting transactions with customers)? If not, explain why not. What minimum amount would be more appropriate? For example, should the minimum fixed-dollar amount be greater than $20 million to account for the use of internal models? If it should be a greater amount, how much greater should it be (e.g., $30 million, $50 million, $100 million, or some other amount)? Alternatively, should the minimum fixed-dollar amount be less than $20 million? If it should be a lower amount, how much lower (e.g., $15 million, $10 million, $5 million or some other amount)? If a greater or lesser

99 See OTC Derivatives Dealers, 63 FR 59362; Alternative Net Capital Requirements Adopting Release, 69 FR 34428. Further, the deductions to tentative net capital taken by nonbank SBSDs and broker-dealers are intended to create a pool of new liquid assets that can be used for any risk assumed by the firm and not only market risk. A tentative net capital requirement also serves as a capital buffer for these other risks to offset the narrower type of risk intended to be covered by calculating net capital using internal models.

100 OTC Derivatives Dealers, 63 FR 59362.

alternative amount is recommended, explain why it would be more appropriate for stand-alone SBSDs that are approved to use internal models.

2. Is it necessary to impose a minimum tentative net capital requirement for stand-alone SBSDs using internal models to capture additional risks not incorporated into VaR models (consistent with those tentative minimum met capital requirements imposed on OTC derivatives dealers)? If not, why not?

3. Is the proposed amount of the minimum tentative net capital level of $100 million for stand-alone SBSDs using internal models appropriate? If not, explain why not. For example, should the minimum tentative net capital amount be greater than $100 million to account for the use of internal models? If it should be a greater amount, how much greater should it be (e.g., $150 million, $200 million, $250 million, or some other amount)? Should it be a lesser amount (e.g., $75 million, $50 million, or some other amount)? If a greater or lesser alternative amount is recommended, explain why it would be more appropriate for stand-alone SBSDs that are approved to use internal models.

4. Are there metrics other than a fixed-dollar minimum tentative net capital requirement that would more appropriately reflect the risk of nonbank SBSDs? If so, identify them and explain why they would be preferable. For example, instead of an absolute fixed-dollar minimum tentative net capital requirement, should the minimum tentative net capital requirement be linked to a scalable metric such as the size of a nonbank SBSD? For any scalable minimum tentative net capital requirements identified, explain how the computation would work in practice and how the minimum requirement would address the same objectives of a fixed-dollar minimum. Would the 8% margin factor provide an appropriate and workable restraint on the amount of leverage incurred by stand-alone

SBSDs that are approved to use internal models? Is there another measure that would more accurately and effectively address the leverage risk of these firms? If so, identify the measure and explain why it would be more accurate and effective.

iv. Broker-Dealer SBSDs Using Internal Models and ANC Broker-Dealers

Under the current requirements of Rule 15c3-1, a broker-dealer that seeks to use internal models to compute net capital must apply to the Commission to become an ANC broker-dealer.[101] If the application is granted, the ANC broker-dealer is able to take less than 100% deductions for unsecured receivables from OTC derivatives counterparties (non-ANC broker-dealers must deduct these receivables in full) and can use VaR models in lieu of the standardized haircuts to take deductions on their proprietary positions in securities and money market instruments to the extent the firm has been approved to use an internal model for the type of position.[102] It is expected that some broker-dealer SBSDs would seek to use internal models to compute net capital – as have some broker-dealers – by applying to become ANC broker-dealers. Broker-dealer SBSDs using internal models would be subject to the existing provisions and proposed amendments to those provisions currently applicable to ANC broker-dealers.

Under the proposed amendments, the current net capital requirements for ANC broker-dealers in Rule 15c3-1 would be enhanced to account for the firms' large size, the scale of their custodial activities, and the potential that they may become substantially more active in the security-based swap markets under the Dodd-Frank Act's OTC derivatives reforms. As discussed in more detail below, the proposed enhancements would include increasing the minimum tentative net capital and minimum net capital requirements; increasing the "early

101 See 17 CFR 240.15c3-1e.

102 Id.

warning" notice threshold; narrowing the types of unsecured receivables for which ANC broker-dealers may take a credit risk charge in lieu of a 100% deduction; and requiring ANC broker-dealers to comply with a new liquidity requirement.[103]

Currently, an ANC broker-dealer must maintain minimum tentative net capital of at least $1 billion and minimum net capital of at least $500 million.[104] In addition, an ANC broker-dealer must provide the Commission with an "early warning" notice when its tentative net capital falls below $5 billion.[105] These relatively high minimum capital requirements (as compared with the requirements for other types of broker-dealers) reflect the substantial and diverse range of business activities engaged in by ANC broker-dealers and their importance as intermediaries in the securities markets.[106] Further, the heightened capital requirements reflect the fact that, as noted above, VaR models are more risk sensitive but also may not capture all risks and generally permit substantially reduced deductions to tentative net capital as compared to the standardized haircuts.[107]

The proposals to strengthen the requirements for ANC broker-dealers are made in response to issues that arose during the 2008 financial crisis, recognizing the large size of these firms, and the scale of their custodial responsibilities. The proposals also are based on the Commission staff's experience supervising the ANC broker-dealers. The financial crisis

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103 See proposed amendments to 17 CFR 240.15c3-1; 17 CFR 240.15c3-1e.

104 See 17 CFR 240.15c3-1(a)(7)(i).

105 See 17 CFR 240.15c3-1(a)(7)(ii).

106 For example, based on data from broker-dealer FOCUS Reports, the six ANC broker-dealers collectively hold in excess of one trillion dollars' worth of customer securities. Under Rule 17a-5 (17 CFR 240.17a-5), broker-dealers must file periodic reports on Form X-17A-5 (Financial and Operational Combined Uniform Single Reports, "FOCUS Reports"). Unless an exception applies, the Commission's rules deem all reports filed under Rule 17a-5 confidential. 17 CFR 240.17a-5(a)(3). The FOCUS Report requires, among other financial information, a balance sheet, income statement, and net capital and customer reserve computations. The FOCUS Report data used in this release is year-end 2011 FOCUS Report data.

107 See Alternative Net Capital Requirements Adopting Release, 69 FR 34428.

demonstrated the risks to financial firms when market conditions are stressed and how the failure of a large firm can accelerate the further deterioration of market conditions.[108] The proposals are designed to bolster the ANC broker-dealer net capital rules to ensure that these firms continue to maintain sufficient capital reserves to account for market, credit, operational, and other risks.[109] While the rationale for these enhancements exists irrespective of whether the ANC broker-dealers ultimately register as SBSDs, the proposed increased capital requirements also are designed to account for increased security-based swap activities by these firms. FOCUS Report data and the Commission staff's supervision of the ANC broker-dealers indicate that these firms currently do not engage in a substantial business in security-based swaps.[110] It is expected, however, that they may increase their security-based swap activities after the Dodd-Frank Act's OTC derivatives reforms are implemented and become effective because security-based swap activities will need to be conducted in regulated entities.[111] Consequently, financial institutions that currently deal in security-based swaps will need to register as an SBSD or register one or more affiliates as an SBSD. To the extent they want to offer securities products and services beyond those related to security-based swaps, they also will need to be registered as broker-dealers. Using an existing broker-dealer – particularly an ANC broker-dealer that already is capitalized and has risk management systems and personnel in place – could provide efficiencies that create incentives to register the same entity as a nonbank SBSD.

Under the proposed amendments to Rule 15c3-1, ANC broker-dealers would be required

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108 See, e.g., World Economic Outlook: Crisis and Recovery, International Monetary Fund ("IMF") (Apr. 2009), available at http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf.

109 See Alternative Net Capital Requirements Adopting Release, 69 FR 34428.

110 The ANC broker-dealers are subject to ongoing Commission staff supervision, which includes monthly meetings with senior staff of the ANC broker-dealers. This supervision program provides the Commission with information about the current practices of the ANC broker-dealers.

111 This expectation is based on information gathered as part of the ANC broker-dealer supervision program.

to maintain: (1) tentative net capital of not less than $5 billion; and (2) net capital of not less than the greater of $1 billion or the financial ratio amount required pursuant to paragraph (a)(1) of Rule 15c3-1 plus the 8% margin factor.[112] FOCUS Report data indicates that the six current ANC broker-dealers report capital levels in excess of these proposed increased minimum requirements. While raising the tentative net capital requirement under Rule 15c3-1 from $1 billion to $5 billion would be a significant increase, the existing "early warning" notice requirement for ANC broker-dealers is $5 billion.[113] This $5 billion "early warning" threshold acts as a de facto minimum tentative net capital requirement since ANC broker-dealers seek to maintain sufficient levels of tentative net capital to avoid the necessity of providing this regulatory notice. Accordingly, the objective in raising the minimum capital requirements for ANC broker-dealers is not to require the six existing ANC broker-dealers to increase their current capital levels (as they already maintain tentative net capital in excess of $5 billion).[114] Rather, the goal is to establish new higher minimum requirements designed to ensure that the ANC broker-dealers continue to maintain high capital levels and that any new ANC broker-dealer entrants maintain capital levels commensurate with their peers.

As indicated above, the proposed amendments to Rule 15c3-1 would require an ANC broker-dealer to incorporate the 8% margin factor into its net capital calculation.[115] Consequently, an ANC broker-dealer would be required at all times to maintain tentative net capital of not less than $5 billion and net capital of not less than the greater of $1 billion or the

112 See proposed amendments to paragraph (a)(7)(i) of Rule 15c3-1.

113 See 17 CFR 240.15c3-1(a)(7)(i).

114 The ANC broker-dealers report to the Commission staff, as part of the ANC broker-dealer supervision program, levels of tentative net capital that generally are well in excess of $6 billion, which, as discussed below, is the proposed new "early warning" threshold for ANC broker-dealers.

115 See proposed amendments to paragraph (a)(7)(i) of Rule 15c3-1. As discussed above in section II.A.2.a.i. of this release, the 8% margin factor is designed to adjust the firm's minimum net capital requirement in tandem with the risk associated with the broker-dealer firm's security-based swap activity.

sum of the ratio requirement under paragraph (a)(1) of Rule 15c3-1 and eight percent (8%) of the risk margin amount for security-based swaps carried by the ANC broker-dealer.[116]

Under the proposal, an ANC broker-dealer would be required to provide early warning notification to the Commission if its tentative net capital fell below $6 billion.[117] The purpose of an "early warning" notice requirement is to require a broker-dealer to provide notice when its level of regulatory capital falls to a level that approaches its required minimum capital requirement but is sufficiently above the minimum that the Commission and SROs can increase their monitoring of the firm before the minimum is breached. The proposed increase in the minimum tentative net capital requirement to $5 billion necessitates a corresponding increase in the "early warning" threshold to an amount above $5 billion. Existing early warning thresholds for OTC derivatives dealers include a requirement to provide notice when the firm's tentative net capital falls below an amount that is 120% of the firm's required minimum tentative net capital amount.[118] The proposed new "early warning" threshold for ANC broker-dealers of $6 billion in tentative net capital is modeled on this requirement and is equal in percentage terms (120%) to the amount that the early warning level exceeds the minimum tentative net capital requirement for OTC derivatives dealers.

The rules applicable to ANC broker-dealers provide that the Commission may impose additional conditions on an ANC broker-dealer under certain circumstances.[119] In particular, paragraph (e) of Appendix E to Rule 15c3-1 establishes a non-exclusive list of circumstances under which the Commission may restrict the business of an ANC broker-dealer, including when

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116 See proposed amendments to paragraph (a)(7)(i) of Rule 15c3-1.

117 See proposed amendments to paragraph (a)(7)(ii) of Rule 15c3-1. As noted above, the ANC broker-dealers report to the Commission staff tentative net capital levels that generally are well in excess of $6 billion.

118 See 17 CFR 240.17a-11(c)(3).

119 See 17 CFR 240.15c3-1e(e)(1).

the firm's tentative net capital falls below the early warning threshold.[120] In this event, the Commission – if it finds it is necessary or appropriate in the public interest or for the protection of investors – may impose additional conditions on the firm, including requiring the firm to submit to the Commission a plan to increase its tentative net capital (to an amount above the early warning level).[121] Additional restrictions could include restricting the ANC broker-dealer's business on a product-specific, category-specific, or general basis; requiring the firm to file more frequent reports with the Commission; modifying the firm's internal risk management controls or procedures; requiring the firm to compute deductions for market and credit risk using standardized haircuts; or imposing any other additional conditions, if the Commission finds that imposition of other conditions is necessary or appropriate in the public interest or for the protection of investors.[122]

Request for Comment

The Commission generally requests comment on the proposed minimum capital requirements for ANC broker-dealers. Commenters are referred to the general questions above in section II.A.2.a.i. of this release about the 8% margin factor as applied broadly to nonbank SBSDs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is the proposed increased minimum net capital requirement from \$500 million to \$1 billion for ANC broker-dealers appropriate? If not, explain why not. What minimum amount would be preferable? For example, should the minimum fixed-dollar amount be greater than \$1 billion to account for the large size of these firms and the scale of their

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120 Id.

121 Id. See also Alternative Net Capital Requirements Adopting Release, 69 FR 34428.

122 See 17 CFR 240.15c3-1e(e).

custodial activities? If so, explain why. If it should be a greater amount, how much greater should it be (e.g., $1.5 billion, $2 billion, $3 billion, or some other amount)? Alternatively, should the minimum fixed-dollar amount be less than $1 billion? If so, explain why. If it should be a lower amount, how much lower (e.g., $950 million, $900 million, $850 million, $800 million, $750 million, or some other amount)? If a greater or lesser alternative amount is recommended, explain why it would be preferable.

2. Is the proposed increase in the minimum tentative net capital level for ANC broker-dealers appropriate? If not, explain why not. For example, should the minimum tentative net capital amount be greater than $5 billion to account for the use of internal models and the large size of these firms and the scale of their custodial activities? If it should be a greater amount, how much greater should it be (e.g., $6 billion, $8 billion, $10 billion, or some other amount)? Should it be lesser amount (e.g., $4 billion, $3 billion, $2 billion or some other amount)? If a greater or lesser alternative amount is recommended, explain why it would be preferable.

3. Is the proposed increase in the early warning threshold from $5 billion to $6 billion for ANC broker-dealers appropriate? If not, explain why not. For example, should the minimum tentative net capital amount be greater than $6 billion, given that the current early warning threshold ($5 billion) is five times the current tentative net capital requirement ($1 billion)? If the early warning level should be a greater amount, how much greater should it be (e.g., $8 billion, $10 billion, $12 billion, $20 billion, $25 billion, or some other amount)? Should it be lesser amount (e.g., $5.8 billion, 5.5 billion, or some other amount)? If a greater or lesser alternative amount is recommended, explain why it would be preferable.

4. Is it appropriate to require broker-dealer SBSDs to become ANC broker-dealers in order to use internal models? For example, would it be appropriate to permit broker-dealer SBSDs to use internal models but subject them to lesser minimum capital requirements than the ANC broker-dealers? If so, explain why. In addition, provide suggested alternative minimum capital requirements.
5. Is combining the 8% margin factor requirement with the applicable Rule 15c3-1 financial ratio requirement an appropriate way to determine a minimum net capital requirement for ANC broker-dealers? If not, explain why not.
6. Would the 8% margin factor provide an appropriate and workable restraint on the amount of leverage incurred by ANC broker-dealers? If not, explain why not. Is there another measure that would more accurately and effectively address the leverage risk of these firms? If so, identify the measure and explain why it would be more accurate and effective.

Additional Request for Comment on VaR-Based Capital Charges

On June 7, 2012, the OCC, the FDIC, and the Federal Reserve (collectively, the "Banking Agencies") approved a joint final rule ("Final Rule") regarding market risk capital rules.[123] Certain portions of the Final Rule relate to the use of financial models for regulatory capital purposes. Generally, the Banking Agencies stated that the Final Rule is designed to "better capture positions for which the market risk capital rules are appropriate; to reduce procyclicality; enhance the rules' sensitivity to risks that are not adequately captured under current methodologies; and increase transparency through enhanced disclosures." The effective date for the Final Rule is January 1, 2013.

123 Risk Based Capital Guidelines: Market Risk, Federal Reserve, FDIC, OCC, 77 FR 53059 (Aug. 30, 2012).

Under the Final Rule, the capital charge for market risk is the sum of: (1) its VaR-based capital requirement; (2) its stressed VaR-based capital requirement; (3) any specific risk add-ons; (4) any incremental risk capital requirement; (5) any comprehensive risk capital requirement; and (6) any capital requirement for de minimis exposures. Generally, the qualitative and quantitative requirements for the Banking Agencies' VaR-based capital requirement are similar to the VaR-based capital requirements for ANC broker-dealers, OTC derivatives dealers, and, as proposed, for nonbank SBSDs approved to use internal models.

The Banking Agencies' stressed VaR-based capital requirement is a new requirement that banks calculate a VaR measure with model inputs calibrated to reflect historical data from a continuous 12-month period that reflects a period of significant financial stress appropriate to the bank's current portfolio. The stressed VaR requirement is designed to address concerns that the Banking Agencies' existing VaR-based measure, due to inherent limitations, proved inadequate in producing capital requirements appropriate to the level of losses incurred at many banks during the financial crisis and to mitigate procyclicality in the existing market risk capital requirement for banks.

The Final Rule also specifies modeling standards for specific risk and eliminates the current option for a bank to model some but not all material aspects of specific risk for an individual portfolio of debt or equity positions. To address concerns about the ability to model specific risk of securitization products, the Final Rule would require a bank to calculate an additional capital charge "add-on" for certain securitization positions that are not correlation trading positions.

Further, under the Final Rule, a bank that measures the specific risk of a portfolio of debt positions using internal models is required to calculate an incremental risk measure for those positions using an internal model (an incremental risk model). Generally, incremental risk consists of the risk of default and credit migration risk of a position. Under the Final Rule, an internal model used to calculate capital charges for incremental risk must measure incremental risk over a one-year time horizon and at a one-tail, 99.9% confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions.

A bank may measure all material price risk of one or more portfolios of correlation trading positions using a comprehensive risk model. Among the requirements for using a comprehensive risk model is that the model measure comprehensive risk consistent with a one-year time horizon and at a one-tail, 99.9% confidence level, under the assumption of either a constant level of risk or constant positions.

The Commission seeks comment on whether the Final Rule adopted by the Banking Agencies for calculating market risk capital requirements should be required for ANC broker-dealers, OTC derivatives dealers, and nonbank SBSDs that have approval to use internal models for regulatory capital purposes, and, if so, which aspects of the proposed rules of the Banking Agencies would be appropriate in this context.

b. Computing Net Capital

i. The Net Liquid Assets Test

The net liquid assets test embodied in Rule 15c3-1 is being proposed as the regulatory capital standard for all nonbank SBSDs (i.e., stand-alone SBSDs and broker-dealer SBSDs) because these firms, as previously noted, are expected to engage in a securities business with respect to security-based swaps that is similar to the dealer activities of broker-dealers and because some broker-dealers likely will be registered as nonbank SBSDs. In addition, Rule 15c3-1 currently contains provisions designed to address dealing in OTC derivatives by broker-dealers.[124] Furthermore, Rule 15c3-1 has been the capital standard for broker-dealers since 1975 and, generally, it has promoted the maintenance of prudent levels of capital. As discussed in section II.A.1. of this release, the net liquid assets test is designed to promote liquidity; the rule allows a broker-dealer to engage in activities that are part of conducting a securities business (e.g., taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors). Consequently, under the proposed rules, this standard – the net liquid assets test – would be applied to all categories of nonbank SBSDs. The objective is to require the nonbank SBSD to maintain sufficient liquidity so that if it fails financially it can meet all unsubordinated obligations to customers and counterparties and have adequate resources to wind-down in an orderly manner without the need for a formal proceeding.

The net liquid assets test is imposed through the mechanics of how a broker-dealer is required to compute net capital pursuant to Rule 15c3-1. These requirements are set forth in paragraph (c)(2) of Rule 15c3-1, which defines the term "net capital."[125] The first step is to compute the broker-dealer's net worth under GAAP.[126] Next, the broker-dealer must make certain adjustments to its net worth to calculate net capital.[127] These adjustments are designed to leave the firm in a position where each dollar of unsubordinated liabilities is matched by more

124 See 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f.

125 See 17 CFR 240.15c3-1(c)(2).

126 See id. See also, e.g., Computation of Net Capital on FOCUS Report Part II, available at http://sec.gov/about/forms/formx-17a-5_2.pdf. Net worth is to be computed in accordance with GAAP. See Interpretation Rule 15c3-1(c)(2)/01 by the Financial Industry Regulatory Authority ("FINRA"), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/interpretationsfor/p037763.pdf.

127 See 17 CFR 240.15c3-1(c)(2).

than a dollar of highly liquid assets.[128] There are thirteen categories of net worth adjustments required by the rule.[129] The most significant adjustments are briefly discussed below.

The first adjustment permits the broker-dealer to add back to net worth liabilities that are subordinated to all other creditors pursuant to a loan agreement that meets requirements set forth in Appendix D to the net capital rule.[130] Appendix D prescribes a number of requirements for a loan to qualify for the "add-back" treatment.[131] For example, the loan agreement must provide that the broker-dealer cannot re-pay the loan at term if doing so would reduce its net capital to certain levels above the minimum requirement.[132]

The second adjustment to net worth is that the broker-dealer must add unrealized gains and deduct unrealized losses in the firm's accounts, mark-to-market all long and short positions in listed options, securities, and commodities as well as add back certain deferred tax liabilities.[133]

The third adjustment is that the broker-dealer must deduct from net worth any asset that

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128 See, e.g., Net Capital Requirements for Brokers and Dealers, 54 FR at 315 ("The [net capital] rule's design is that broker-dealers maintain liquid assets in sufficient amounts to enable them to satisfy promptly their liabilities. The rule accomplishes this by requiring broker-dealers to maintain liquid assets in excess of their liabilities to protect against potential market and credit risks.") (footnote omitted).

129 See 17 CFR 240.15c3-1(c)(2)(i)-(xiii).

130 See 17 CFR 240.15c3-1(c)(2)(ii); 17 CFR 240.15c3-1d.

131 See 17 CFR 240.15c3-1d(b).

132 See 17 CFR 240.15c3-1d(b)(8). The restriction on repayment, if triggered, makes the subordinated loan take on the characteristics of permanent capital in that the loan cannot be repaid until such time as the conditions preventing repayment no longer exist. Other requirements for the subordinated loan include that the agreement shall: (1) have a term of at least one year; (2) effectively subordinate any right of the lender to receive any payment (a defined term) with respect thereto, together with accrued interest or compensation, to the prior payment or provision for payment in full of all claims of all present and future creditors of the broker-dealer arising out of any matter occurring prior to the date on which the related payment obligation (a defined term) matures; and (3) provide that the cash proceeds thereof shall be used and dealt with by the broker-dealer as part of its capital and shall be subject to the risks of the broker-dealer's business. 17 CFR 240.15c3-1d(b)(1), (3), and (4).

133 See 17 CFR 240.15c3-1(c)(2)(i).

is not readily convertible into cash.[134] This means the broker-dealer must deduct the following types of assets (among others): real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and other expenses; goodwill; and most unsecured receivables.[135] An additional adjustment is that the broker-dealer must deduct 100% of the carrying value of securities for which there is no "ready market" or which cannot be publicly offered or sold because of statutory, regulatory, or contractual arrangements or other restrictions.[136] After making these and other adjustments and taking charges required under Appendix B to Rule 15c3-1,[137] the broker-dealer is left with an amount of adjusted net worth that is defined in the rule as "tentative net capital."[138]

As discussed in more detail below, the final step in the process of computing net capital is to take deductions from tentative net capital to account for the market risk inherent in the proprietary positions of the broker-dealer and to create a buffer of extra liquidity to protect against other risks associated with the securities business.[139] Most broker-dealers use the

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134 See 17 CFR 240.15c3-1(c)(2)(iv).

135 Id.

136 See 17 CFR 240.15c3-1(c)(2)(vii). Rule 15c3-1 defines ready market to include a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom. See 17 CFR 240.15c3-1(c)(11). The rule also provides that a ready market will be deemed to exist where the securities have been accepted as collateral for a loan by a bank as defined in section 3(a)(6) of the Exchange Act and where the broker-dealer demonstrates to its designated examining authority that such securities adequately secure such loans. Id. The rule further provides that indebtedness will be deemed to be adequately secured when the excess of the market value of the collateral over the amount of the indebtedness is sufficient to make the loan acceptable as a fully secured loan to banks regularly making secured loans to broker-dealers. See 17 CFR 240.15c3-1(c)(5).

137 17 CFR 240.15c3-1b.

138 See 17 CFR 240.15c3-1(c)(15). Tentative net capital – net worth after the adjustments – is the amount by which highly liquid assets plus subordinated debt of the broker-dealer exceeds total liabilities. See 17 CFR 240.15c3-1(c)(15). Hence, the adjustments to net worth required by Rule 15c3-1 impose the net liquid assets test.

139 See, e.g., Uniform Net Capital Rule, 42 FR 31778 ("[Haircuts] are intended to enable net capital computations to reflect the market risk inherent in the positioning of the particular types of securities

standardized haircuts prescribed in Rule 15c3-1 to determine the amount of the deductions they must take from tentative net capital. ANC broker-dealers and OTC derivatives dealers may use internal VaR models to determine the amount of the deductions for positions for which they have been approved to use VaR models.[140] For all other types of positions, they must use standardized haircuts. The standardized haircuts prescribe deductions in amounts that are based on the type of security or money market instrument and, in the case of certain debt instruments, the time-to-maturity of the bond.[141] Under the VaR model approach, the amount of the deductions is based on an estimate of the maximum potential loss the portfolio of securities would be expected to incur over a fixed time period at a certain probability level.

In order to comply with the proposed net liquid assets test capital standard for nonbank SBSDs, broker-dealer SBSDs would be required to comply with the existing provisions of Rule 15c3-1 and proposed amendments to the rule designed to account for security-based swap activities. Consequently, a broker-dealer SBSD would compute its net capital pursuant to the provisions described above. Stand-alone SBSDs would be subject to the net liquid assets test capital standard through application of proposed new Rule 18a-1.[142] The mechanics of computing net capital in Rule 18a-1 would be the same as the existing mechanics for computing net capital in Rule 15c3-1.[143]

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enumerated in [the rule]"); Net Capital Rule, 50 FR 42961 ("These percentage deductions, or 'haircuts', take into account elements of market and credit risk that the broker-dealer is exposed to when holding a particular position."); Net Capital Rule, 62 FR 67996 ("Reducing the value of securities owned by broker-dealers for net capital purposes provides a capital cushion against adverse market movements and other risks faced by the firms, including liquidity and operational risks.") (footnote omitted).

140 See 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f.

141 See 17 CFR 240.15c3-1(c)(2)(vi).

142 See proposed new Rule 18a-1.

143 Compare 17 CFR 240.15c3-1(c)(2), with paragraph (c)(1) of proposed new Rule 18a-1.

ii. Standardized Haircuts for Security-Based Swaps

As discussed above, Rule 15c3-1 provides two alternative approaches for taking the deductions to tentative net capital to compute net capital: standardized haircuts and internal VaR models.[144] ANC broker-dealers and OTC derivatives dealers are permitted to use internal VaR models to take deductions for types of positions for which they have been approved to use the models. For all other types of positions, they must use the standardized haircuts. Broker-dealers that are not ANC broker-dealers or OTC derivatives dealers must use the standardized haircuts for all positions. The same approach is being proposed for nonbank SBSDs.[145] Under this proposal, a nonbank SBSD would be required to apply standardized haircuts to its proprietary positions unless the Commission approves the firm to use internal models for those positions.

Nonbank SBSDs would be required to apply the standardized haircuts currently set forth in Rule 15c3-1 for securities positions for which they have not been approved to use internal models.[146] The standardized haircuts in Rule 15c3-1 prescribe differing deduction amounts for a variety of classes of securities, including, for example: securities guaranteed as to principal or interest by the government of the United States ("U.S. government securities");[147] certain municipal securities;[148] Canadian debt obligations;[149] certain types of mutual funds;[150] certain

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144 See 17 CFR 240.15c3-1(a)(5), (a)(7), and (c)(2)(vi). See also 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f.

145 See section II.A.1. of this release.

146 See 17 CFR 240.15c3-1(c)(2)(vi); paragraph (c)(1)(vi) of proposed new Rule 18a-1. As proposed, paragraph (c)(1)(vi) of proposed new Rule 18a-1 would incorporate by reference the standardized haircuts in paragraph (c)(2)(vi) of Rule 15c3-1 rather than repeat them in the rule text.

147 See 17 CFR 240.15c3-1(c)(2)(vi)(A).

148 See 17 CFR 240.15c3-1(c)(2)(vi)(B). To qualify for the deductions under this paragraph, the municipal security cannot be traded flat or in default as to principal or interest (a bond is traded flat if it is sold or traded without accrued interest). Id. A municipal security that does not meet this condition would be subject to the deductions prescribed in the catchall provisions discussed below in the paragraph accompanying this footnote or the 100% deduction to net worth for securities that do not have a ready market discussed above in section II.A.2.b.i. of this release. See 17 CFR 240.15c3-1(c)(2)(iv), (c)(2)(vi)(J), and (c)(2)(vi)(K).

149 See 17 CFR 240.15c3-1(c)(2)(vi)(C).

types of commercial paper, bankers acceptances, and certificates of deposit;[151] certain nonconvertible debt securities;[152] certain convertible debt securities;[153] certain cumulative, nonconvertible preferred stock;[154] and certain options.[155] The rule also contains catchall provisions to account for securities that are not included in these specific classes of securities.[156] Generally, the catchall provisions impose higher deductions than the deductions in the specifically identified classes of securities.[157] Further, as discussed above in section II.A.2.b.i. of this release, if a security does not have a "ready market," it is subject to the 100% deduction

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150 See 17 CFR 240.15c3-1(c)(2)(vi)(D).

151 See 17 CFR 240.15c3-1(c)(2)(vi)(E). To qualify for the deductions under this paragraph, the instrument must have a fixed rate of interest or be sold at a discount and be rated in one of the three highest categories by at least two nationally recognized statistical rating organizations ("NRSROs"). Id. If the instrument does not meet these conditions, it is subject to the deductions prescribed in the catchall provisions discussed below in the paragraph accompanying this footnote or the 100% deduction to net worth for securities that do not have a ready market discussed above in section II.A.2.b.i. of this release. See 17 CFR 240.15c3-1(c)(2)(iv), (c)(2)(vi)(J), and (c)(2)(vi)(K). Pursuant to section 939A of the Dodd-Frank Act, the Commission has proposed substituting the NRSRO-rating requirement in this provision and other provisions of Rule 15c3-1 with a different standard of creditworthiness. See Pub. L. 111-203 § 939A and Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, Exchange Act Release No. 64352 (Apr. 27, 2011), 76 FR 26550 (May 6, 2011) ("Reference Removal Release").

152 See 17 CFR 240.15c3-1(c)(2)(vi)(F). To qualify for the deductions under this paragraph, a nonconvertible debt security must have a fixed interest rate and a fixed maturity date, not be traded flat or in default as to principal or interest, and be rated in one of the four highest rating categories by at least two NRSROs. Id. If the nonconvertible debt security does not meet these conditions it is subject to the deductions prescribed in the catchall provisions discussed below in the paragraph accompanying this footnote or the 100% deduction to net worth for securities that do not have a ready market discussed above in section II.A.2.b.i. of this release. See 17 CFR 240.15c3-1(c)(2)(iv), (c)(2)(vi)(J), and (c)(2)(vi)(K). Pursuant to section 939A of the Dodd-Frank Act, the Commission has proposed substituting the NRSRO-rating requirement in this provision with a different standard of creditworthiness. See Pub. L. 111-203 § 939A; Reference Removal Release, 76 FR 26550.

153 See 17 CFR 240.15c3-1(c)(2)(vi)(G).

154 See 17 CFR 240.15c3-1(c)(2)(vi)(H). To qualify for the deductions under this paragraph, a nonconvertible preferred stock must rank prior to all other classes of stock of the same issuer, be rated in one of the four highest rating categories by at least two NRSROs, and not be in arrears as to dividends. Id. If the nonconvertible preferred stock does not meet these conditions, it is subject to the deductions prescribed in the catchall provisions discussed below in the paragraph accompanying this footnote or the 100% deduction to net worth for securities that do not have a ready discussed above. See 17 CFR 240.15c3-1(c)(2)(iv), (c)(2)(vi)(J), and (c)(2)(vi)(K). Pursuant to section 939A of the Dodd-Frank Act, the Commission has proposed substituting the NRSRO-rating requirement in this provision with a different standard of creditworthiness. See Pub. L. 111-203 § 939A; Reference Removal Release, 76 FR 26550.

155 See 17 CFR 240.15c3-1(c)(2)(vi); 17 CFR 240.15c3-1a.

156 See 17 CFR 240.15c3-1(c)(2)(vi)(J)-(K).

157 Compare 17 CFR 240.15c3-1(c)(2)(vi)(A)-(H), with 17 CFR 240.15c3-1(c)(2)(vi)(J)-(K).

from net worth.[158]

Security-based swaps currently are not an identified class of securities in Rule 15c3-1.[159] The proposed amendments to Rule 15c3-1 and proposed new Rule 18a-1 would establish standardized deductions for security-based swaps that would apply to broker-dealers registered as nonbank SBSDs and broker-dealers that are not registered as SBSDs (in the case of Rule 15c3-1), and to stand-alone SBSDs (in the case of Rule 18a-1).[160] Some broker-dealers may engage in a de minimis amount of security-based swap activity, which would allow them to take advantage of an exemption from the definition of "security-based swap dealer" and not require them to register as SBSDs.[161] Rule 15c3-1 currently requires broker-dealers to take haircuts on their proprietary security-based swap positions as they must for all proprietary positions. Because there are no specific standardized haircuts for security-based swaps, a broker-dealer currently is required to apply a deduction based on the existing provisions (e.g., the catchall provisions). For certain types of OTC derivatives, the deduction is the notional amount of the derivative multiplied by the deduction that would apply to the underlying instrument referenced by the derivative.[162]

The proposals would establish two separate sets of standardized haircuts for security-based swaps: one applicable to security-based swaps that are credit default swaps and one

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158 See 17 CFR 240.15c3-1(c)(2)(vii).

159 See 17 CFR 240.15c3-1(c)(2)(vi).

160 See proposed new paragraph (c)(2)(vi)(O) of Rule 15c3-1; paragraph (c)(1)(vi) of proposed new Rule 18a-1.

161 See section 3(a)(71) of the Exchange Act (15 U.S.C. 78c(a)(71)) (defining the term security-based swap dealer); Entity Definitions Adopting Release, 77 FR 30596; Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 65543 (Oct. 12, 2011), 76 FR 65784 (Oct. 24, 2011) ("SBSD Registration Proposing Release").

162 See Net Capital Rule, Exchange Act Release No. 32256 (May 6, 1993), 58 FR 27486, 27490 (May 10, 1993).

applicable to other security-based swaps.[163]

Credit Default Swaps

The proposed standardized haircuts for cleared and uncleared security-based swaps that are credit default swaps ("CDS security-based swaps") are designed to account for the unique attributes of these positions.[164] A CDS security-based swap is an instrument in which the "protection buyer" makes a series of payments to the "protection seller" and, in return, the "protection seller" is obligated to make a payment to the "protection buyer" if a credit event occurs with respect to one or more entities referenced in the contract or with respect to certain types of obligations of the entity or entities referenced in the contract.[165] The credit events that can trigger a payment obligation of the protection seller on a CDS security-based swap referencing a corporate entity typically include the bankruptcy of the entity or entities referenced in the contract and the non-payment of interest and/or principal on one or more of specified type(s) of obligations issued by the entity or entities referenced in the contract.[166] In the case of a CDS security-based swap that references an asset-backed security, the credit events may include a principal write-down, a failure to pay interest, and an interest shortfall.[167] CDS security-based swaps referencing both asset-backed securities and corporate entities can include other standardized and customized credit events.

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163 See proposed new paragraph (c)(2)(vi)(O) of Rule 15c3-1; paragraph (c)(1)(vi) of proposed new Rule 18a-1.

164 See section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68)) (defining the term security-based swap) and Product Definitions Adopting Release, 77 FR 48207 (Joint Commission and CFTC release adopting interpretative guidance and rules to, among other things, further define the types of credit default swaps that would meet the definition of security-based swap).

165 See Product Definitions Adopting Release, 77 FR 48207. See also The Credit Default Swap Market – Report, IOSCO FR05/12 (June 2012) available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD385.pdf.

166 See Product Definitions Adopting Release, 77 FR at 48267.

167 Id. at 48267, note 682.

In addition to the entity or asset-backed security to which they reference, CDS security-based swaps are defined by the amount of protection purchased (the notional amount) and the tenor of the contract (e.g., 1, 3, 5, 7, or 10 years). For example, a protection buyer can enter into a credit default swap referencing XYZ Company with a notional amount of $10 million and a tenor of five years. If XYZ Company suffers a credit event (as defined in the contract) during the five-year period before the contract expires, the protection seller must pay the protection buyer $10 million less the then-current market value of $10 million of obligations issued or guaranteed by XYZ Company.[168] To receive this protection, the protection buyer must pay the protection seller periodic (typically quarterly) payments over the five-year term of the contract and possibly an additional upfront amount. The cumulative amount of annual payments can be expressed as a "spread" in basis points.[169] The spread at which a CDS security-based swap trades is based on the market's estimation of the risk that XYZ Company will suffer a credit event (as defined in the contract) that triggers the credit seller's payment obligation as well as the market's assessment of the size of that payment. The greater the estimated risk that a credit event will occur (or the greater the expected payment contingent upon a credit event occurring), the higher the spread (i.e., the cost of buying the protection).

168 While most CDS security-based swaps currently use a standardized "Auction Settlement" mechanism to determine the amount of payment due from a protection seller to the protection buyer after the occurrence of a credit event, in some contracts the protection buyer is required to deliver obligations issued or guaranteed by the entity referenced in the contract to the protection seller. The protection seller can use the value of those obligations to offset the payment to the protection buyer.

169 Most CDS security-based swaps currently trade with contractually standardized fixed rates (100 basis points or 500 basis points for standard North American corporate CDS security-based swaps). Buyers and sellers of protection agree on upfront payments to adjust the value of the contract from the contractual fixed rate to the rate which reflects the credit risks perceived by the market. For example, if the market spread for a one-year CDS security-based swap on XYZ Company is 200 basis points per annum and the notional amount is $10 million, a CDS security-based swap with a standardized 100-basis points fixed rate would have quarterly payments of $25,000 (for $100,000 in annual payments) and an upfront payment of approximately $100,000. See http://www.cdsmodel.com/cdsmodel/ for documentation on the standard model to convert an upfront payment on a CDS security-based swap to a spread (or vice-versa) and https://www.theice.com/cds/Calculator.shtml for an implementation of the standard model.

The proposed standardized haircuts for CDS security-based swaps would be based on a "maturity grid" approach.[170] Rule 15c3-1 currently uses maturity grids to prescribe standardized haircuts for various classes of debt instruments.[171] The grids impose a sliding scale of haircuts with the largest deductions applying to bonds with the longest period of time-to-maturity.[172] The grids also permit broker-dealers to completely or partially net long and short positions in these classes of debt instruments when the maturities of long and short positions are in the same

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170 See proposed new paragraph (c)(2)(vi)(O)(1) of Rule 15c3-1; paragraph (c)(1)(vi)(A) of proposed new Rule 18a-1.

171 See 17 CFR 240.15c3-1(c)(2)(vi)(A), (B), (C), (E), and (G). See also FINRA Rule 4240 (which prescribes margin requirements for CDS security-based swaps and includes a maturity-grid approach), available in the FINRA Manual at http://www.finra.org; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1, to Implement an Interim Pilot Program with Respect to Margin Requirements for Certain Transactions in Credit Default Swaps, Exchange Act Release No. 59955 (May 22, 2009), 74 FR 25586 (May 28, 2009) (File No. SR-FINRA 2009-012); Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Extend the Implementation of FINRA Rule 4240 (Margin Requirements for Credit Default Swaps), Exchange Act Release No. 66528 (Mar. 7, 2012) (File No. SR-FINRA-2012-014) (extending interim pilot program until July 17, 2012); Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Extend the Implementation of FINRA Rule 4240 (Margin Requirements for Credit Default Swaps), Exchange Act Release No. 67449 (July 17, 2012) (extending interim pilot program until July 17, 2013).

172 Id. For example, the grid for certain nonconvertible debt securities has nine maturity categories (this class of debt instrument includes corporate debt and asset-backed securities). See 17 CFR 240.15c3-1(c)(2)(vi)(F)(1). Each category prescribes a different deduction and the amounts of the deductions increase as the maturity increases. Id. The following table shows the maturity categories and corresponding deductions for these securities:

Time to Maturity Category	Deduction
Less than 1 year	2.0%
1 year but less than 2 years	3.0%
2 years but less than 3 years	5.0%
3 years but less than 5 years	6.0%
5 years but less than 10 years	7.0%
10 years but less than 15 years	7.5%
15 years but less than 20 years	8.0%
20 years but less than 25 years	8.5%
25 years or more	9%

category, subcategory, or, in some cases, between certain adjacent categories.[173] The permitted netting allows the broker-dealer to reduce its required deductions.[174]

The proposed grid for CDS security-based swaps would prescribe the applicable deduction based on two variables: the length of time to maturity of the CDS security-based swap contract and the amount of the current offered basis point spread on the CDS security-based swap.[175] As discussed above, the maturity grids for debt instruments in Rule 15c3-1 require increased capital charges as maturity increases. Similarly, the vertical axis of the proposed grid for CDS security-based swaps (presented in the first column of the grid) would contain nine maturity categories ranging from 12 months or less (the smallest deduction) to 121 months and longer (the largest deduction).[176] The horizontal axis in the proposed maturity grid (presented in the top row of the grid) would contain six spread categories ranging from 100 basis points or less (the smallest deduction) to 700 basis points and above (the largest deduction).[177] Similar to the current "haircut" grids under Rule 15c3-1, the proposed grid for CDS security-based swaps is designed to be risk sensitive by specifying a range of maturity and spread buckets.

The number of maturity and spread categories in the proposed grid for CDS security-based swaps is based on Commission staff experience with the maturity grids for other securities

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173 See 17 CFR 240.15c3-1(c)(2)(vi)(A), (B), (C), (E), and (G).

174 Netting would be permitted under the proposed rule for cleared and non-cleared CDS because the CDS will have the same underlying reference obligation and similar time to maturity and spread factors.

175 See proposed new paragraph (c)(2)(vi)(O)(1)(i) of Rule 15c3-1; paragraph (c)(1)(vi)(A)(1) of proposed new Rule 18a-1. The current offered spread would be the spread on the CDS security-based swap offered by the market at the time of the net capital computation and not the spread specified under the terms of the contract.

176 See proposed new paragraph (c)(2)(vi)(O)(1)(i) of Rule 15c3-1; paragraph (c)(1)(vi)(A)(1) of proposed new Rule 18a-1.

177 Id.

in Rule 15c3-1 and, in part, on FINRA Rule 4240.[178] While FINRA Rule 4240 is one reference point, the maturity grid it specifies does not appear to have been widely used by market participants, in part because a significant amount of business in the current CDS security-based swap market is conducted by entities that are not members of FINRA.[179] Accordingly, the proposed grid draws largely on Commission staff experience and reasoned judgments about the appropriate specifications, and, as detailed below, the Commission requests comment and empirical data as to whether these specifications or others appropriately reflect the unique attributes of CDS security-based swaps.

The horizontal "spread" axis is designed to address the specific credit risk associated with the obligor or obligation referenced in the contract. As noted above, the spread increases as the protection seller's estimation of the likelihood of a credit event occurring increases. Therefore, the net capital deduction – which is designed to address the risk inherent in the instrument – should increase as the spread increases. Combining the two components (maturity and spread) in the grid results in the smallest deduction (1% of notional) required for a short CDS security-based swap with a maturity of 12 months or less and a spread of 100 basis points or below and the largest deduction (50% of notional) required for a short CDS security-based swap with a maturity of 121 months or longer and a spread of 700 basis points or more. The deduction for an un-hedged short position in a CDS security-based swap (i.e., when the nonbank SBSD is the

178 See Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Amend FINRA Rule 4240 (Margin Requirements for Credit Default Swaps), Exchange Act Release No. 66527 (Mar. 7, 2012) (File No. SR-FINRA-2012-015) (in which FINRA amended the maturity grid in Rule 4240 in the interest of regulatory clarity and efficiency, and based upon FINRA's experience in the administration of the rule).

179 Broker-dealers historically have not participated in a significant way in security-based swap trading, in part, because the Exchange Act has not previously defined security-based swaps as "securities" and, therefore, they have not been required to be traded through registered broker-dealers. Existing broker-dealer capital requirements, however, make it relatively costly to conduct these activities in broker-dealers, as discussed in section II.A.2. of this release. As a result, security-based swap activities, including CDS transactions, currently are generally concentrated in entities that are affiliated with the parent companies of broker-dealers, but not in broker-dealers themselves.

seller of protection) would be the applicable percentage specified in the grid. The deduction for an un-hedged long position in a CDS security-based swap (i.e., when the nonbank SBSD is the buyer of protection) would be 50% of the applicable deduction in the grid.[180]

The proposed deduction requirements for CDS security-based swaps would permit a nonbank SBSD to net long and short positions where the credit default swaps reference the same entity (in the case of CDS securities-based swaps referencing a corporate entity) or obligation (in the case of CDS securities-based swaps referencing an asset-backed security), reference the same credit events that would trigger payment by the seller of protection, reference the same basket of obligations that would determine the amount of payment by the seller of protection upon the occurrence of a credit event, and are in the same or adjacent maturity and spread categories (as long as the long and short positions each have maturities within three months of the other maturity category).[181] In this case, the nonbank SBSD would need to take the specified percentage deduction only on the notional amount of the excess long or short position.[182]

A reduced deduction also could be taken for long and short CDS security-based swap positions in the same maturity and spread categories and that reference corporate entities in the same industry sector.[183] In this case, the market risk of the offsetting positions is mitigated to the

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180 See proposed new paragraph (c)(2)(vi)(O)(1)(ii) of Rule 15c3-1; paragraph (c)(1)(vi)(A)(2) of proposed new Rule 18a-1. The approach of taking 100% of the applicable deduction for short positions in CDS security-based swaps and 50% for long positions in CDS security-based swaps is consistent with FINRA Rule 4240 and is designed to account for the greater risk inherent in short CDS security-based swaps.

181 See proposed new paragraph (c)(2)(vi)(O)(1)(iii)(A) of Rule 15c3-1; paragraph (c)(1)(vi)(A)(3)(i) of proposed new Rule 18a-1.

182 Id. For example, assume the nonbank SBSD is short protection on $10 million in notional CDS security-based swaps on XYZ Company with a 4.25-year (51-month) maturity that trades at a 290 basis point spread and long protection on $8 million in notional CDS security-based swaps on XYZ Company with a 5.25-year (63-month) maturity that trades at a 310 basis point spread. Rather than take the deductions on the short protection $10 million position and the long protection $8 million position individually, the nonbank SBSD would take a deduction on the excess short position of $2 million ($10 million short protection position minus the $8 million long protection position) of 5-year maturity CDS security-based swaps trading at a 290 basis point spread.

183 Id.

extent that macroeconomic factors similarly impact companies in a particular industry sector, because corporate entities in the same industry sector would likely be similarly impacted by market events affecting that specific industry. The proposed rule would not identify a specific source for determining industry sector classifications in order to provide firms flexibility and to avoid requiring firms to rely on a specific commercial entity to comply with the rule. Instead, a nonbank SBSD would need to use an industry sector classification system that is reasonable in terms of grouping types of companies with similar business activities and risk characteristics, and document the industry sector classification system used for the purposes of the rule.[184] A nonbank SBSD could use a third-party's classification system or develop its own classification system, subject to these limitations. The nonbank SBSD would need to be able to demonstrate the reasonableness of the system it uses.

Reduced deductions also would apply for strategies where the firm is long (short) a bond or asset-backed security and long (short) protection through a CDS security-based swap referencing the same underlying bond or asset-backed security. In the case where the nonbank SBSD is long a bond or an asset-backed security and long protection through a credit default swap, the nonbank SBSD would be required to take 50% of the deduction required on the bond (i.e., no deduction would be required with respect to the CDS security-based swap and a lesser deduction would apply to the bond than would be the case if it were not paired with a CDS

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184 See proposed new paragraph (c)(2)(vi)(O)(1)(iii)(A) of Rule 15c3-1; paragraph (c)(1)(vi)(A)(3)(i) of proposed new Rule 18a-1. An example of an industry sector classification system is: consumer discretionary, consumer staples, energy, financials, health care, industrials, information technology, materials, telecommunication services, and utilities. See the Global Industry Classification Standard developed by MSCI and Standard & Poor's, available at http://www.msci.com/resources/pdfs/MK-GICS-DIR-3-02.pdf. Another example of an industry sector classification system is: basic materials, cyclical consumer, energy, financials, healthcare, industrials, non-cyclical consumer, technology, telecommunications, and utilities. See Thompson Reuters' business classifications, available at http://thomsonreuters.com/products_services/financial/thomson_reuters_indices/trbc/sectors/.

security-based swap).[185] In other words, the deduction the nonbank SBSD would take if it held the bond in isolation would be reduced by one-half to account for the protection provided by the CDS security-based swap referencing the bond. This reduced deduction for the long bond position reflects the risk-reducing effects of the protection provided by the long CDS security-based swap position. If the nonbank SBSD is short a bond or asset-backed security and short protection through a credit default swap, the nonbank SBSD would be required to take the deduction required on the bond or asset-backed security (i.e., no deduction would be required with respect to the CDS security-based swap).[186]

Non-Credit Default Swaps

Security-based swaps that are not credit default swaps (each, a "non-CDS security-based swap") can be divided into two broad categories: those that reference equity securities and those that reference debt instruments.[187] Total return swaps are an example of a non-CDS security-based swap. A total return swap is an instrument that requires one of the counterparties (the seller) to make a payment to the other counterparty (the buyer) that is based on the price appreciation of, and income from, the underlying security referenced by the security-based swap.[188] The buyer in return makes a payment that is based on a variable interest rate plus any depreciation of the underlying security referenced by the security-based swap.[189] The "total return" consists of the price appreciation or depreciation plus any interest or income.[190]

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185 See proposed new paragraph (c)(2)(vi)(O)(1)(iii)(B) of Rule 15c3-1; paragraph (c)(1)(vi)(A)(3)(ii) of proposed new Rule 18a-1.

186 See proposed new paragraph (c)(2)(vi)(O)(1)(iii)(C) of Rule 15c3-1; paragraph (c)(1)(vi)(A)(3)(iii) of proposed new Rule 18a-1.

187 See Product Definitions Adopting Release, 77 FR at 48207.

188 See id. at 48264.

189 Id.

190 Id. The total return swap is designed to put the buyer in the position of having exposure to the reference security without actually owning it. Thus, the seller pays the buyer appreciation (i.e., gains) and any

The proposed standardized haircut for a non-CDS security-based swap would be the deduction currently prescribed in Rule 15c3-1 applicable to the instrument referenced by the security-based swap multiplied by the contract's notional amount.[191] For example, the standardized haircut for an exchange traded equity security typically is 15%.[192] Consequently, under the proposal, the standardized haircut for a non-CDS security-based swap referencing an exchange traded equity security would be a deduction equal to the notional amount of the security-based swap multiplied by 15%.[193] The same approach would apply to a non-CDS security-based swap referencing a debt instrument. For example, Rule 15c3-1 prescribes a 7% standardized haircut for a corporate bond that has a maturity of five years and is not traded flat or in default as to principal or interest and is rated in one of the four highest rating categories by at least two NRSROs.[194] Under the proposal, a non-CDS security-based swap referencing such a bond would require a deduction equal to the contract's notional amount multiplied by 7%.[195]

Linking the standardized deduction for the non-CDS security-based swap to the standardized deduction that would apply to the instrument referenced by the security-based swap is based on the rationale that changes in the market value of the instrument underlying the security-based swap will result in corresponding changes to the market value of the security-

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interest or income on the security and the buyer pays the seller any depreciation (i.e., loss) on the reference security plus a variable interest rate.

191 See proposed new paragraph (c)(2)(vi)(O)(2) of Rule 15c3-1; paragraph (c)(1)(vi)(B) of proposed new Rule 18a-1.

192 See 17 CFR 240.15c3-1(c)(2)(vi)(J).

193 If the notional amount was $5 million, the standardized haircut would be $750,000 ($5 million x 0.15 = $750,000). The approach of multiplying the notional amount by the percentage deduction applicable to the reference security is consistent with the CFTC's proposed capital charges of equity swaps for nonbank swap dealers that are not using models and are FCMs. See CFTC Capital Proposing Release, 76 FR at 27812-27813.

194 See 17 CFR 240.15c3-1(c)(2)(vi)(F)(1)(v).

195 If the notional amount was $5 million, the standardized haircut would be $350,000 ($5 million x 0.07 = $350,000).

based swap. The proposal also is consistent with the treatment of equity security-based swaps under Rule 15c3-1.[196] Moreover, the potential volatility of the changes in the non-CDS security-based swap is expected to be similar to the potential volatility in the instrument underlying the security-based swap. For example, as discussed above, the standardized haircut for an exchange traded equity security is 15%,[197] whereas the standardized haircut is 7% for a corporate bond that has a maturity of five years and is not traded flat or in default as to principal or interest and is rated in one of the four highest rating categories by at least two NRSROs.[198] The equity security has a higher deduction amount because it is expected to have a greater amount of market risk.[199]

The examples above reflect the proposed standardized haircuts for a single non-CDS security-based swap treated in isolation. It is expected that nonbank SBSDs will maintain portfolios of multiple non-CDS security-based swaps with offsetting long and short positions to hedge their risk. Under the proposed standardized haircuts for non-CDS security-based swaps, nonbank SBSDs would be able to recognize the offsets currently permitted under Rule 15c3-1.[200] In particular, as discussed below, nonbank SBSDs would be permitted to treat a non-CDS security-based swap that references an equity security ("equity security-based swap") under the provisions of Appendix A to Rule 15c3-1, which produces a single haircut for portfolios of

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196 See Net Capital Rule, 58 FR at 27490.

197 See 17 CFR 240.15c3-1(c)(2)(vi)(J).

198 See 17 CFR 240.15c3-1(c)(2)(vi)(F)(1).

199 See, e.g., Net Capital Rule, Exchange Act Release No. 39456 (Dec. 17, 1997), 62 FR 68011 (Dec. 30, 1997) ("[A] broker-dealer's haircut for equity securities is equal to 15 percent of the market value of the greater of the long or short equity position plus 15 percent of the market value of the lesser position, but only to the extent this position exceeds 25 percent of the greater position. In contrast to the uniform haircut for equity securities, the haircuts for several types of interest rate sensitive securities, such as government securities, are directly related to the time remaining until the particular security matures.").

200 See proposed new paragraph (c)(2)(vi)(O)(2) of Rule 15c3-1; paragraph (c)(1)(vi)(B) of proposed new Rule 18a-1.

equity options and related positions.[201] Similarly, nonbank SBSDs would be permitted to treat a non-CDS security-based swap that references a debt instrument ("debt security-based swap") in the same manner as debt instruments are treated in the Rule 15c3-1 grids in terms of allowing offsets between long and short positions where the instruments are in the same maturity categories, subcategories, and in some cases, adjacent categories for the purposes of computing haircuts for debt security-based swaps.[202]

Appendix A to Rule 15c3-1 prescribes a standardized theoretical pricing model to determine a potential loss for a portfolio of equity positions involving the same equity security to establish a single haircut for the group of positions ("Appendix A methodology").[203] Proposed amendments to Appendix A to Rule 15c3-1 would permit equity security-based swaps to be included in portfolios of equity positions for which the Appendix A methodology is used to compute a portfolio haircut.[204] Under these proposed amendments, broker-dealer SBSDs and

201 See 17 CFR 240.15c3-1a; Appendix A to proposed new Rule 18a-1.

202 See 17 CFR 240.15c3-1(c)(2)(vi).

203 See 17 CFR 240.15c3-1a; Appendix A to proposed new Rule 18a-1.

204 Specifically, Appendix A to Rule 15c3-1 would be amended to include equity security-based swaps within the definition of the term "underlying instrument" in paragraph (a)(4) of Appendix A. This would allow these positions to be included in portfolios of equity positions involving the same equity security for purposes of the Appendix A methodology. In addition, the proposals would include security futures on single stocks within the definition of the term "underlying instrument," which would permit these positions to be included in portfolios of positions involving the same underlying security for purposes of the Appendix A methodology, subject to a minimum charge. This proposal is made in response to legislative and regulatory developments that have occurred since the Appendix A methodology was adopted in 1997. See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997). When the Appendix A methodology was adopted, security futures trading was prohibited in the U.S. This prohibition was repealed by the Commodity Futures Modernization Act of 2000, which established a framework for the joint regulation of security futures products by the Commission and the CFTC. Pub. L. No. 106-554, 114 Stat. 2763 (2000). Because security futures contracts on individual stocks generally track the price of the underlying stock, and, at expiration, the price of the security futures contract equals the price of the underlying stock, the proposed amendments would treat a security future on an underlying stock as if it were the underlying stock. Appendix A to Rule 18a-1 similarly would include equity security-based swaps and security futures products in the definition of "underlying instrument." See paragraph (a)(4) of proposed new Rule 18a-1a. See also letter from Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, Commission, to Timothy H. Thompson, Senior Vice President and Chief Regulatory Officer, Chicago Board Options Exchange, Incorporated ("CBOE"), and Grace B. Vogel, Executive Vice President, Member Regulation, Risk Oversight and Operational Regulation, FINRA (May

broker-dealers that are not registered as SBSDs would be able to include equity security-based swaps in portfolios of equity positions for purposes of the Appendix A methodology. In addition, proposed new Rule 18a-1 would permit stand-alone SBSDs to use the Appendix A methodology as well.[205] By permitting equity security-based swaps to be included in portfolios of related equity positions, broker-dealer SBSDs and broker-dealers that are not registered as SBSDs would be able to employ a more sensitive measure of the risk when computing net capital than would be the case if the positions were treated in isolation.

Under the Appendix A methodology (as proposed to be amended), a nonbank SBSD could group equity security-based swaps, options, security futures, long securities positions, and short securities positions involving the same underlying security (e.g., XYZ Company common stock) and stress the current market price for each position at ten equidistant points along a range of positive and negative potential future market movements, using an approved theoretical option pricing model that satisfies certain conditions specified in the rule.[206] For equity security-based swaps, the ten stress points for a portfolio of related positions would span a range from -15% to +15% (i.e., -15%, -12%, -9%, -6%, -3%, +3%, +6%, +9%, +12%, +15%).[207] The gains and losses of each position (e.g., a security-based swap, option, and a security future referencing XYZ Company and a long position and short position in XYZ Company stock) in the portfolio

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4, 2012) (no-action letter permitting broker-dealers when calculating net capital using a theoretical pricing model pursuant to Appendix A to Rule 15c3-1 to group U.S.-listed security futures contracts on individual stocks with equity options on, and positions in, the same underlying instrument under paragraph (b)(1)(ii)(A) of Appendix A).

205 See proposed new Rule 18a-1a.

206 See 17 CFR 240.15c3-1a(b)(1); paragraph (b)(1) of proposed new Rule18a-1a. Presently, there is only one theoretical options pricing model that has been approved for this purpose.

207 This range of price movements (+/-) 15% is consistent with the prescribed 15% haircut for most equity securities. See 17 CFR 240.15c3-1(c)(2)(vi)(J).

would be allowed to offset each other to yield a net gain or loss at each stress point.[208] The stress point that yields the largest potential net loss for the portfolio would be used to calculate the aggregate haircut for all the positions in the portfolio.[209] This method would permit a nonbank SBSD to compute deductions for a portfolio of equity security-based swaps in a more risk sensitive manner by accounting for the risk of the entire portfolio, rather than the risk of each position within the portfolio.

With respect to portfolios of debt security-based swaps, a nonbank SBSD could use the offsets permitted in the debt-maturity grids in Rule 15c3-1.[210] The debt-maturity grids permit the broker-dealer to reduce the amount of the deductions when long debt security positions are offset by short debt security positions. For example, as discussed above, the maturity grid for nonconvertible debt securities has nine maturity categories.[211] In each category, the broker-dealer is required to take the specified deduction on the greater of the long or short positions in the category.[212] Consequently, the broker-dealer need not take a deduction on the gross amount of these positions (i.e., the broker-dealer need not take a deduction for the long and short

208 For example, at the -6% stress point, XYZ Company stock long positions would experience a 6% loss, short positions would experience a 6% gain, and XYZ Company options would experience gains or losses depending on the features of the options. These gains and losses are added up resulting in a net gain or loss at that point.

209 Because options are part of the portfolio, the greatest portfolio loss (or gain) would not necessarily occur at the largest potential market move stress points (+/-) 15%. This is because a portfolio that holds derivative positions that are far out of the money would potentially realize large gains at the greatest market move points as these positions come into the money. Thus, the greatest net loss for a portfolio conceivably could be at any market move stress point. In addition, the Appendix A methodology imposes a minimum charge based on the number of options contracts in a portfolio that applies if the minimum charge is greater than the largest stress point charge. See 17 CFR 240.15c3-1a(b)(1)(v)(C)(2); paragraph (b)(1)(iv)(C)(2) of proposed new Rule 18a-1a. This minimum charge is designed to address issues such as leverage and liquidity risk that may exist even if the market risk of the portfolio is very low as a result of closely-correlated hedging.

210 See proposed new paragraph (c)(2)(vi)(O)(2) of Rule 15c3-1; paragraph (c)(1)(vi)(B) of proposed new Rule 18a-1 (incorporating by reference the standardized haircuts in Rule 15c3-1).

211 See 17 CFR 240.15c3-1(c)(2)(vi)(F)(1).

212 Id.

positions). In addition, the rule permits the broker-dealer to exclude nonconvertible debt securities from the maturity categories if they are hedged by other similar nonconvertible debt securities or government securities or futures on government securities.[213] The excluded positions are subject to a separate maturity grid that imposes lower deductions.[214] The proposed amendments to Rule 15c3-1 and proposed new Rule 18a-1 would permit broker-dealer SBSDs and stand-alone SBSDs, respectively, to treat debt security-based swaps in the same manner as the debt instruments they reference are treated for the purposes of determining haircuts. Consequently, nonbank SBSDs could recognize the offsets and hedges that those provisions permit to reduce the deductions on portfolios of debt security-based swaps.

Request for Comment

The Commission generally requests comment on the proposed standardized haircuts for calculating deductions for security-based swaps. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is the proposed maturity/spread grid approach for CDS security-based swaps appropriate in terms of addressing the risk of these positions? If not, explain why not. How could the proposed maturity/spread grid approach be modified to better address the risk of these positions?

2. Do broker-dealers currently use the spread/maturity grid in FINRA Rule 4240 to determine capital charges for credit default swaps? If so, what has been the experience of broker-dealers in using the grid? If not, what potential practical issues does the maturity/spread grid raise? Are there ways these practical issues could be addressed through modifications to the proposed maturity/spread grid?

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213 See 17 CFR 240.15c3-1(c)(2)(vi)(F)(2).

214 See 17 CFR 240.15c3-1(c)(2)(vi)(F)(3).

3. Is there an alternative maturity/spread grid approach that would be a preferable model for the standardized haircuts? If so, identify the model and explain why it would be preferable. For example, should the standardized haircut for a CDS security-based swap that references an obligation be based on the standardized haircut that would apply to the obligation under paragraph (c)(2)(vi) of Rule 15c3-1? If so, explain why. If not, explain why not. How could a CDS security-based swap that references an obligor as an entity be addressed under such a standardized haircut approach? For example, could the standardized haircut that would apply to obligations (e.g., bonds) issued by the obligor be used as a proxy for the standardized haircut that would apply to the CDS security-based swap referencing the obligor? If so, explain why.
4. Are the proposed spread categories for the CDS security-based swap grid appropriate? If not, explain why not. For example, should there be more spread categories? If so, specify the total number of recommended spread categories and the basis point ranges that should be in each category, and explain why the recommended modifications would be preferable. Should there be fewer spread categories? If so, specify the total number of recommended spread categories and the basis point ranges that should be in each category, and explain why the recommended modifications would be preferable.
5. Would there always be an observable current offered basis point spread for purposes of determining the applicable spread category for a CDS security-based swap? If it could be the case that a CDS security-based swap does not have an observable current offered spread, how should the spread category be determined and how should the rule be modified to require the use of the determined spread category? For example, should the rule require that the nonbank SBSD apply the greatest percentage deduction applicable to

the CDS security-based swap based on its maturity (i.e., the deduction prescribed in "700 or more" basis points spread category) or another deduction amount?

6. Are the proposed maturity categories for the CDS security-based swap grid appropriate? If not, explain why not. For example, should there be more maturity categories? If so, specify the total number of recommended maturity categories and the time ranges that should be in each category, and explain why the recommended modifications would be preferable. Should there be fewer maturity categories? If so, specify the total number of recommended maturity categories and the time ranges that should be in each category, and explain why the recommended modifications would be preferable.
7. Are the proposed percentage deductions in the CDS security-based swap grid appropriate? If not, explain why not. For example, should the percentage deductions be greater? If so, specify the greater deductions and explain why they would be preferable. Should the percentage deductions be lesser? If so, specify the lesser deductions and explain why it would be preferable.
8. Is the proposed 50% reduced deduction for long CDS security-based swaps appropriate? If not, explain why not. For example, should the amount of the reduced deduction be greater? If so, specify the amount and explain why it would be preferable. Should the amount of the reduced deduction be lesser? If so, specify the lesser amount and explain why it would be preferable.
9. Is the proposed offset and corresponding reduced deduction for net long and short positions where the CDS security-based swaps reference the same obligor or obligation and are in the same maturity and spread categories appropriate? If not, explain why not.

10. Is the proposed offset and corresponding reduced deduction for net long and short positions where the CDS security-based swaps reference the same obligor or obligation, are in the same spread category, and are in an adjacent maturity category and have maturities within three months of the other maturity category appropriate? If not, explain why not.

11. Is the proposed offset and corresponding reduced deduction for long and short CDS security-based swap positions in the same maturity and spread categories and that reference obligors or obligations of obligors in the same industry sector appropriate? If not, explain why not.

12. Should the rule specify an industry sector classification system? If so, specify the recommended industry sector classification system and explain why it would be useful for the purposes of the standardized haircuts for CDS security-based swaps.

13. If a nonbank SBSD uses its own industry sector classification system, what factors would be relevant in evaluating whether the system is reasonable?

14. Should there be a concentration charge that would apply when the notional amount of the long and short CDS security-based swap positions in the same maturity and spread categories and that reference obligors or obligations of obligors in the same industry sector exceed a certain threshold to account for the potential that long and short positions may not directly offset each other? If so, explain why. If not, explain why not.

15. Is the proposed deduction for a position where a nonbank SBDS is long a bond and long a CDS security-based swap on the same underlying obligor appropriate? If not, explain why not. For example, is the proposed provision that the reduced deduction would apply only if the CDS security-based swap allowed the nonbank SBSD to deliver the bond to

satisfy the firm's obligation on the swap appropriate? If not, explain why not. Additionally, is reducing the deduction applicable to the bond by 50% an appropriate reduction level? Should the reduction be less than 50% (e.g., 25%) or greater than 50% (e.g., 75%)?

16. Is the proposed reduced deduction for a position where a nonbank SBDS is short a bond and short a CDS security-based swap on the same underlying bond appropriate? If not, explain why not.
17. Should the Commission propose separate grids for CDS security-based swaps that reference a single obligor or obligation and CDS security-based swaps that reference a narrow based index? If so, how should the two grids differ?
18. Are the proposed standardized haircuts for non-CDS security-based swaps appropriate? If not, explain why not. For example, would the risk characteristics of non-CDS security-based swaps (e.g., price volatility) be similar to the instruments they reference? If not, explain why not.
19. Are there practical issues with treating equity security-based swaps under the Appendix A methodology? If so, describe them. Are there modifications that could be made to the Appendix A methodology to address any practical issues identified? If so, describe the modifications.
20. Are there provisions in Appendix A to Rule 15c3-1 not included in Appendix A to Rule 18a-1 that should be incorporated into the latter rule? If so, identify the provisions and explain why they should be incorporated into Appendix A to Rule 18a-1. For example, should the strategy-based methodology in Appendix A to Rule 15c3-1 be applied to equity security-based swaps? If so, explain why.

21. Are there practical issues with treating debt security-based swaps under the debt maturity grids in Rule 15c3-1? If so, describe them. Are there modifications that could be made to address any practical issues identified? If so, describe the modifications.

iii. VaR Models

The proposed capital requirements for nonbank SBSDs would permit the use of internal VaR models to compute deductions for proprietary securities positions, including security-based swap positions, in lieu of the standardized haircuts. VaR models are used by financial institutions for internal risk management purposes.[215] In addition, VaR models are used to compute market risk charges in international bank capital standards[216] and are permitted by the Commission's rules for ANC broker-dealers and OTC derivatives dealers.[217] Furthermore, the prudential regulators and the CFTC have proposed permitting the use of VaR models in their capital requirements for bank SBSDs, bank swap dealers, and swap dealers.[218] The use of VaR models to calculate market risk charges for security-based swap positions would be subject to the conditions described below.

Broker-dealer SBSDs that are not already ANC broker-dealers would need to obtain approval to operate as ANC broker-dealers to use internal VaR models to compute net capital. Stand-alone SBSDs also would need to obtain Commission approval to use VaR models for this

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215 See Alternative Net Capital Requirements Adopting Release, 69 FR 34428 (The option to use VaR models is "intended to reduce regulatory costs for broker-dealers by allowing very highly capitalized firms that have developed robust internal risk management practices to use those risk management practices, such as mathematical risk measurement models, for regulatory purposes"); Net Capital Rule, Exchange Act Release No. 39456 (Dec. 17, 1997), 62 FR 68011 (Dec. 30, 1997) ("Given the increased use and acceptance of VAR as a risk management tool, the Commission believes that it warrants consideration as a method of computing net capital requirements for broker-dealers.").

216 See, e.g., Amendment to the capital accord to incorporate market risks, Basel Committee on Banking Supervision (Jan. 1996); 12 CFR part 3; 12 CFR parts 208 and 225; 12 CFR part 325.

217 See 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f. See also Alternative Net Capital Requirements Adopting Release, 69 FR 34428; OTC Derivatives Dealers, 63 FR 59362.

218 See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564; CFTC Capital Proposing Release, 76 FR 27802.

purpose. The requirements for a broker-dealer to apply for approval to operate as an ANC broker-dealer are contained in Appendix E to Rule 15c3-1.[219] Pursuant to these requirements, the applicant must provide the Commission with various types of information about the applicant.[220] A stand-alone SBSD applying for approval to use internal models to compute net capital would be required to provide similar information (though a stand-alone SBSD would not be required to provide certain information relating to its holding company or affiliates that is required of ANC broker-dealer applicants).[221]

A broker-dealer applying to become an ANC broker-dealer is required to provide the Commission with, among other things, the following information:

- An executive summary of the information provided to the Commission with its application and an identification of the ultimate holding company of the ANC broker-dealer;[222]

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219 See 17 CFR 240.15c3-1e. The application covers both the use of internal VaR models to compute deductions for proprietary positions and internal credit risk models to compute charges for unsecured receivables relating to OTC derivatives. Id. Specifically, the broker-dealer may apply to the Commission for authorization to compute deductions pursuant to Appendix E to Rule 15c3-1 in lieu of computing deductions pursuant to paragraph (c)(2)(vi) (the standardized haircuts) and paragraph (c)(2)(vii) (the 100% deduction for securities with no ready market) of Rule 15c3-1 and to compute deductions for credit risk pursuant to Appendix E for unsecured receivables arising from transactions in OTC derivatives in lieu of computing deductions pursuant to paragraph (c)(2)(iv) of Rule 15c3-1 (the deductions for unsecured receivables). See 17 CFR 240.15c3-1e(a). The use of internal credit risk models is discussed below in section II.A.2.b.iv. of this release.

220 See Alternative Net Capital Requirements Adopting Release, 69 FR at 34433.

221 See paragraph (d)(1) of proposed new Rule 18a-1. Appendix E to Rule 15c3-1 requires a broker-dealer applying to become an ANC broker-dealer to provide information about the broker-dealer's ultimate holding company and affiliates. See 17 CFR 240.15c3-1e(a)(1)(viii)-(ix) and (a)(2). Consistent with the requirements for OTC derivatives dealers, the proposed application requirements for stand-alone SBSDs seeking approval to use internal models would not require the submission of the information about the firm's ultimate holding company and affiliates required in paragraphs (a)(1)(viii)-(ix) and (a)(2)(i)-(xi) of Appendix E to Rule 15c3-1. Compare 17 CFR 240.15c3-1e(a)(1) and (a)(2), with paragraph (d)(1) of proposed new Rule 18a-1 and 17 CFR 240.15c3-1f(a). This additional information may be more appropriate for a broker-dealer applying to operate as an ANC broker-dealer because of its ability to engage in wider ranges of activities than a stand-alone nonbank SBSD, such as engaging in a general securities business. The information about the ultimate holding company and affiliates is designed to help ensure the Commission can monitor activities of the holding company and affiliates that could negatively impact the financial well-being of the broker-dealer. See Alternative Net Capital Requirements Adopting Release, 69 FR at 34430.

222 See 17 CFR 240.15c3-1e(a)(1)(i). A stand-alone SBSD also would be required to provide this information in an application to use internal models. See paragraph (d)(1)(i)(A) of proposed new Rule 18a-1.

- A comprehensive description of the internal risk management control system of the broker-dealer and how that system satisfies the requirements set forth in Rule 15c3-4;[223]

- A list of the categories of positions that the ANC broker-dealer holds in its proprietary accounts and a brief description of the methods that the ANC broker-dealer will use to calculate deductions for market and credit risk on those categories of positions;[224]

- A description of the mathematical models to be used to price positions and to compute deductions for market risk, including those portions of the deductions attributable to specific risk, if applicable, and deductions for credit risk; a description of the creation, use, and maintenance of the mathematical models; a description of the ANC broker-dealer's internal risk management controls over those models, including a description of each category of persons who may input data into the models; if a mathematical model incorporates empirical correlations across risk categories, a description of the process for measuring correlations; a description of the backtesting procedures the ANC broker-dealer will use to backtest the mathematical model used to calculate maximum potential exposure; a description of how each mathematical model satisfies the applicable qualitative and quantitative requirements set forth in paragraph (d) of Appendix E to Rule 15c3-1; and a statement describing the extent to which each mathematical model used to compute deductions for market and credit risk will be used as part of the risk analyses and reports presented to senior management;[225]

- If the ANC broker-dealer is applying to the Commission for approval to use scenario analysis to calculate deductions for market risk for certain positions, a list of those types of positions, a description of how those deductions will be calculated using scenario analysis, and an explanation of why each scenario analysis is appropriate to calculate deductions for market risk on those types of positions;[226]

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223 See 17 CFR 240.15c3-1e(a)(1)(ii). A stand-alone SBSD also would be required to provide this information in an application to use internal models. See paragraph (d)(1)(i)(B) of proposed new Rule 18a-1. As discussed below in section II.A.2.c. of this release, ANC broker-dealers are required to comply with Rule 15c3-4, and to provide this information in an application to use internal models. See 17 CFR 240.15c3-1e(a)(1)(ii), 17 CFR 240.15c3-1(a)(7)(iii) and 17 CFR 240.15c3-4. A nonbank SBSD that does not use internal models also would be required to comply with Rule 15c3-4, but would not have to provide information to the Commission unless it determined to apply to the Commission to use internal models. See paragraph (g) of proposed new Rule 18a-1 and section II.A.2.c. of this release discussing this requirement.

224 See 17 CFR 240.15c3-1e(a)(1)(iii). A stand-alone SBSD also would be required to provide this information in an application to use internal models. See paragraph (d)(1)(i)(C) of proposed new Rule 18a-1.

225 See 17 CFR 240.15c3-1e(a)(1)(iv). A stand-alone SBSD also would be required to provide this information in an application to use internal models. See paragraph (d)(1)(i)(D) of proposed new Rule 18a-1.

226 See 17 CFR 240.15c3-1e(a)(1)(v). A stand-alone SBSD also would be required to provide this information in an application to use internal models. See paragraph (d)(1)(i)(E) of proposed new Rule 18a-1. As discussed below, ANC broker-dealers can use scenario analysis in certain cases to determine deductions for some positions.

- A description of how the ANC broker-dealer will calculate current exposure;[227]

- A description of how the ANC broker-dealer will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable;[228]

- For each instance in which a mathematical model used by the ANC broker-dealer to calculate a deduction for market risk or to calculate maximum potential exposure for a particular product or counterparty differs from the mathematical model used by the ultimate holding company of the ANC broker-dealer to calculate an allowance for market risk or to calculate maximum potential exposure for that same product or counterparty, a description of the difference(s) between the mathematical models;[229] and

- Sample risk reports that are provided to the persons at the ultimate holding company who are responsible for managing group-wide risk and that will be provided to the Commission pursuant to Rule 15c3-1g.[230]

The Commission may request that a broker-dealer applying to operate as an ANC broker-dealer supplement its application ("ANC application") with other information relating to the internal risk management control system, mathematical models, and financial position of the broker-dealer.[231] A broker-dealer's ANC application and all submissions in connection with the

227 See 17 CFR 240.15c3-1e(a)(1)(vi). A stand-alone SBSD also would be required to provide this information in an application to use internal models. See paragraph (d)(1)(i)(F) of proposed new Rule 18a-1.

228 See 17 CFR 240.15c3-1e(a)(1)(vii). A stand-alone SBSD also would be required to provide this information in an application to use internal models. See paragraph (d)(1)(i)(G) of proposed new Rule 18a-1. As discussed below in section II.A.2.b.iv. of this release, internal credit ratings are used to compute the credit risk charge.

229 See 17 CFR 240.15c3-1e(a)(2)(xi). A stand-alone SBSD also would be required to provide this information in an application to use internal models. See paragraph (d)(1)(i)(H) of proposed new Rule 18a-1.

230 See 17 CFR 240.15c3-1e(a)(2)(xiii). A stand-alone SBSD would be required to provide similar information in an application to use internal models. See paragraph (d)(1)(i)(I) of proposed new Rule 18a-1. The proposed requirement for stand-alone SBSDs to provide this information refers to sample risk reports that are provided to "management" as opposed to the "ultimate holding company." Id. As a practical matter, the two provisions would achieve the same result; namely, the submission of sample reports that are provided to senior levels of the firm. However, because the stand-alone SBSD application provisions do not require information about holding companies and affiliates, the proposed text of the rule refers to "management."

231 See 17 CFR 240.15c3-1e(a)(4). A similar provision would apply to stand-alone SBSDs applying to use internal models. See paragraph (d)(2) of proposed new Rule 18a-1.

ANC application are accorded confidential treatment, to the extent permitted by law.[232] If any information in an ANC application is found to be or becomes inaccurate before the Commission approves the application, the broker-dealer must notify the Commission promptly and provide the Commission with a description of the circumstances in which the information was inaccurate along with updated, accurate information.[233] The Commission may approve, in whole or in part, an ANC application or an amendment to the application, subject to any conditions or limitations the Commission may require if the Commission finds the approval to be necessary or appropriate in the public interest or for the protection of investors.[234]

As part of the ANC application approval process, the Commission staff reviews the operation of the broker-dealer's VaR model, including a review of associated risk management controls and the use of stress tests, scenario analyses, and back-testing.[235] As part of this process and on an ongoing basis, the broker-dealer applicant is required to demonstrate to the Commission that the VaR model reliably accounts for the risks that are specific to the types of positions the broker-dealer intends to include in the model computations. During the review, the Commission assesses the quality, rigor, and adequacy of the technical components of the VaR model and of related model governance processes. Stand-alone SBSDs applying for approval to use internal models to compute net capital would be subject to similar reviews of their VaR models as part of the application process.

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232 See 17 CFR 240.15c3-1e(a)(5). See also 5 U.S.C. 552; Alternative Net Capital Requirements Adopting Release, 69 FR at 34433 (discussing confidential treatment of ANC applications). A similar provision would apply to information submitted by stand-alone SBSDs applying to use internal models. See paragraph (d)(3) of proposed new Rule 18a-1.

233 See 17 CFR 240.15c3-1e(a)(6). A similar provision would apply to stand-alone SBSDs applying to use internal models. See paragraph (d)(4) of proposed new Rule 18a-1.

234 See 17 CFR 240.15c3-1e(a)(7). A similar provision would apply to applications of stand-alone SBSDs applying to use internal models. See paragraph (d)(5) of proposed new Rule 18a-1.

235 The Commission also reviews the broker-dealer's credit risk model.

After an ANC application is approved, an ANC broker-dealer is required to amend and submit to the Commission for approval its ANC application before materially changing its VaR model or its internal risk management control system.[236] Further, an ANC broker-dealer is required to notify the Commission 45 days before it ceases using a VaR model to compute net capital.[237] Finally, the Commission, by order, can revoke an ANC broker-dealer's ability to use a VaR model to compute net capital if the Commission finds that the ANC broker-dealer's use of the model is no longer necessary or appropriate in the public interest or for the protection of investors.[238] In this case, the broker-dealer would need to revert to using the standardized haircuts for all positions.

An ANC broker-dealer must comply with certain qualitative and quantitative requirements set forth in Appendix E to Rule 15c3-1.[239] A stand-alone SBSD approved to use a VaR model would be subject to the same qualitative and quantitative requirements.[240] In this regard, VaR models estimate the maximum potential loss a portfolio of securities and other instruments would be expected to incur over a fixed time period at a certain probability level. The model utilizes historical market data to generate potential values of a portfolio of positions taking into consideration the observed correlations between different types of assets.

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236 See 17 CFR 240.15c3-1e(a)(8). This requirement also applies to material changes to the ANC broker-dealer's internal credit risk model. Id. A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(6) of proposed new Rule 18a-1.

237 See 17 CFR 240.15c3-1(a)(10). This requirement also applies to the ANC broker-dealer's internal credit risk model. Id. A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(7) of proposed new Rule 18a-1.

238 See 17 CFR 240.15c3-1e(a)(11). This requirement also applies to the ANC broker-dealer's internal credit risk model. Id. A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(8) of proposed new Rule 18a-1.

239 See 17 CFR 15c3-1e(d).

240 Compare 17 CFR 15c3-1e(d), with paragraph (d)(9) of proposed new Rule 18a-1.

The qualitative requirements in Appendix E to Rule 15c3-1 specify, among other things, that: (1) each VaR model must be integrated into the ANC broker-dealer's daily internal risk management system;[241] (2) each VaR model must be reviewed periodically by the firm's internal audit staff, and annually by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.);[242] and (3) the VaR measure computed by the model must be multiplied by a factor of at least three but potentially a greater amount based on the number of exceptions to the measure resulting from quarterly back-testing exercises.[243]

The quantitative requirements specify that the VaR model of the ANC broker-dealer must, among other things: (1) use a 99%, one-tailed confidence level with price changes equivalent to a ten-business-day movement in rates and prices;[244] (2) use an effective historical

241 See 17 CFR 240.15c3-1e(d)(1)(i). A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(9)(i)(A) of proposed new Rule 18a-1.

242 See 17 CFR 240.15c3-1e(d)(1)(ii). The annual review must be conducted in accordance with procedures agreed upon by the broker-dealer and the registered public accounting firm conducting the review. A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(9)(i)(B) of proposed new Rule 18a-1.

243 See 17 CFR 240.15c3-1e(d)(1)(iii). A back-testing exception occurs when the ANC broker-dealer's actual one-day loss exceeds the amount estimated by its VaR model. See, e.g., Supervisory framework for the use of "backtesting" in conjunction with the internal models approach to market risk capital requirements, Basel Committee on Banking Supervision (Jan. 1996) ("The essence of all backtesting efforts is the comparison of actual trading results with model-generated risk measures. If this comparison is close enough, the backtest raises no issues regarding the quality of the risk measurement model. In some cases, however, the comparison uncovers sufficient differences that problems almost certainly must exist, either with the model or with the assumptions of the backtest. In between these two cases is a grey area where the test results are, on their own, inconclusive."). Depending on the number of back-testing exceptions, the ANC broker-dealer may need to increase the market risk multiplier to 3.40, 3.50, 3.65, 3.75, 3.85, or 4.00. Id. Increasing the multiplier increases the deduction amount, which in turn is designed to account for a model that is producing less accurate measures. The same multiplier provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(9)(i)(C) of proposed new Rule 18a-1.

244 See 17 CFR 240.15c3-1e(d)(2)(i). This means the potential loss measure produced by the model is a loss that the portfolio could experience if it were held for ten trading days and that this potential loss amount would be exceeded only once every 100 trading days. A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(9)(ii)(A) of proposed new Rule 18a-1.

observation period of at least one year;[245] (3) use historical data sets that are updated at least monthly and are reassessed whenever market prices or volatilities change significantly;[246] and (4) take into account and incorporate all significant, identifiable market risk factors applicable to positions of the ANC broker-dealer, including risks arising from non-linear price characteristics, empirical correlations within and across risk factors, spread risk, and specific risk for individual positions.[247]

The deduction an ANC broker-dealer must take to tentative net capital in lieu of the standardized haircuts is an amount equal to the sum of four charges.[248] The first is a portfolio market risk charge for all positions that are included in the ANC broker-dealer's VaR models (i.e., the amount measured by each VaR model multiplied by a factor of at least three).[249] The second charge is a specific risk charge for positions where specific risk was not captured in the VaR model.[250] The third charge is for positions not included in the VaR model where the ANC

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245 See 17 CFR 240.15c3-1e(d)(2)(iii). A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(9)(ii)(C) of proposed new Rule 18a-1.

246 See 17 CFR 240.15c3-1e(d)(2)(iii). A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(9)(ii)(C) of proposed new Rule 18a-1.

247 See 17 CFR 240.15c3-1e(d)(2)(iv). A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (d)(9)(ii)(D) of proposed new Rule 18a-1.

248 See 17 CFR 240.15c3-1e(b). A similar provision would apply to stand-alone SBSDs approved to use internal models. See paragraph (e)(1) of proposed new Rule 18a-1.

249 See 17 CFR 240.15c3-1e(b)(1). A similar charge would apply to stand-alone SBSDs in determining their deduction amount. See paragraph (e)(1)(i) of proposed new Rule 18a-1.

250 See 17 CFR 240.15c3-1e(b)(2). Specific risk is the risk that a security price will change for reasons unrelated to broader market moves. The market risk charge is designed to address the risk that the value of a portfolio of trading book assets will decline as a result of a broad move in market prices or interest rates. For example, the potential that the S&P 500 index will increase or decrease on the next trading day creates market risk for a portfolio of equity securities positions (longs, shorts, options, and OTC derivatives) and the potential that interest rates will increase or decrease on the next trading day creates market risk for a portfolio of fixed-income positions (longs, shorts, options, and OTC derivatives). The specific risk charge is designed to address the risk that the value of an individual position would decline for reasons unrelated to a broad movement of market prices or interest rates. For example, specific risk includes the risk that the value of an equity security will decrease because the issuer announces poor earnings for the previous quarter or the value of a debt security will decrease because the issuer's credit rating is lowered. The Commission is proposing a similar charge that would apply to stand-alone SBSDs in determining their deduction amount. See paragraph (e)(1)(ii) of proposed new Rule 18a-1.

broker-dealer is approved to determine a charge using scenario analysis.[251] The fourth charge is determined by applying the standardized haircuts for all other positions.[252]

Finally, ANC broker-dealers are subject to on-going supervision with respect to their internal risk management, including their use of VaR models.[253] In this regard, the Commission staff meets regularly with senior risk managers at each ANC broker-dealer to review the risk analytics prepared for the firm's senior management. These reviews focus on the performance of the risk measurement infrastructure, including statistical models, risk governance issues such as modifications to and breaches of risk limits, and the management of outsized risk exposures. In addition, Commission staff and personnel from an ANC broker-dealer hold regular meetings focused on financial results, the management of the firm's balance sheet, and, in particular, the liquidity of the balance sheet. The Commission staff also monitors the performance of the ANC broker-dealer's internal models through regular reports generated by the firms for their internal risk management purposes (backtesting, stress test, and other monthly risk reports) and discussions with firm personnel (scheduled and ad hoc).[254] Material changes to the internal models are also subject to review and approval.[255] Stand-alone SBSDs approved to use internal models to compute net capital would be subject to similar monitoring and reviews.

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251 See 17 CFR 240.15c3-1e(b)(3). A similar charge would apply to stand-alone SBSDs in determining their deduction amount. See paragraph (e)(1)(iii) of proposed new Rule 18a-1.

252 See 17 CFR 240.15c3-1e(b)(4). A similar charge would apply to stand-alone SBSDs in determining their deduction amount. See paragraph (e)(1)(iv) of proposed new Rule 18a-1.

253 More detailed descriptions of the Commission's ANC broker-dealer program are available on the Commission's website at http://www.sec.gov/divisions/marketreg/bdriskoffice.htm and http://www.sec.gov/divisions/marketreg/bdaltnetcap.htm. The ultimate holding companies of the ANC broker-dealers also are subject to monitoring by Commission staff.

254 In addition to regularly scheduled meetings, communications with ANC broker-dealers may increase in frequency, dependent on existing market conditions, and at times, may involve daily, weekly or other ad hoc calls or meetings.

255 See 17 CFR 240.15c3-1e(a)(8).

Request for Comment

The Commission generally requests comment on the proposed requirements for using VaR models to compute net capital. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Would VaR models appropriately account for the risks of security-based swaps? If not, explain why not. For example, do the characteristics of security-based swaps make it more difficult to measure their market risk using VaR models than it is to measure the market risk of other types of securities using VaR models? If so, explain why.
2. Are the application requirements in Appendix E to Rule 15c3-1 an appropriate model for the application requirements in proposed new Rule 18a-1? If not, explain why not.
3. Are there provisions in the application requirements in Appendix E to Rule 15c3-1 not incorporated into proposed new Rule 18a-1 that should be included in the proposed rule, such as information regarding the ultimate holding company of the nonbank SBSD? If so, identify the provisions and explain why they should be incorporated into the proposed rule.
4. Is the review process for ANC applications an appropriate model for the review process for stand-alone SBSDs seeking approval to use internal models to compute net capital? If not, explain why not.
5. Are there ways to facilitate the timely review of applications from nonbank SBSDs to use internal models if a large number of applications are filed at the same time? For example, could a more limited review process be used if a banking affiliate of a nonbank SBSD has been approved by a prudential regulator to use the same model the nonbank

SBSD intends to use? If so, what conditions should attach to such approval? Are there other indicia of the reliability of such models that could be relied on?

6. Are the qualitative requirements in Appendix E to Rule 15c3-1 an appropriate model for the qualitative requirements in proposed new Rule 18a-1?

7. More generally, are the qualitative requirements in Appendix E to Rule 15c3-1 appropriate for VaR models that will include security-based swaps? If not, explain why not. For example, are there additional or alternative qualitative requirements that should be required to address the unique risk characteristics of security-based swaps? If so, describe them and explain why they would be appropriate qualitative requirements.

8. Are the quantitative requirements in Appendix E to Rule 15c3-1 an appropriate model for the quantitative requirements in proposed new Rule 18a-1? If not, explain why not.

9. More generally, are the quantitative requirements in Appendix E to Rule 15c3-1 appropriate for VaR models that will include security-based swaps? If not, explain why not. For example, are there additional or alternative quantitative requirements that should be required to address the unique risk characteristics of security-based swaps? If so, describe them and explain why they would be preferable.

10. Are the components of the deduction an ANC broker-dealer must take from tentative net capital under Appendix E to Rule 15c3-1 an appropriate model for the components of the deduction a stand-alone SBSD approved to use internal models would be required to take from tentative net capital under proposed new Rule 18a-1? If not, explain why not.

11. Should the Commission employ the same type of on-going monitoring process used for ANC broker-dealers to monitor stand-alone SBSDs using internal models? If not, explain why not.

iv. Credit Risk Charges

Obtaining collateral is one of the ways dealers in OTC derivatives manage their credit risk exposure to OTC derivatives counterparties.[256] Collateral may be provided to cover the amount of the current exposure of the dealer to the counterparty.[257] In this case, the collateral is designed to protect the dealer from losing the positive market value of the OTC contract if the counterparty defaults.[258] Collateral also may be provided to cover an amount in excess of the current exposure (sometimes referred to as "residual exposure") of the dealer to the counterparty.[259] In this case, the collateral is designed to protect the dealer from potential future credit risk exposure to the counterparty ("potential future exposure").[260] This risk, among other things, is that the current exposure may increase in the future and the counterparty will default on the obligation to provide additional collateral to cover the increase or an increase in the amount of current exposure will occur after the counterparty defaults and is no longer providing

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256 See, e.g., International Swaps and Derivatives Association, Inc. ("ISDA"), Market Review of OTC Derivative Bilateral Collateralization Practices, Release 2.0 (Mar. 1, 2010), available at http://www.isda.org/c_and_a/pdf/Collateral-Market-Review.pdf ("Market Review of OTC Derivative Bilateral Collateralization Practices"); Committee on Payment and Settlement Systems and the Euro-currency Standing Committee of the Central Banks of the Group of Ten countries, OTC Derivatives: Settlement Procedures And Counterparty Risk Management, (Sept. 1998), available at http://www.bis.org/publ/ecsc08.pdf ("OTC Derivatives: Settlement Procedures And Counterparty Risk Management").

257 See, e.g., ISDA, Independent Amounts, Release 2.0 (Mar. 1, 2010) ("Independent Amounts"). The current exposure is the amount that the counterparty would be obligated to pay the nonbank SBSD if all the OTC derivatives contracts with the counterparty were terminated (i.e., the net positive value of the OTC contracts to the nonbank SBSD and the net negative value of the OTC contracts to the counterparty). The amount payable on the OTC derivatives contracts (the positive value) is determined by marking-to-market the OTC derivatives contracts and netting contracts with a positive value against contracts with a negative value. The market value of an OTC derivatives contract also is referred to as the replacement value of the contract as that is the amount the nonbank SBSD would need to pay to enter into an identical contract with a different counterparty.

258 Id. at 2 ("The commercial reason for basing the collateral requirement around the Exposure is that this represents an approximation of the amount of credit default loss that would occur between the parties if one were to default.").

259 Id. at 4.

260 Id. at 6 ("The underlying commercial reason behind Independent Amounts is the desire to create a "cushion" of additional collateral to protect against certain risk….").

collateral.[261]

As discussed below in section II.B. of this release, the margin rule for non-cleared security-based swaps – proposed new Rule 18a-3 – would require a nonbank SBSD to collect collateral from a counterparty to cover current and potential future exposure to the counterparty.[262] However, under the rule, a nonbank SBSD would not be required to collect collateral from a commercial end user to cover current and potential future exposure to the commercial end user.[263] This proposed exception to collecting collateral from commercial end users is intended to address concerns that have been expressed by these entities and others that the imposition of margin requirements on commercial companies that use derivatives to mitigate business risks could disrupt their ability to enter into hedging transactions by making it prohibitively expensive.[264] At the same time, because collecting collateral is an important means of mitigating risk, nonbank SBSDs would be required to take a 100% deduction from net worth if collateral is not collected from a commercial end user to cover the amount of the nonbank

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261 Id.

262 See proposed new Rule 18a-3.

263 See paragraph (c)(1)(iii)(A) of proposed new Rule 18a-3. As discussed in section II.B. of this release, proposed new Rule 18a-3 would contain three other exceptions to the requirements in the rule to collect and hold collateral. See paragraphs (c)(1)(iii)(B), (C), and (D) of proposed new Rule 18a-3. The proposed alternative credit risk charge discussed in this section of the release would not apply to these other exceptions.

264 See, e.g., letter from the Honorable Debbie Stabenow, Chairman, Committee on Agriculture, Nutrition and Forestry, U.S. Senate, the Honorable Frank D. Lucas, Chairman, Committee on Agriculture, U.S. House of Representatives, the Honorable Tim Johnson, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and the Honorable Spencer Bachus, Chairman, Committee on Financial Services, U.S. House of Representatives to Secretary Timothy Geithner, Department of Treasury, Chairman Gary Gensler, CFTC, Chairman Ben Bernanke, Federal Reserve Board, and Chairman Mary Schapiro, Commission (Apr. 6, 2011); letter from the Honorable Christopher Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and the Honorable Blanche Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, to the Honorable Barney Frank, Chairman, Financial Services Committee, U.S. House of Representatives, and the Honorable Collin Peterson, Chairman, Committee on Agriculture, U.S. House of Representatives (June 30, 2010); 156 CONG. REC. S5904 (daily ed. July 15, 2010) (statement of Sen. Lincoln). See also letter from Coalition for Derivatives End-Users to David A. Stawick, Secretary, CFTC (July 11, 2011); letter from Paul Cicio, President, Industrial Energy Users of America, to David A. Stawick, Secretary, CFTC (July 11, 2011); letter from Coalition for Derivatives End-Users to Elizabeth Murphy, Secretary, Commission and David A. Stawick, Secretary, CFTC (Sept. 10, 2010).

SBSD's uncollateralized current exposure.[265] In addition, as discussed below in section II.A.2.b.v. of this release, nonbank SBSDs would be required to take a capital charge equal to the amount that the potential future exposure to the commercial end user – as measured under proposed new Rule 18a-3 – is uncollateralized.[266] As an alternative to taking these 100% capital charges for uncollateralized current and potential future exposure to a commercial end user, an ANC broker-dealer and a stand-alone SBSD using internal models could take a credit risk charge using a methodology in Appendix E to Rule 15c3-1.[267] 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.

ANC broker-dealers currently are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (i.e., they can add back the amount of the uncollateralized current exposure).[268] Instead of the 100% deduction that applies to most unsecured receivables under Rule 15c3-1, ANC broker-dealers are permitted to take a credit risk charge based on the uncollateralized credit exposure to the counterparty.[269] In most cases, the credit risk charge is significantly less than a 100% deduction, since it is a percentage of the amount of the receivable that otherwise would be deducted in full. ANC broker-dealers are permitted to use this approach because they are required to implement

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265 See 17 CFR 240.15c3-1(c)(2)(iv)(B) (which requires a broker-dealer – and would require a broker-dealer SBSD – to deduct unsecured and partly secured receivables); paragraph (c)(1)(iii)(B) of proposed new Rule 18a-1 (which would contain an analogous provision for stand-alone SBSDs).

266 See proposed new paragraph (c)(2)(xiv) of Rule 15c3-1; paragraph (c)(1)(viii)(B)(1) of proposed Rule 18a-1.

267 See proposed amendments to paragraph (a)(7) of Rule 15c3-1; paragraph (a)(2) of proposed new Rule 18a-1.

268 See 17 CFR 240.15c3-1e(c). OTC derivatives dealers are permitted to treat such uncollateralized receivables in a similar manner. See 17 CFR 240.15c3-1f.

269 See 17 CFR 240.15c3-1e(c); 17 CFR 240.15c3-1(a)(7).

processes for analyzing credit risk to OTC derivative counterparties and to develop mathematical models for estimating credit exposures arising from OTC derivatives transactions and determining risk-based capital charges for those exposures.[270] Under the current requirements, this approach is used for uncollateralized OTC derivatives receivables from all types of counterparties.[271] For the reasons discussed below, this treatment would be narrowed under the proposed capital requirements for ANC broker-dealers and stand-alone SBSDs using internal models so that it would apply only to uncollateralized receivables from commercial end users arising from security-based swaps (i.e., uncollateralized receivables from other types of counterparties would be subject to the 100% deduction from net worth).[272]

The current requirements for determining risk-based capital charges for credit exposures are prescribed in Appendix E to Rule 15c3-1. These requirements are based on a method of computing capital charges for credit risk exposures in the international capital standards for banking institutions. In general terms, credit risk is the risk of loss arising from a borrower or counterparty's failure to meet its obligations in accordance with agreed terms, including, for example, by failing to make a payment of cash or delivery of securities. The considerations that inform an entity's assessment of a counterparty's credit risk therefore are broadly similar across the various relationships that may arise between the dealer and the counterparty. Accordingly, the methodology in Appendix E to Rule 15c3-1 should be a reasonable model for determining risk-based capital charges for credit exposures whether the entity in question is an ANC broker-dealer or a stand-alone SBSD using models. Similarly, because credit risk arises regardless of

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270 Id.

271 Id. While the requirements permit this treatment for unsecured receivables from all types of counterparties, the amount of the credit risk charge – as discussed below – depends on the creditworthiness of the counterparty. Id.

272 See proposed amendments to paragraphs (a) and (c) of Rule 15c3-1e.

the number or size of transactions, the methodology should apply in a consistent manner whether an entity deals exclusively in OTC derivatives, maintains a significant book of such derivatives, or only engages in one from time to time.

As discussed above in section II.A.2.b.i. of this release, the capital standard in Rule 15c3-1 is a net liquid assets test. The rule imposes this test by requiring a broker-dealer to deduct all illiquid assets, including most unsecured receivables.[273] The goal is to require the broker-dealer to hold more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities. The rule requires a 100% deduction for most types of unsecured receivables because these assets cannot be readily converted into cash to provide immediate liquidity to the broker-dealer.[274] FOCUS Report data and Commission staff experience with supervising the ANC broker-dealers indicates that ANC broker-dealers have not engaged in a large volume of OTC derivatives transactions since these rules were adopted in 2004. Therefore, they have not had significant amounts of unsecured receivables that could be subject to the credit risk charge provisions in Appendix E to Rule 15c3-1. However, when the Dodd-Frank Act's OTC derivatives reforms are implemented and become effective, ANC broker-dealers could significantly increase the amount of the receivables these firms have relating to OTC derivatives. This development could adversely impact the liquidity of the ANC broker-dealers to the extent exposures to OTC derivatives are not collateralized.

For these reasons, ANC broker-dealers (including broker-dealer SBSDs that are approved to use internal models) would be required to treat uncollateralized receivables from counterparties arising from security-based swaps like most other types of unsecured receivables (i.e., subjecting them to a 100% deduction from net worth) except when the counterparty is a

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273 See 17 CFR 240.15c3-1(c)(2)(iv).

274 See Interpretation Guide to Net Capital Computation for Brokers and Dealers, 32 FR at 858.

commercial end user. In the case of a commercial end user, the ANC broker-dealer would be permitted to continue to take a credit risk charge in lieu of the 100% deduction.[275] Stand-alone SBSDs that are approved to use internal models also would be permitted to take a credit risk charge for uncollateralized receivables arising from security-based swaps with (and only with) commercial end users in lieu of the 100% deduction.[276]

Under the proposed capital requirements for nonbank SBSDs, this credit risk charge for a commercial end user could serve as an alternative to the proposed capital charge in lieu of collecting collateral to cover potential future exposure.[277] The proposed capital charge in lieu of margin is designed to address situations where a nonbank SBSD does not collect sufficient (or any) collateral to cover potential future exposure relating to cleared and non-cleared security-based swaps.[278] This situation may arise with respect to counterparties to non-cleared security-based swaps that are commercial end users because proposed new Rule 18a-3 would not require nonbank SBSDs to collect collateral from them to cover either current or potential future exposure.[279]

The proposed method for calculating the credit risk charge for commercial end users would be the same method ANC broker-dealers currently are permitted to use for all OTC derivatives counterparties.[280] A stand-alone SBSD approved to use internal models would use

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275 See proposed amendments to paragraphs (a) and (c) of Rule 15c3-1e.

276 See paragraph (e)(2) of proposed new Rule 18a-1.

277 See proposed new paragraph (c)(2)(xiv) of Rule 15c3-1; paragraph (c)(1)(viii)(B)(1) of proposed Rule 18a-1.

278 Id.

279 See paragraph (c)(1)(iii)(A) of proposed new Rule 18a-3.

280 See 17 CFR 240.15c3-1e(c); paragraph (e)(2) of proposed new Rule 18a-1.

the same method.[281] Under this method, the credit risk charge is the sum of three calculated amounts: (1) a counterparty exposure charge; (2) a concentration charge if the current exposure to a single counterparty exceeds certain thresholds; and (3) a portfolio concentration charge if aggregate current exposure to all counterparties exceeds certain thresholds.[282]

The first component of the credit risk charge is the counterparty exposure charge.[283] An ANC broker-dealer must determine an exposure charge for each OTC derivatives counterparty. The first component of the credit risk charge is the aggregate of the exposure charges across all counterparties. The exposure charge for a counterparty that is insolvent, in a bankruptcy proceeding, or in default of an obligation on its senior debt, is the net replacement value of the OTC derivatives contracts with the counterparty (i.e., the net amount of the uncollateralized current exposure to the counterparty).[284] The counterparty exposure charge for all other counterparties is the credit equivalent amount of the ANC broker-dealer's exposure to the counterparty multiplied by an applicable credit risk weight factor and then multiplied by 8%.[285] The credit equivalent amount is the sum of the ANC broker-dealer's: (1) maximum potential exposure ("MPE") to the counterparty multiplied by a back-testing determined factor; and (2)

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281 See paragraph (e)(2) of proposed new Rule 18a-1. While this discussion focuses on the application of the method in the context of ANC broker-dealers, the same method would be used by stand-alone SBSDs for the reasons described above, in particular the fact that credit risk exposure should not vary materially depending on whether an entity is a broker-dealer SBSD or a stand-alone SBSD.

282 17 CFR 240.15c3-1e(c).

283 17 CFR 240.15c3-1e(c)(1). A stand-alone SBSD approved to use internal models would be required to take an identical credit risk charge for this type of counterparty. See paragraph (e)(2)(i) of proposed new Rule 18a-1.

284 See 17 CFR 240.15c3-1e(c)(1)(i). In other words, the uncollateralized receivable is deducted in full. A stand-alone SBSD approved to use internal models would take an identical credit risk charge for this type of counterparty. See paragraph (e)(2)(i)(A) of proposed new Rule 18a-1.

285 See 17 CFR 240.15c3-1e(c)(1)(ii). A stand-alone SBSD approved to use internal models would take an identical credit risk charge for this type of counterparty. See paragraph (e)(2)(i)(B) of proposed new Rule 18a-1. The 8% multiplier is consistent with the calculation of credit risk in the OTC derivatives dealers rules and with the Basel Standard, and is designed to dampen leverage to help ensure that the firm maintains a safe level of capital. See Alternative Net Capital Requirements Adopting Release, 69 FR at 34436, note 42.

current exposure to the counterparty.[286] The MPE amount is a charge to address potential future exposure and is calculated using the ANC broker-dealer's VaR model as applied to the counterparty's positions after giving effect to a netting agreement with the counterparty, taking into account collateral received from the counterparty, and taking into account the current replacement value of the counterparty's positions.[287] The current exposure amount is the current replacement value of the counterparty's positions after giving effect to a netting agreement with the counterparty and taking into account collateral received from the counterparty.[288]

A collateral agreement gives the dealer the right of recourse to an asset or assets that can be sold or the value of which can be applied in the event the counterparty defaults on an obligation arising from an OTC derivatives contract between the dealer and the counterparty.[289] Collateral "ideally" is "an asset of stable and predictable value, an asset that is not linked to the value of the transaction in any way and an asset that can be sold quickly and easily if the need arises."[290] Appendix E to Rule 15c3-1 sets forth requirements for taking account of collateral in determining the MPE and current exposure amounts.[291] These requirements are designed to require collateral that meets the characteristics noted above. The requirements, among other things, include that the collateral is: (1) marked-to-market each day; (2) subject to a daily margin

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286 See 17 CFR 240.15c3-1e(c)(4)(i). The amount of the factor is based on backtesting exceptions. A stand-alone SBSD approved to use internal models would determine the credit equivalent amount in the same manner. See paragraph (e)(2)(iv)(A) of proposed new Rule 18a-1.

287 See 17 CFR 240.15c3-1e(c)(4)(ii). A stand-alone SBSD approved to use internal models would compute MPE in the same manner. See paragraph (e)(2)(iv)(B) of proposed new Rule 18a-1.

288 See 17 CFR 240.15c3-1e(c)(4)(iii). A stand-alone SBSD approved to use internal models would compute current exposure in the same manner. See paragraph (e)(2)(iv)(C) of proposed new Rule 18a-1.

289 See Market Review of OTC Derivative Bilateral Collateralization Practices at 5.

290 Id.

291 See 17 CFR 240.15c3-1e(c)(4)(v). A stand-alone SBSD approved to use internal models would be subject to the same requirements in order to be permitted to take into account collateral when determining the MPE and current exposure amounts. See paragraph (e)(2)(iv)(E) of proposed new Rule 18a-1.

maintenance requirement;[292] (3) in the ANC broker-dealer's possession and control; (4) liquid and transferable; (5) capable of being liquidated promptly without intervention of any other party; (6) subject to a legally enforceable collateral agreement; (7) not comprised of securities issued by the counterparty or a party related to the ANC broker-dealer or the counterparty; (8) comprised of instruments that can be included in the ANC broker-dealer's VaR model; and (9) not used in determining the credit rating of the counterparty.[293]

Appendix E to Rule 15c3-1 sets forth certain minimum requirements for giving effect to netting agreements[294] when determining the MPE and current exposure amounts.[295] Specifically, an ANC broker-dealer may include the effect of a netting agreement that allows the netting of gross receivables from and gross payables to a counterparty upon default of the counterparty if:

- The netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings;
- The gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and
- For internal risk management purposes, the ANC broker-dealer monitors and controls its

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292 This refers to an internal maintenance margin requirement (i.e., not one imposed by regulation).

293 See 17 CFR 240.15c3-1e(c)(4)(v)(A)-(H). A stand-alone SBSD approved to use internal models would be subject to the same requirements. See paragraph (e)(2)(iv)(E)(1)-(8) of proposed new Rule 18a-1.

294 Netting agreements are bilateral contracts between two counterparties that enter into OTC derivatives contracts with each other. In netting agreements, the two parties agree that if one counterparty defaults, the pending OTC derivatives contracts between the parties will be closed out and a single net payment obligation will be determined (as opposed to payment obligations for each separate OTC derivatives contract between the parties). The amount of the single net payment obligation is determined by offsetting OTC derivatives contracts that have a positive value to a counterparty with OTC derivatives contracts that have a negative value to the counterparty. After the offsets, one counterparty has an amount of positive value, which to the other counterparty is a negative value. This is the amount of the single net payment obligation. If the non-defaulting counterparty is owed the single net payment amount, it can liquidate collateral held to secure the obligations of the defaulting counterparty. However, if the non-defaulting party does not hold collateral, it becomes a general creditor of the defaulting counterparty with respect to the amount of the single net payment obligation.

295 See 17 CFR 240.15c3-1e(c)(4)(iv). A stand-alone SBSD approved to use internal models would be subject to the same requirements in order to be permitted to take into account netting agreements when determining MPE and current exposure amounts. See paragraph (e)(2)(iv)(D) of proposed new Rule 18a-1.

exposure to the counterparty on a net basis.[296]

These requirements are designed to ensure that the netting agreement between the ANC broker-dealer and the counterparty permits the ANC broker-dealer to reduce the receivables and payables between the two entities to a single net payment obligation.

The counterparty exposure charge is the sum of the MPE and current exposure amounts multiplied by an applicable credit risk weight factor and then multiplied by 8%.[297] Appendix E to Rule 15c3-1 prescribes three standardized credit risk weight factors (20%, 50%, and 150%) and, as an alternative, permits an ANC broker-dealer with Commission approval to use internal methodologies to determine appropriate credit risk weights to apply to counterparties.[298] A higher percentage credit risk weight factor results in a larger counterparty exposure charge amount. Moreover, because the counterparty exposure charge is designed to require the ANC broker-dealer to hold capital to address the firm's credit risk exposure to the counterparty, the selection of the appropriate risk weight factor to use for a given counterparty is based on an assessment of the creditworthiness of the counterparty. ANC broker-dealers are permitted to use internally derived credit ratings to select the appropriate risk weight factor.[299]

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296 See 17 CFR 240.15c3-1e(c)(4)(iv)(A)-(C). A stand-alone SBSD approved to use internal models would be subject to the same requirements. See paragraphs (e)(2)(iv)(D)(1)-(3) of proposed new Rule 18a-1.

297 See 17 CFR 240.15c3-1e(c)(1)(ii). As noted above, an 8% multiplier is consistent with the international bank capital standards and is designed to dampen leverage to help ensure that the ANC broker-dealer maintains a safe level of capital. See Alternative Net Capital Requirements Adopting Release, 69 FR at 34436.

298 See 17 CFR 240.15c3-1e(c)(4)(vi). A stand-alone SBSD approved to use internal models would be subject to the same requirements. See paragraph (e)(2)(iv)(F) of proposed new Rule 18a-1. The credit risk weights in Appendix E to Rule 15c3-1 were based on the international bank capital standards. See Alternative Net Capital Requirements Adopting Release, 69 FR at 34436 ("These proposed credit risk weights were based on the formulas provided in the Foundation Internal Ratings-Based approach to credit risk proposed by the Basel Committee and were derived using a loss given default (the percent of the amount owed by the counterparty the firm expects to lose if the counterparty defaults) of 75%.") (citations omitted).

299 See 17 CFR 240.15c3-1e(c)(4)(vi)(D). There is a basic method for ANC broker-dealers to determine the applicable risk weight factor using external credit ratings of NRSROs. See 17 CFR 240.15c3-1e(c)(4)(vi)(A)-(C). Currently, all six ANC broker-dealers are approved to use internally derived credit ratings. See Reference Removal Release, 76 FR at 26555. Pursuant to section 939A of the Dodd-Frank

The second component of an ANC broker-dealer's credit risk charge is a counterparty concentration charge.[300] This charge accounts for the additional risk resulting from a relatively large exposure to a single counterparty.[301] This charge is triggered if the current exposure of the ANC broker-dealer to a counterparty exceeds 5% of the tentative net capital of the ANC broker-dealer.[302] In this case, the ANC broker-dealer must take a counterparty concentration charge equal to: (1) 5% of the amount by which the current exposure exceeds 5% of tentative net capital for a counterparty with a risk weight factor of 20% or less; (2) 20% of the amount by which the current exposure exceeds 5% of tentative net capital for a counterparty with a risk weight factor of greater than 20% and less than 50%; and (3) 50% of the amount by which the current exposure exceeds 5% of tentative net capital for a counterparty with a risk weight factor of 50% or more.[303]

The third – and final – component of the credit risk charge is a portfolio concentration

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Act, the Commission has proposed eliminating the basic method of using NRSRO credit ratings and, consequently, if the proposals are adopted, an ANC broker-dealer would be required to use internally derived credit ratings. See Pub. L. 111-203 § 939A and Reference Removal Release, 76 FR at 26555-26556. Consistent with section 939A of the Dodd-Frank Act, there would not be a basic method for stand-alone SBSDs approved to use internal models. See paragraph (e)(2)(iv)(F) of proposed new Rule 18a-1. Consequently, these nonbank SBSDs would be required to use internally derived credit ratings to determine the appropriate risk weight factor to apply to a counterparty. This does not mean that an ANC broker-dealer or stand-alone SBSD could not include external credit ratings as part of its internal credit rating methodology. See Reference Removal Release, 76 FR at 26552-26553 (identifying external credit ratings as one of several factors a broker-dealer could consider when assessing credit risk under the Commission's proposals to substitute NRSRO credit ratings in the broker-dealer rules with a different standard of creditworthiness).

300 See 17 CFR 240.15c3-1e(c)(2). A stand-alone SBSD approved to use internal models would be subject to the same counterparty concentration charge. See paragraph (e)(2)(ii) of proposed new Rule 18a-1.

301 Concentration charges are intended to provide a liquidity cushion if a lack of diversification of positions exposes the firm to additional risk.

302 See 17 CFR 240.15c3-1e(c)(2)(i)-(iii). A stand-alone SBSD approved to use internal models would be subject to the same threshold in determining the counterparty concentration charge. See paragraphs (e)(2)(ii)(A)-(C) of proposed new Rule 18a-1.

303 See 17 CFR 240.15c3-1e(c)(1)(i)-(iii). A stand-alone SBSD approved to use internal models would be subject to the same charges. See paragraphs (e)(2)(ii)(A)-(C) of proposed new Rule 18a-1.

charge.[304] The portfolio concentration charge is designed to address the risk of having a relatively large amount of unsecured receivables relative to the size of the firm. This charge is triggered when the aggregate current exposure of the ANC broker-dealer to all counterparties exceeds 50% of the firm's tentative net capital.[305] In this case, the portfolio concentration charge is equal to 100% of the amount by which the aggregate current exposure exceeds 50% of the ANC broker-dealer's tentative net capital.[306]

Request for Comment

The Commission generally requests comment on the proposed credit risk charges. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Should ANC broker-dealers and stand-alone SBSDs using internal models be required to deduct in full unsecured receivables from commercial end users, rather than being permitted to use the proposed credit risk charge? If so, explain why. If not, explain why not. For example, would ANC broker-dealers and stand-alone SBSDs using internal models have substantial amounts of receivables from commercial end users that, if not collateralized, could adversely impact the liquidity of these firms? If so, what measures in addition to the proposed credit risk charge could be implemented to address the risk of uncollateralized credit risk exposure to commercial end users in the absence of a required 100% deduction? Commenters should provide data to support their responses to these questions.

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304 See 17 CFR 240.15c3-1e(c)(3). A stand-alone SBSD approved to use internal models would be subject to the same portfolio concentration charge. See paragraph (e)(2)(iii) of proposed new Rule 18a-1.

305 17 CFR 240.15c3-1e(c)(3).

306 See 17 CFR 240.15c3-1e(c)(3). A stand-alone SBSD approved to use internal models would be subject to the same charge. See paragraph (e)(2)(iii) of proposed new Rule 18a-1.

2. Should ANC broker-dealers and stand-alone SBSDs using internal models be required to take a capital charge in lieu of margin for non-cleared security-based swaps with commercial end users? If so, explain why. If not, explain why not. For example, would ANC broker-dealers and stand-alone SBSDs using internal models enter into substantial amounts of non-cleared security-based swaps with commercial end users that could adversely impact the risk profiles of these firms, if collateral was not collected to cover potential future exposure? If so, what measures in addition to the proposed credit risk charge could be implemented to address this risk in the absence of a required 100% deduction? Commenters should provide data to support their responses to these questions.
3. Is the credit risk charge an appropriate measure to address the risk to nonbank SBSDs of having uncollateralized current and potential future exposure to commercial end users? If so, explain why. If not, explain why not. Are there other measures that could be implemented as an alternative or in addition to the credit risk charge to address the risk of this uncollateralized exposure? If so, identify the measures and explain why they would be appropriate alternatives or supplements to the credit risk charge.
4. What will be the economic impact of the credit risk charge? For example, will the additional capital that a nonbank SBSD would be required to maintain because of the credit risk charge result in costs that will be passed through to end users? Please explain.
5. Should the application of the credit risk charge be expanded to unsecured receivables from other types of counterparties? If so, explain why. If not, explain why not. How would such an expansion impact the liquidity of nonbank SBSDs?
6. Should the application of the credit risk charge be expanded to the other exceptions to the

margin collateral requirements in proposed new Rule 18a-3? If so, explain why. If not, explain why not. How would such an expansion impact the risk profile of nonbank SBSDs?

7. The ability to take a credit risk charge in lieu of a 100% deduction for an unsecured receivable would apply only to unsecured receivables from commercial end users arising from security-based swap transactions. Consequently, an ANC broker-dealer and a nonbank SBSD would need to take a 100% deduction for unsecured receivables from commercial end users arising from swap transactions. Should the application of the credit risk charge be expanded to include unsecured receivables from commercial end users arising from swap transactions? If so, explain why. If not, explain why not. How would such an expansion impact the liquidity of nonbank SBSDs?
8. Is the overall method of computing the credit risk charge appropriate for nonbank SBSDs? If not, explain why not. For example, are there differences between ANC broker-dealers and nonbank SBSDs that would make the method of computing the credit risk charge appropriate for the former but not appropriate for the latter? If so, identify the differences and explain why they would make the credit risk charge not appropriate for nonbank SBSDs. What modifications should be made to the method of computing the credit risk charge for nonbank SBSDs?
9. Are the steps required to compute the credit risk charge understandable? If not, identify the steps that require further explanation.
10. Is the method of computing the first component of the credit risk charge – the counterparty exposure charge – appropriate for nonbank SBSDs? If not, explain why not. For example, is the calculation of the credit equivalent amount for a counterparty (i.e., the

sum of the MPE and the current exposure to the counterparty) a workable requirement for nonbank SBSDs? If not, explain why not.

11. Are the conditions for taking collateral into account when calculating the credit equivalent amount appropriate for nonbank SBSDs? If not, explain why not.
12. Are the conditions for taking netting agreements into account when calculating the credit equivalent amount appropriate for nonbank SBSDs? If not, explain why not.
13. Are the standardized risk weight factors (20%, 50%, and 150%) proposed for calculating the credit equivalent amount appropriate for nonbank SBSDs? If not, explain why not.
14. Is the method of computing the second component of the credit risk charge – the counterparty concentration charge – appropriate for nonbank SBSDs? If not, explain why not.
15. Is the method of computing the third component of the credit risk charge – portfolio concentration charge – appropriate for nonbank SBSDs? If not, explain why not.

v. Capital Charge In Lieu of Margin Collateral

As discussed above in section II.B. of this release, collateral is one of the ways dealers in OTC derivatives manage their credit risk exposure to OTC derivatives counterparties.[307] Collateral may be provided to cover the amount of the current exposure of the dealer to the counterparty.[308] Collateral also may be provided to cover the potential future exposure of the dealer to the counterparty, i.e., margin collateral.[309] Clearing agencies will impose margin collateral requirements on their clearing members, including nonbank SBSDs, for cleared

307 See Market Review of OTC Derivative Bilateral Collateralization Practices.

308 See Independent Amounts.

309 Id. at 4.

security-based swaps.[310] In addition, as discussed below in section II.B. of this release, proposed new Rule 18a-3 would establish margin collateral requirements for nonbank SBSDs with respect to non-cleared security-based swaps.[311] Furthermore, FINRA also prescribes margin requirements for security-based swaps.[312]

Rule 15c3-1 currently requires a broker-dealer to take a deduction from net worth for under-margined accounts.[313] Specifically, the broker-dealer is required to deduct from net worth the amount of cash required in each customer's and noncustomer's account to meet a maintenance margin requirement of the firm's designated examining authority after application of calls for margin, marks to the market, or other required deposits which are outstanding five business days or less.[314] These deductions serve the same purpose as the deductions a broker-dealer is required to take on proprietary securities positions in that they account for risk of the positions in the customer's account, which the broker-dealer may need to liquidate if the customer defaults on obligations to the broker-dealer.

In order to prescribe a similar requirement for security-based swap positions, Rule 15c3-1 would be amended to require broker-dealer SBSDs to take a deduction from net worth for the amount of cash required in the account of each security-based swap customer to meet the margin requirements of a clearing agency, self-regulatory organization ("SRO"), or the Commission, after application of calls for margin, marks to the market, or other required deposits which are outstanding one business day or less.[315] An analogous provision would be included in new Rule

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310 See discussion below in section II.B. of this release.

311 See proposed new Rule 18a-3.

312 See FINRA Rule 4240.

313 See 17 CFR 240.15c3-1(c)(2)(xii).

314 Id.

315 See proposed new paragraph (c)(2)(xii)(B) of Rule 15c3-1.

18a-1, though it would not refer to margin requirements of SROs because stand-alone SBSDs will not be members of SROs.[316] These provisions would require broker-dealer SBSDs to take capital charges when their security-based swap customers do not meet margin collateral requirements of clearing agencies, SROs, or the Commission after one business day from the date the margin collateral requirement arises. The capital charge would be designed to address the risk to nonbank SBSDs that arises from not collecting the margin collateral.[317]

As discussed below in section II.B. of this release, proposed new Rule 18a-3 would require nonbank SBSDs to collect collateral to meet account equity requirements by noon of the next business day from the day the account equity requirement arises.[318] Consequently, to be consistent with the proposed requirement to collect collateral within one day, the under-margined capital charge for security-based swap accounts would be triggered within one day of the margin requirement arising, as opposed to the five-day trigger in Rule 15c3-1.

In addition to the deductions for under-margined security-based swap accounts, the proposed rules would impose capital charges designed to address situations where the account of a security-based swap customer is meeting all applicable margin requirements but the margin collateral requirement results in the collection of an amount of collateral that is insufficient to address the risk because, for example, the requirement for cleared security-based swaps established by a clearing agency does not result in sufficient margin collateral to cover the nonbank SBSD's exposure or because an exception to collecting margin collateral for non-cleared security-based swaps exists.[319] These proposed capital charges would not apply in the

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316 See paragraph (c)(1)(ix) of proposed new Rule 18a-1.

317 See section II.B.1. of this release for a discussion of the purpose of margin collateral.

318 See paragraph (c)(1)(ii) of proposed new Rule 18a-3.

319 See proposed new paragraph (c)(2)(xiv) of Rule 15c3-1; paragraph (c)(1)(viii) of proposed new Rule 18a-1. The exceptions to the proposed margin rule are discussed below.

circumstance, discussed in the preceding section, involving unsecured receivables from commercial end users, which would be separately addressed by proposed new Rule 18a-1 and proposed amendments to Rule 15c3-1.[320] The proposed capital charges relating to margin collateral would be required deductions from the nonbank SBSD's net worth when computing net capital.[321] The proposals are intended to require a nonbank SBSD to set aside net capital to address the risks of potential future exposure that are mitigated through the collection of margin collateral. The set aside net capital would serve as an alternative to obtaining margin collateral for this purpose.

With respect to cleared security-based swaps, for which margin requirements will not be established by the Commission, the rules would impose a capital charge that would apply if a nonbank SBSD collects margin collateral from a counterparty in an amount that is less than the deduction that would apply to the security-based swap if it was a proprietary position of the nonbank SBSD (i.e., less than an amount determined by using the standardized haircuts in Commission Rule 15c3-1, as proposed to be amended, and in proposed new Rule 18a-1 or a VaR model, as applicable).[322] This aspect of the proposal is intended to adequately account for the risk of the counterparty defaulting by requiring the nonbank SBSD to maintain capital in the place of margin collateral in an amount that is no less than would be required for a proprietary

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320 As discussed above in section II.A.2.b.v. of this release, nonbank SBSDs would be required to take a 100% deduction to net worth when calculating net capital equal to their uncollateralized current exposure to a counterparty arising from a security-based swap except that an ANC broker-dealer and a stand-alone SBSD approved to use internal models could take a credit risk charge as an alternative to the 100% deduction if the counterparty was a commercial end user. See 17 CFR 240.15c3-1(c)(2)(iv)(B) (which requires a broker-dealer – and would require a broker-dealer SBSD – to deduct unsecured and partly secured receivables); paragraph (c)(1)(iii)(B) of proposed new Rule 18a-1 (which would contain an analogous provision for stand-alone SBSDs).

321 Id.

322 See proposed paragraph (c)(2)(xiv)(A) of Rule 15c3-1; paragraph (c)(1)(viii)(A) of proposed Rule 18a-1.

position.[323] This requirement also is intended to ensure that there is a standard minimum coverage for exposure to cleared security-based swap counterparties apart from the individual clearing agency margin requirements, which could vary among clearing agencies and over time. If the counterparty defaults, the nonbank SBSD would need to liquidate the counterparty's cleared security-based swaps and other positions in the account to cover the counterparty's obligation to the nonbank SBSD. Thus, the nonbank SBSD will become subject to the market risk of these positions in the event of the counterparty's default. If the positions decrease in value, the nonbank SBSD may not be able to cover the defaulted counterparty's obligations to the nonbank SBSD through the liquidation of the positions because the cash proceeds from the liquidation may yield less than the obligation.

Margin collateral is designed to mitigate this risk by serving as a buffer to account for a decrease in the market value of the counterparty's positions between the time of the default and the liquidation. If the amount of the margin collateral is insufficient to make up the difference, the nonbank SBSD will incur losses. This proposed capital charge is designed to require the nonbank SBSD to hold sufficient net capital, as an alternative to margin, to enable it to withstand such losses.

With respect to non-cleared security-based swaps, the rules would impose capital charges to address three exceptions in proposed new Rule 18a-3 (the nonbank SBSD margin rule).[324]

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323 As discussed in section II.B.2. of this release, the margin requirements for non-cleared security-based swaps would be the same as the deductions to net capital that a nonbank SBSD would take on the positions under Rule 15c3-1, as proposed to be amended, and proposed new Rule 18a-1.

324 See paragraphs (c)(1)(iii)(A), (C), and (D) of proposed new Rule 18a-3. There is a fourth exception in proposed new Rule 18a-3 under which a nonbank SBSD would not be required to collect margin collateral to cover potential future exposure to another SBSD. See paragraph (c)(1)(iii)(B)-Alternative A of proposed new Rule 18a-3. There would not be a capital charge in lieu of collecting margin collateral from another SBSD because capital charges could impact the firm's liquidity, and each SBSD would be subject to regulatory capital requirements. A second alternative (Alternative B) being proposed in new Rule 18a-3 would require a nonbank SBSD to have margin collateral posted to an account at a third-party custodian in an amount sufficient to cover the nonbank SBSD's potential future exposure to the other SBSD. See

Under these three exceptions, a nonbank SBSD would not be required to collect (or, in one case, hold) margin collateral. As discussed below in section II.B.2.b. of this release, proposed Rule 18a-3 would require a nonbank SBSD to perform a daily calculation of a margin amount for the account of each counterparty to a non-cleared security-based swap transaction.[325] Proposed new Rule 18a-3 also would require a nonbank SBSD to collect and hold margin collateral (in the form of cash, securities, and/or money market instruments) from each counterparty in an amount at least equal to the calculated margin amount to the extent that amount is greater than the amount of positive equity in the account.[326] The rule would, however, provide exceptions in certain cases.[327] Consequently, the three proposed capital charges discussed below are designed to serve as an alternative to margin collateral by requiring the nonbank SBSD to hold sufficient net capital to enable it to withstand losses if the counterparty defaults.

The first proposed capital charge would apply when a nonbank SBSD not approved to

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paragraph (c)(1)(iii)(B)-Alternative B – of proposed new Rule 18a-3. These two alternatives are discussed in more detail in section II.B.2. of this release.

325 See paragraph (c)(1)(i)(B) of proposed new Rule 18a-3. The term margin in proposed new Rule 18a-3 would be defined to mean the amount of positive equity in an account of a counterparty. See paragraph (b)(5) of proposed new Rule 18a-3.

326 See paragraph (c)(1)(ii) of proposed new Rule 18a-3. See also paragraph (c)(4) of proposed new Rule 18a-3 (requiring among other things that collateral be in the physical possession or control of the nonbank SBSD and that the collateral must be capable of being liquidated promptly by the nonbank SBSD). As discussed in section II.B.2. of this release, the term equity in proposed new Rule 18a-3 would be defined to mean the total current fair market value of securities positions in an account of a counterparty (excluding the time value of an over-the-counter option), plus any credit balance and less any debit balance in the account after applying a qualifying netting agreement with respect to gross derivatives payables and receivables. See paragraph (b)(4) of proposed new Rule 18a-3. The term negative equity in proposed new Rule 18a-3 would be defined to mean equity of less than $0. See paragraph (b)(6) of proposed new Rule 18a-3. The term positive equity in proposed new Rule 18a-3 would be defined to mean equity of greater than $0. See paragraph (b)(7) of proposed new Rule 18a-3.

327 See paragraphs (c)(1)(iii)(A), (C), and (D) of proposed new Rule 18a-3. As noted above and discussed in more detail in section II.B.2. of this release, one alternative being considered is to establish a fourth exception in proposed new Rule 18a-3 under which a nonbank SBSD would not be required to collect margin collateral to cover potential future exposure to another SBSD. See paragraph (c)(1)(iii)(B) of proposed new Rule 18a-3. Under this alternative, there would not be a capital charge in lieu of collecting margin collateral from the other SBSD because capital charges could impact the firm's liquidity, and each SBSD would be subject to regulatory capital requirements. The other alternative would require nonbank SBSDs to have margin collateral posted to an account at a third-party custodian in an amount sufficient to cover the nonbank SBSD's potential future exposure to the other SBSD.

use internal models does not collect sufficient margin collateral from a counterparty to a non-cleared security-based swap because the counterparty is a commercial end user.[328] As discussed below in section II.B.2.c.i. of this release, a nonbank SBSD would not be required to collect margin collateral from commercial end users for non-cleared security-based swaps.[329] The nonbank SBSD would be required to take a capital charge equal to the margin amount less any positive equity in the account of the commercial end user if the nonbank SBSD did not collect margin collateral from the commercial end user pursuant to this exception.[330] As discussed above in section II.A.2.b.iv. of this release, as an alternative to this deduction, an ANC broker-dealer and a stand-alone SBSD approved to use internal models could incur a credit risk charge.

The second proposed capital charge would apply when the nonbank SBSD does not hold the margin collateral because the counterparty to the non-cleared security-based swap is requiring the margin collateral to be segregated pursuant to section 3E(f) of the Exchange Act.[331] Section 3E(f) of the Exchange Act, among other things, provides that the segregated account authorized by that provision must be carried by an independent third-party custodian and be designated as a segregated account for and on behalf of the counterparty.[332] Collateral held in this manner would not be in the physical possession or control of the nonbank SBSD, nor would it would be capable of being liquidated promptly by the nonbank SBSD without the intervention

328 See proposed paragraph (c)(2)(xiv)(B)(1) of Rule 15c3-1; paragraph (c)(1)(viii)(B)(1) of proposed new Rule 18a-1.

329 See paragraph (c)(1)(iii)(A) of proposed new Rule 18a-3.

330 See proposed new paragraph (c)(2)(xiv)(B)(1) of Rule 15c3-1; paragraph (c)(1)(viii)(B)(1) of proposed new Rule 18a-1. If collateral is not collected from a commercial end user, the nonbank SBSD would be required to take a 100% deduction for the amount of the uncollateralized current exposure. As discussed above in section II.A.2.b.iv. of this release, as alternative to this deduction, an ANC broker-dealer and a stand-alone SBSD approved to use internal models could take a credit risk charge.

331 See proposed new paragraph (c)(2)(xiv)(B)(2) of Rule 15c3-1; paragraph (c)(1)(viii)(B)(2) of proposed new Rule 18a-1.

332 See 15 U.S.C. 78c-5(f)(3).

of another party. Consequently, it would not meet collateral requirements in proposed new Rule 18a-3.[333] Because collateral segregated under section 3E(f) of the Exchange Act would not be under the control of the nonbank SBSD, consistent with the existing capital requirements that apply to broker-dealers, the Commission is proposing to require the nonbank SBSD to take a capital charge equal to the margin amount less any positive equity in the account of the counterparty.[334]

The third proposed capital charge would apply when a nonbank SBSD does not collect sufficient margin collateral from a counterparty to a non-cleared security-based swap because the transaction was entered into prior to the effective date of proposed new Rule 18a-3 (a "legacy non-cleared security-based swap").[335] The nonbank SBSD would not be required to collect margin collateral for accounts holding legacy non-cleared security-based swaps.[336] This proposal is designed to avoid the difficulties of requiring a nonbank SBSD to renegotiate security-based swap contracts in order to come into compliance with new margin collateral requirements, which would be a complex task.[337] In lieu of collecting the margin collateral, the

333 See paragraphs (c)(4)(i) and (iii) of proposed new Rule 18a-3.

334 See proposed new paragraph (c)(2)(xiv)(B)(2) of Rule 15c3-1; paragraph (c)(1)(viii)(B)(2) of proposed new Rule 18a-1.

335 See proposed new paragraph (c)(2)(xiv)(B)(3) of Rule 15c3-1; paragraph (c)(1)(viii)(B)(3) of proposed new Rule 18a-1.

336 See paragraph (c)(1)(iii)(D) of proposed new Rule 18a-3. A nonbank SBSD would need to take a 100% deduction for the amount of the uncollateralized current exposure arising from a legacy non-cleared security-based swap because (as discussed above) this amount would be an unsecured receivable from the counterparty and subject to a 100% deduction in the computation of net capital under Rule 15c3-1 and proposed new Rule 18a-1.

337 The CFTC has proposed a similar exception for legacy swap transactions. See CFTC Margin Proposing Release, 76 FR at 23734 ("The Commission believes that the pricing of existing swaps reflects the credit arrangements under which they were executed and that it would be unfair to the parties and disruptive to the markets to require that the new margin rules apply to those positions."). The prudential regulators proposed to permit a covered swap entity to exclude pre-effective swaps from initial margin calculations, while requiring these entities to collect variation margin, consistent with industry practice. Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27569.

nonbank SBSD would be required to take a capital charge equal to the margin amount less any positive equity in the account.[338]

Request for Comment

The Commission generally requests comment on the proposed capital in lieu of margin requirements. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Would the proposed deductions for under-margined accounts be appropriate for cleared security-based swap margin requirements, which would be established by clearing agencies and SROs? If not, explain why not. For example, is the requirement to take the deduction after one business day workable in the context of cleared security-based swaps? If not, explain why not. In addition, should the margin requirements of clearing agencies be included in the deduction for under-margined accounts?
2. Would the proposed deductions for under-margined accounts be appropriate for non-cleared security-based swap margin requirements, which would be established by proposed new Rule 18a-3 and, potentially, by SROs? If not, explain why not. For

338 The prudential regulators and CFTC have not proposed new capital charges for legacy swaps and legacy security-based swaps; nor have they proposed specific margin collateral requirements for such positions. See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564; CFTC Capital Proposing Release, 76 FR 27802; CFTC Margin Proposing Release, 76 FR 23732. With respect to banks, the credit risk of holding legacy security-based swap positions is already taken into account by existing capital requirements for banks. The proposed capital charge in lieu of margin for nonbank SBSDs is based on a concern that, after SBSD registration requirements take effect, financial institutions may transfer large volumes of legacy non-cleared security-based swaps from unregulated affiliates to newly registered nonbank SBSDs, including broker-dealer SBSDs. As noted above, the Commission understands that registered broker-dealers currently do not engage in a high volume of security-based swap transactions. An influx of legacy non-cleared security-based swaps into a newly registered nonbank SBSD could create substantial risks to the entity. Under the proposed rule, nonbank SBSDs would be required to hold sufficient collateral to cover the current exposure and potential future exposure that arise from these transactions or, alternatively, to take appropriate capital charges to address these risks. Entities holding legacy non-cleared security-based swaps could either obtain additional capital in order to register as nonbank SBSDs or legacy non-cleared security-based swaps could be held and "wound down" in one entity while a separate entity is used to conduct new business.

example, is the requirement to take the deduction after one business day workable in the context of non-cleared security-based swaps? If not, explain why not.

3. Should there be a deduction for under-margined swap accounts? If so, explain why. If not, explain why not.
4. Would the proposed capital charges in lieu of collecting margin collateral appropriately address the potential future exposure risk of nonbank SBSDs arising from security-based swaps? If not, explain why not. Are there alternative means of addressing this risk? If so, identify and explain them.
5. Is the proposed capital charge in lieu of margin for cleared security-based swaps appropriate? If not, explain why not. In particular, if the amount of margin collateral required to be collected for cleared security-based swaps is less than the capital deduction that would apply to the positions, would the margin collateral nonetheless be sufficient? If so, explain why. In addition, should SBSDs approved to use internal models be permitted to use their VaR models (as opposed to the standardized haircuts) for purposes of determining whether this capital charge applies? If so, explain why.
6. Is the proposed capital charge in lieu of margin for non-cleared security-based swaps with counterparties that are commercial end users appropriate? If not, explain why not.
7. Should there be an exception for broker-dealer SBSDs and stand-alone SBSDs not using internal models from the requirement to take a capital charge in lieu of collecting margin collateral from commercial end users? If so, explain why such an exception would not negatively impact the risk profiles of these nonbank SBSDs and suggest alternative measures that could be implemented to address the risk of uncollateralized potential future exposure to commercial end users.

8. Should there be a capital charge in lieu of margin for non-cleared swaps with counterparties that are <u>commercial end users</u>? If so, explain why. If not, explain why not.

9. Is it appropriate to apply the proposed capital charge in lieu of margin for non-cleared security-based swaps with counterparties that require segregation pursuant to section 3E(f) of the Exchange Act? If not, explain why not.

10. Should there be an exception for counterparties that require segregation pursuant to section 3E(f) of the Exchange Act from the requirement to take a capital charge in lieu of margin collateral? If so, explain why such an exception would not negatively impact the risk profiles of nonbank SBSDs and suggest alternative measures that could be implemented to address the risk of not holding collateral to cover the potential future exposure.

11. Should there be a capital charge in lieu of margin for non-cleared swaps with counterparties that require margin collateral with respect to the swaps to be segregated and held by an independent third party custodian? If so, explain why. If not, explain why not.

12. Is the proposed capital charge in lieu of margin for non-cleared security-based swaps in accounts that hold legacy security-based swaps appropriate, or should there be an exception from the capital charge for legacy security-based swaps? Is there an alternate measure that could be implemented to address the risk of uncollateralized potential future exposure resulting from legacy security-based swaps? If the proposed capital charge applies to legacy security-based swaps, explain how the proposed capital charge in lieu of margin collateral would change the economics of the transactions previously entered into.

How would any such change(s) be reflected in the cost of maintaining those, or initiating, new positions? Would there be any other impacts of the change in treatment of the legacy positions?

13. If there is an exception from the capital charge for legacy security-based swaps, how would such an exception impact the risk profiles of nonbank SBSDs?
14. After the SBSD registration requirements take effect, would substantial amounts of legacy security-based swaps with uncollateralized potential future exposure be transferred to broker-dealer SBSDs? Would entities with substantial amounts of legacy security-based swaps with uncollateralized potential future exposure register as stand-alone SBSDs?
15. Would it be practical for financial institutions to wind down legacy security-based swaps in existing entities rather than transferring them to nonbank SBSDs? What legal and operational issues would this approach raise?
16. Should there be a capital charge in lieu of margin for non-cleared swap accounts that hold legacy swaps? If so, explain why. If not, explain why not.
17. What should be deemed a legacy security-based swap? For example, if a nonbank SBSD dealer holds an existing legacy security-based swap that is subsequently modified for risk mitigation purposes, should this be deemed a new security-based swap transaction or should it continue to be treated as a legacy security-based swap?

vi. Treatment of Swaps

CFTC Rule 1.17 prescribes minimum capital requirements for FCMs.[339] The rule imposes a net liquid assets test capital standard.[340] Broker-dealers that are registered as FCMs

[339] See 17 CFR 1.17.

are subject to Rule 15c3-1 and CFTC Rule 1.17.[341] CFTC Rule 1.17 provides that an FCM registered as a broker-dealer must maintain a minimum amount of adjusted net capital equal to the greater of, among other amounts, the minimum amount of net capital required by Rule 15c3-1.[342] CFTC Rule 1.17 also prescribes standardized haircuts for securities positions by incorporating by reference the standardized haircuts in Rule 15c3-1.[343] Similarly, Rule 15c3-1, through Appendix B, prescribes capital deductions for commodities positions of a broker-dealer by incorporating by reference deductions in CFTC Rule 1.17 to the extent Rule 15c3-1 does not otherwise prescribe a deduction for the type of commodity position.[344]

Broker-dealer SBSDs (as broker-dealers) would be subject to Appendix B to Rule 15c3-1.[345] Appendix B to proposed new Rule 18a-1 would prescribe capital deductions for commodities positions of stand-alone SBSDs and would be modeled on Appendix B to Rule 15c3-1.[346] Consequently, under the provisions of Rule 15c3-1 and proposed new Rule 18a-1,

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340 Id.

341 See 17 CFR 240.15c3-1; 17 CFR 1.17.

342 See 17 CFR 1.17(a)(1)(i)(D).

343 See 17 CFR 1.17(c)(5)(v)-(vii).

344 See 17 CFR 240.15c3-1b(a)(1).

345 17 CFR 240.15c3.-1b.

346 Compare 17 CFR 240.15c3-1b, with Appendix B to proposed new Rule 18a-1. As discussed above in section II.A.2.b.ii. of this release, a broker-dealer's minimum net capital requirement is the greater of a fixed-dollar amount specified in Rule 15c3-1 and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of customer debit items ratio. The minimum net capital requirement for a stand-alone SBSD under proposed Rule 18a-1, however, would not use either of these financial ratios; rather, its minimum net capital requirement would be determined by calculating the 8% margin factor. Appendix B to Rule 15c3-1 contains provisions that factor into a broker-dealer's calculation of the aggregate indebtedness financial ratio. See 17 CFR 240.15c3-1b(a)(1) and (a)(2). Those provisions are not included in Appendix B to proposed new Rule 18a-1 because stand-alone SBSDs would not use the aggregate indebtedness financial ratio to determine their minimum net capital requirement.

nonbank SBSDs would be required to take deductions for commodity positions when computing net capital.[347]

In addition, nonbank SBSDs and broker-dealers may have proprietary positions in swaps. Consequently, Appendix B to Rule 15c3-1 would be amended to establish standardized haircuts for proprietary swap positions and analogous provisions would be included in Appendix B to proposed new Rule 18a-1.[348] This would make the standardized swap haircuts applicable to nonbank SBSDs and broker-dealers.[349] An ANC broker-dealer and a stand-alone SBSD could apply to include different types of swaps in their VaR models. If approved, the firm would not need to apply the standardized haircuts for the type of swaps covered by the approved models.

The proposed standardized haircuts for swaps are similar to the proposed standardized haircuts for security-based swaps. Specifically, swaps that are credit default swaps referencing a broad based securities index ("Index CDS swaps") would be subject to a maturity grid similar to the proposed maturity grid for CDS security-based swaps.[350] All other swaps would be subject to a standardized haircut determined by multiplying the notional amount of the swap by the percentage deduction that would apply to the type of asset or event referenced by the swap.

Index CDS Swaps

The standardized haircuts proposed for Index CDS swaps would use the maturity grid approach proposed for CDS security-based swaps discussed above in section II.A.2.b.ii. of this release. This would provide for a consistent standardized haircut approach for Index CDS swaps

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347 See 17 CFR 240.15c3-1b; Appendix B to proposed new Rule 18a-1.

348 See proposed new paragraph (b) of Rule 15c3-1b; paragraph (b) of proposed new Rule 18a-1b.

349 A nonbank SBSD that is registered as a swap dealer with the CFTC also would be required to comply with the CFTC's capital requirements applicable to swap dealers as would a broker-dealer that is registered as a swap dealer (just as a broker-dealer registered as an FCM must comply with Rule 15c3-1 and CFTC Rule 1.17).

350 See proposed new paragraph (b)(1)(i) of Rule 15c3-1b; paragraph (b)(1)(i) of proposed new Rule 18a-1b.

and CDS security-based swaps though, as discussed below, the haircuts would be lower for the Index CDS security-based swaps. As with CDS security-based swaps, the proposed maturity grid for Index CDS swaps prescribes the applicable deduction based on two variables: the length of time to maturity of the swap and the amount of the current offered spread on the swap.[351] The vertical axis of the proposed grid would contain nine maturity categories ranging from 12 months or less (the smallest deduction) to 121 months and longer (the largest deduction).[352] The horizontal axis would contain six spread categories ranging from 100 basis points or less (the smallest deduction) to 700 basis points and above (the largest deduction).[353]

The haircut percentages in the proposed maturity grid for Index CDS swaps would be one-third less than the haircut percentages in the maturity grid for CDS security-based swaps to account for the diversification benefits of an index.[354] For example, the proposed haircut for an Index CDS swap with a maturity of 12 months or less and a spread of 100 basis points or less would be 0.67% as opposed to a 1% haircut for a CDS security-based swap in the same maturity and spread categories. This one-third reduction in the haircut percentages is consistent with how broad-based equity security-indices are treated in the Appendix A methodology as compared with single name equity securities and narrow-based equity index securities. Specifically, as discussed above in section II.A.2.b.ii. of this release, the Appendix A methodology requires portfolios of single name equity securities and narrow-based equity index securities to be stressed at 10 equidistant valuation points within a range consisting of a (+/-) 15% market move. Portfolios of broad-based equity index securities are stressed at 10 equidistant valuation points

351 See proposed new paragraph (b)(1)(i)(A) of Rule 15c3-1b; paragraph (b)(1)(i)(A) of proposed new Rule 18a-1b.

352 Id.

353 Id.

354 Id.

within a range consisting of a (+/-) 10% market move, which is two-thirds of the market move range applicable to single name equity securities and narrow-based equity index securities.

Consistent with the maturity grid approach for CDS security-based swaps, the proposed deduction for an un-hedged long position in an Index CDS swap would be 50% of the applicable haircut in the grid.[355] The proposed deduction requirements for Index CDS swaps would permit a nonbank SBSD to net long and short positions where the credit default swaps reference the same index, are in the same spread categories, are in the same maturity categories or in adjacent maturity categories, and have maturities within three months of each other.[356] In this case, the nonbank SBSD would need to take the specified haircut only on the notional amount of the excess long or short position.[357]

Reduced deductions also would apply for strategies where the firm is long a basket of securities consisting of the components of an index and long (buyer of protection on) an Index CDS swap on the index.[358] The reduced deduction for this strategy would apply only if the credit default swap allowed the nonbank SBSD to deliver a security in the basket to satisfy the firm's obligation on the swap.[359] In this case, the nonbank SBSD would be required to take 50% of the deduction required on the securities in the basket (i.e., no deduction would be required with respect to the Index CDS swap and a lesser deduction would apply to the securities).[360] If the nonbank SBSD is short (seller of protection) a basket of securities consisting of the components

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355 See proposed new paragraph (b)(1)(i)(B) of Rule 15c3-1b; paragraph (b)(1)(i)(B) of proposed new Rule 18a-1b.

356 See proposed new paragraph (b)(1)(i)(C)(i) of Rule 15c3-1b; paragraph (b)(1)(i)(C)(i) of proposed new Rule 18a-1b.

357 Id.

358 See proposed new paragraph (b)(1)(i)(C)(ii) of Rule 15c3-1b; paragraph (b)(1)(i)(C)(ii) of proposed new Rule 18a-1b.

359 Id.

360 Id.

of an index and short a credit default swap that references the index, the nonbank SBSD would be required only to take the deduction required on the securities in the basket (i.e., no deduction would be required with respect to the Index CDS swap).[361]

Interest Rate Swaps

For interest rate swaps, Appendix B to both Rule 15c3-1 and proposed new Rule 18a-1 would prescribe a standardized haircut equal to a percentage of the notional amount of the swap that is generally based on the standardized haircuts in Rule 15c3-1 for U.S. government securities.[362] An interest rate swap typically involves the exchange of specified or determinable cash flows at specified times based upon a notional amount.[363] The notional amount is not exchanged but is used to calculate the fixed or floating rate interest payments under the swap.

Under the proposed rule, each side of the interest rate swap would be converted into a synthetic bond position based on the notional amount of the swap and the interest rates against which payments are calculated. These synthetic bonds would then be placed into the standardized haircut grid in Rule 15c3-1 for U.S. government securities. Any obligation to receive payments under the swap would be categorized as a long position; any obligation to make payments under the swap would be categorized as a short position. A position receiving or paying based on a floating interest rate generally would be treated as having a maturity equal to the period until the next interest reset date; a position receiving or paying based on a fixed rate would be treated as having a maturity equal to the residual maturity of the swap. Synthetic bond equivalents derived from interest rate swaps, when offset against one another, would be subject to a one percent charge based on the swap's notional amount. Any synthetic bond equivalent

361 See proposed new paragraph (b)(1)(i)(C)(iii) of Rule 15c3-1b; paragraph (b)(1)(i)(C)(iii) of proposed new Rule 18a-1b.

362 See 17 CFR 240.15c3-1(c)(2)(vi)(A).

363 See Net Capital Rule, Exchange Act Release No. 39455 (Dec. 17, 1997), 62 FR 67996 (Dec. 30, 1997).

that would be subject to a standardized haircut of less than one percent under the approach described above would be subject to a minimum deduction equal to a one percent charge against the notional value of the swap.[364] This minimum haircut of one percent is designed to account for potential differences between the movement of interest rates on U.S. government securities and interest rates upon which swap payments are based.

All Other Swaps

In the case of a swap that is not an Index CDS swap or an interest rate swap, the applicable haircut would be the amount calculated by multiplying the notional value of the swap and the percentage specified in either Rule 15c3-1 or CFTC Rule 1.17 for the asset, obligation, or event referenced by the swap.[365] For example, a swap referencing a commodity that is not covered by an open futures contract or commodity option would be subject to a capital deduction applicable to the commodity as if it were a long or short inventory position with a market value equal to the notional value of the swap. This would typically result in a deduction equal to 20% of the notional value of the swap.[366] The deduction for un-hedged currency swaps referencing certain major foreign currencies, including the euro, British pounds, Canadian dollars, Japanese yen, or Swiss francs, would be 6%.[367] This deduction could be reduced by an amount equal to any reduction recognized for a comparable long or short position in the referenced instrument, obligation, or event under Appendix B to Rule 15c3-1, as proposed to be amended, and proposed

364 Under Rule 15c3-1, U.S. government securities with a maturity of less than nine months are subject to net capital deductions ranging from three-quarters of 1% to 0%. See 17 CFR 240.15c3-1(c)(2)(vi)(A)(1)(i)-(iii).

365 See proposed new paragraph (b)(2) of Rule 15c3-1b; paragraph (b)(2) of proposed new Rule 18a-1b.

366 See 17 CFR 240.15c3-1b(a)(3)(ix)(C); paragraph (a)(2)(ix)(C) of proposed new Rule 18a-1b.

367 See CFTC Rule 1.17(c)(5)(ii)(E) (imposing a 6% haircut). 17 CFR 1.17(c)(5)(ii)(E). Currency swaps may involve exchanges of fixed amounts of currencies. If a nonbank SBSD has a currency swap in which it receives one foreign currency and pays out another foreign currency, the broker-dealer would treat the currency swap as a long position in a forward of the one foreign currency and an unrelated short position in the other foreign currency for capital purposes. See, e.g., Net Capital Rule, Exchange Act Release No. 32256 (May 4, 1993), 58 FR 27486, 27490 (May 10, 1993).

new Rule 18a-1, or CFTC Rule 1.17. For example, a commodity swap referencing an agricultural product that is covered by an open futures contract or commodity option in that product would be subject to a 5% deduction from the notional value of the swap, rather than the 20% deduction specified above.[368] Finally, swaps referencing an equity index could be treated under Appendix A to Rule 15c3-1 and proposed new Rule 18a-1.

Request for Comment

The Commission generally requests comment on the proposed standardized haircuts swaps. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Which types of swap activities would nonbank SBSDs engage in? How would nonbank SBSDs use swaps?
2. Which types of swap activities would broker-dealers engage in? How would broker-dealers use swaps?
3. Do the proposed standardized haircuts for swaps provide a reasonable and workable solution for determining capital charges? Explain why or why not. Are there preferable alternatives? If so, describe those alternatives.
4. Are there additional categories of swaps, other than commodity swaps, currency swaps, and interest rate swaps, that the Commission should address in Rule 15c3-1 and/or proposed Rule 18a-1? If so, describe them.
5. Are the proposed standardized haircuts for swaps too high or too low? If so, please explain why and provide data to support the explanation.
6. Are there capital charges that should be applied to swaps? If so, describe them.

368 See 17 CFR 240.15c3-1b(a)(3)(ix)(B); paragraph (a)(2)(ix)(B) of proposed new Rule 18a-1b.

7. Do the proposed standardized haircuts for swaps adequately recognize offsets in establishing capital deductions? If not, what offsets should be recognized, for what type of swap, and why? Provide data, if applicable, and identify why that offset would be appropriate.
8. Do the proposed standardized haircuts for swaps provide any incentives or disincentives to effect swap transactions in a particular type of legal entity (e.g., in a stand-alone SBSD versus a broker-dealer SBSD)? Describe the incentives and/or disincentives.
9. Do the proposed standardized haircuts for swaps provide any competitive advantages or disadvantages for a particular type of legal entity? Describe the advantages and/or disadvantages.
10. How closely do the movements of interest rates on U.S. government securities track the movements of interest rates upon which interest rate swap payments are based? Is the proposed 1% minimum percentage deduction for interest rate swaps appropriate given that U.S. government securities with a maturity of less than nine months have a haircut ranging from three-quarters of 1% to 0%?

c. Risk Management

Prudent financial institutions establish and maintain integrated risk management systems that seek to have in place management policies and procedures designed to help ensure an awareness of, and accountability for, the risks taken throughout the firm and to develop tools to address those risks.[369] A key objective of a risk management system is to ensure that the firm does not ignore any material source of risk.[370] Elements of an integrated risk management

369 See Trends in Risk Integration and Aggregation, Joint Forum, Bank of International Settlements (Aug. 2003), available at http://www.bis.org/publ/joint07.pdf.

370 Id.

system include a dedicated risk management function, which seeks to promote integrated and systematic approaches to risk management and to develop and encourage the use of a common set of metrics for risk throughout the firm.[371] This function generally includes establishing common firm-wide definitions of risk and requiring that different business segments of the firm apply such definitions consistently for risk reporting purposes.[372] The risk management function in a financial institution also typically prepares background material and data analysis (risk reports) for senior managers to review and use to discuss firm-wide risks.[373]

Nonbank SBSDs would be required to comply with Rule 15c3-4, which requires the establishment of a risk management control system.[374] Rule 15c3-4 was adopted in 1998 as part of the OTC derivatives dealer oversight program.[375] The rule requires an OTC derivatives dealer to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.[376] It also requires OTC derivatives dealers to establish, document, and maintain procedures designed to prevent the firm from engaging in securities activities that are not permitted of OTC derivatives dealers pursuant to Rule 15a-1.[377] Rule 15c3-4 identifies a number of elements that must be part of an OTC derivatives dealer's internal risk management control system.[378] These include, for example, that the system have:

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371 Id.

372 Id.

373 Id.

374 See proposed new paragraph (a)(10)(ii) of Rule 15c3-1 (17 CFR 240.15c3-1); paragraph (g) of proposed new Rule 18a-1. See also 17 CFR 240.15c3-4.

375 See 17 CFR 240.15c3-4; OTC Derivatives Dealers, 63 FR 59362.

376 See 17 CFR 240.15c3-4.

377 See 17 CFR 240.15c3-4; 17 CFR 240.15a-1.

378 See 17 CFR 240.15c3-4(c).

- A risk control unit that reports directly to senior management and is independent from business trading units;[379]

- Separation of duties between personnel responsible for entering into a transaction and those responsible for recording the transaction in the books and records of the OTC derivatives dealer;[380]

- Periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent certified public accountants) of the OTC derivatives dealer's risk management systems;[381] and

- Definitions of risk, risk monitoring, and risk management.[382]

Rule 15c3-4 further provides that the elements of the internal risk management control system must include written guidelines, approved by the OTC derivatives dealer's governing body, that cover various topics, including, for example:

- Quantitative guidelines for managing the OTC derivatives dealer's overall risk exposure;[383]

- The type, scope, and frequency of reporting by management on risk exposures;[384]

- The procedures for and the timing of the governing body's periodic review of the risk monitoring and risk management written guidelines, systems, and processes;[385]

- The process for monitoring risk independent of the business or trading units whose activities create the risks being monitored;[386]

- The performance of the risk management function by persons independent from or senior to the business or trading units whose activities create the risks;[387]

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379 See 17 CFR 240.15c3-4(c)(1).

380 See 17 CFR 240.15c3-4(c)(2).

381 See 17 CFR 240.15c3-4(c)(3). The annual review must be conducted in accordance with procedures agreed to by the firm and the independent certified public accountant conducting the review.

382 See 17 CFR 240.15c3-4(c)(4).

383 See 17 CFR 240.15c3-4(c)(5)(iii).

384 See 17 CFR 240.15c3-4(c)(5)(iv).

385 See 17 CFR 240.15c3-4(c)(5)(v).

386 See 17 CFR 240.15c3-4(c)(5)(vi).

387 See 17 CFR 240.15c3-4(c)(5)(vii).

- The authority and resources of the groups or persons performing the risk monitoring and risk management functions;[388]

- The appropriate response by management when internal risk management guidelines have been exceeded;[389]

- The procedures to monitor and address the risk that an OTC derivatives transaction contract will be unenforceable;[390]

- The procedures requiring the documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions;[391] and

- The procedures authorizing specified employees to commit the OTC derivatives dealer to particular types of transactions.[392]

Rule 15c3-4 also requires management to periodically review, in accordance with the written procedures, the business activities of the OTC derivatives dealer for consistency with risk management guidelines.[393]

In 2004, when adopting the ANC broker-dealer oversight program, the Commission included a requirement that an ANC broker-dealer must comply with Rule 15c3-4.[394] The Commission explained this requirement:

> Participants in the securities markets are exposed to various risks, including market, credit, funding, legal, and operational risk. These risks result, in part, from the diverse range of financial instruments that broker-dealers now trade. Risk management controls within a broker-dealer promote the stability of the firm and, consequently, the stability of the marketplace. A firm that adopts and follows appropriate risk management controls reduces

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388 See 17 CFR 240.15c3-4(c)(5)(viii).

389 See 17 CFR 240.15c3-4(c)(5)(ix).

390 See 17 CFR 240.15c3-4(c)(5)(x).

391 See 17 CFR 240.15c3-4(c)(5)(xi).

392 See 17 CFR 240.15c3-4(c)(5)(xii).

393 See 17 CFR 240.15c3-4(d).

394 See 17 CFR 240.15c3-1(a)(7)(iii); Alternative Net Capital Requirements Adopting Release, 69 FR 34428. ANC broker-dealers – because they are not subject to Rule 15a-1 – do not need to comply with the provisions of Rule 15c3-4 relating to Rule 15a-1. See 17 CFR 240.15c3-1(a)(7)(iii); 17 CFR 240.15c3-4; 17 CFR 240.15a-1.

> its risk of significant loss, which also reduces the risk of spreading the losses to other market participants or throughout the financial markets as a whole.[395]

The Commission is proposing to require that nonbank SBSDs comply with Rule 15c3-4 because their activities will involve risk management concerns similar to those faced by other firms subject to the rule.[396] In particular, dealing in OTC derivatives, including security-based swaps, creates various types of risk that need to be carefully managed.[397] These risks are due, in part, to the characteristics of OTC derivative products and the way OTC derivative markets have evolved in comparison to the markets for exchange-traded securities.[398] For example, individually negotiated OTC derivative products, including security-based swaps, generally are less liquid than exchange-traded instruments and involve a high degree of leverage. Furthermore, market participants face risks associated with the financial and legal ability of counterparties to perform under the terms of specific transactions. Consequently, a firm that is active in dealing in these types of instruments should have an internal risk management control system that helps the firm identify and mitigate the risks it is facing. Rule 15c3-4 is designed to require an OTC derivatives dealer and ANC broker-dealer to take prudent measures to protect the firm from losses that can result from failing to account for and control risk. Requiring nonbank SBSDs to comply with Rule 15c3-4 is designed to promote the establishment of effective risk management control systems by these firms.[399] Moreover, based on Commission

395 Alternative Net Capital Requirements Adopting Release, 69 FR at 34449.

396 Like ANC broker-dealers, nonbank SBSDs would not need to comply paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of Rule 15c3-4. These are the provisions that specifically reference Rule 15a-1. See 17 CFR 240.15c3-4.

397 See OTC Derivatives: Settlement Procedures And Counterparty Risk Management at 11-15.

398 See OTC Derivatives Dealers, Exchange Act Release No. 39454 (Dec. 17, 1997), 62 FR 67940 (Dec. 30, 1997).

399 See paragraph (g) of proposed new Rule 18a-1 (which would apply Rule 15c3-4 to stand-alone SBSDs); proposed new paragraph (a)(10)(ii) of Rule 15c3-1 (which would apply Rule 15c3-4 to broker-dealer

staff experience, it is expected that many nonbank SBSDs will be affiliates of firms already subject to these requirements.

Request for Comment

The Commission generally requests comment on the proposed risk management requirements. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are the types of management controls required by Rule 15c3-4 appropriate for addressing the risks associated with engaging in a security-based swap business? If not, explain why not.
2. Are there types of risk management controls not identified in Rule 15c3-4 that would be appropriate to prescribe for nonbank SBSDs? If so, identify the controls and explain why they would be appropriate for nonbank SBSDs.
3. Are the factors listed in paragraph (b) of Rule 15c3-4 appropriate for nonbank SBSDs? If not, explain why not.
4. Are there any additional factors that a nonbank SBSD should consider when adopting its internal control system guidelines, policies, and procedures, in addition to the factors listed in paragraph (b) of Rule 15c3-4? If so, identify the factors and explain why they should be included.
5. Are the elements prescribed in paragraph (c) of Rule 15c3-4 appropriate for nonbank SBSDs? If not, explain why not.

SBSDs); 17 CFR 240.15c3-1(a)(7)(iii) (which applies Rule 15c3-4 to ANC broker-dealers); 17 CFR 240.15c3-4.

6. Are there any additional elements that a nonbank SBSD should include in its internal risk management system in addition to the applicable elements prescribed in paragraph (c) of Rule 15c3-4? If so, identify the elements and explain why they should be included.

7. Are there any elements in paragraph (c) of Rule 15c3-4 that should not be applicable to nonbank SBSDs other than elements in paragraphs (c)(xiii) and (xiv)? If so, identify the elements and explain why they should not be applicable.

8. Are the factors management would need to consider in its periodic review of the nonbank SBSD's business activities for consistency with the risk management guidelines appropriate for nonbank SBSDs? If not, explain why not.

9. Should management consider any additional factors in its periodic review of the nonbank SBSD's business activities for consistency with the risk management guidelines other than those listed in paragraph (d) of Rule 15c3-4? If so, identify the factors and explain why they should be included.

10. Are there any factors in paragraph (d) of Rule 15c3-4 that management should not consider other than the factors in paragraphs (d)(8) and (9)? If so, identify the factors and explain why they should not be considered.

d. Funding Liquidity Stress Test Requirement

The Commission is proposing that ANC broker-dealers and nonbank SBSDs approved to use internal models be subject to liquidity risk management requirements. Funding liquidity risk has been defined as the risk that a firm will not be able to efficiently meet both expected and unexpected current and future cash flow and collateral needs without adversely impacting either the daily operations or the financial condition of the firm.[400] The consequences of liquidity

[400] See Joint Forum, Bank of International Settlements, The management of liquidity risk in financial groups, (May 2006), at 1, note 1 ("The management of liquidity risk in financial groups"). See also Basel

funding strains for financial institutions active in a securities business include the inability to continue to issue unsecured long-term debt to finance illiquid assets and requirements to deliver additional collateral to continue to finance liquid assets on a secured basis.[401] The causes of funding liquidity strain for a financial institution include firm-specific events such as credit rating downgrades and other negative news leading to a loss of market confidence in the firm.[402] Funding liquidity also can come under stress such as occurred during the financial crisis.[403] Traditionally, financial institutions have used liquidity funding stress tests as a means to measure liquidity risk.[404] For institutions active in securities trading, liquidity funding stress tests generally estimate cash and collateral needs over a period of time and assume that sources to meet those needs (e.g., issuance of long and short unsecured term debt, secured funding lines, and lines of credit) will become impaired or be unavailable.[405] To manage funding liquidity risk, these firms maintain pools of liquid unencumbered assets that can be used to raise funds during a liquidity stress event to meet cash needs.[406] The size of the liquidity pool is based on the firm's

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Committee on Banking Supervision, Principles for Sound Liquidity Risk Management and Supervision (Sept. 2008), at 1, note 2 ("Funding liquidity risk is the risk that the firm will not be able to meet efficiently both expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the firm. Market liquidity risk is the risk that a firm cannot easily offset or eliminate a position at the market price because of inadequate market depth or market disruption."); Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 55432 (Mar. 9, 2007), 72 FR 12862, 12870, note 72 (Mar. 19, 2007) ("Liquidity risk includes the risk that a firm will not be able to unwind or hedge a position or meet cash demands as they become due."); Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, Federal Reserve, 77 FR 594 (Jan. 5, 2012) (proposing a rule to require certain large financial institutions to conduct liquidity stress testing at least monthly).

401 See The management of liquidity risk in financial groups at 10.

402 See id. at 6-8.

403 See Risk Management Lessons from the Global Bank Crisis of 2008, Senior Supervisors Group (SSG) (Oct. 21, 2009) ("Risk Management Lessons from the Global Bank Crisis of 2008").

404 The management of liquidity risk in financial groups at 8-12.

405 Id. at 10-11.

406 Id.

estimation of how much funding will be lost from external sources during a stress event and the duration of the event.[407]

The financial crisis demonstrated that the funding liquidity risk management practices of certain individual financial institutions were not sufficient to handle a liquidity stress event of that magnitude.[408] In particular, it has been observed that the stress tests utilized by financial institutions had weaknesses[409] and the amount of contingent liquidity they maintained to replace external sources of funding was insufficient to cover the institutions' liquidity needs.[410]

As discussed above in section II.A.2.c. of this release, nonbank SBSDs approved to use internal models would be subject to Rule 15c3-4, which currently applies to ANC broker-dealers and OTC derivatives dealers.[411] Rule 15c3-4 requires each firm subject to the rule to "establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks."[412] The Commission's supervision of ANC broker-dealers consists of regular meetings with firm personnel to review each firm's financial results, the management of

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407 Id.

408 See Risk Management Lessons from the Global Bank Crisis of 2008.

409 Id. at 14 ("Market conditions and the deteriorating financial state of firms exposed weaknesses in firms' approaches to liquidity stress testing, particularly with respect to secured borrowing and contingent funding needs. These deteriorating conditions underscored the need for greater consideration of the overlap between systemic and firm-specific events and longer time horizons, and the connection between stress tests and business-as-usual liquidity management.").

410 Id. at 15 ("Interviewed firms typically calculated and maintained a measurable funding cushion, such as 'months of coverage,' which is conceptually similar to rating agencies' twelve-month liquidity alternatives analyses. Some institutions were required to maintain a liquidity cushion that could withstand the loss of unsecured funding for one year. Many institutions found that this metric did not capture important elements of stress that the organizations faced, such as the loss of secured funding and demands for collateral to support clearing and settlement activity and to mitigate the risks of accepting novations.") (emphasis in the original).

411 See 17 CFR 240.15c3-4.

412 17 CFR 240.15c3-4.

the firm's balance sheet, and, in particular, the liquidity of the firm's balance sheet.[413] Emphasis is placed on funding and liquidity risk management plans and liquidity stress scenarios.[414] The Commission staff also meets regularly with the firm's financial controllers to review and discuss price verification results and other financial controls, particularly concerning illiquid or hard-to-value assets or large asset concentrations.[415]

Given the large size of ANC broker-dealers and the potentially substantial role that stand-alone SBSDs approved to use internal models may play in the security-based swap markets, these firms would be required to take steps to manage funding liquidity risk.[416] Specifically, these firms would be required to perform a liquidity stress test at least monthly and, based on the results of that test, maintain liquidity reserves to address potential funding needs during a stress event.[417]

Under the proposal, an ANC broker-dealer and stand-alone SBSD using internal models would need to perform a liquidity stress test at least monthly that takes into account certain assumed conditions lasting for 30 consecutive days.[418] The results of the liquidity stress test would need to be provided within ten business days of the month end to senior management that has responsibility to oversee risk management at the firm. In addition, the assumptions

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413 A more detailed description of the Commission's ANC broker-dealer program is available on the Commission's website at http://www.sec.gov/divisions/marketreg/bdaltnetcap.htm.

414 Id.

415 Id.

416 See proposed new paragraph (f) to Rule 15c3-1; paragraph (f) of proposed new Rule 18a-1.

417 Id. The requirement to conduct the liquidity stress test on at least a monthly basis is designed to ensure that the test is conducted at sufficiently regular intervals to account for material changes that could impact the firm's liquidity profile. In this regard, the ANC broker-dealers are required to prepare and file monthly financial reports, which are designed to allow securities regulators to monitor their financial condition. See 17 CFR 240.17a-5; compare Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 FR 594 (Jan. 5, 2012) (Federal Reserve's proposed rule to require a "covered company" to conduct liquidity stress testing at least monthly).

418 Based on the Commission staff's experience, ANC broker-dealers currently perform regular liquidity stress tests.

underlying the liquidity stress test would need to be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the firm and at least annually by senior management of the firm. These provisions are designed to promote the engagement of senior level risk managers and managers of the firm in the implementation of the liquidity stress test and senior level risk managers in monitoring the results of the liquidity stress test.

These required assumed conditions are designed to be consistent with the liquidity stress tests performed by the ANC broker-dealers (based on Commission staff experience supervising the firms) and to address the types of liquidity outflows experienced by ANC broker-dealers and other broker-dealers in times of stress. The required assumed conditions would be:

- A stress event that includes a decline in creditworthiness of the firm severe enough to trigger contractual credit-related commitment provisions of counterparty agreements;
- The loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding, including intercompany advances and unfunded committed lines of credit;
- The potential for a material net loss of secured funding;
- The loss of the ability to procure repurchase agreement financing for less liquid assets;
- The illiquidity of collateral required by and on deposit at clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets;
- A material increase in collateral required to be maintained at registered clearing agencies of which the firm is a member; and
- The potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the firm, including those related to customer businesses of the firm.[419]

These proposed minimum elements are designed to ensure that ANC broker-dealers and stand-alone SBSDs using internal models employ a stress test that is severe enough to produce an

[419] See proposed new paragraph (f)(1) to Rule 15c3-1; paragraph (f)(1) of proposed new Rule 18a-1.

estimate of a potential funding loss of a magnitude that might be expected in a severely stressed market. As discussed below, the results of the stress test would be used by the firm to determine the amount of contingent liquidity to be maintained. The proposals would require that the ANC broker-dealer and stand-alone SBSD itself must maintain at all times liquidity reserves based on the results of the liquidity stress test.[420] The liquidity reserves would need to be comprised of unencumbered cash or U.S. government securities.[421] This limitation with respect to the assets that can be used for the liquidity reserves requirement is designed to ensure that only the most liquid instruments are held in the reserves, given that the market for less liquid instruments is generally disproportionately volatile during a time of market stress.

The results of stress tests play a key role in shaping an entity's liquidity risk contingency planning.[422] Thus, stress testing and contingency planning are closely intertwined.[423] Under the proposals, the ANC broker-dealer and a stand-alone SBSD using internal models would be required to establish a written contingency funding plan.[424] The plan would need to clearly set out the strategies for addressing liquidity shortfalls in emergency situations,[425] and would need to

420 See proposed new paragraph (f)(3) of Rule 15c3-1; paragraph (f)(3) of proposed new Rule 18a-1.

421 See proposed new paragraph (f)(3) of Rule 15c3-1; paragraph (f)(3) of proposed new Rule 18a-1.

422 See, e.g., Federal Reserve, FDIC, OCC, OTS, and NCUA, Interagency Policy Statement on Funding and Liquidity Risk Management 7, SR 10-6 (Mar. 17, 2010).

423 Id.

424 Based on staff experience supervising the ANC broker-dealers, all of the ANC broker-dealers that are part of a holding company generally have a written contingency funding plan, generally at the holding company level. This proposed rule would require that each ANC broker-dealer and stand-alone SBSD using internal models maintain a written contingency funding plan at the entity level (in addition to any holding company plan). See also Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 FR at 604. The Federal Reserve stated that the objectives of the contingency funding plan are to provide a plan for responding to a liquidity crisis, to identify alternate liquidity sources that a covered company can access during liquidity stress events, and to describe steps that should be taken to ensure that the covered company's sources of liquidity are sufficient to fund its operating costs and meet its commitments while minimizing additional costs and disruptions. Id. at 610.

425 See proposed new paragraph (f)(4) of Rule 15c3-1; paragraph (f)(4) of proposed new Rule 18a-1.

address the policies, roles, and responsibilities for meeting the liquidity needs of the firm and communicating with the public and other market participants during a liquidity stress event.[426]

Request for Comment

The Commission generally requests comment on the proposed liquidity stress test requirement. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are the proposed funding liquidity requirements appropriate for ANC broker-dealers and nonbank SBSDs that use internal models? If not, explain why not. Are there modifications that would improve the funding liquidity provisions? If so, explain them.
2. Should the proposed funding liquidity requirements apply to a broader group of broker-dealers (e.g., all broker-dealers that hold customer securities and cash or all broker-dealer with total assets in excess of minimum threshold)? Explain why or why not.
3. Should the proposed funding liquidity requirements apply to all nonbank SBSDs? If so, explain why. If not, explain why not.
4. Is monthly an appropriate frequency for the liquidity stress test? For example, would it be preferable to require the liquidity stress test on a more frequent basis such as weekly, or, alternatively, on a less frequent basis such as quarterly? If so, explain why.
5. Is the requirement to provide the results of the liquidity stress test within ten business days to senior management that has responsibility to oversee risk management at the firm appropriate? If not, explain why not. Should results be provided in a shorter or longer

426 See proposed new paragraph (f)(4) of Rule 15c3-1; paragraph (f)(4) of proposed new Rule 18a-1. To promote the flow of necessary information during a liquidity stress, the Federal Reserve's proposed rule would require the event management process to include a mechanism that ensures effective reporting and communication within the covered company and with outside parties, including the Federal Reserve and other relevant supervisors, counterparties, and other stakeholders. Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 FR at 611.

timeframe than ten business days? For example, is ten business days sufficient time to run the stress tests, generate the results, and provide them to senior management? If the time-frame should be longer or shorter, identify the different timeframe and explain why it would be more appropriate than ten business days.

6. Is the requirement that the assumptions underlying the liquidity stress test be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the firm and at least annually by senior management of firm appropriate? If not, explain why not. Should the reviews be more or less frequent? If so, identify the frequency and explain why it would be more appropriate than quarterly and annually.
7. Are the required assumptions of the funding liquidity stress test appropriate? If not, explain why not.
8. Are there additional or alternative assumptions that should be required in the funding liquidity stress test? If so, identify the additional or alternative assumptions and explain why they should be included.
9. Are the required assumptions of the funding liquidity stress test understandable? If not, identify the elements that require further explanation.
10. Should other types of securities in addition to U.S. government securities be permitted for the liquidity pool? If so, identify the types of securities and explain why they should be permitted.
11. Are the requirements for the written contingency funding plan appropriate? If not, explain why not.
12. Should additional or alternative requirements for the written contingency funding plan be required? If so, identify the additional or alternative requirements and explain why they

should be required.

e. Other Rule 15c3-1 Provisions Incorporated into Rule 18a-1

Rule 15c3-1 has five other sets of provisions that are proposed to be included in new Rule 18a-1: (1) debt-equity ratio requirements;[427] (2) capital withdrawal notice requirements;[428] (3) subsidiary consolidation requirements (Appendix C);[429] and (4) subordinated loan agreement requirements (Appendix D).[430]

i. Debt-Equity Ratio Requirements

Rule 15c3-1 sets limits on the amount of a broker-dealer's outstanding subordinated loans.[431] The limits are prescribed in terms of debt-to-equity amounts.[432] The debt-to-equity limits are designed to ensure that a broker-dealer has a base of permanent capital in addition to any subordinated loans, which – as discussed above – are permitted to be added back to net worth when computing net capital.[433] Proposed new Rule 18a-1 would contain the same debt-to-equity limits.[434] The objective of this parallel provision in Rule 18a-1 is to require nonbank SBSDs to maintain a base of permanent capital.

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427 See 17 CFR 240.15c3-1(d).

428 See 17 CFR 240.15c3-1(e).

429 See 17 CFR 240.15c3-1c.

430 See 17 CFR 240.15c3-1d.

431 See 17 CFR 240.15c3-1(d).

432 Id.

433 See Net Capital Rule, Exchange Act Release No. 9891 (Dec. 5, 1972), 38 FR 56, 59 (Jan. 3, 1973) ("The Commission has discovered a large number of instances in which broker-dealers were able to comply with the net capital although the firms [sic] net worth been entirely depleted. Compliance with the rule was possible only because subordinated debt is a permissible form of capital. Such conditions rendered the firm technically insolvent since its liabilities exceeded its assets.").

434 See paragraph (h) of proposed new Rule 18a-1.

Request for Comment

The Commission generally requests comment on the proposal to incorporate the debt-equity ratio provisions of Rule 15c3-1 into proposed new Rule 18a-1. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following question:

1. Are the debt-equity ratio requirements in Rule 15c3-1 appropriate standards for stand-alone SBSDs? If not, explain why not and suggest an alternative standard.

ii. Capital Withdrawal Requirements

Rule 15c3-1 requires that a broker-dealer provide notice when it seeks to withdraw capital in an amount that exceeds certain thresholds.[435] For example, a broker-dealer must give the Commission a two-day notice before a withdrawal that would exceed 30% of the firm's excess net capital and a notice within two days after a withdrawal that exceeded 20% of that measure.[436] The notice provisions are designed to alert the Commission and the firm's designated examining authority that capital is being withdrawn to assist in the monitoring of the financial condition of the broker-dealer. Rule 15c3-1 also restricts capital withdrawals that could have certain financial impacts on the firm, including withdrawals that reduce net capital below certain numerical levels.[437] These restrictions are designed to ensure that the broker-dealer maintains a buffer of net capital above its minimum required amount. Finally, under the rule, the Commission may issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain

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435 See 17 CFR 240.15c3-1(e)(1).

436 See 17 CFR 240.15c3-1(e)(1).

437 See 17 CFR 240.15c3-1(e)(2).

circumstances.[438] This provision and several of the notice and restriction provisions were put in place after the failure of the investment bank Drexel Burnham Lambert, Inc. ("Drexel").[439] Drexel, prior to its bankruptcy, transferred significant funds from its broker-dealer subsidiary to the holding company without notice to the Commission or Drexel's designated examining authority.[440]

Stand-alone SBSDs would be subject to the same provisions, with one difference.[441] In 2007, the Commission proposed amendments to Rule 15c3-1 to eliminate certain of the conditions required in an order restricting the withdrawals or the making of loans or advances to stockholders, insiders, and affiliates.[442] More specifically, under Rule 15c3-1, the Commission can, by order, restrict a broker-dealer for a period up to 20 business days from making capital withdrawals, loans, and advances only to the extent the withdrawal, loan, or advance would exceed 30% of the broker-dealer's excess net capital when aggregated with other such transactions over a 30-day period.[443] The current requirement raises a concern, based on Commission staff experience, that to the extent the books and records of a broker-dealer that is in financial distress are incomplete or inaccurate it can be difficult for regulators to determine the

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438 See 17 CFR 240.15c3-1(e)(3).

439 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991).

440 Id. at 9125.

441 See paragraph (i) of proposed new Rule 18a-1.

442 Amendments to Financial Responsibility Rules for Broker-Dealers, 72 FR 12862.

443 See 17 CFR 240.15c3-1(e)(3)(i). To issue an order, the Commission must, based on the facts and information available, conclude that the withdrawal, advance or loan may be detrimental to the financial integrity of the broker-dealer, or may unduly jeopardize the broker-dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker-dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970 ("SIPA"). See 17 CFR 240.15c3-1(e)(3)(i)(B). Furthermore, the rule provides that an order temporarily prohibiting the withdrawal of capital shall be rescinded if the Commission determines that the restriction on capital withdrawal should not remain in effect and that the hearing will be held within two business days from the date of the request in writing by the broker-dealer. See 17 CFR 240.15c3-1(e)(3)(ii).

firm's actual net capital and excess net capital amounts.[444] An order that limits withdrawals to a percentage of excess net capital may be difficult to enforce as it may not always be clear when that threshold had been reached.[445] Given these concerns and consistent with the proposed amendment to Rule 15c3-1, the Commission is proposing that its ability to restrict withdrawals of capital, loans or advances by stand-alone SBSDs not be limited based on the amount of the withdrawal, loan or advance in relation to the amount of the firms' excess net capital.[446]

Request for Comment

The Commission generally requests comment on the proposal to incorporate the capital withdrawal provisions of Rule 15c3-1 into proposed new Rule 18a-1. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are the capital withdrawal requirements in Rule 15c3-1 appropriate standards for stand-alone SBSDs? If not, explain why and suggest an alternative standard.
2. Under Rule 15c3-1, a broker-dealer must give the Commission notice two days before a withdrawal that would exceed 30% of the firm's excess net capital and two days after a withdrawal that exceeded 20% of that measure. Are these thresholds appropriate for stand-alone SBSDs? If not, explain why not and suggest alternative thresholds.
3. Rule 15c3-1 also restricts capital withdrawals that would have certain financial impacts on a broker-dealer such as lowering net capital below certain levels. Are these same requirements appropriate standards for stand-alone SBSDs?

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444 See Amendments to Financial Responsibility Rules for Broker-Dealers, 72 FR at 12873.

445 Id.

446 See paragraph (i) of proposed new Rule 18a-1; Amendments to Financial Responsibility Rules for Broker-Dealers, 72 FR at 12873.

4. Under the proposed amendments, the 30% of excess net capital limitation currently contained in Rule 15c3-1 with respect to Commission orders restricting withdrawals would be eliminated. However, under the proposed amendments, the Commission in issuing an order restricting withdrawals could impose such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors. Please identify terms and conditions that the Commission should consider to be included in such orders. For example, under certain circumstances, would it be appropriate for the current limitation in Rule 15c3-1 to be included in the order? Alternatively, should the 30% of excess net capital limitation currently contained in Rule 15c3-1 be retained in proposed new Rule 18a-1? If so, please explain why.

iii. Appendix C

Appendix C to Rule 15c3-1 requires a broker-dealer in computing its net capital and aggregate indebtedness to consolidate in a single computation assets and liabilities of any subsidiary or affiliate for which it guarantees, endorses or assumes directly or indirectly obligations or liabilities.[447] The assets and liabilities of a subsidiary or affiliate whose liabilities and obligations have not been guaranteed, endorsed, or assumed directly or indirectly by the broker-dealer may also be consolidated.[448] By including the assets and liabilities of a subsidiary in its net capital computation, a firm may receive flow-through net capital benefits because the consolidation may serve to increase the firm's net capital and thereby assist it in meeting the minimum requirements of Rule 15c3-1. Appendix C sets forth the requirements that must be met to consolidate in a single net capital computation the assets and liabilities of subsidiaries and

447 See 17 CFR 240.15c3-1c.

448 Id.

affiliates in order to obtain flow-through capital benefits for a parent broker-dealer.[449] Specifically, the broker-dealer must possess majority ownership and control over the consolidated subsidiary or affiliate and obtain an opinion of counsel essentially stating that at least the portion of the subsidiary's or affiliate's net asset value related to the broker-dealer's ownership interest therein may be distributed to the broker-dealer (or a trustee in a SIPA liquidation) within thirty days, at the request of the distributee.[450] In addition, subordinated obligations of the subsidiary or affiliate may not serve to increase the net worth of the broker-dealer unless the obligations also are subordinated to the claims of present and future creditors of the broker-dealer.[451] Appendix C also requires that liabilities and obligations of a subsidiary or affiliate of the broker-dealer that are guaranteed, endorsed, or assumed either directly or indirectly by the broker-dealer must be reflected in the firm's net capital computation.[452]

Based on Commission staff experience and information from an SRO, very few broker-dealers consolidate subsidiaries or affiliates to obtain the flow-through capital benefits under Appendix C to Rule 15c3-1. The review and information from the SRO indicate that the limited use results from the difficulty in obtaining the required opinion of counsel. Consequently, Appendix C to proposed new Rule 18a-1 would contain only the requirement that a stand-alone SBSD include in its net capital computation all liabilities or obligations of a subsidiary or affiliate of the stand-alone SBSD that the SBSD guarantees, endorses, or assumes either directly

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449 See 17 CFR 240.15c3-1c.

450 See 17 CFR 240.15c3-1c(b). FINRA Rule 4150(a) requires that prior written notice be given to FINRA whenever a FINRA member guarantees, endorses or assumes, directly or indirectly, the obligations or liabilities of another person. Paragraph (b) of the rule requires that prior written approval must be obtained from FINRA whenever any member seeks to receive flow-through capital benefits in accordance with Appendix C to Rule 15c3-1. This makes compliance with the rule more stringent because FINRA must pre-approve the subordinated debt for FINRA member firms who wish to take advantage of the capital benefits available under Appendix C of Rule 15c3-1. As of June 1, 2012, of the 4,711 broker-dealers registered with the Commission, 4,437 were FINRA member firms.

451 See 17 CFR 240.15c3-1c(c)(2).

452 See 17 CFR 240.15c3-1c(d).

or indirectly. Thus, stand-alone SBSDs would not be able to claim flow-through capital benefits for consolidated subsidiaries or affiliates. The Commission does not expect that this difference in approach between Rule 15c3-1 and proposed new Rule 18a-1 would create any competitive disadvantage for stand-alone SBSDs vis-à-vis broker-dealer SBSDs, given the limited use of the flow-through benefits provision under the current rule.

Request for Comment

The Commission generally requests comment on Appendix C of both Rule 15c3-1 and proposed Rule 18a-1. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Should the flow-through capital benefit provisions of Appendix C to Rule 15c3-1 be eliminated? If so, explain why. Alternatively, should the flow-through capital benefit provisions in Appendix C to Rule 15c3-1 be incorporated into proposed Rule 18a-1? If so, explain why.
2. Would stand-alone SBSDs be subject to a competitive disadvantage vis-à-vis broker-dealer SBSDs as a result of the differences between proposed Appendix C of Rule 18a-1 and Appendix C of Rule 15c3-1? Would these differences provide an incentive for an entity to register a nonbank SBSD as a broker-dealer SBSD? Please explain.

iv. Appendix D

Appendix D to Rule 15c3-1 sets forth the minimum and non-exclusive requirements for satisfactory subordination agreements.[453] A subordination agreement is a contract between a broker-dealer and a third party pursuant to which the third party lends money or provides a collateralized note to the broker-dealer. Generally, broker-dealers use subordination agreements

[453] 17 CFR 240.15c3-1d.

to borrow from third parties (typically affiliates) to increase the broker-dealer's net capital.[454] Nonbank SBSDs also are expected to use subordinated debt to obtain financing for their activities and the proposals discussed below would prescribe when such loans would receive favorable capital treatment.

In order to receive beneficial regulatory capital treatment under Rule 15c3-1, the obligation to the third party must be subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as defined under Appendix D.[455] Among other things, a satisfactory subordination agreement must prohibit, except under strictly defined limitations, prepayments or any payment of an obligation before the expiration of at least one year from the effective date of the subordination agreement.[456] This provision was designed to ensure the adequacy as well as the permanence of capital in the industry.[457]

There are two types of subordination agreements under Appendix D to Rule 15c3-1: (1) a subordinated loan agreement, which is used when a third party lends cash to a broker-dealer;[458] and (2) a secured demand note agreement, which is a promissory note in which a third party agrees to give cash to a broker-dealer on demand during the term of the note and provides cash or securities to the broker-dealer as collateral.[459]

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454 See 17 CFR 240.15c3-1(c)(2)(ii).

455 Id.

456 See 17 CFR 240.15c3-1d(b)(1).

457 See Net Capital Requirements for Broker-Dealers; Amended Rules, Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512, 3516 (Jan. 25, 1982).

458 See 17 CFR 240.15c3-1d(a)(2)(ii).

459 See 17 CFR 240.15c3-1d(a)(2)(v)(A). Under a secured demand note agreement, the third party cannot sell or otherwise use the collateral unless the third party substitutes securities of equal value for the deposited securities. See 17 CFR 240.15c3-1d(a)(2)(v)(D).

A broker-dealer SBSD would be subject to the provisions of Appendix D to Rule 15c3-1 through parallel provisions in Appendix D to proposed new Rule 18a-1.[460] However, only the subordinated loan agreement provisions would be included in Appendix D to proposed new Rule 18a-1. Thus, stand-alone SBSDs would not be able to use secured demand note agreements to obtain beneficial regulatory capital treatment under proposed Appendix D to Rule 18a-1. Based on Commission staff experience, broker-dealers infrequently utilize secured demand notes as a source of capital, and the amounts of these notes are relatively small in size. Therefore, this form of regulatory capital is not being proposed for stand-alone SBSDs. Accordingly, Appendix D to proposed new Rule 18a-1 would refer solely to "subordinated loan agreements" in the provisions where Appendix D to Rule 15c3-1 refers more broadly to "subordination agreements."[461]

Subordination agreements under Appendix D to Rule 15c3-1 are approved by a broker-dealer's designated examining authority.[462] A broker-dealer also is required to notify its designated examining authority upon the occurrence of certain events under Appendix D to Rule 15c3-1.[463] Because the term "designated examining authority" applies only to registered broker-dealers (i.e., stand-alone SBSDs would not have a designated examining authority), the

460 Appendix D to Rule 15c3-1d has provisions that apply if an action (e.g., repayment of the subordinated loan) would cause the broker-dealer's net capital to fall below certain thresholds (e.g., 120% of the broker-dealer's minimum net capital requirement) and a provision that applies if the broker-dealer's net capital has fallen below its minimum net capital requirement. See paragraphs (b)(7), (b)(8)(i), (b)(10)(ii)(B), (c)(2), and (c)(5)(i)(B) of 17 CFR 240.15c3-1d. Proposed new Rule 18a-1 would contain analogous provisions that would be based on the proposed minimum net capital and tentative net capital requirements for stand-alone SBSDs. See paragraphs (b)(6), (b)(7), (b)(9)(ii)(A), (c)(2), and (c)(4)(i) of proposed new Rule 18a-1d. In addition, in order to reflect the minimum net capital requirements that would apply to broker-dealer SBSDs, conforming amendments are being proposed for Rule 15c3-1d. See proposed amendments to paragraphs (b)(7), (b)(8)(i), (b)(10)(ii)(B), (c)(2), and (c)(5)(i)(B) of 17 CFR 240.15c3-1d.

461 The term "subordination agreements" as used in Appendix D to Rule 15c3-1 references both subordinated loan agreements and secured demand note agreements.

462 See 17 CFR 240.15c3-1d(c)(6)(i). See also FINRA Rule 4110(e)(1), which provides that subordinated loans and secured demand notes must be approved by FINRA in order to receive beneficial regulatory capital treatment.

463 See, e.g., 17 CFR 240.15c3-1d(b)(6).

provisions of Appendix D to Rule 18a-1 refer to the "Commission" instead of the "designated examining authority." Specifically, under paragraph (c)(5) of Appendix D to proposed Rule 18a-1, a stand-alone SBSD would be required to file two copies of any proposed subordinated loan agreement (including nonconforming subordinated loan agreements) at least 30 days prior to the proposed execution date of the agreement with the Commission.[464] The rule would also require an SBSD to file with the Commission a statement setting forth the name and address of the lender, the business relationship of the lender to the SBSD, and whether the SBSD carried an account for the lender effecting transactions in security-based swaps at or about the time the proposed agreement was filed.[465]

Request for Comment

The Commission generally requests comment on Appendix D to both Rule 15c3-1 and proposed new Rule 18a-1. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Should the secured demand note provisions of Appendix D to Rule 15c3-1 be eliminated? Alternatively, should the secured demand note provisions be incorporated into Appendix D to proposed new Rule 18a-1? If so, explain why.
2. Would stand-alone SBSDs be disadvantaged vis-à-vis broker-dealer SBSDs as a result of the differences between proposed Appendix D to proposed new Rule 18a-1 and Appendix D to Rule 15c3-1? Would these differences provide an incentive for an entity to register a nonbank SBSD as a broker-dealer SBSD? Please explain.

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464 See paragraph (c)(5) of proposed new Rule 18a-1d.

465 Id.

3. Proposed Capital Rules for Nonbank MSBSPs

Proposed new Rule 18a-2 would establish capital requirements for nonbank MSBSPs. In particular, a nonbank MSBSP would be required at all times to have and maintain positive tangible net worth.[466] A tangible net worth standard is being proposed for nonbank MSBSPs, rather than the net liquid assets test in Rule 15c3-1, because the entities that may need to register as nonbank MSBSPs may engage in a diverse range of business activities different from, and broader than, the securities activities conducted by broker-dealers or SBSDs (otherwise they would be required to register as an SBSD and/or broker-dealer). For example, these entities may engage in commercial activities that require them to have substantial fixed assets to support manufacturing and/or result in them having significant assets comprised of unsecured receivables. Requiring them to adhere to a net liquid assets test could result in their having to obtain significant additional capital or engage in costly restructurings.

The term tangible net worth would be defined to mean the nonbank MSBSP's net worth as determined in accordance with generally accepted accounting principles in the United States, excluding goodwill and other intangible assets.[467] In determining net worth, all long and short positions in security-based swaps, swaps, and related positions would need to be marked to their market value.[468] Further, a nonbank MSBSP would be required to include in its computation of tangible net worth all liabilities or obligations of a subsidiary or affiliate that the participant guarantees, endorses, or assumes, either directly or indirectly.[469] The proposed definition of tangible net worth would allow nonbank MSBSPs to include as regulatory capital assets that

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466 See paragraph (a) of proposed new Rule 18a-2. If a broker-dealer is required to register as a nonbank MSBSP, it would need to continue to comply with Rule 15c3-1 in addition to proposed new Rule 18a-2.

467 See paragraph (b) of proposed new Rule 18a-2.

468 Id. This provision is modeled on paragraph (c)(2)(vi)(B)(1) of Rule 15c3-1. See 17 CFR 240.15c3-1(c)(2)(vi)(B)(1). See also paragraph (c)(1)(i)(B)(1) of proposed new Rule 18a-1.

469 See paragraph (b) of proposed new Rule 18a-2.

would be deducted from net worth under Rule 15c3-1, such as property, plant, equipment, and unsecured receivables. At the same time, it would require the deduction of goodwill and other intangible assets.[470]

Because nonbank MSBSPs, by definition, will be entities that engage in a substantial security-based swap business, they would be required to comply with Rule 15c3-4 with respect to their security-based swap and swap activities.[471] As discussed above in section II.A.2.c. of this release, Rule 15c3-4 requires OTC derivatives dealers and ANC broker-dealers to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with their business activities, including market, credit, leverage, liquidity, legal, and operational risks.[472] The proposal that nonbank MSBSPs be subject to Rule 15c3-4 is designed to promote sound risk management practices with respect to the risks associated with OTC derivatives.

Finally, the risk that the failure of a nonbank MSBSP could have a destabilizing market impact is being addressed in part by the account equity requirements in proposed new Rule 18a-3 – as discussed below in section II.B.2.c.ii. of this release – that would require a nonbank MSBSP to deliver collateral to counterparties to cover the counterparty's current exposure to the nonbank MSBSP. The proposed requirement that nonbank MSBSPs deliver collateral to counterparties is designed to address a risk that arose during the 2008 credit crisis (i.e., the existence of large uncollateralized exposures of market participants to a single entity). The proposed requirements in proposed new Rule 18a-2 that a nonbank MSBSP maintain positive tangible net worth and

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470 The proposed definition of tangible net worth is consistent with the CFTC's proposed definition of tangible net equity. See CFTC Capital Proposing Release, 76 FR at 27828 (defining tangible net equity as "equity as determined under U.S. generally accepted accounting principles, and excludes goodwill and other intangible assets.").

471 See paragraph (c) of proposed new Rule 18a-2.

472 See 17 CFR 240.15c3-4.

establish risk management controls are designed to serve as an extra measure of protection but be flexible enough to account for the potential range of business activities of these entities.

Request for Comment

The Commission generally requests comment on the proposed capital requirements for nonbank MSBSPs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is a tangible net worth test an appropriate standard for a nonbank MSBSP? Would a net liquid assets test capital standard be more appropriate? If so, describe the rationale for such an approach.
2. Should nonbank MSBSPs be permitted to calculate their tangible net worth using generally accepted accounting principles in jurisdictions other than U.S., such as where the nonbank MSBSP is incorporated, organized, or has its principal office? If so, explain why.
3. Can the risks to market stability presented by nonbank MSBSPs be largely addressed through margin requirements?
4. Should proposed new Rule 18a-2 require that a nonbank MSBSP maintain a minimum fixed-dollar amount of tangible net equity, for example, equal to $20,000,000 or some greater or lesser amount? If so, explain the merits of imposing a fixed-dollar amount and identify the recommended fixed-dollar amount.
5. Should proposed new Rule 18a-2 require that a nonbank MSBSP compute capital charges for market risk and credit risk? For example, should such a requirement be modeled on the CFTC's proposed market and credit risk charges for nonbank swap dealers and

nonbank major swap participants that are not using internal models and are not FCMs?[473] If nonbank SBSDs should be required to take market and credit risk charges, explain why. If not, explain why not.

6. Should nonbank MSBSPs be subject to a leverage test and if so, how should it be designed? Explain the rationale for such a test.

7. Should a nonbank MSBSP be subject to a minimum tangible net worth requirement that is proportional to the amount of risk incurred by the MSBSP through its outstanding security-based swap transactions? More specifically, should an MSBSP calculate an "adjusted tangible net worth" by subtracting market risk deductions for their security-based swaps (either based on the standardized haircuts or on approved models) from their tangible net worth and be required to maintain sufficient capital such that this adjusted tangible net worth figure is positive?

B. MARGIN

1. Introduction

As discussed above in section II.A.2.b.iv. of this release, dealers in OTC derivatives manage credit risk to their OTC derivatives counterparties through collateral and netting agreements.[474] The two types of credit exposure arising from OTC derivatives are current exposure and potential future exposure. The current exposure is the amount that the counterparty would be obligated to pay the dealer if all the OTC derivatives contracts with the counterparty were terminated (i.e., it is the amount of the current receivable from the counterparty). This form of credit risk arises from the potential that the counterparty may default on the obligation to pay

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473 See CFTC Capital Proposing Release, 76 FR at 27809-27812.

474 See Market Review of OTC Derivative Bilateral Collateralization Practices; OTC Derivatives: Settlement Procedures and Counterparty Risk Management.

the current receivable. The potential future exposure is the amount that the current exposure may increase in favor of the dealer in the future. This form of credit risk arises from the potential that the counterparty may default before providing the dealer with additional collateral to cover the incremental increase in the current exposure or that the current exposure will increase after a default when the counterparty has ceased to provide additional collateral to cover such increases and before the dealer can liquidate the position.

Dealers may require counterparties to provide collateral to cover their current and potential future exposures to the counterparty.[475] On the other hand, they may not require collateral for these purposes because, for example, the counterparty is deemed to be of low credit risk.[476] Alternatively, agreements between a dealer and its counterparties could require the counterparties to begin delivering collateral during the pendency of the transaction if certain "trigger events," e.g., a downgrade of the counterparty's credit rating, occur. Prior to the financial crisis, the ability to enter into OTC derivatives transactions without having to deliver collateral allowed counterparties to enter into OTC derivatives transactions without the necessity of using capital to support the transactions.[477] So, when "trigger events" occurred during the financial crisis, counterparties faced significant liquidity strains in seeking to meet the

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475 In the Dodd-Frank Act, collateral collected to cover current exposure is referred to as variation margin and collateral collected to cover potential future exposure is referred to as initial margin. See, e.g., section 15F(e)(2)(B)(i)-(ii) of the Exchange Act (15 U.S.C. 78o-10(e)(2)(B)(i)-(ii)) and section 4s(e)(1)(A)-(B) of the CEA (7 U.S.C. 6s(e)(1)(A)-(B)), added by the Dodd-Frank Act. In this release, collateral collected to cover potential future exposure is referred to as margin collateral.

476 See, e.g., Orice M. Williams, Director, Financial Markets and Community Investment, General Accountability Office ("GAO"), Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps, GAO-09-397T (Mar. 2009), available at http://www.gao.gov/new.items/d09397t.pdf (testimony before the U.S. House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises).

477 Id. at 13.

requirements to deliver collateral.[478] As a result, some dealers experienced large uncollateralized exposures to counterparties experiencing financial difficulty, which, in turn, risked exacerbating the already severe market dislocation.[479]

The Dodd-Frank Act seeks to address the risk of uncollateralized credit risk exposure arising from OTC derivatives by, among other things, mandating margin requirements for non-cleared security-based swaps and swaps. In particular, section 764 of the Dodd-Frank Act added new section 15F to the Exchange Act.[480] Section 15F(e)(2)(B) of the Exchange Act provides that the Commission shall adopt rules for nonbank SBSDs and nonbank MSBSPs imposing "both initial and variation margin requirements on all security-based swaps that are not cleared by a registered clearing agency."[481] Section 15F(e)(2)(A) of the Exchange Act provides that the prudential regulators shall prescribe initial and variation margin requirements for non-cleared security-based swap transactions applicable to bank SBSDs and bank MSBSPs.[482] Section 15F(e)(3)(A) also provides that "[t]o offset the greater risk to the security-based swap dealer or major security-based swap participant and the financial system arising from the use of security-based swaps that are not cleared," the margin requirements proposed by the Commission and prudential regulators shall "help ensure the safety and soundness" of the SBSDs and the

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478 Id. See also GAO, Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc., GAO-11-616 (Sept. 2011), available at http://www.gao.gov/assets/590/585560.pdf ("Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc.").

479 See Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc. at 5-6.

480 See Pub. L. 111-203 § 764.

481 15 U.S.C. 78o-10(e)(2)(B).

482 See 15 U.S.C. 78o-10(e)(2)(A). The prudential regulators have proposed margin rules with respect to non-cleared swaps and security-based swaps that would apply to bank swap dealers, bank major swap participants, bank SBSDs, and bank MSBSPs. See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564. The prudential regulators refer to collateral to cover current exposure as variation margin and collateral to cover potential future exposure as initial margin. Id.

MSBSPs, and "be appropriate for the risk associated with non-cleared security-based swaps held" by an SBSD or MSBSP.[483]

Similarly, sections 4s(e)(1)(A) and (B) of the CEA provide that the prudential regulators and the CFTC shall prescribe margin requirements for, respectively, bank swap dealers and bank major swap participants, and nonbank swap dealers and nonbank major swap participants.[484] Further, section 4s(e)(3)(A) of the CEA provides, among other things, that "[t]o offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared," the margin requirements adopted by the prudential regulators and the CFTC shall "help ensure the safety and soundness" of swap dealers and major swap participants, and "be appropriate for the risk associated with non-cleared swaps held" by these entities.[485]

The margin requirements that must be established with respect to non-cleared security-based swaps and non-cleared swaps will operate in tandem with provisions in the Dodd-Frank Act requiring that security-based swaps and swaps must be cleared through a registered clearing agency or registered DCO, respectively, unless an exception to mandatory clearing exists.[486]

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483 15 U.S.C. 78o-10(e)(3)(A).

484 See 7 U.S.C. 6s(e)(1)(A) and (B). The CFTC has proposed margin requirements with respect to non-cleared swaps that would apply to nonbank swap dealers and nonbank major swap participants. See CFTC Margin Proposing Release, 76 FR 23732. The CFTC refers to collateral to cover current exposure as variation margin and collateral to cover potential future exposure as initial margin. Id.

485 7 U.S.C. 6s(e)(3)(A).

486 See Pub. L. 111–203 § 763 (adding section 3C(a)(1) of the Exchange Act (15 U.S.C. 78c-3(a)(1) (mandatory clearing of security-based swaps)) and Pub. L. 111–203 § 723 (adding section 2(h) of the CEA (7 U.S.C. 2(h) (mandatory clearing of swaps)). The mandatory clearing provisions in the Exchange Act and CEA contain exceptions from the mandatory clearing requirement for certain types of entities, security-based swaps, and swaps. See Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, Exchange Act Release No. 67286 (June 28, 2012), 77 FR 41602 (July 13, 2012) (explaining exceptions to mandatory clearing for security-based swaps) ("Process for Submissions of Security-Based Swaps"); Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade, 76 FR 77728 (Dec. 30, 2010) (explaining exceptions to mandatory clearing for swaps). Security-based swaps and swaps that are not required to be cleared would be non-cleared security-based swaps and swaps.

More specifically, section 3C of the Exchange Act,[487] as added by section 763(a) of the Dodd-Frank Act, creates, among other things, a clearing requirement with respect to certain security-based swaps. Specifically, this section provides that "[i]t shall be unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to a clearing agency that is registered under this Act or a clearing agency that is exempt from registration under this Act if the security-based swap is required to be cleared."[488]

Clearing agencies and DCOs that operate as central counterparties ("CCPs") manage credit and other risks through a range of controls and methods, including prescribed margin rules for their members.[489] Thus, the mandatory clearing requirements established by the Dodd-Frank Act for security-based swaps and swaps, in effect, will establish margin requirements for cleared security-based swaps and cleared swaps and, thereby, complement the margin requirements for

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487 15 U.S.C. 78c-3 et seq.

488 15 U.S.C. 78c-3(a)(1) (as added by section 763(a) of the Dodd-Frank Act). The requirement that a security-based swap must be cleared will stem from the determination to be made by the Commission. Such determination may be made in connection with the review of a clearing agency's submission regarding a security-based swap, or any group, category, type or class of security-based swap, the clearing agency plans to accept for clearing. See 15 U.S.C. 78c-3(b)(2)(C)(ii) (as added by section 763(a) of the Dodd-Frank Act) ("[t]he Commission shall . . . review each submission made under subparagraphs (A) and (B), and determine whether the security-based swap, or group, category, type, or class of security-based swaps, described in the submission is required to be cleared".). In addition, section 3C(b)(1) of the Exchange Act provides that "[t]he Commission on an ongoing basis shall review each security-based swap, or any group, category, type, or class of security-based swaps to make a determination that such security-based swap, or group, category, type, or class of security-based swaps should be required to be cleared."

489 See Clearing Agency Standards for Operation and Governance, Exchange Act Release No. 64017 (Mar. 3, 2011), 76 FR 14472 (Mar. 16, 2011) ("Clearing Agency Standards for Operation and Governance"). A CCP interposes itself between two counterparties to a transaction. See Process for Submissions of Security-Based Swaps, 77 FR at 41603. For example, when an OTC derivatives contract between two counterparties that are members of a CCP is executed and submitted for clearing, it is typically replaced by two new contracts--separate contracts between the CCP and each of the two original counterparties. At that point, the original counterparties are no longer counterparties to each other. Instead, each acquires the CCP as its counterparty, and the CCP assumes the counterparty credit risk of each of the original counterparties that are members of the CCP. To address the credit risk of acting as a CCP, clearing agencies and DCOs require their clearing members to post collateral for proprietary and customer positions of the member cleared by the clearing agency or DCO. They also may require their clearing members to collect collateral from their customers. In addition, as discussed below, the Federal Reserve and the broker-dealer SROs prescribe margin rules requiring broker-dealers to collect margin collateral from their customers for financed securities transactions and facilitated short sales of securities. Id.

non-cleared security-based swaps and non-cleared swaps established by the Commission, the prudential regulators, and the CFTC.[490]

Pursuant to section 15F(e) of the Exchange Act, the Commission is proposing new Rule 18a-3 to establish margin requirements for nonbank SBSDs and nonbank MSBSPs with respect to non-cleared security-based swaps. The provisions of proposed Rule 18a-3 are based on the margin rules applicable to broker-dealers (the "broker-dealer margin rules").[491] The goal of modeling proposed new Rule 18a-3 on the broker-dealer margin rules is to promote consistency with existing rules and to facilitate the portfolio margining of security-based swaps with other types of securities. In the securities markets, margin rules have been set by relevant regulatory authorities (the Federal Reserve and the SROs) since the 1930s.[492] The requirement that an SRO file proposed margin rules with the Commission has promoted the establishment of consistent margin levels across the SROs, which mitigates the risk that SROs (as well as their member firms) will compete by implementing lower margin levels and also helps ensure that margin

490 See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27567 ("In the derivatives clearing process, central counterparties (CCPs) manage the credit risk through a range of controls and methods, including a margining regime that imposes both initial margin and variation margin requirements on parties to cleared transactions. Thus, the mandatory clearing requirement established by the Dodd-Frank Act for swaps and security-based swaps will effectively require any party to any transaction subject to the clearing mandate to post initial and variation margin to the CCP in connection with that transaction.") (footnote omitted). See also Clearing Agency Standards for Operation and Governance, 76 FR at 14482 (proposing a requirement that clearing agencies acting as CCPs must establish, implement, maintain, and enforce written policies and procedures reasonably designed to use margin requirements to limit credit exposures to members in normal market conditions, use risk-based models and parameters to set margin requirements, and review the models and parameters at least monthly).

491 Broker-dealers are subject to margin requirements in rules promulgated by the Federal Reserve (12 CFR 220.1, et seq.), SROs (see, e.g., FINRA Rules 4210-4240), and, with respect to security futures, jointly by the Commission and the CFTC (17 CFR 242.400-406).

492 The Federal Reserve originally adopted Regulation T pursuant to section 7 of the Exchange Act shortly after the enactment of the Exchange Act. See 1934 Fed. Res. Bull. 675. The purposes of the Federal Reserve's margin rules include: (1) regulation of the amount of credit directed into securities speculation and away from other uses; (2) protection of the securities markets from price fluctuations and disruptions caused by excessive margin credit; (3) protection of investors against losses arising from undue leverage in securities transactions; and (4) protection of broker-dealers from the financial exposure involved in excessive margin lending to customers. See Charles F. Rechlin, Securities Credit Regulation § 1:3 (2d ed. 2008).

levels are set at sufficiently prudent levels to reduce systemic risk.[493] Basing proposed Rule 18a-3 on the broker-dealer margin rules is intended to achieve these same objectives in the market for security-based swaps.

Under the broker-dealer margin rules, an accountholder is required to maintain a specified level of equity in a securities account at a broker-dealer (i.e., the market value of the assets in the account must exceed the amount of the accountholder's obligations to the broker-dealer by a prescribed amount).[494] This equity serves as a buffer in the event the accountholder fails to meet an obligation to the broker-dealer and the broker-dealer must liquidate the assets in the account to satisfy the obligation.[495] The equity also provides liquidity to the broker-dealer with which to fund the credit extended to the accountholder. The amount of the equity required to be maintained in the account depends on the securities transactions being facilitated through the resources of the broker-dealer because the equity requirement increases as the risk of the securities purchased with borrowed funds or sold short with borrowed securities increases.

Proposed new Rule 18a-3 is based on these same principles and is intended to form part of an integrated program of financial responsibility requirements, along with the proposed capital and segregation standards. For example, proposed new Rule 18a-1 would impose a capital charge in certain cases for uncollateralized exposures arising from security-based swaps. The

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493 Pursuant to section 19(b)(1) of the Exchange Act, each SRO must file with the Commission any proposed change in, addition to, or deletion from the rules of the exchange electronically on a Form 19b-4 through the Electronic Form 19b-4 Filing System, which is a secure website operated by the Commission. 15 U.S.C. 78s(b)(1); 17 CFR 240.19b-4.

494 See, e.g., 12 CFR 220.2; FINRA Rule 4210(a)(5); 17 CFR 242.401(a)(8). Accountholder obligations to the broker-dealer generally arise from the accountholder borrowing funds from the broker-dealer to finance securities purchases and the accountholder relying on the broker-dealer to borrow securities or use its own securities to make delivery on short sales of securities by the accountholder.

495 The account equity requirement, in effect, mandates that the account contain sufficient collateral to cover the broker-dealer's current exposure to the accountholder plus a buffer to address potential future exposure.

segregation requirements are intended to ensure that initial margin collected by SBSDs is protected from their proprietary business risks.[496]

Request for Comment

The Commission generally requests comment on the proposal to model the nonbank SBSD margin rule for non-cleared security-based swaps on the broker-dealer margin rules. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are there other margin standards that would more appropriately address the risks of non-cleared security-based swaps and/or be more practical margining programs for non-cleared security-based swaps? If so, identify them and explain how they would be more appropriate and/or practical.
2. What are the current margining practices of dealers in OTC derivatives with respect to contracts that likely would be security-based swaps subject to proposed new Rule 18a-3? How do those margining practices differ from the proposed requirements in proposed new Rule 18a-3?
3. As a practical matter, would the structure of proposed new Rule 18a-3 accommodate portfolio margining of security-based swaps and swaps? If so, explain why. If not, explain why not.

2. Proposed Margin Requirements for Nonbank SBSDs and Nonbank MSBSPs

a. Scope of Rule 18a-3

Proposed new Rule 18a-3 would apply to nonbank SBSDs and nonbank MSBSPs.[497] As

[496] See proposed new Rules 18a-1, 18a-3, and 18a-4.

[497] See paragraph (a) of proposed new Rule 18a-3.

discussed in more detail below, the proposed rule would require nonbank SBSDs to collect collateral from their counterparties to non-cleared security-based swaps to cover both current exposure and potential future exposure to the counterparty (i.e., the rule would require the account to have prescribed minimum levels of equity); however, there would be exceptions to these requirements for certain types of counterparties and for certain types of transactions. The collateral collected to address the potential future exposure (the margin collateral) would need to be sufficient to meet the level of account equity required by the proposed rule. The required level of account equity would be based on the risk of the positions in the account.

Proposed new Rule 18a-3 would require a nonbank MSBSP to collect collateral from counterparties to which the nonbank MSBSP has current exposure and deliver collateral to counterparties that have current exposure to the nonbank MSBSP; however, there would be exceptions to these requirements for certain types of counterparties. These requirements would apply only to current exposure (i.e., nonbank MSBSPs and their counterparties would not be required to exchange collateral to cover potential future exposure to each other).

The proposed rule would not identify the types of instruments that must be delivered as collateral (e.g., U.S. government securities). However, it would place limitations on the collateral that could be collected by nonbank SBSDs. First, the rule would require the nonbank SBSD to take haircuts on the collateral equal to the amounts of the deductions required under Rule 15c3-1, as proposed to be amended, and proposed new Rule 18a-1, as applicable to the nonbank SBSD. Second, the rule would prescribe conditions with respect to the collateral modeled on the conditions in Appendix E to Rule 15c3-1, discussed above in section II.A.2.b.iv. of this release, that determine when collateral can be taken into account for purposes of determining a potential credit risk charge for exposure to certain counterparties.[498]

Finally, the provisions in proposed new Rule 18a-3 are intended to establish minimum margin requirements for non-cleared security-based swaps. A nonbank SBSD and a nonbank MSBSP could establish "house" margin requirements that are more conservative than those specified in the proposed new rule.[499] For example, a nonbank SBSD could require that a minimum level of equity must be maintained in the accounts of counterparties that exceed the level of equity required to be maintained pursuant to the proposed new rule. In addition, a nonbank SBSD and a nonbank MSBSP could specifically identify and thereby limit the types of instruments they will accept as collateral.

b. Daily Calculations

i. Nonbank SBSDs

Proposed new Rule 18a-3 would require nonbank SBSDs to collect collateral from their counterparties to non-cleared security-based swaps to cover both current exposure and potential future exposure, subject to certain exceptions discussed below.[500] Consequently, proposed new Rule 18a-3 would require a nonbank SBSD to perform two calculations as of the close of each business day with respect to each account carried by the firm for a counterparty to a non-cleared security-based swap transaction.[501] A nonbank SBSD would be required to increase the frequency of the calculations (i.e., perform intra-day calculations) during periods of extreme

498 See 17 CFR 240.15c3-1e(c)(4)(v)(A)-(H).

499 Under broker-dealer margin rules, broker-dealers also can establish "house" margin requirements as long as they are at least as restrictive as the Federal Reserve and SRO margin rules. See, e.g., FINRA Rule 4210(d).

500 See paragraphs (c)(1)(ii) and (iii) of proposed new Rule 18a-3.

501 See paragraphs (c)(1)(i)(A) and (B) of proposed new Rule 18a-3. For purposes of proposed new Rule 18a-3, the term account would mean an account carried by a nonbank SBSD or nonbank MSBSP for a counterparty that holds non-cleared security-based swaps. See paragraph (b)(1) of proposed new Rule 18a-3. In addition, the term counterparty would mean a person with whom the nonbank SBSD or nonbank MSBSP has entered into a non-cleared security-based swap transaction. See paragraph (b)(3) of proposed new Rule 18a-3.

volatility and for accounts with concentrated positions.[502] These more frequent calculations would be designed to monitor the nonbank SBSD's counterparty risk exposure in situations where a default by a counterparty or multiple counterparties would have a more significant adverse impact on the financial condition of the nonbank SBSD than under more normal circumstances.[503] One consequence of the more frequent calculations could be that the nonbank SBSD requests that a counterparty deliver collateral during the day pursuant to a "house" margin requirement to account for changes in the value of the securities and money market instruments held in the account.

As discussed below in section II.B.2.c.i. of this release, the daily calculations would form the basis for the nonbank SBSD to determine the amount of collateral the counterparty would need to deliver to cover any current exposure and potential future exposure the nonbank SBSD has to the counterparty. The proposed rule would except certain counterparties from this requirement. Even if the counterparty is not required to deliver collateral, the calculations – by measuring the current and potential future exposure to the counterparty – would assist the nonbank SBSD in managing its credit risk and understanding the extent of its uncollateralized credit exposure to the counterparty and across all counterparties. In addition, as discussed above in section II.A.2.a. of this release, the calculations would be used for determining the risk margin amount for purposes of calculating the 8% margin factor to determine the nonbank SBSD's minimum net capital requirement.[504]

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502 See paragraph (c)(7) of proposed new Rule 18a-3.

503 Compare FINRA Rule 4210(d) which states that procedures shall be established by members to: "(1) review limits and types of credit extended to all customers; (2) formulate their own margin requirements; and (3) review the need for instituting higher margin requirements, mark-to-markets and collateral deposits than are required by this [margin rule] for individual securities or customer accounts."

504 See proposed new paragraph (c)(16) of Rule 15c3-1; paragraph (c)(6) of proposed new Rule 18a-1.

The first calculation would be to determine the amount of equity in the account.[505] For purposes of the rule, the term equity would mean the total current fair market value of securities positions in an account of a counterparty (excluding the time value of an over-the-counter option), plus any credit balance and less any debit balance in the account after applying a qualifying netting agreement with respect to gross derivatives payables and receivables.[506] Consequently, the first step in calculating the equity would be to mark-to-market all of the securities positions in the account, including non-cleared security-based swap positions. The second step would be to add to that amount any credit balance in the account or subtract from that amount any debit balance in the account. Credit balances would include payables the nonbank SBSD owed to the counterparty. Payables could relate to cash deposited into the account, the proceeds of the sales of securities held in the account, and/or interest and dividends earned from securities held in the account. In addition, payables could relate to derivatives in the account, including non-cleared security-based swaps with a net replacement value in the favor of the counterparty. Debit balances would be receivables to the nonbank SBSD owed by the counterparty, including any net replacement values in favor of the nonbank SBSD arising from derivatives positions and any other amounts owed to the nonbank SBSD by the counterparty.

As indicated by the proposed definition of equity, the nonbank SBSD could offset payables and receivables relating to derivatives in the account by applying a qualifying netting agreement with the counterparty. To qualify for this treatment, a netting agreement would need to meet the minimum requirements prescribed in Appendix E to Rule 15c3-1 to qualify for

505 See paragraph (c)(1)(i)(A) of proposed new Rule 18a-3.

506 See paragraph (b)(4) of proposed new Rule 18a-3. The time value of an OTC option is the amount that the current market value of the option exceeds the in-the-money amount of the option. See also, generally, FINRA Rule 4210(a)(5) (defining equity to mean the customer's ownership interest in the account, computed by adding the current market value of all securities "long" and the amount of any credit balance and subtracting the current market value of all securities "short" and the amount of any debit balance).

purposes of the credit risk charge discussed above in section II.A.2.b.iv. of this release.[507] These requirements are designed to ensure that the netting agreement between the nonbank SBSD and the counterparty permits the nonbank SBSD to reduce the receivables and payables relating to derivatives between the two entities to a single net payment obligation.

The equity is the amount that results after marking-to-market the securities positions and adding the credit balance or subtracting the debit balance (including giving effect to qualifying netting agreements). If the value of the securities positions in the account exceeds the amount of any debit balance, the account would have a positive equity.[508] On the other hand, if the amount of the debit balance is greater, the account would have a negative equity.[509] The negative equity in an account would be equal to the nonbank SBSD's current exposure to the counterparty.

The second calculation would be to determine a margin amount for the account to address potential future exposure.[510] The proposed rule would prescribe a standardized method and a model-based method for calculating the margin amount.[511] The method for determining the

507 See paragraph (c)(5) of proposed new Rule 18a-3; 17 CFR 240.15c3-1e(c)(4)(iv).

508 The proposed rule would define the term positive equity to mean equity of greater than \$0. See paragraph (b)(7) of proposed new Rule 18a-3.

509 The proposed rule would define the term negative equity to mean equity of less than \$0. See paragraph (b)(6) of proposed new Rule 18a-3.

510 See paragraph (c)(1)(i)(B) of proposed new Rule 18a-3.

511 See paragraph (d) of proposed new Rule 18a-3. Similarly, the prudential regulators have proposed that bank SBSDs and bank swap dealers have the option of using internal models to calculate initial margin requirements for non-cleared security-based swaps. See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27567-27568 ("With respect to initial margin, the proposed rule permits a covered swap entity to select from two alternatives to calculate its initial margin requirements. A covered swap entity may calculate its initial margin requirements using a standardized 'lookup' table that specifies the minimum initial margin that must be collected, expressed as a percentage of the notional amount of the swap or security-based swap. These percentages depend on the broad asset class of the swap or security-based swap. Alternatively, a covered swap entity may calculate its minimum initial margin requirements using an internal margin model that meets certain criteria and that has been approved by the relevant prudential regulator.") (footnotes omitted). On the other hand, the CFTC, because of concerns about the resources necessary to approve the use of internal models for margining purposes and the fact that nonbank swap dealers may not have internal models, proposed that nonbank swap dealers must use either external models or a standardized approach to determine initial margin (though the CFTC did propose a provision under which the CFTC could approve the use of an internal model should the CFTC obtain sufficient

margin amount would be similar to the approach a nonbank SBSD would need to use to determine haircuts on proprietary security-based swap positions when computing net capital.[512] This approach would maintain consistency between the proposed margin and capital rules. Specifically, paragraph (d) of proposed new Rule 18a-3 would divide security-based swaps into two classes: CDS security-based swaps and all other security-based swaps. Paragraph (d) would define the standardized methodology for determining the margin amount for each class of security-based swap by reference to the standardized haircuts that would apply to the class in proposed new Rule 18a-1 (if a stand-alone SBSD) or Rule 15c3-1, as proposed to be amended (if a broker-dealer SBSD).[513] Paragraph (d) would provide further that, if the nonbank SBSD was

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resources). See CFTC Margin Proposing Release, 76 FR at 23737. The external models proposed by the CFTC are: (1) a model currently in use for margining cleared swaps at a DCO; (2) a model currently in use for modeling non-cleared swaps by an entity subject to regular assessment by a prudential regulator; or (3) a model available for licensing to any market participant by a vendor. Id. The use of external models is not being proposed for nonbank SBSDs because the basis for permitting firms to use VaR models to compute net capital is to align their internally developed (i.e., not vender-developed) risk management processes with the process for computing net capital. See Alternative Net Capital Requirements Adopting Release, 69 FR at 34428 (the option to use VaR models is "intended to reduce regulatory costs for broker-dealers by allowing very highly capitalized firms that have developed robust internal risk management practices to use those risk management practices, such as mathematical risk measurement models, for regulatory purposes").

512 See paragraph (d) of proposed new Rule 18a-3; proposed new paragraph (c)(2)(vi)(O) of Rule 15c3-1; paragraph (c)(1)(vi) of proposed new Rule 18a-1.

513 See paragraphs (d)(1)(i) and (ii) of proposed new Rule 18a-3. As discussed in section II.A.2.b.ii. of this release, proposed new Rule 18a-1 and Rule 15c3-1, as proposed to be amended, would prescribe standardized haircuts for security-based swaps. See proposed new paragraph (c)(2)(vi)(O) of Rule 15c3-1; paragraph (c)(1)(vi) of proposed new Rule 18a-1. Consequently, for CDS security-based swaps, the nonbank SBSD would use the proposed maturity/spread grid in proposed new paragraph (c)(2)(vi)(O)(1) of Rule 15c3-1 and paragraph (c)(1)(vi)(A) of proposed new Rule 18a-1 to determine the margin amount. See paragraph (d)(1)(i) of proposed new Rule 18a-3. While the required standardized haircuts would be the same in Rule 15c3-1, as proposed to be amended, and proposed new Rule 18a-1, the nonbank SBSD would refer to Rule 15c3-1 if it is a broker-dealer SBSD and proposed new Rule 18a-1 if it is a stand-alone SBSD. For all equity security-based swaps and debt security-based swaps (other than CDS security-based swaps), the nonbank SBSD would use the method of multiplying the notional amount of the position by the standardized haircut that would apply to the underlying security as specified in proposed new paragraph (c)(2)(vi)(O)(2) of Rule 15c3-1 and paragraph (c)(1)(vi)(B) of proposed new Rule 18a-1. See paragraph (d)(ii) of proposed new Rule 18a-3. For equity security-based swaps, this would include being able to use the methodology in Appendix A to Rule 15c3-1, as proposed to be amended, and in Appendix A to proposed new Rule 18a-1, as applicable to the nonbank SBSD. For debt security-based swaps, this would include being able to use the offsets that are permitted in the debt maturity grids in paragraph (c)(2)(vi) of Rule 15c3-1. See 17 CFR 240.15c3-1(c)(2)(vi).

approved to use internal models to compute net capital, the firm could use its internal VaR model to determine the margin amount for security-based swaps for which the firm had been approved to use the model, except that the margin amount for equity security-based swaps would need to be determined exclusively using the standardized haircuts.[514] Consequently, for debt security-based swaps, a nonbank SBSD approved to use internal models could calculate the margin amount using the firm's VaR model to the extent the firm is approved to include these types of positions in the model for the purposes of computing net capital. For all other positions, a nonbank SBSD would need to use the standardized haircut approach. Nonbank SBSDs that are not approved to use internal models to compute net capital would need to use the standardized haircuts for all positions to calculate the margin amount.

As noted above, a nonbank SBSD (regardless of whether it is approved to use internal models to compute net capital) would be required to calculate the margin amount for equity security-based swaps using the standardized haircuts, which includes the ability to use the methodology in Appendix A to Rule 15c3-1. This proposal is designed to establish a margin requirement for equity security-based swaps that is consistent with SRO portfolio margin rules for equity securities, which are based on the Appendix A methodology.[515] This provision would allow broker-dealer SBSDs to include equity security-based swaps in the portfolios of equity securities positions for which they calculate margin requirements using the SRO portfolio margin

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514 See paragraph (d)(2) of proposed new Rule 18a-3.

515 See FINRA Rule 4210(g); CBOE Rule 12.4. See also FINRA, Portfolio Margin Frequently Asked Questions, available at www.finra.org. As discussed in section II.A.2.b.ii. of this release, Appendix A to Rule 15c3-1 permits a broker-dealer to group options, futures, long securities positions, and short securities positions involving the same underlying security and stress the current market price for each position at ten equidistant points along a range of positive and negative potential future market movements, using an approved theoretical options pricing model that satisfies certain conditions specified in the rule. See 17 CFR 240.15c3-1a. The gains and losses of each position in the portfolio offset each other to yield a net gain or loss at each stress point. The stress point that yields the largest potential net loss for the portfolio would be used to calculate the aggregate haircut for all the positions in the portfolio. Id.

rules.[516] The proposal also would ensure a consistent portfolio margin approach for equity security products across nonbank SBSDs and broker-dealers that are not SBSDs, and thereby reduce opportunity for regulatory arbitrage.

Request for Comment

The Commission generally requests comment on the proposed daily calculation requirements for nonbank SBSDs in proposed new Rule 18a-3. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is the proposed definition of equity appropriate? For example, would the proposed definition be practical in terms of determining the net equity in an account holding non-cleared security-based swaps? If the proposed definition is not appropriate, explain why and provide suggested alternative definitions.
2. Should the definition of equity include the time value of an over-the-counter option? If so, explain why.
3. Should the terms current market value, credit balance, and debit balance be defined for the purpose of proposed new Rule 18a-3? For example, would defining these terms provide greater clarity to the definition of equity in the proposed rule? If these terms should be defined, explain why and provide suggested definitions.
4. Are the proposed requirements for netting agreements to qualify for purposes of determining the amount of equity in an account appropriate? If not, explain why not.

516 See, e.g., FINRA Rule 4210(g)(2)(G) (defining the term "unlisted derivative" for purposes of inclusion in the Appendix A methodology as used in the rule to calculate a portfolio margin requirement to mean "any equity-based or equity index-based unlisted option, forward contract, or security-based swap that can be valued by a theoretical pricing model approved by the [Commission].") (emphasis added).

Are there additional or alternative provisions that should be contained in the netting agreement requirements? If so, identify and explain them.

5. Is the proposed method for calculating the margin amount appropriate? If not, explain why not. For example, is it appropriate to use the techniques in Rule 15c3-1, as proposed to be amended, and proposed new Rule 18a-1 to determine the margin amount? If not, explain why not. Are there alternative methods for calculating the margin amount that would be preferable? If so, identify them and explain why they would be preferable.
6. Should proposed new Rule 18a-3 allow an alternative method of calculating the margin amount that would permit a nonbank SBSD to determine the margin amount for a non-cleared security-based swap based on the margin required by a registered clearing agency for a cleared security-based swap whose terms and conditions closely resemble the terms and conditions of the non-cleared security-based swap (similar to the CFTC's proposal)? Would there be sufficient similarity between certain cleared and non-cleared security-based swaps to make this approach workable? In addition, if this alternative approach was permitted, how could the potential differences in margin requirements across clearing agencies be addressed?
7. In addition to internal models, should external models be permitted such as: (1) a model currently in use for margining cleared security-based swaps at a clearing agency; (2) a model currently in use for modeling non-cleared swaps by an entity subject to regular assessment by a prudential regulator; or (3) a model available for licensing to any market participant by a vendor? What would be the advantages and disadvantages of permitting external models?

8. How would the proposed standardized approaches to determining the margin amount differ from the standardized approaches the prudential regulators proposed for determining the initial margin amount?

9. The provisions for using VaR models to compute net capital require that the model use a 99%, one-tailed confidence level with price changes equivalent to a ten-business-day movement in rates and prices. This means the VaR model used for the purpose of determining a counterparty's margin amount also would need to use a 99%, one-tailed confidence level with price changes equivalent to a ten-business-day movement in rates and prices. The ten-business-day requirement is designed to account for market movements that occur over a period of time as opposed to a single day. This is designed to ensure that the VaR model uses potential market moves that are large enough to capture multi-day moves in rates and prices. Given this purpose, should the VaR model be required to use a longer period of time (e.g., 15, 20, 25, or 30 business days) to establish a potentially greater margin collateral requirement for customers given that they may not be subject to capital and other prudential requirements? Would the 3-times multiplication factor proposed to be required for VaR models used by nonbank SBSDs (which, under the proposal, would need to be increased in response to back-testing exceptions) be necessary if the time period were longer than 10 business days? If not, explain why not.

ii. Nonbank MSBSPs

Proposed new Rule 18a-3 would require nonbank MSBSPs to collect collateral from counterparties to which the nonbank MSBSP has current exposure and provide collateral to counterparties that have current exposure to the nonbank MSBSP.[517] Consequently, a nonbank MSBSP would be required to calculate as of the close of business each day the amount of equity in each account of a counterparty.[518] Consistent with the proposal for nonbank SBSDs, a nonbank MSBSP would be required to increase the frequency of its calculations (i.e., perform intra-day calculations) during periods of extreme volatility and for accounts with concentrated positions.[519]

As would be the case for a nonbank SBSD, the first step for a nonbank MSBSP in calculating the equity in an account would be to mark-to-market all of the securities positions in the account, including non-cleared security-based swap positions. The second step would be to add to that amount any credit balance in the account or subtract from that amount any debit balance.[520] The nonbank MSBSP could offset payables and receivables relating to derivatives in

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517 See paragraph (c)(2)(ii) of proposed new Rule 18a-3.

518 See paragraph (c)(2)(i) of proposed new Rule 18a-3. A nonbank MSBSP would apply the definitions in paragraph (b) of proposed new Rule 18a-3 for the purposes of complying with the requirements in the rule. See paragraph (b) of proposed new Rule 18a-3. The term equity would be defined to mean the total current fair market value of securities positions in an account of a counterparty (excluding the time value of an over-the-counter option), plus any credit balance and less any debit balance in the account after applying a qualifying netting agreement with respect to gross derivatives payables and receivables. See paragraph (b)(4) of proposed new Rule 18a-3. The time value of an OTC option is the amount that the current market value of the option exceeds the in-the-money amount of the option. In addition, the term account is proposed to be defined to mean an account carried by a nonbank SBSD or nonbank MSBSP for a counterparty that holds non-cleared security-based swaps. See paragraph (b)(1) of proposed new Rule 18a-3. Furthermore, the term counterparty is proposed to mean a person with whom the nonbank SBSD or nonbank MSBSP has entered into a non-cleared security-based swap transaction. See paragraph (b)(3) of proposed new Rule 18a-3.

519 See paragraph (c)(7) of proposed new Rule 18a-3. These more frequent calculations would be designed to monitor the nonbank MSBSP's counterparty risk exposure in situations where a default by a counterparty or multiple counterparties would have a more significant adverse impact on the financial condition of the nonbank MSBSP than under more normal circumstances. One consequence of the more frequent calculations could be that the nonbank MSBSP requests that a counterparty deliver collateral during the day pursuant to a "house" margin requirement to account for changes in the value of the securities and money market instruments held in the account.

520 Credit balances would include payables the nonbank MSBSP owed to the counterparty. Payables could relate to cash deposited into the account, the proceeds of the sales of securities held in the account, and interest and dividends earned from securities held in the account. In addition, payables could relate to derivatives in the account such as non-cleared security-based swaps with a net replacement value in the favor of the counterparty. Debit balances would be receivables to the nonbank MSBSP owed by the

the account by applying a qualifying netting agreement with the counterparty. To qualify for this treatment, a netting agreement would need to meet the minimum requirements prescribed in Appendix E to Rule 15c3-1 to qualify for purposes of the credit risk charge discussed above in section II.A.2.b.iv. of this release.[521] These requirements, set forth in paragraph (c)(5) of Rule 18a-3, are designed to ensure that the netting agreement between the nonbank MSBSP and the counterparty permits the nonbank MSBSP to reduce the receivables and payables between the two entities to a single net payment obligation.[522]

If the value of the securities positions plus the amount of any cash in the account exceeds the amount of the debit balance, the account would have positive equity.[523] This would mean the counterparty has current exposure to the nonbank MSBSP. On the other hand, if the amount of the debit balance is greater, the account would have negative equity.[524] This would mean the nonbank MSBSP has current exposure to the counterparty.

Nonbank MSBSPs would not be required to deliver or collect margin collateral to collateralize potential future exposure.[525] For that reason, Rule 18a-3 would not require nonbank MSBSPs to calculate a margin amount, and the rule would not require counterparties to provide margin collateral to nonbank MSBSPs to maintain equity levels above the nonbank MSBSP's current exposure. When a counterparty provides margin collateral to collateralize potential future exposure, the counterparty is exposed to credit risk in the amount that the collateral

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counterparty. Receivables could relate to derivatives in the account such as non-cleared security-based swaps with a net replacement value in the favor of the nonbank MSBSP.

521 See paragraph (c)(5) of proposed new Rule 18a-3; 17 CFR 240.15c3-1e(c)(4)(iv).

522 See paragraph (c)(5) of proposed new Rule 18a-3.

523 The proposed rule would define the term positive equity to mean equity of greater than $0. See paragraph (b)(7) of proposed new Rule 18a-3.

524 The proposed rule would define the term negative equity to mean equity of less than $0. See paragraph (b)(6) of proposed new Rule 18a-3.

525 See paragraph (c)(2)(i) of proposed new Rule 18a-3 (only requiring calculation of the equity in the account of each counterparty).

provided to the dealer exceeds the dealer's current exposure to the counterparty. With respect to nonbank SBSDs, collateralizing potential future exposure is intended to promote the financial responsibility of the nonbank SBSD, as the margin collateral received from the counterparty protects the nonbank SBSD from the risks arising from fluctuations in the value of the underlying positions before the collateral can be sold. The counterparty, in turn, would be protected by the net liquid assets test standard applicable to the nonbank SBSD,[526] which is significantly more conservative than the tangible net worth capital standard proposed for nonbank MSBSPs.[527] The counterparties also would be protected by the proposed segregation requirements with respect to the margin collateral delivered by counterparties.[528]

The proposed margin requirements for nonbank MSBSPs are designed to "neutralize" the credit risk between a nonbank MSBSP and a counterparty. The collection of collateral from counterparties would strengthen the liquidity of the nonbank MSBSP by collateralizing its current exposure to counterparties. Nonbank MSBSPs, in contrast to nonbank SBSDs, would be required to deliver collateral to counterparties to collateralize their current exposure to the nonbank MSBSP, which would lessen the impact on the counterparties if the nonbank MSBSP failed, and is intended to account for the fact that nonbank MSBSPs would be subject to less stringent capital requirements than nonbank SBSDs.

In addition, as discussed in section II.A.3. of the release, the entities that may need to register as nonbank MSBSPs could include companies that engage in commercial activities that are not necessarily financial in nature (e.g., manufacturing, agriculture, and energy) and for which a net liquid assets test could be impractical. Finally, because of these differences in

526 See 17 CFR 240.15c3-1; proposed new Rule 18a-1.

527 See proposed new Rule 18a-2.

528 See proposed new Rule 18a-4.

business models, nonbank MSBSPs may not have the systems and personnel necessary to operate daily margin collateral programs to address potential future exposure.

Request for Comment

The Commission generally requests comment on the proposed daily calculation requirements for nonbank MSBSPs. Commenters are referred to the questions about the daily calculation requirements for nonbank SBSDs above in section II.B.2.b.i. of this release to the extent those questions address provisions in proposed new Rule 18a-3 that also apply to nonbank MSBSPs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Which types of counterparties would be expected to transact with nonbank MSBSPs? Which types of security-based swap transactions would these counterparties enter into with nonbank MSBSPs?
2. Should nonbank MSBSPs be required to calculate a daily margin amount for each counterparty? For example, even if they were not required to collect collateral to cover potential future exposure, would the calculation of the margin amount better enable them to measure and understand their counterparty risk?
3. If nonbank MSBSPs should calculate a daily margin amount, how should such amount be calculated? Should a nonbank MSBSP be required to calculate a margin amount using the methods prescribed in paragraph (d) of proposed new Rule 18a-3 or some other method? For example, should nonbank MSBSPs be permitted to use external models to determine a margin amount?
4. Would nonbank MSBSPs have the systems and personnel necessary to operate daily margin collateral programs to calculate a daily margin amount?

c. Account Equity Requirements

i. Nonbank SBSDs

A nonbank SBSD would be required to calculate as of the close of each business day: (1) the amount of equity in the account of each counterparty; and (2) a margin amount for the account of each counterparty.[529] On the next business day following the calculations, the nonbank SBSD would be required to collect cash, securities, and/or money market instruments from the counterparty in an amount at least equal to the negative equity (current exposure) in the account plus the margin amount (potential future exposure).[530] The collateral collected would be designed to ensure that the counterparty maintains a minimum level of positive net equity in the account. The proposed rule would require the nonbank SBSD to collect collateral for this purpose from each counterparty, except as discussed below.

A nonbank SBSD would need to collect cash, securities, and/or money market instruments to meet the account equity requirements in proposed new Rule 18a-3. Other types of assets would not be eligible as collateral. In addition, under proposed new Rule 18a-3, the fair market value of securities and money market instruments held in the account of a counterparty would need to be reduced by the amount of the deductions the nonbank SBSD would apply to the positions pursuant to Rule 15c3-1, as proposed to be amended, or proposed new Rule 18a-1, as applicable, for the purpose of determining whether the level of equity in the account meets the minimum requirement.[531] Accordingly, securities and money market instruments with no "ready market" or which cannot be publicly offered or sold because of statutory, regulatory, or contractual arrangements or other restrictions would be subject to a 100% deduction and,

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529 See paragraph (c)(1)(i) of proposed new Rule 18a-3. See also paragraph (b)(4) of proposed new Rule 18a-3 (defining the term equity).

530 See paragraph (c)(1)(ii) of proposed new Rule 18a-3.

531 See paragraph (c)(3) of proposed new Rule 18a-3.

therefore, these types of securities and money market instruments would have no value in terms of meeting the account equity requirement.[532] All other securities and money market instruments in the account would be reduced in value by the amount of the deductions required in Rule 15c3-1, as proposed to be amended, and proposed new Rule 18a-1, as applicable to the nonbank SBSD.[533] The amount of the deductions would increase for securities and money market instruments with greater market risk and, thereby, account for the risk that the nonbank SBSD may not be able to liquidate the securities and money market instruments at current market values to satisfy the obligation of a defaulted counterparty.[534] These deductions would limit the types of securities and money market instruments a counterparty could provide as collateral and require a counterparty to increase the amount of collateral delivered to account for the deductions taken on securities collateral in the account.[535]

The prudential regulators and the CFTC are proposing to specifically identify the asset classes that would be eligible collateral for purposes of their margin rules.[536] Proposed new Rule

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532 See 17 CFR 240.15c3-1(c)(2)(vii); paragraph (c)(1)(iv) of proposed new Rule 18a-1.

533 See 17 CFR 240.15c3-1(c)(2)(vi); paragraphs (c)(1)(vi)-(vii) of proposed new Rule 18a-1.

534 See 17 CFR 240.15c3-1(c)(2)(vi); paragraphs (c)(1)(vi)-(vii) of proposed new Rule 18a-1.

535 For example, assume an account holds securities and money market instruments valued at $50, a credit balance of $10, and a debit balance of $58. The equity in the account would be $2 ($50 of securities and money market instruments' value + $10 in credits - $58 in debits = $2). Assume that the margin amount calculated for the account is $10. This would mean that the account needs to have positive equity of at least $10 (it currently has positive equity of only $2). Assume that the deduction under Rule 15c3-1 for the $50 of securities and money market positions held in the account is $7. This would mean that the counterparty would need to deliver $15 in cash (i.e., not $8) to meet the minimum $10 account equity requirement ($50 of securities and money market instruments' value - $7 deduction + $10 in credits - $58 in debits + $15 cash collateral deposit = $10). Moreover, if the counterparty delivered securities and/or money market instruments to meet the account equity requirement, the fair market value of the securities and money market instruments would need to be greater than $15 because their value would be reduced by the amount of the deduction in Rule 15c3-1 or proposed new Rule 18a-1, as applicable.

536 See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564; CFTC Margin Proposing Release, 76 FR 23732. The proposal of the prudential regulators would limit eligible collateral to cash, foreign currency to the extent the payment obligation under the security-based swap or swap is denominated in the currency, obligations guaranteed by the United States as to principal and interest, and, with respect to initial margin only, a senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks, and the Federal

18a-3 would not limit collateral in this way. However, comment is sought below in section II.B.3. of this release on the question of whether to define the term eligible collateral in a manner that is similar to the proposals of the prudential regulators and the CFTC.

The reason for not proposing a definition of eligible collateral is that counterparties are expected to engage in a wide range of trading strategies that include security-based swaps. Consequently, the account of a counterparty may hold, for example, the security underlying a security-based swap, as well as a short position, option, and single stock future on the underlying security.[537] Because of the relationship between security-based swaps and these other security positions, permitting various types of securities to count as collateral may be more practical for margin arrangements involving security-based swaps than for other types of derivatives. A more limited definition of eligible collateral could require a counterparty that has positive equity in an account equal to or in excess of the margin amount to deliver additional collateral to the extent the positions in the account did not meet the definition. The counterparty's credit exposure to the nonbank SBSD therefore would be increased in a way that may not be necessary to account for the nonbank SBSD's potential future exposure to the counterparty.[538]

The Commission is proposing certain additional requirements for eligible collateral,

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Agricultural Mortgage Corporation, or any obligation that is an "insured obligation," as the term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank. See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27589. The proposal of the CFTC would limit eligible collateral for initial margin to cash, foreign currency to the extent the payment obligation under the security-based swap is denominated in the currency, obligations guaranteed by the United States as to principal and interest, and a senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks, and the Federal Agricultural Mortgage Corporation, or any obligation that is an "insured obligation," as the term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank. CFTC Margin Proposing Release, 76 FR at 23747. The CFTC's proposal would limit eligible collateral for variation margin to cash and obligations guaranteed by the United States as to principal and interest. Id.

537 See, e.g., FINRA Rule 4210(g) (permitting customer portfolio margining); 17 CFR 240.15c3-1a; Appendix A to proposed new Rule 18a-1.

538 A counterparty will have credit exposure to a nonbank SBSD to the extent that collateral held in the account of the counterparty has a mark-to-market value in excess of the nonbank SBSD's current exposure to the counterparty.

which are modeled on the existing collateral requirements in Appendix E to Rule 15c3-1.[539] As discussed above in section II.A.2.b.iv. of this release, collateral "ideally" is "an asset of stable and predictable value, an asset that is not linked to the value of the transaction in any way, and an asset that can be sold quickly and easily if the need arises."[540] The requirements in Appendix E to Rule 15c3-1 are designed to achieve these objectives.[541] The proposed additional requirements include:

- The collateral must be subject to the physical possession or control of the nonbank SBSD;
- The collateral must be liquid and transferable;
- The collateral must be capable of being liquidated promptly by the nonbank SBSD without intervention by any other party;
- The collateral agreement between the nonbank SBSD and the counterparty must be legally enforceable by the nonbank SBSD against the counterparty and any other parties to the agreement;
- The collateral must not consist of securities issued by the counterparty or a party related to the nonbank SBSD, or to the counterparty; and
- If the Commission has approved the nonbank SBSD's use of a VaR model to compute net capital, the approval allows the nonbank SBSD to calculate deductions for market risk for the type of collateral.[542]

These proposed collateral requirements are designed to ensure that the treatment of collateral requirements remains consistent between the proposed capital and margin requirements. As discussed above in section II.A.2.b.v. of this release, a nonbank SBSD would be required to take a capital charge if a counterparty does not deliver cash, securities, and/or money market instruments to the nonbank SBSD to meet an account equity requirement within

539 See paragraph (c)(4) of proposed new Rule 18a-3.

540 Market Review of OTC Derivative Bilateral Collateralization Practices at 5.

541 See 17 CFR 240.15c3-1e(c)(4)(v).

542 See paragraphs (c)(4)(i)-(c)(4)(vi) of proposed new Rule 18a-3.

one business day of the requirement being triggered. In addition, proposed new Rule 18a-3 would require the nonbank SBSD to take prompt steps to liquidate securities and money market instruments in the account to the extent necessary to eliminate the account equity deficiency.[543] Under this provision, which is modeled on a similar requirement in the broker-dealer margin rules,[544] a nonbank SBSD could need to liquidate positions in the account to reduce debits arising from those transactions. The rule would not require that the liquidations must be completed within a specific timeframe.[545] Instead, the rule is designed to give the nonbank SBSD the flexibility to conduct an orderly liquidation, taking into account market conditions and the risk profile of the account.

There would be four exceptions to the account equity requirements.[546] The first would apply to counterparties that are commercial end users.[547] The second would apply to counterparties that are SBSDs.[548] The third would apply to counterparties that are not commercial end users and that require their margin collateral to be segregated pursuant to section 3E(f) of the Exchange Act.[549] The fourth would apply to accounts of counterparties that are not commercial end users and that hold legacy non-cleared security-based swaps.[550] Under these

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543 See paragraph (c)(8) of proposed new Rule 18a-3.

544 See 12 CFR 220.4(d) (providing that if a margin call is not met within the required time, the broker-dealer must liquidate securities sufficient to meet the margin call or to eliminate any margin deficiency existing on the day such liquidation is required, whichever is less).

545 See paragraph (c)(8) of proposed new Rule 18a-3.

546 See paragraphs (c)(1)(iii)(A)-(D) of proposed new Rule 18a-3.

547 See paragraph (c)(1)(iii)(A) of proposed new Rule 18a-3.

548 See paragraph (c)(1)(iii)(B)-Alternative A of proposed new Rule 18a-3. An alternative approach is being proposed that would not be an exception to the account equity requirement under which a nonbank SBSD would need to collect collateral from another SBSD to cover the negative equity in the account and the margin amount for the account. In addition, the collateral collected to cover the margin amount would need to be held by an independent third-party custodian. See paragraph (c)(1)(iii)(B)-Alternative B of proposed new Rule 18a-3.

549 See paragraph (c)(1)(iii)(C) of proposed new Rule 18a-3.

550 See paragraph (c)(1)(iii)(D) of proposed new Rule 18a-3.

exceptions, applicable accounts would not need to meet certain account equity requirements in proposed new Rule 18a-3 and, therefore, the nonbank SBSD would be exempted from the requirements to take prompt steps to liquidate securities in the account to the extent necessary to eliminate the account equity deficiency. However, as discussed above in section II.A.2.b.v. of this release, in these cases the nonbank SBSD would need to take capital charges in lieu of meeting the account equity requirements in certain circumstances.[551]

Exception for commercial end users

Under the first exception to the account equity requirements, a nonbank SBSD would not be required to collect cash, securities, and/or money market instruments to cover the negative equity (current exposure) or margin amount (potential future exposure) in the account of a counterparty that is a commercial end user.[552] As discussed above in section II.A.2.b.v. of this release, this proposed exception to the requirement to collect collateral is intended to address concerns that have been expressed by commercial end users and others that the imposition of margin requirements on commercial companies that use derivatives to mitigate the risk of business activities that are not financial in nature could unduly disrupt their ability to enter into hedging transactions. The proposed exception is intended to permit nonbank SBSDs and commercial end users to negotiate individual agreements that would reflect the credit risk of the commercial end user and the nature and extent of the non-cleared security-based swap

551 See proposed new paragraph (c)(2)(xiv) of Rule 15c3-1; paragraph (c)(1)(viii) of proposed Rule 18a-1.

552 See paragraph (c)(1)(iii)(A) of proposed Rule 18a-3. The exception would apply to negative equity in the account and the margin amount calculated for the account. However, a nonbank SBSD would be required to take a 100% deduction from net worth for the amount of the uncollateralized negative equity and take the proposed capital charge in lieu of margin collateral discussed above in section II.A.2.b.v. of this release. See 17 CFR 240.15c3-1(c)(2)(iv)(B) (deductions for unsecured receivables); paragraph (c)(1)(iii)(B) of proposed new Rule 18a-1 (deductions for unsecured receivables); proposed new paragraph (c)(2)(xiv) of Rule 15c3-1 (proposed capital charge in lieu of margin); paragraph (c)(1)(viii) of proposed Rule 18a-1 (proposed capital charge in lieu of margin). As an alternative to these capital charges, ANC broker-dealers and stand-alone SBSDs using internal models could take the credit risk charge discussed in section II.A.2.b.iv. of this release. See amendments to paragraph (a)(7) of Rule 15c3-1; paragraph (a)(2) of proposed new Rule 18a-1.

transactions with the end user, without creating an undue impediment to the ability of the commercial end user to hedge its commercial risks.[553]

The proposed exception for commercial end users also is intended to account for the different risk profiles of commercial end users as compared with financial end users.[554] When credit markets are under strain, as in 2008, financial end users, such as hedge funds, can face liquidity stress, which increases their risk of default. Further, financial end users as a group, due to the nature of their business, may engage in security-based swap transactions in greater volume than commercial end users, increasing the risk of substantial concentration of counterparty exposure to nonbank SBSDs, and potentially creating greater systemic risk from the failure of a single entity.[555]

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553 The margin rule proposed by the prudential regulators would require the entities subject to the rule to establish credit exposure limits for each nonfinancial end user "under appropriate credit processes and standards," and to collect collateral to the extent that individual exposures exceed those limits. See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27587. The margin rule proposed by the CFTC would permit entities subject to the rule and nonfinancial end users "to set initial margin and variation margin requirements in their discretion" but each entity subject to the proposed rule would be required to calculate daily exposure amounts for nonfinancial end users for risk management purposes. See CFTC Margin Proposing Release, 76 FR at 27736.

554 See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27571 ("Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity."). See also CFTC Margin Proposing Release, 76 FR at 27735 ("The Commission believes that financial entities, which are generally not using swaps to hedge or mitigate commercial risk, potentially pose greater risk to CSEs than non-financial entities.").

555 The margin rules proposed by the prudential regulators and the CFTC would differentiate collateral requirements based on whether a financial end user is "high risk" or "low risk." See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27571-27572; CFTC Margin Proposing Release, 76 FR at 23736-23737. A "low risk" financial end user is defined in their proposals as an entity that: (1) is subject to capital requirements established by a prudential regulator or a state insurance regulator; (2) predominantly uses OTC derivatives for hedging purposes; and (3) does not have significant OTC derivatives exposure. See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27572; CFTC Margin Proposing Release, 76 FR at 23735-23736. A low risk financial end user would not be required to deliver initial or variation margin if the amounts required are less than certain prescribed thresholds. See id. While not all financial end users present the same degree of counterparty risk, an exception from the account equity requirements based on the risk profile of the financial end user is not being proposed. This is because margin collateral is an important means of managing credit risk and the concerns expressed with respect to commercial end users being required to deliver margin collateral generally do not apply to financial end users as they customarily deliver margin collateral. As discussed in sections II.A.1. and II.A.2.b.i. of this

For purposes of the rule, the term commercial end user means any person (other than a natural person) that: (1) engages primarily in commercial activities that are not financial in nature and that is not a financial entity as that term is defined in section 3C(g)(3) of the Exchange Act;[556] and (2) is using non-cleared security-based swaps to hedge or mitigate risk relating to the commercial activities.[557] The proposed definition of commercial end user is modeled on the exception to the mandatory clearing provisions for security-based swaps in section 3C of the Exchange Act.[558] Among other things, to qualify for the mandatory clearing exception, one of the counterparties to the security-based swap transaction must not be a financial entity and must be using security-based swaps to hedge or mitigate commercial risk.[559]

Under the proposed definition, an individual could not qualify as a commercial end user. In addition, because the proposed definition provides that a commercial end user must engage primarily in commercial activities that are not financial in nature and must not be a financial entity as defined in section 3C(g)(3) of the Exchange Act, entities such as banks, broker-dealers,

release, the proposed capital standard for nonbank SBSDs is based on the net liquid assets test embodied in Rule 15c3-1. Under this test, most unsecured receivables are deducted in full when computing net capital because of their illiquidity. Proposed new Rule 18a-3 is designed to complement this treatment of unsecured receivables by limiting the exceptions to the requirement to collect collateral from counterparties to circumstances that provide a compelling reason for the trade-off between the risk-mitigating benefits of collateral and practical impediments to delivering collateral. With respect to nonbank SBSDs, there does not appear to be a compelling reason to establish a two-tiered approach for financial end users. First, financial end users generally pose more risk than commercial end users. Second, the different credit risk profiles of financial end users may not always be clear, which may make it difficult to differentiate between high and low risk financial end users. Third, market participants have told the Commission staff that financial end users entering into security-based swap transactions generally already deliver collateral to dealers to cover current and potential future exposure.

556 See 15 U.S.C. 78o-3(g)(3). Section 3C(g) of the Exchange Act defines the term financial entity to mean: (1) a swap dealer; (2) an SBSD; (3) a major swap participant; (4) an MSBSP; (5) a commodity pool as defined in section 1a(10) of the CEA; (6) a private fund as defined in section 202(a) of the Investment Advisors Act of 1940; (7) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002); or (8) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956.

557 See paragraph (b)(2) of proposed new Rule 18a-3.

558 Compare 15 U.S.C. 78c-3(g)(1), with paragraph (b)(2) of proposed new Rule 18a-3.

559 See 15 U.S.C. 78c-3(g)(1).

FCMs, SBSDs, swap dealers, MSBSPs, swap participants, mutual funds, private funds, commodity pools, and employee benefit plans would not qualify as a commercial end user.[560] Furthermore, the proposed definition provides that the commercial end user must be using non-cleared security-based swaps to hedge or mitigate commercial risk.

The rationale for exempting commercial end users from the requirement to deliver collateral to meet the account equity requirements is that these end users often do not deliver collateral by current practice, and requiring them to do so could adversely impact their ability to mitigate the risk of their commercial activities by entering into hedging transactions. If an end user is using non-cleared security-based swaps for purposes other than hedging (e.g., to take directional investment positions), the rationale for exempting the end user from the account equity requirements would not apply. An end user that is using non-cleared security-based swaps for investment purposes is not acting like a commercial end user, and, as such, no exemption would be available under the rule.

As discussed below in section II.B.2.e. of this release, a nonbank SBSD would be required to establish, maintain, and document procedures and guidelines for monitoring the risk of accounts holding non-cleared security-based swaps.[561] Among other things, a nonbank SBSD

560 See, e.g., 15 U.S.C. 78c-3(g)(3). The prudential regulators and the CFTC have proposed definitions of financial end user and financial entity, respectively, in their non-cleared security-based swap margin rules in addition to their proposed definitions of nonfinancial end user. See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27571 (defining financial end user), and CFTC Capital Proposing Release, 76 FR at 23736 (defining financial entity). As discussed above, the CFTC and prudential regulators are proposing margin requirements that would differentiate collateral requirements based on whether a financial end user or financial entity is "high risk" or "low risk." Id. In other words, their proposals would provide for potentially different treatment for three classes of entities: (1) nonfinancial end users; (2) financial end users (low risk and high risk); and (3) entities that are neither a nonfinancial end user nor a financial end user. Therefore, they need to define the terms financial end user and financial entity, respectively. Because proposed new Rule 18a-3 would treat financial end users no differently than entities that are neither a commercial end user nor a financial end user, the Commission's proposed margin rule does not contain a definition of financial end user. However, as discussed below, the proposed rule would provide different treatment for counterparties that are SBSDs.

561 See paragraph (e) of proposed new Rule 18a-3.

would be required to have procedures and guidelines for determining, approving, and periodically reviewing credit limits for each counterparty to a non-cleared security-based swap.[562] Consequently, if a nonbank SBSD does not collect collateral from a commercial end user, it would need to establish a credit limit for the end user and periodically review the credit limit in accordance with its risk monitoring guidelines.[563] The rule would not prohibit a nonbank SBSD from requiring margin collateral from a commercial end user.

Exception for counterparties that are SBSDs

The second exception to the account equity requirements in proposed new Rule 18a-3 would apply to counterparties that are SBSDs.[564] Two alternatives with respect to SBSD counterparties are being proposed. Under the first alternative, a nonbank SBSD would not need to collect cash, securities, and/or money instruments to collateralize the margin amount (potential future exposure) in the account of a counterparty that is another SBSD ("Alternative A"). This approach is consistent with the broker-dealer margin rules, which generally do not require a broker-dealer to collect margin collateral from another broker-dealer. Under the second alternative, a nonbank SBSD would be required to collect cash, securities and/or money market instruments to collateralize both the negative equity (current exposure) and the margin amount (potential future exposure) in the account of a counterparty that is another SBSD ("Alternative

562 See paragraph (e)(2) of proposed new Rule 18a-3. This is also consistent with the broker-dealer margin rules. See FINRA Rule 4210(d), which requires that FINRA member firms establish procedures to: (1) review limits and types of credit extended to all customers; (2) formulate their own margin requirements; and (3) review the need for instituting higher margin requirements, mark-to-markets and collateral deposits than are required by the Rule for individual securities or customer accounts. See also FINRA Interpretation 4210(d)/01, available at http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/industry/p122203.pdf (noting that FINRA Rule 4210(d) "requires that members determine the total dollar amount of credit to be extended to any one customer or on any one security to limit the potential loss or exposure to the member. It is important that specific limits be established to prevent any one customer or group of customers from endangering the member's capital.").

563 See id.

564 See paragraph (c)(1)(iii)(B) of proposed new Rule 18a-3.

B").[565] Moreover, the cash, securities, and/or money market instruments would be required to be segregated in an account at an independent third-party custodian pursuant to the requirements of section 3E(f) of the Exchange Act.[566] Alternative B is consistent with the proposals of the prudential regulators and the CFTC.[567]

The two alternatives are being proposed in order to elicit detailed comment on each approach in terms of comparing how they would meet the goals of the Dodd-Frank Act,[568] address systemic issues relating to non-cleared security-based swaps, raise practical issues, alter current market practices and conventions, result in benefits and costs, and impact the security-based swap markets and the participants in those markets.

Under Alternative A, a nonbank SBSD would be required to collect cash, securities, and/or money market instruments from another SBSD only to cover the amount of negative equity (the current exposure) in the account of the counterparty.[569] Accordingly, under this approach, the nonbank SBSD would not be required to collect cash, securities, and/or money market instruments from another SBSD to collateralize the margin amount (the potential future

565 Alternative B is not an exception to the account equity requirements in proposed new Rule 18a-3 because it would require collateral to cover the negative equity and margin amount in an account of another SBSD. However, its requirement for how the collateral must be held – at an independent third-party custodian on behalf of the counterparty – is different from how the proposed rule requires that collateral from other types of counterparties be held (other than counterparties that elect segregation under section 3E(f) of the Exchange Act (15 U.S.C. 78c-5(f)).

566 See 15 U.S.C. 78c-5(f).

567 See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564; CFTC Margin Proposing Release, 76 FR 23732.

568 See 15 U.S.C. 78o-10(e)(3)(A) ("[t]o offset the greater risk to the security-based swap dealer or major security-based swap participant and the financial system arising from the use of security-based swaps that are not cleared," the margin requirements proposed by the Commission and prudential regulators shall "help ensure the safety and soundness" of the SBSD and the MSBSP and "be appropriate for the risk associated with non-cleared security-based swaps held" by an SBSD and MSBSP).

569 See paragraph (c)(1)(iii)(B) of proposed new Rule 18a-3-Alternative A. To the extent the margin amount was not collateralized, the nonbank SBSD would be required to take the proposed capital charge in lieu of margin collateral discussed above in section II.A.2.b.v. of this release.

exposure).[570] In other words, a counterparty that is another SBSD would not be required to maintain a minimum level of positive equity in the counterparty's account.

Requiring a nonbank SBSD to deliver collateral to cover potential future exposure could impact its liquidity. As discussed above in sections II.A.1. and II.A.2.b.i. of this release, the proposed capital requirements for nonbank SBSDs are based on a net liquid assets test. The objective of the test is to require the firm to maintain in excess of a dollar of highly liquid assets for each dollar of liabilities in order to facilitate the liquidation of the firm if necessary and without the need for a formal proceeding. When assets are delivered to another party as margin collateral, they become unsecured receivables from the party holding the margin collateral. Consequently, they no longer are readily available to be liquidated by the delivering party. In times of market stress, a nonbank SBSD may need to liquidate assets to raise funds and reduce its leverage. However, if assets are in the control of another nonbank SBSD, they would not be available for this purpose. For this reason, the assets would need to be deducted from net worth when the nonbank SBSD computes net capital under the proposed capital requirements.[571] As a result, the nonbank SBSD would need to maintain the required minimum amount of net capital after taking into account these deductions.

Promoting the liquidity of nonbank SBSDs is the policy consideration underlying Alternative A. In addition, the prudential regulators and the CFTC have received comments on this issue in response to their proposals raising concerns about requiring bank SBSDs and swap dealers to exchange collateral to cover potential future exposure and to have the collateral held by an independent third-party custodian. For example, some commenters assert that imposing

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570 Id. Like all counterparties to non-cleared security-based swaps, counterparties that are SBSDs would be subject to the risk monitoring requirements in paragraph (e) of proposed new Rule 18a-3.

571 See 17 CFR 240.15c3-1(c)(2)(iv)(B); paragraph (c)(1)(iii)(B) of proposed Rule 18a-1. Collateral provided to another party as margin would be subject to this 100% deduction.

segregated initial margin requirements on trades between swap entities would result in a tremendous cost to the financial system in the form of a massive liquidity drain, and that swap dealers will lose the ability to reinvest this collateral to finance other lending or derivatives transactions, thereby reducing capital formation and increasing costs.[572] One commenter stated that, in general, with respect to non-cleared swaps, charging more initial margin (as compared to cleared swaps) could have unintended consequences, including the inefficient use of capital by sophisticated market participants in highly regulated industries, which could create a drag on the financial system, slow economic growth, and diminish customer choice.[573]

Another commenter stated that a combination of daily variation margin, robust operational procedures, legally enforceable netting and collateral agreements, and regulatory capital requirements provide comprehensive risk mitigation for collateralized derivatives, and that any additional initial margin requirements for swaps between swap entities would be

572 See, e.g., letter from Robert Pickel, Executive Vice Chairman, ISDA, and Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, Securities Industry and Financial Markets Association ("SIFMA"), to David Stawick, Secretary, CFTC (July 11, 2011), available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47802&SearchText=SIFMA ("SIFMA /ISDA Comment Letter to the CFTC"); letter from Robert Pickel, Executive Vice Chairman, ISDA, and Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, to Jennifer J. Johnson, Secretary, Federal Reserve, et al. (July 6, 2011), available at http://www.fdic.gov/regulations/laws/federal/2011/11c22ad79.PDF ("SIFMA/ISDA Comment Letter to the Prudential Regulators"); letter from the Honorable Darrell Issa, Chairman, Committee on Oversight and Government Reform, U.S. House of Representatives, to Ben Bernanke, Chairman, Federal Reserve et al. (July 22, 2011), available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47943&SearchText=issa, and letter from Mark Scanlan, Vice President, Agriculture and Rural Policy, Independent Community Bankers of America, to the CFTC et al. (July 11, 2011), available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47762&SearchText=scanlan. One commenter noted that there is no statutory requirement for covered swap entities to hold initial margin of other covered swap entities at an independent third party custodian. See letter from Christine Cochran, President, Commodity Markets Council, to the OCC et al. (July 11, 2011), available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47777&SearchText=cochran. Here and below, this release refers to public comments on the margin proposals by the CFTC and the prudential regulators to more fully reflect the available views without endorsing those comments or expressing a view as to the validity of the comments.

573 See letter from Mark R. Thresher, Executive Vice President, Chief Financial Officer, Nationwide, to the OCC (June 24, 2011), available at http://www.federalreserve.gov/SECRS/2011/June/20110628/R-1415/R-1415_062311_81363_349039663039_1.pdf.

unnecessary and unwarranted.[574] A commenter argued that the proposed initial margin requirements are inconsistent with proven market practice, ignore significant differences in credit quality among swap dealers and financial entities which justify different margining treatment, and will lead to excessive amounts of collateral being required in comparison to the actual risks of the underlying swap transactions and portfolios.[575] Finally, a commenter argued that initial margin requirements should differentiate based on credit quality, and that the prudential regulators' margin rulemaking identifies no risk-based justification for layering zero threshold, bilateral initial margin requirements for all swap dealers above and beyond their existing variation margin requirements.[576]

On the other hand, a number of comments submitted in response to the proposals of the prudential regulators and the CFTC supported bilateral margining and argued that it should be extended to require SBSDs and swap dealers to exchange margin collateral with all counterparties.[577] For example, one commenter stated that the financial crisis demonstrated that

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574 See SIFMA/ISDA Comment Letter to the CFTC; SIFMA/ISDA Comment Letter to the Prudential Regulators. This commenter also stated that precedent exists in the broker-dealer margin rules for not imposing any initial margin requirements on trades between swap entities. Id.

575 See letter from Don Thompson, Managing Director and Associate General Counsel, J.P. Morgan Chase & Co., to the OCC et al. (June 24, 2011), available at http://www.federalreserve.gov/SECRS/2011/June/20110627/R-1415/R-1415_062311_81366_349039350535_1.pdf ("J.P. Morgan Letter"). Another commenter pointed out that life insurers also typically do not post initial margin and recommended that initial margin requirements be appropriately sized to reflect the potential exposure during the close out of a defaulting party. See letter from Carl B. Wilkerson, Vice President and Chief Counsel, Securities and Litigation, American Council of Life Insurers, to the OCC et al. (July 11, 2011), available at http://www.federalreserve.gov/SECRS/2011/July/20110728/R-1415/R-1415_071111_81817_507164831320_1.pdf.

576 See J.P. Morgan Letter. This commenter stated that initial margin is appropriate in some circumstances, but it must take into account the credit quality of counterparties.

577 See, e.g., letter from Scott C. Goebel, Senior Vice President, General Counsel, FMR Co., to John Walsh, Acting Comptroller of the Currency, OCC (July 11, 2011); letter from Kevin M. Budd, Associate General Counsel, and Todd F. Lurie, Assistant General Counsel, MetLife, to OCC et al. (July 11, 2011); letter from John R. Gidman, on behalf of the Association of Institutional Investors, to Ms. Jennifer Johnson, Secretary, Federal Reserve, et al. (July 11, 2011); letter from R. Glenn Hubbard, Co-Chair, John L. Thornton, Co-Chair, and Hal S. Scott, Director, Committee on Capital Markets Regulation, to John Walsh, Acting Comptroller, OCC (July 11, 2011), available at

the premise of one-way margin is flawed.[578] This commenter stated that two-way margin requirements would aid safety and soundness by helping a swap dealer and its counterparty offset their exposures and prevent them from building up exposures they cannot fulfill.[579]

The prudential regulators explained the reasoning behind their proposal as follows:

> Non-cleared swaps transactions with counterparties that are themselves swap entities pose risk to the financial system because swap entities are large players in swap and security-based swap markets and therefore have the potential to generate systemic risk through their swap activities. Because of their interconnectedness and large presence in the market, the failure of a single swap entity could cause severe stress throughout the financial system. Accordingly, it is the preliminary view of the Agencies that all non-cleared swap transactions with swap entities should require margin.[580]

Alternative B is being proposed in light of the policy considerations underlying the proposals of the prudential regulators and the CFTC.[581] Under Alternative B, a nonbank SBSD would be required to obtain cash, securities, and/or money market instruments from another SBSD to cover the negative equity (current exposure) and margin amount (potential future

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http://www.federalreserve.gov/SECRS/2011/July/20110719/R-1415/R-1415_071111_81821_322996697020_1.pdf; letter from Dennis M. Kelleher, President and Chief Executive Officer, and Wallace C. Turbeville, Derivatives Specialist, Better Markets, Inc., to Jennifer J. Johnson, Secretary, Federal Reserve (July 11, 2011), available at http://www.federalreserve.gov/SECRS/2011/July/20110728/R-1415/R-1415_071111_81861_504963784471_1.pdf; letter from Americans for Financial Reform, to John Walsh, Acting Comptroller, OCC (July 11, 2011), available at http://www.federalreserve.gov/SECRS/2011/July/20110728/R-1415/R-1415_071111_81864_448738394756_1.pdf.

578 Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David Stawick, Secretary, CFTC (July 11, 2011), available at is http://www.ici.org/pdf/25344.pdf ("ICI Letter").

579 See the ICI Letter.

580 See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27570-27571 (footnote omitted). See also CFTC Margin Proposing Release, 76 FR at 23735 ("It is the nature of the dealer business that dealers are at the center of the markets in which they participate. Similarly, a major swap participant, by its terms, is a significant trader. Collectively, [swap dealers and major swap participants] pose greater risk to the markets and the financial system than other swap market participants. Accordingly, under the mandate of Section 4s(e), the Commission believes that they should be required to collect margin from one another.").

581 See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564; CFTC Margin Proposing Release, 76 FR 23744.

exposure) in the other SBSD's account.[582] In addition, the cash, securities, and/or money market instruments delivered to cover the margin amount would need to be carried by an independent third party custodian pursuant to the requirements of section 3E(f) of the Exchange Act.[583] Therefore, not only would there be no exception to the account equity requirement for counterparties that are SBSDs, but the treatment of the collateral would be different than for other types of counterparties in that it would be required to be held by an independent third-party custodian.[584]

Exception for counterparties that elect segregation under section 3E(f)

Under the third exception to the account equity requirements in proposed new Rule 18a-3, a nonbank SBSD would not be required to hold the cash, securities, and/or money market instruments delivered by a counterparty that is not a commercial end user to cover the margin amount (potential future exposure), if the counterparty elects to have the cash, securities, and/or money market instruments segregated pursuant to section 3E(f) of the Exchange Act.[585] Section 3E(f) sets forth provisions under which a counterparty to a non-cleared security-based swap with an SBSD can require that collateral to cover potential future exposure must be segregated.[586] Among other things, section 3E(f) provides that the collateral must be segregated in an account carried by an independent third-party custodian and designated as a segregated account for and on behalf of the counterparty.[587]

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582 See paragraph (c)(1)(iii)(B) of proposed Rule 18a-3-Alternative B.

583 Id.

584 Id.

585 See paragraph (c)(1)(iii)(C) of proposed new Rule 18a-3. This exception would not apply to negative equity in the counterparty's account, which would need to be collateralized by cash, securities, and/or money market instruments held by the nonbank SBSD. See 15 U.S.C. 78c-5(f)(2)(B)(i) (providing that the segregation provisions in section 3E(f) of the Exchange Act do not apply to variation margin payments).

586 See 15 U.S.C. 78c-5(f)(1)-(3).

587 See 15 U.S.C. 78c-5(f)(3).

As discussed below in section II.C. of this release, proposed new Rule 18a-3 would establish certain conditions that collateral would need to meet before its value could be included in the determination of the amount of equity in an account.[588] Among other conditions, the collateral would need to be subject to the physical possession or control of the nonbank SBSD and capable of being liquidated promptly by the nonbank SBSD without intervention by any other party.[589] Margin collateral segregated pursuant to section 3E(f) of the Exchange Act would not meet either of these conditions. First, the collateral would be in the physical possession or control of an independent third-party custodian rather than the nonbank SBSD. Second, the collateral could not be liquidated by the nonbank SBSD without the intervention of the independent third-party custodian. For these reasons, the value of the margin collateral held by the independent third-party custodian could not be included when determining the amount of equity in the account of the counterparty at the nonbank SBSD.

Exception for accounts holding legacy security-based swaps

Under the fourth exception to the account equity requirements in proposed new Rule 18a-3, a nonbank SBSD would not be required to collect cash, securities, and/or money market instruments to cover the negative equity (current exposure) or margin amount (potential future exposure) in a security-based swap legacy account.[590] Proposed new Rule 18a-3 would define security-based swap legacy account to mean an account that holds no security-based swaps

588 See paragraph (c)(4) of proposed new Rule 18a-3.

589 See paragraphs (c)(4)(i)-(iii) of proposed new Rule 18a-3.

590 See paragraph (c)(1)(iii)(D) of proposed new Rule 18a-3. While this exception would apply to negative equity in the account and the margin amount calculated for the account, a nonbank SBSD would be required to take a 100% deduction from net worth for the amount of the uncollateralized current exposure and take the proposed capital charge in lieu of margin collateral discussed above in section II.A.2.b.v. of this release. See proposed new paragraph (c)(2)(xiv) of Rule 15c3-1; paragraph (c)(1)(viii) of proposed new Rule 18a-1. In addition, like all counterparties to non-cleared security-based swaps, these counterparties would be subject to the risk monitoring requirements in paragraph (e) of proposed new Rule 18a-3.

entered into after the effective date of the rule and that is used to hold only security-based swaps entered into prior to the effective date of the rule, as well as collateral for those security-based swaps.[591] As discussed above in section II.A.2.b.v. of this release, this exception would be designed to address the impracticality of renegotiating contracts governing security-based swap transactions that predate the effectiveness of proposed new Rule 18a-3 in order to come into compliance with the account equity requirements in the rule.[592]

Request for Comment

The Commission generally requests comment on the proposed account equity requirements for counterparties of nonbank SBSDs in proposed new Rule 18a-3.[593] In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Would it be appropriate to limit the assets that could be used to collateralize the negative equity and margin amounts in an account to cash, securities, and money market instruments? Are there other types of assets that should be permitted to meet the account equity requirements in proposed new Rule 18a-3? If so, identify the other asset types and compare their liquidity to cash, securities, and money market instruments.
2. Is the proposed requirement to take deductions on securities and money market instruments in calculating the amount of equity in an account appropriate? If not, explain why not. Are there other measures that a nonbank SBSD could be required to take to

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591 See paragraph (b)(9) of proposed new Rule 18a-3.

592 As noted above in section II.A.2.b.v. of this release, the CFTC has proposed a similar exception for legacy swaps. See CFTC Margin Proposing Release, 76 FR at 23734. The prudential regulators proposed to permit a covered swap entity to exclude pre-effective swaps from initial margin calculations, while requiring these entities to collect variation margin, consistent with industry practice. See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27569.

593 As discussed earlier, the Commission is soliciting comment below in section II.B.3. of this release on whether to define the term eligible collateral in a manner similar to the prudential regulators and the CFTC.

address the risk that securities and money market instruments may not be able to be liquidated at current market values to cover the obligations of a defaulted counterparty? If so, explain how the other measures would be an adequate substitute to deductions.

3. Are the proposed conditions (modeled on the Appendix E conditions) for taking into account collateral in determining the amount of equity in an account appropriate for proposed new Rule 18a-3? If not, explain why not. Should any individual condition be eliminated? If so, explain why. Are there additional conditions that should be added? If so, identify them and explain how they would promote the goal of ensuring that collateral can be promptly liquidated to cover the obligation of a defaulted counterparty.
4. Is the proposed requirement that a nonbank SBSD take prompt steps to liquidate securities in an account to the extent necessary to eliminate an account equity deficiency appropriate? For example, should there be a specific time-frame (e.g., 1, 2, 3, 4, 5, or some other number of business days) in which the nonbank SBSD is required to liquidate securities in the account? If so, explain why a specific time-frame would be preferable to requiring the nonbank SBSD to act promptly.
5. Is the proposed exception to the account equity requirements for commercial end users appropriate? If not, explain why not. Should commercial end users be required to collateralize negative equity and the margin amount in their accounts? Explain why or why not. Should the exception apply only to the margin amount (i.e., should commercial end users be required to collateralize the negative equity in their accounts)? Explain why or why not.
6. Is the proposed definition of commercial end user appropriate? If not, explain why not. For example, would the proposed definition of commercial end user be too broad, or too

narrow, in terms of capturing types of counterparties for which the exception would not be appropriate? If so, explain why and suggest how the definition could be modified to address this issue.

7. Should the rule contain a proposed definition of financial end user? If so, explain why. For example, would a definition of financial end user similar to the definitions of the prudential regulators and CFTC provide needed clarity to the definition of commercial end user (i.e., by specifying certain entities that are not commercial end users)?
8. Do commercial end users use security-based swaps to hedge commercial risk? If so, identify the type of commercial risk they hedge with security-based swaps and explain how security-based swaps are used to hedge this risk.
9. Should proposed new Rule 18a-3 define the term commercial risk for the purpose of providing greater clarity as to the meaning of the term commercial end user? If so, how should the term commercial risk be defined?
10. Should there be a two-tiered approach with respect to the account equity requirements for financial end users based on whether they are low risk or high risk, similar to the proposed approach of the prudential regulators and the CFTC? If so, explain why.
11. How do non-commercial end users presently use security-based swaps? For example, do they use them to hedge commercial risk? If so, identify the type of commercial risk they hedge with security-based swaps.
12. With respect to counterparties that are SBSDs, how would Alternatives A and B compare in terms of promoting the goals of the Dodd-Frank Act, including limiting the risks posed by non-cleared security-based swaps? How would each address or fail to address systemic issues relating to non-cleared security-based swaps?

13. What would be the impact of Alternatives A and B on the efficient use of capital?

14. What would be the practical effects of Alternatives A and B on the capital and liquidity positions, or the financial health generally, of nonbank SBSDs? How would each alter current market practices and conventions with respect to collateralizing credit exposures arising from non-cleared security-based swaps? Are there practical issues with respect to Alternatives A and B? If so, identify and explain them.

15. How would the benefits of Alternatives A and B compare? How would the costs compare?

16. How would Alternatives A and B impact the market for security-based swaps? How would they impact participants in those markets?

17. How would Alternatives A and B promote the clearing of security-based swaps? For example, would Alternative B – because of the requirement to fund margin collateral requirements – incentivize nonbank SBSDs to transact in cleared security-based swaps? If so, explain why.

18. What would be the potential impact if the Commission adopted Alternative A and the prudential regulators and the CFTC adopted rules similar to Alternative B? Consider and explain the impact competitively and practically.

19. Would the proposed exception to the account <u>equity</u> requirements for counterparties that elect segregation under section 3E(f) of the Exchange Act be appropriate? If not, explain why not.

20. Would the proposed exception to the account <u>equity</u> requirements for accounts that elect to hold legacy security-based swaps be appropriate? If not, explain why not.

21. Would it be appropriate to permit legacy security-based swaps to be held in an entity that is not an SBSD? If so, why, and what conditions should be imposed on such an entity?

22. Should counterparties be required to post variation margin with respect to legacy swaps? Is this consistent with current market practice?

23. Should there be an exception from the account equity requirements for small banks, savings associations, farm credit system institutions, and credit unions from the account equity requirements (e.g., for entities with assets of $10 billion or less)?[594] Explain why or why not.

24. Should there be an exception from the account equity requirements for affiliates of the nonbank SBSD? For example, do affiliates present less credit risk than non-affiliates? If there should be an exception for affiliates, should it be limited to certain affiliates? For example, should the exception only apply to affiliates that are subject to capital and other regulatory requirements? Please explain.

25. Should there be an exception for foreign governmental entities? Explain why or why not. Should types of foreign governmental entities be distinguished for purposes of an exception? For example, are there objective benchmarks based on creditworthiness that could be used to distinguish between foreign governmental entities for which the exception to the account equity requirements would and would not be appropriate? If so, identify the benchmarks and explain how they could be incorporated into the rule.

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[594] See, e.g., 15 U.S.C. 78c-3(g)(3)(B) (requiring the Commission to consider whether to exempt small banks, savings associations, farm credit system institutions and credit unions from the definition of "financial entity" contained in Exchange Act section 3C(g)(3)(A) for the purposes of mandatory clearing of security-based swaps). See also End-User Exception to Mandatory Clearing of Security-Based Swaps, Exchange Act Release No. 63556 (Dec. 15, 2010), 75 FR 79992, 80000-80002 (Dec. 21, 2010).

26. Do dealers in OTC derivatives currently collect collateral from foreign governmental entities for their OTC derivatives transactions? If so, from which types of foreign governmental entities?

27. Do national foreign governments typically guarantee the obligations of political subdivisions and agencies? If so, identify the types of political subdivisions and agencies that are guaranteed and are not guaranteed.

ii. Nonbank MSBSPs

A nonbank MSBSP would be required to calculate as of the close of each business day the amount of equity in the account of each counterparty to a non-cleared security-based swap.[595] On the next business day following the calculation, the nonbank MSBSP would be required to either collect or deliver cash, securities, and/or money market instruments to the counterparty depending on whether there was negative or positive equity in the account of the counterparty.[596] Specifically, if the account has negative equity as calculated on the previous business day, the nonbank MSBSP would be required to collect cash, securities, and/or money market instruments in an amount equal to the negative equity.[597] Conversely, if the account has positive equity as calculated on the previous business day, the nonbank MSBSP would be required to deliver cash, securities, and/or money market instruments to the counterparty in an amount equal to the positive equity.[598]

Nonbank MSBSPs may not maintain two-sided markets or otherwise engage in activities

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595 See paragraph (c)(2)(i) of proposed new Rule 18a-3.

596 See paragraph (c)(2)(ii) of proposed new Rule 18a-3. As indicated, the nonbank MSBSP would need to deliver cash, securities, and/or money market instruments and, consequently, other types of assets would not be eligible as collateral.

597 See paragraph (c)(2)(ii)(A) of proposed new Rule 18a-3. In this case, the nonbank MSBSP would have current exposure to the counterparty in an amount equal to the negative equity.

598 See paragraph (c)(2)(ii)(B) of proposed new Rule 18a-3.

that would require them to register as an SBSD.[599] They will, however, by definition, maintain substantial positions in particular categories of security-based swaps.[600] These positions could create significant risk to counterparties to the extent the counterparties have uncollateralized current exposure to the nonbank MSBSP. In addition, they could pose significant risk to the nonbank MSBSP to the extent it has uncollateralized current exposure to its counterparties. The proposed account equity requirements for nonbank MSBSPs are designed to address these risks by imposing a requirement that nonbank MSBSPs on a daily basis must "neutralize" the credit risk between the nonbank MSBSP and the counterparty either by collecting or delivering cash, securities, and/or money market instruments in an amount equal to the positive or negative equity in the account.

Unlike nonbank SBSDs, nonbank MSBSPs would not be required to reduce the fair market value of securities and money market instruments held in the account of a counterparty (or delivered to a counterparty) for purposes of determining whether the level of equity in the account meets the minimum requirement. As discussed above in section II.B.2.c.i. of this release, the reductions taken by a nonbank SBSD would be based on the deductions that would apply to the positions pursuant to Rule 15c3-1, as proposed to be amended, and proposed new Rule 18a-1, as applicable.[601] Nonbank MSBSPs would not be subject to these rules and, consequently, would not be required to comply with them for purposes of proposed new Rule 18a-3.

Like nonbank SBSDs, nonbank MSBSPs would be subject to the requirements in paragraph (c)(4) of proposed new Rule 18a-3, which are modeled on the existing collateral

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599 See Entity Definitions Adopting Release, 77 FR 30596.

600 See 15 U.S.C. 78c(a)(67); Entity Definitions Adopting Release, 77 FR 30596.

601 See paragraph (c)(3) of proposed new Rule 18a-3.

requirements in Appendix E to Rule 15c3-1.[602] As discussed above in section II.A.2.b.iv of this release, these requirements are designed to ensure that the collateral is an asset of stable and predictable value, an asset that is not linked to the value of the transaction in any way, and an asset that can be sold quickly and easily if the need arises.

Nonbank MSBSPs would be required to take prompt steps to liquidate securities and money market instruments in the account to the extent necessary to eliminate an account equity deficiency.[603] These steps could include liquidating non-cleared security-based swap positions in the account to reduce debits arising from those transactions. The rule would not require that the liquidations must be completed within a specific timeframe in order to provide the nonbank MSBSP flexibility to conduct an orderly liquidation, taking into account market conditions and the risk profile of the account.

There would be three exceptions to the account equity requirements for nonbank MSBSPs.[604] The first exception would apply to counterparties that are commercial end users.[605] Under this exception, the nonbank MSBSP would not be required to collect collateral from a commercial end user when the account of the end user has negative equity.[606] This exception would be consistent with the proposed exception from the account equity requirements for accounts of commercial end users at nonbank SBSDs. However, nonbank MSBSPs would not be required to take a credit risk charge or capital charge relating to the amount of the uncollected

602 See paragraph (c)(4) of proposed new Rule 18a-3; 17 CFR 240.15c3-1e(c)(4)(v).

603 See paragraph (c)(8) of proposed new Rule 18a-3.

604 See paragraph (c)(2)(iii) of proposed new Rule 18a-3. MSBSPs could choose to collect collateral in these cases.

605 See paragraph (c)(2)(iii)(A) of proposed new Rule 18a-3.

606 Id.

margin.[607] The reason for this proposed exception is the concern that requiring commercial end users to deliver collateral could impair their ability to manage commercial risks through hedging transactions. A nonbank MSBSP would be required to deliver cash, securities, and/or money market instruments to a commercial end user as necessary to collateralize the end user's current exposure to the nonbank MSBSP.

Under the second exception, a nonbank MSBSP would not be required to collect cash, securities, and/or money market instruments from an SBSD to collateralize the amount of the negative equity in the account of the SBSD. Under the account equity requirements in proposed new Rule 18a-3, a nonbank SBSD would be required to collect collateral from a nonbank MSBSP to cover the negative equity and margin amount in the account of the nonbank MSBSP carried by the nonbank SBSD.[608] Once a nonbank SBSD collected these amounts, a nonbank MSBSP would have current exposure to the nonbank SBSD, at a minimum, equal to the amount of the positive equity required to be maintained in the nonbank MSBSP's account at the nonbank SBSD. A regulatory requirement that the nonbank MSBSP must collect collateral from the nonbank SBSD to collateralize the amount of the positive equity in the account at the nonbank SBSD could defeat the purpose of proposed new Rule 18a-3; namely, that nonbank SBSDs collect cash, securities, and/or money market instruments to collateralize their potential future exposure to the counterparties, including nonbank MSBSPs.[609] In essence, the proposed

607 Compare paragraph (c)(1)(iii)(A) of proposed new Rule 18a-3, with paragraph (c)(2)(iii)(A) of proposed Rule new 18a-3.

608 See paragraph (c)(1)(ii) of proposed Rule 18a-3. As discussed above, MSBSPs would not be included in the definition of commercial end user. Consequently, an MSBSP would be required to deliver cash, securities, and/or money market instruments to collateralize the negative equity and the margin amount in its security-based swap account at a nonbank SBSD.

609 For example, assume a nonbank SBSD calculates that the account of a nonbank MSBSP has a negative equity of $20 (current exposure) and a margin amount of $50 (potential future exposure) pursuant to paragraph (c)(1)(i) of proposed new Rule 18a-3. On the next business day, the nonbank SBSD would need to collect cash, securities, and/or money market instruments to collateralize these amounts pursuant to

requirements reflect a general preference in favor of requiring counterparties to nonbank SBSDs to fully collateralize their obligations to the nonbank SBSDs.

The third exception would apply to a security-based swap legacy account.[610] Under this exception, consistent with the proposed corresponding exception applying to accounts with nonbank SBSDs, a nonbank MSBSP would not be required to collect cash, securities, and/or money market instruments to collateralize the negative equity in a security-based swap legacy account. In addition, the MSBSP would not be required to deliver collateral to cover the positive equity in the account. This exception would be designed to address the impracticality of renegotiating contracts governing security-based swap transactions that predate the effectiveness of proposed new Rule 18a-3 in order to come into compliance with the account equity requirements in the rule.

Request for Comment

The Commission generally requests comment on the proposed account equity requirements for counterparties of nonbank MSBSPs in proposed Rule 18a-3. Commenters are referred to the questions about the account equity requirements for nonbank SBSDs above in section II.B.2.c.i. of this release to the extent those questions address provisions in proposed new Rule 18a-3 that also apply to nonbank MSBSPs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

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paragraph (c)(1)(ii) of proposed new Rule 18a-3. Assume the nonbank MSBSP delivers cash as collateral. It would need to deliver $70 in cash, of which $50 (as collateral for the margin amount) would be a receivable from the nonbank SBSD to the nonbank MSBSP. In other words, the $50 (as a receivable from the nonbank SBSD) would be the nonbank MSBSP's current exposure to the nonbank SBSD. If the nonbank MSBSP was required to collect collateral from the nonbank SBSD to cover this amount, the account of the nonbank MSBSP at the nonbank SBSD would not meet the minimum equity requirement of $50.

610 See paragraph (c)(2)(iii)(C) of proposed new Rule 18a-3. The term security-based swap legacy account would be defined to mean an account that holds no security-based swaps entered into after the effective date of the rule and that is used only to hold security-based swaps entered into prior to the effective date of the rule and collateral for those security-based swaps. See paragraph (b)(9) of proposed new Rule 18a-3.

1. Are the proposed account equity requirements for nonbank MSBSPs appropriate? If not, explain why not.
2. Should nonbank MSBSPs be required to reduce the fair market value of securities and money market instruments for purposes of determining whether the level of equity in the account meets the minimum requirement? What would be the impact of not requiring nonbank MSBSPs to reduce the fair market value of securities and money market instruments for purposes of determining whether the level of equity in the account meets the minimum requirement?
3. Should nonbank MSBSPs be required to collect or deliver cash, securities, and/or money market instruments to collateralize a margin amount (potential future exposure) in addition to the negative equity amount (current exposure)? Should they be required to deliver cash, securities, and/or money market instruments to a commercial end user to collateralize a margin amount? Please explain.
4. Is the proposed exception to the account equity requirements for credit exposures to commercial end users appropriate? If not, explain why not. For example, because nonbank MSBSPs would not be required to take a credit risk charge or capital charge relating to the amount of uncollected margin collateral, would nonbank MSBSPs be subject to additional risks not applicable to nonbank SBSDs? If so, explain why. If not, explain why not.
5. Is the proposed exception to the account equity requirements for credit exposures to SBSDs appropriate? If not, explain why not.
6. Is the proposed exception to the account equity requirements for credit exposures in security-based swap legacy accounts appropriate? If not, explain why not.

d. $100,000 Minimum Transfer Amount

Proposed new Rule 18a-3 would establish a minimum transfer amount of $100,000 with respect to a particular counterparty.[611] Under this provision, a nonbank SBSD and a nonbank MSBSP would not be required to collect or deliver collateral to meet an account equity requirement if the amount required to be collected or delivered is equal to or less than $100,000. If the minimum transfer amount is exceeded, the entire account equity requirement would need to be collateralized, not just the amount of the requirement that exceeds $100,000.

The proposed minimum transfer provision is designed to establish a threshold so that the degree of risk reduction achieved by requiring account equity requirements to be collateralized is sufficiently small that the costs of delivering collateral may not be justified. The proposed $100,000 threshold is based on the proposals of the prudential regulators and the CFTC.[612]

Request for Comment

The Commission generally requests comment on the minimum transfer amount in proposed new Rule 18a-3. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

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611 See paragraph (c)(6) of proposed Rule 18a-3.

612 See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27575; CFTC Margin Proposing Release, 76 FR at 23735 ("In order to reduce transaction costs, proposed § 23.150 would establish a 'minimum transfer amount' of $100,000. Initial and variation margin payments would not be required to be made if below that amount. This amount was selected in consultation with the prudential regulators. It represents an amount sufficiently small that the level of risk reduction might not be worth the transaction costs of moving the money. It only affects the timing of collection; it does not change the amount of margin that must be collected once the $100,000 level is exceeded."). Some commenters to the CFTC and Prudential Regulators proposed margin rules, while generally supporting the use of minimum transfer amounts, stated that they should have the flexibility to set higher minimum transfer amounts and that minimum transfer amounts up to $250,000 were more consistent with prevailing industry practice. See letter from the Coalition for Derivatives End-Users, to David A. Stawick, Secretary, CFTC (July 11, 2011), available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47804; letter from Carl B. Wilkerson, Vice President & Chief Counsel, Securities & Litigation, American Council of Life Insurers, to the Prudential Regulators and David A. Stawick, Secretary, CFTC (July 11, 2011), available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47742; letter from Lisa M. Ledbetter, Vice President and Deputy General Counsel, Legislative and Regulatory Affairs, Freddie Mac, to David A. Stawick, Secretary, CFTC (July 11, 2011), available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47771.

1. Is it appropriate to have a minimum transfer amount? If not, explain why not. For example, should an account equity requirement be collateralized regardless of the amount of cash, securities, and/or money market instruments that would need to be transferred to meet the requirement?
2. Is $100,000 an appropriate minimum transfer amount? Should the amount be greater than $100,000 (e.g., $150,000, $200,000, $500,000, or some other amount)? If so, identify the amount and explain why it would be a better threshold. Should the amount be less than $100,000 (e.g., $75,000, $50,000, $25,000, or some other amount)? If so, identify the amount and explain why it would be a better threshold.

e. Risk Monitoring and Procedures

A nonbank SBSD would be required to monitor the risk of each account of a counterparty to a non-cleared security-based swap and establish, maintain, and document procedures and guidelines for monitoring the risk of such accounts.[613] The nonbank SBSD also would be required to review, in accordance with written procedures, and at reasonable periodic intervals, its non-cleared security-based swap activities for consistency with the risk monitoring procedures and guidelines.[614] The risk monitoring procedures and guidelines would need to include, at a minimum, procedures and guidelines for:

- Obtaining and reviewing the account documentation and financial information necessary for assessing the amount of current and potential future exposure to a given counterparty permitted by the nonbank SBSD;

613 See paragraph (e) of proposed new Rule 18a-3. Paragraph (e) of proposed new Rule 18a-3 would not apply to nonbank MSBSPs. As discussed below, the proposed risk monitoring procedures are designed to address the risk that results from dealing in non-cleared security-based swaps (i.e., the type of activity that would require a nonbank MSBSP to register as an SBSD). See 15 U.S.C. 78o-10(a)(1); Entity Definitions Proposing Release, 75 FR at 80174. As discussed above in section II.A.3 of this release, a nonbank MSBSP would be required to comply with Rule 15c3-4, which requires an entity subject to its provisions to establish a risk management control system.

614 See paragraph (e) of proposed new Rule 18a-3.

- Determining, approving, and periodically reviewing credit limits for each counterparty, and across all counterparties;
- Monitoring credit risk exposure to the security-based swap dealer from non-cleared security-based swaps, including the type, scope, and frequency of reporting to senior management;
- Using stress tests to monitor potential future exposure to a single counterparty and across all counterparties over a specified range of possible market movements over a specified time period;
- Managing the impact of credit exposure related to non-cleared security-based swaps on the nonbank SBSD's overall risk exposure;
- Determining the need to collect collateral from a particular counterparty, including whether that determination was based upon the creditworthiness of the counterparty and/or the risk of the specific non-cleared security-based swap contracts with the counterparty;
- Monitoring the credit exposure resulting from concentrated positions with a single counterparty and across all counterparties, and during periods of extreme volatility; and
- Maintaining sufficient equity in the account of each counterparty to protect against the largest individual potential future exposure of a non-cleared security-based swap carried in the account of the counterparty as measured by computing the largest maximum possible loss that could result from the exposure.

These proposed requirements are modeled on similar requirements in FINRA Rule 4240, which establishes an interim pilot program imposing margin requirements for transactions in credit default swaps executed by a FINRA member.[615] As discussed above in section II.A.2.c. of this release, nonbank SBSDs would be required to comply with Rule 15c3-4.[616] Rule 15c3-4 requires an OTC derivatives dealer to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with its business activities,

615 See FINRA Rule 4240. The risk monitoring requirements in FINRA Rule 4240 were, in turn, modeled on risk monitoring requirement in SRO portfolio margining rules. See FINRA Rule 4210(g); Rules 12.4 and 15.8A of the CBOE.

616 17 CFR 240.15c3-4.

including market, credit, leverage, liquidity, legal, and operational risks.[617] Risk management systems are designed to help ensure an awareness of, and accountability for, the risks taken throughout a firm and to develop tools to address those risks.[618] A key objective of a risk management system is to ensure that a firm does not ignore any material source of risk.[619]

The procedures and guidelines that a nonbank SBSD would establish pursuant to proposed new Rule 18a-3 would be a part of the broader system of risk management controls the nonbank SBSD would establish pursuant to Rule 15c3-4.[620] The requirement in proposed new Rule 18a-3 is designed to require specific risk management procedures and guidelines with respect to the risks of acting as a dealer in non-cleared security-based swaps, which could result in a nonbank SBSD carrying accounts for significant numbers of counterparties and effecting numerous transactions for counterparties on a daily basis. For example, the nonbank SBSD would be required to have procedures and guidelines for determining, approving, and periodically reviewing credit limits for each counterparty, and across all counterparties.[621] In addition, the nonbank SBSD would be required to have procedures and guidelines for determining the need to collect collateral from a particular counterparty, including whether that determination was based upon the creditworthiness of the counterparty and/or the risk of the specific non-cleared security-based swap contracts with the counterparty.[622] As discussed above in section II.B.2.c.i. of this release, nonbank SBSDs would not be required to collect collateral from a commercial end user to meet the account equity requirements in proposed new Rule 18a-

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617 Id.

618 See Joint Forum, Bank of International Settlements, Trends in Risk Integration and Aggregation, (Aug. 2003), available at http://www.bis.org/publ/joint07.pdf.

619 Id.

620 17 CFR 240.15c3-4.

621 See paragraph (e)(2) of proposed new Rule 18a-3.

622 See paragraph (e)(6) of proposed new Rule 18a-3.

3.[623] However, the firm would be required to determine credit limits for the end user and analyze the need for collecting collateral from the end user. These risk monitoring procedures and guidelines are designed to prevent the nonbank SBSD from allowing its credit exposure to the end user to reach a level that creates a substantial risk that the default of the end user could have a material adverse impact on the nonbank SBSD.

Request for Comment

The Commission generally requests comment on the requirements in proposed new Rule 18a-3 to monitor risk and to have risk monitoring procedures and guidelines. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are the required elements of the risk monitoring procedures and guidelines appropriate? If not, explain why not. Should there be additional or alternative required elements to the risk monitoring procedures and guidelines? If so, identify them and explain why they should be included.
2. Are the descriptions of the required elements of the risk monitoring procedures and guidelines in paragraphs (e)(1) through (8) of proposed new Rule 18a-3 sufficiently clear in terms of what is proposed to be required of nonbank SBSDs? If not, explain why not and suggest changes to make the elements more clear.
3. Is it appropriate to require that the risk monitoring procedures and guidelines be a part of the system of risk management control prescribed in Rule 15c3-4? If not, explain why not.
4. What are the current practices of dealers in OTC derivatives in terms of monitoring the

623 See paragraph (c)(1)(iii)(A) of proposed new Rule 18a-3.

risk of counterparties? Are the requirements in proposed new Rule 18a-3 consistent with current practices? Are they more limited or are they broader than current practices?

5. Should nonbank MSBSPs be subject to the requirements of paragraph (e) of proposed new Rule 18a-3? If so, explain why. If not, explain why not.

3. Specific Request for Comment to Limit the Use of Collateral

Proposed new Rule 18a-3 does not specifically identify classes of assets that could be used to meet the account equity requirements in the rule. The Commission, however, is considering whether it would be appropriate to adopt limits on eligible collateral similar to those the prudential regulators and the CFTC proposed.[624] Specifically, comment is sought on whether proposed new Rule 18a-3 should define the term eligible collateral in order to narrowly prescribe the classes of assets that would qualify as collateral to meet the account equity requirements. For example, one approach would be to limit eligible collateral to cash and U.S. government securities.

Limiting eligible collateral to cash and U.S. government securities could be a way to ensure that a nonbank SBSD will be able to liquidate the collateral promptly and at current market prices if necessary to cover the obligations of a defaulting counterparty. During a period of market stress, the value of collateral other than cash pledged as margin also may come under stress through rapid market declines and systemic liquidations and deleveraging by financial institutions. Generally, U.S. government securities are substantially less susceptible to this risk than other types of securities and, in fact, may become the investment of choice during a period of market stress as investors seek the relative safety of these securities.[625]

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624 See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27578; CFTC Margin Proposing Release, 76 FR at 23738-23739.

625 See IMF, Global Financial Stability Report, The Quest for Lasting Stability (Apr. 2012), available at http://www.imf.org/external/pubs/ft/gfsr/2012/01/pdf/text.pdf.

Another approach would be to adopt the definition of eligible collateral proposed by the prudential regulators or to adopt the "forms of margin" proposed by the CFTC.[626] Both of these proposed approaches would extend eligible collateral beyond cash and U.S. government securities but would not permit the use of certain securities (e.g., listed equities that would be permitted by proposed Rule 18a-3).

The Commission also seeks comment in response to the following questions, including empirical data in support of comments:

1. Should the types of assets that could be used to meet the nonbank SBSD account equity requirements in proposed new Rule 18a-3 be more limited? Explain why or why not. For example, are the proposed provisions that would require a nonbank SBSD to mark-to-market the value of the collateral, apply haircuts to the collateral, and adhere to the collateral requirements incorporated from Appendix E to Rule 15c3-1 sufficient to ensure that collateral is able to serve the purpose of protecting the nonbank SBSD from the credit exposure of a counterparty to a non-cleared security-based swap? If so, explain why. If not, explain why not.
2. Explain the risk to nonbank SBSDs if they are permitted to accept a broader range of securities and money market instruments (as proposed in new Rule 18a-3) to meet the account equity requirements.
3. Should the types of assets that could be used to meet the nonbank MSBSP account equity requirements in proposed new Rule 18a-3 be more limited? Explain why or why not. Since nonbank MSBSPs would not be required to apply haircuts to the collateral or adhere to the collateral requirements incorporated from Appendix E to Rule 15c3-1,

626 See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27578; CFTC Margin Proposing Release, 76 FR at 23738-23739 (proposing that only certain types of financial instruments be eligible collateral).

should the types of collateral they are allowed to accept be more limited? Explain why or why not.

4. Explain the risk to nonbank MSBSPs if they are permitted to accept a broader range of securities and money market instruments (as proposed in new Rule 18a-3) to meet the account equity requirements.

5. If the term eligible collateral is defined for purposes of proposed new Rule 18a-3, should the definition include securities of government-sponsored entities? If so, identify the government-sponsored entities and explain why the securities of the identified entity would be appropriate collateral. Alternatively, explain why securities of government-sponsored entities generally or individually should not be included in a potential definition of eligible collateral.

6. If the term eligible collateral is defined for purposes of proposed new Rule 18a-3, should the definition include immediately-available cash funds denominated in a foreign currency when the currency is the same currency in which payment obligations under the security-based swap are required to be settled? If so, should eligible collateral be limited to specific foreign currencies? If so, identify the currencies and explain why the identified currencies would be appropriate collateral. Alternatively, explain why foreign currencies generally or individually should not be included in a potential definition of eligible collateral.

7. If the term eligible collateral is defined for purposes of proposed new Rule 18a-3, should the definition include immediately-available cash funds denominated in foreign currency even in cases where the currency is not the same currency in which payment obligations under the security-based swap are required to be settled? If so, should eligible collateral

be limited to specific foreign currencies? If so, identify the currencies and explain why the identified currencies would be appropriate collateral in this circumstance. Alternatively, explain why foreign currencies in this circumstance should not be included in a potential definition of eligible collateral.

8. If the term eligible collateral is defined for purposes of proposed new Rule 18a-3, should the definition include securities of foreign sovereign governments? If so, identify the foreign sovereign governments and explain why the securities of the identified foreign sovereign governments would be appropriate collateral. Alternatively, explain why securities of foreign sovereign governments should not be included in the definition of eligible collateral.

9. If the term eligible collateral is defined for purposes of proposed new Rule 18a-3, should the definition include a fully paid margin equity security, as that term is defined in 12 CFR 220.2,[627] in the case where a non-cleared equity security-based swap references the margin equity security? If so, explain why margin equity securities would be appropriate collateral in this circumstance. Alternatively, explain why margin equity securities in this circumstance should not be included in the definition of eligible collateral.

10. Should there be separate eligible collateral requirements for collateralizing negative equity and the margin amount? For example, should the assets permitted to collateralize negative equity be limited to cash and U.S. government securities, while the assets permitted to collateralize the margin amount encompass a broader range of securities?

627 Regulation T defines margin equity security as a margin security that is an equity security (as defined in section 3(a)(11) of the Exchange Act). See 12 CFR 220.2.

C. SEGREGATION

1. Background

The U.S. Bankruptcy Code provides special protections for customers of stockbrokers (the "stockbroker liquidation provisions").[628] Among other protections, customers share ratably with other customers ahead of all other creditors in the customer property held by the failed stockbroker.[629] Segregation requirements are designed to identify customer property as distinct from the proprietary assets of the firm and to protect customer property by, for example, preventing the firm from using it to make proprietary investments. The goal of segregation is to facilitate the prompt return of customer property to customers either before or during a liquidation proceeding if the firm fails.[630]

The Dodd-Frank Act contains provisions designed to ensure that cash and securities held by an SBSD relating to security-based swaps will be deemed customer property under the stockbroker liquidation provisions.[631] In particular, section 3E(g) of the Exchange Act provides, among other things, that a security-based swap shall be considered to be a security as such term is "used in section 101(53A)(B) and subchapter III of title 11, United States Code"[632] and in the stockbroker liquidation provisions.[633] Section 3E(g) also provides that an account that holds a

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628 See 11 U.S.C. 741-753. SIPA provides similar protections for "customers" of registered broker-dealers. See 15 U.S.C. 78aaa et seq. However, SIPA also provides additional protections such as the right for each customer to receive an advance of up to $500,000 to facilitate the prompt satisfaction of a claim for securities and cash ($250,000 of the $500,000 may be used to satisfy the cash portion of a claim).

629 See 11 U.S.C. 752.

630 See Michael P. Jamroz, The Customer Protection Rule, 57 Bus. Law. 1069 (May 2002).

631 See Pub. L. 111-203 § 763(d) adding section 3E(g) to the Exchange Act (15 U.S.C. 78c-5(g)).

632 See 15 U.S.C. 78c-5(g); 11 U.S.C. 101(53A)(B). Section 101(53A)(B) defines a stockbroker to mean a person—(1) with respect to which there is a customer, as defined in section 741, subchapter III, title 11, United States Code (the definition section of the stockbroker liquidation provisions); and (2) that is engaged in the business of effecting transactions in securities—(i) for the account of others; or (ii) with members of the general public, from or for such person's own account. 11 U.S.C. 101(53A)(B).

633 See 15 U.S.C. 78c-5(g); 11 U.S.C. 741-753.

security-based swap shall be considered to be a securities account as that term is "defined" in the stockbroker liquidation provisions.[634] In addition, section 3E(g) provides that the terms purchase and sale as defined in sections 3(a)(13) and (14) of the Exchange Act, respectively, shall be applied to the terms purchase and sale as used in the stockbroker liquidation provisions.[635] Finally, section 3E(g) provides that the term customer as defined in the stockbroker liquidation provisions excludes any person to the extent the person has a claim based on a non-cleared security-based swap transaction except to the extent of any margin delivered to or by the customer with respect to which there is a customer protection requirement under section 15(c)(3) of the Exchange Act or a segregation requirement.[636]

The provisions of section 3E(g) of the Exchange Act apply the customer protection elements of the stockbroker liquidation provisions to cleared security-based swaps, including related collateral, and, if subject to segregation requirements, to collateral delivered as margin for non-cleared security-based swaps.[637] The Dodd-Frank Act established segregation requirements for cleared and non-cleared security-based swaps and provided the Commission with the authority to adopt rules with respect to segregation. In particular, section 763 of the Dodd-Frank

634 See 15 U.S.C. 78c-5(g); 11 U.S.C. 741. There is no definition of securities account in 11 U.S.C. 741. The term securities account is used in 11 U.S.C. 741(2) and (4) in defining the terms customer and customer property.

635 See 15 U.S.C. 78c-5(g); 11 U.S.C. 741-753. Section 3(a)(13) of the Exchange Act, as amended by the Dodd-Frank Act (Pub. L. 111-203 § 761(a)), defines the term purchase to mean, in the case of security-based swaps, the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require. 15 U.S.C. 78c(a)(13). Section 3(a)(14) of the Exchange Act, as amended by the Dodd-Frank Act (Pub. L. 111-203 § 761(a)), defines the term sale to mean, in the case of security-based swaps, the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require. See 15 U.S.C. 78c(a)(14).

636 See 15 U.S.C. 78c-5(g); 11 U.S.C. 741(2).

637 See 15 U.S.C. 78c-5(g); 11 U.S.C. 741-753.

Act amended the Exchange Act to add new section 3E.[638] Section 3E sets forth requirements applicable to SBSDs and MSBSPs with respect to the segregation of cleared and non-cleared security-based swap collateral and provides the Commission with rulemaking authority in this area.[639] The Commission also has concurrent authority under section 15(c)(3) of the Exchange Act to prescribe segregation requirements for broker-dealers.[640]

Section 3E(b)(1) of the Exchange Act provides that a broker, dealer, or SBSD shall treat and deal with all money, securities, and property of any security-based swap customer received to margin, guarantee, or secure a cleared security-based swap transaction as belonging to the customer.[641] Section 3E(b)(2) provides that the money, securities, and property shall be separately accounted for and shall not be commingled with the funds of the broker, dealer, or SBSD or used to margin, secure, or guarantee any trades or contracts of any security-based swap customer or person other than the person for whom the money, securities, or property are held.[642]

Section 3E(c)(1) of the Exchange Act provides that, notwithstanding section 3E(b), money, securities, and property of cleared security-based swap customers of a broker, dealer, or SBSD may, for convenience, be commingled and deposited in the same one or more accounts

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638 See Pub. L. 111-203 § 763; 15 U.S.C. 78c-5.

639 See 15 U.S.C. 78c-5. Unlike the grants of capital and margin rulemaking authority in the Dodd-Frank Act, section 3E does not divide rulemaking authority for segregation requirements for SBSDs and MSBSPs between the Commission and the prudential regulators. Compare 15 U.S.C. 78o-10(e)(1), with 15 U.S.C. 78c-5. Consequently, the Commission's rulemaking authority in this area extends to bank SBSDs and bank MSBSPs. 15 U.S.C. 78c-5.

640 See 15 U.S.C. 78o(c)(3). See also Pub. L. 111-203 § 771 (codified at 15 U.S.C. 78o-10(e)(3)(B)). Section 771 of the Dodd-Frank Act states that unless otherwise provided by its terms, its provisions relating to the regulation of the security-based swap markets do not divest any appropriate Federal banking agency, the Commission, the CFTC, or any other Federal or State agency, of any authority derived from any other provision of applicable law. See Pub. L. 111-203 § 771. In addition, section 15F(e)(3)(B) of the Exchange Act provides that nothing in section 15F "shall limit, or be construed to limit, the authority" of the Commission "to set financial responsibility rules for a broker or dealer…in accordance with Section 15(c)(3)." 15 U.S.C. 78o-8(e)(3)(B).

641 See section 3E(b)(1) of the Exchange Act (15 U.S.C. 78c-5(b)(1)). As indicated, the provisions of section 3E(b) do not apply to MSBSPs.

642 See section 3E(b)(2) of the Exchange Act (15 U.S.C. 78c-5(b)(2)).

with any bank, trust company, or clearing agency.[643] Section 3E(c)(2) further provides that the Commission may by rule, regulation, or order prescribe terms and conditions under which money, securities, and property of a customer with respect to cleared security-based swaps may be commingled and deposited with any other money, securities, and property received by the broker, dealer, or SBSD and required by the Commission to be separately accounted for and treated and dealt with as belonging to the security-based swap customer of the broker, dealer, or SBSD.[644]

With respect to non-cleared security-based swaps, section 3E(f)(1)(A) of the Exchange Act provides that an SBSD and an MSBSP shall be required to notify a counterparty of the SBSD or MSBSP at the beginning of a non-cleared security-based swap transaction that the counterparty has the right to require the segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty.[645] Section 3E(f)(1)(B) provides that, if requested by the counterparty, the SBSD or MSBSP shall segregate the funds or other property for the benefit of the counterparty and, in accordance with such rules and regulations as the Commission may promulgate, maintain the funds or other property in a segregated account separate from the assets and other interests of the SBSD or MSBSP.[646] Section 3E(f)(3) provides that the segregated account shall be carried by an independent third-party custodian and be designated as a segregated account for and on behalf of the counterparty ("individual segregation").[647] In the case of non-cleared security-based swaps, therefore, each counterparty

643 See section 3E(c)(1) of the Exchange Act (15 U.S.C. 78c-5(c)(1)).

644 See section 3E(c)(2) of the Exchange Act (15 U.S.C. 78c-5(c)(2)).

645 See 15 U.S.C. 78c-5(f)(1)(A). See also section 3E(f)(2)(A) of the Exchange Act, which provides that the provisions of section 3E(f)(1) apply only to a security-based swap between a counterparty and SBSD or MSBSP that is not submitted for clearing to a clearing agency. See 15 U.S.C. 78c-5(f)(2)(A).

646 See 15 U.S.C. 78c-5(f)(1)(B).

647 See 15 U.S.C. 78c-5(f)(3).

has the right to require its collateral to be isolated in an account at an independent custodian that identifies the counterparty by name, rather than commingled with collateral of other counterparties.

The objective of individual segregation is for the funds and other property of the counterparty to be carried in a manner that will keep these assets separate from the bankruptcy estate of the SBSD or MSBSP if it fails financially and becomes subject to a liquidation proceeding. Having these assets carried in a bankruptcy-remote manner protects the counterparty from the costs of retrieving assets through a bankruptcy proceeding caused, for example, because another counterparty of the SBSD or MSBSP defaults on its obligations to the SBSD or MSBSP.

Section 3E(f)(2)(B)(i) of the Exchange Act provides that the segregation requirements for non-cleared security-based swaps do not apply to variation margin payments, so that the right of a counterparty to require individual account segregation applies only to initial and not variation margin.[648] It also provides that the segregation requirements shall not preclude any commercial arrangement regarding the investment of segregated funds or other property that may only be invested in such investments as the Commission may permit by rule or regulation, and the related allocation of gains and losses resulting from any investment of the segregated funds or other property.[649] Finally, section 3E(f)(4) provides that if the counterparty does not choose to require segregation of funds or other property, the SBSD or MSBSP shall send a quarterly report to the counterparty that the firm's back office procedures relating to margin and collateral requirements

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648 See 15 U.S.C. 78c-5(f)(2)(B)(i).

649 See 15 U.S.C. 78c-5(f)(2)(B)(ii). No requirements are being proposed at this time pursuant to the authority in section 3E(f)(1)(B)(ii) of the Exchange Act.

are in compliance with the agreement of the counterparties.[650]

Pursuant, in part, to the grants of rulemaking authority in sections 3E and 15(c)(3) of the Exchange Act, the Commission is proposing new Rule 18a-4 to establish segregation requirements for SBSDs with respect to cleared and non-cleared security-based swaps that would supplement the requirements in section 3E.[651] Proposed new Rule 18a-4 would apply to all types of SBSDs (i.e., it would apply to bank SBSDs, stand-alone SBSDs, and broker-dealer SBSDs).[652] As discussed in more detail below, proposed new Rule 18a-4 would prescribe detailed requirements for how cash, securities, and money market instruments of a customer with cleared security-based swaps must be segregated when an SBSD commingles those assets with the cash and securities of other customers ("omnibus segregation") pursuant to section 3E(c)(1) of the Exchange Act.[653] In addition, the proposed rule would require that cash, securities, and money market instruments of a customer with respect to non-cleared security-based swaps must be treated in the same manner as cash, securities, and money market instruments of a customer with respect to cleared security-based swaps in cases where the counterparty does not elect individual segregation[654] and does not affirmatively waive segregation altogether.[655] In other words, proposed new Rule 18a-4 would establish an alternative omnibus, or "commingled", segregation approach for non-cleared security-based swaps. This approach would be the default requirement under which an SBSD would be required to segregate securities and funds relating

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650 See section 3E(f)(4) of the Exchange Act (15 U.S.C. 78c-5(f)(4)).

651 See 15 U.S.C. 78c-5; 15 U.S.C. 78o(c)(3).

652 Unlike section 15F of the Exchange Act that divides responsibility for capital and margin rules between the Commission and the prudential regulators, section 3E of the Exchange Act provides authority solely to the Commission. Compare 15 U.S.C. 78o-10, with 15 U.S.C. 78c-5.

653 See 15 U.S.C. 78c-5(c)(1).

654 See 15 U.S.C. 78c-5(f)(1)-(3).

655 See 15 U.S.C. 78c-5(f)(4).

to non-cleared security-based swaps and, therefore, apply in the absence of a counterparty electing individual segregation or affirmatively waiving segregation.[656]

The omnibus segregation requirements in Rule 18a-4 would not apply to MSBSPs.[657] Consequently, if an MSBSP holds collateral from a counterparty with respect to non-cleared security-based swaps, it would be subject only to the segregation requirements in section 3E of the Exchange Act with respect to the collateral, and would not be required to segregate the collateral unless the counterparty required individual segregation under section 3E.[658] The omnibus segregation requirements in Rule 18a-4 may not be practical for MSBSPs for the same reasons discussed in sections II.A.3. and II.B.2. of this release with respect to the proposed capital and margin requirements for MSBSPs (i.e., the potentially wide range of business models under which nonbank MSBSPs may operate under the proposed rule, and the uncertain impact that requirements designed for broker-dealers could have on these entities). MSBSPs will instead be subject to the provisions in section 3E(f) of the Exchange Act, which provide certain baseline segregation requirements for non-cleared security-based swaps.[659] In addition, counterparties would be able to negotiate customized segregation agreements with MSBSPs, subject to these provisions.[660]

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656 As discussed below in section II.C.2.c. of this release, an SBSD would be required to obtain a subordination agreement from a counterparty that waives segregation. By entering into the subordination agreement, the counterparty would affirmatively waive segregation. The absence of a subordination agreement would mean that the counterparty is presumed not to have waived segregation and the SBSD would need to treat the counterparty's cash, securities, and/or money market instruments pursuant to the omnibus segregation requirements of proposed new Rule 18a-4.

657 As discussed in more detail below, MSBSPs would be subject to a notification requirement. See paragraph (d)(1) of proposed new Rule 18a-4.

658 The provisions of section 3E of the Exchange Act governing cleared security-based swaps do not apply to nonbank MSBSPs. See 15 U.S.C. 78c-5(b) (referring specifically to a "broker, dealer, or security-based swap dealer" and not to an MSBSP.).

659 See 15 U.S.C. 78c-5(f).

660 Id.

As discussed in more detail below, the omnibus segregation requirements of Rule 18a-4 are modeled on the provisions of the broker-dealer segregation rule – Rule 15c3-3.[661] Rule 15c3-3 is designed "to give more specific protection to customer funds and securities, in effect forbidding brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers; e.g., a firm is virtually precluded from using customer funds to buy securities for its own account."[662] To meet this objective, Rule 15c3-3 requires a broker-dealer that maintains custody of customer securities and cash (a "carrying broker-dealer") to take two primary steps to safeguard these assets. The steps are designed to protect customers by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under SIPA, the securities and cash should be isolated and readily identifiable as "customer property" and, consequently, available to be distributed to customers ahead of other creditors.[663]

The first step required by Rule 15c3-3 is that a carrying broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities.[664]

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661 See 17 CFR 240.15c3-3.

662 See Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 21651 (Jan. 11, 1985), 50 FR 2690, 2690 (Jan. 18, 1985). See also Broker-Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856 (Nov. 10, 1972), 37 FR 25224, 25224 (Nov. 29, 1972).

663 See 15 U.S.C. 78aaa et seq.

664 See 17 CFR 240.15c3-3(d). The term fully paid securities includes all securities carried for the account of a customer in a special cash account as defined in Regulation T promulgated by the Board of Governors of the Federal Reserve System, as well as margin equity securities within the meaning of Regulation T which are carried for the account of a customer in a general account or any special account under Regulation T during any period when section 8 of Regulation T (12 CFR 220.8) specifies that margin equity securities shall have no loan value in a general account or special convertible debt security account, and all such margin equity securities in such account if they are fully paid: provided, however, that the term "fully paid securities" shall not apply to any securities which are purchased in transactions for which the customer has not made full payment. 17 CFR 240.15c3-3(a)(3). The term margin securities means those securities carried for the account of a customer in a general account as defined in Regulation T, as well as securities

Physical possession or control means the broker-dealer must hold these securities in one of several locations specified in Rule 15c3-3 and free of liens or any other interest that could be exercised by a third-party to secure an obligation of the broker-dealer.[665] Permissible locations include a bank, as defined in section 3(a)(6) of the Exchange Act, and a clearing agency.[666]

The second step is that a carrying broker-dealer must maintain a reserve of funds or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers.[667] The account must be titled "Special Account for the Exclusive Benefit of Customers of the Broker-Dealer" ("customer reserve account").[668] The amount of net cash owed to customers is computed pursuant to a formula set forth in Exhibit A to Rule 15c3-3 ("Exhibit A formula").[669] Under the Exhibit A formula, the broker-dealer adds up customer credit items (e.g., cash in customer securities accounts) and then subtracts from that amount customer debit items (e.g., margin loans).[670] If credit items exceed debit items, the net amount must be on

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carried in any special account other than the securities referred to in paragraph (a)(3) of Rule 15c3-3. 17 CFR 240.15c3-3(a)(4). The term excess margin securities means those securities referred to in paragraph (a)(4) of Rule 15c3-3 carried for the account of a customer having a market value in excess of 140 percent of the total of the debit balances in the customer's account or accounts encompassed by paragraph (a)(4) of Rule 15c3-3 which the broker-dealer identifies as not constituting margin securities. 17 CFR 240.15c3-3(a)(5).

665 See 17 CFR 240.15c3-3(c). Customer securities held by the carrying broker-dealer are not assets of the firm. Rather, the carrying broker-dealer holds them in a custodial capacity and the possession and control requirement is designed to ensure that the carrying broker-dealer treats them in a manner that allows for their prompt return.

666 Id.

667 17 CFR 240.15c3-3(e). The term "qualified security" is defined in Rule 15c3-3 to mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States ("U.S. government security"). See 17 CFR 240.15c3-3(a)(6).

668 See 17 CFR 240.15c3-3(e)(1). The purpose of giving the account this title is to alert the bank and creditors of the broker-dealer that this reserve fund is to be used to meet the broker-dealer's obligations to customers (and not the claims of general creditors) in the event the broker-dealer must be liquidated in a formal proceeding.

669 17 CFR 240.15c3-3a.

670 See id.

deposit in the customer reserve account in the form of cash and/or qualified securities.[671] A broker-dealer cannot make a withdrawal from the customer reserve account until the next computation and even then only if the computation shows that the reserve requirement has decreased.[672] The broker-dealer must make a deposit into the customer reserve account if the computation shows an increase in the reserve requirement.

In addition, the Exhibit A formula permits the broker-dealer to offset customer credit items only with customer debit items.[673] This means the broker-dealer can use customer cash to facilitate customer transactions such as financing customer margin loans and borrowing securities to make deliveries of securities customers have sold short.[674] As discussed above in section II.B. of this release, the broker-dealer margin rules require securities customers to maintain a minimum level of equity in their securities accounts. In addition to protecting the broker-dealer from the consequences of a customer default, this equity serves to over-collateralize the customers' obligations to the broker-dealer. This buffer protects the customers whose cash was used to facilitate the broker-dealer's financing of securities purchases and short-

671 17 CFR 240.15c3-3(e). Customer cash is a balance sheet item of the carrying broker-dealer (i.e., the amount of cash received from a customer increases the amount of the carrying broker-dealer's assets and creates a corresponding liability to the customer). The reserve formula is designed to isolate these broker-dealer assets so that an amount equal to the net liabilities to customers is held as a reserve in the form of cash or U.S. government securities. The requirement to establish this reserve is designed to effectively prevent the carrying broker-dealer from using customer funds for proprietary business activities such as investing in securities. The goal is to put the carrying broker-dealer in a position to be able to readily meet its cash obligations to customers by requiring the firm to make deposits of cash and/or U.S. government securities into the customer reserve account in the amount of the net cash owed to customers.

672 See 17 CFR 240.15c3-3(e).

673 See 17 CFR 240.15c3-3a.

674 For example, if a broker-dealer holds $100 for customer A, the broker-dealer can use that $100 to finance a security purchase of customer B. The $100 the broker-dealer owes customer A is a credit in the formula and the $100 customer B owes the broker-dealer is a debit in the formula. Therefore, under the Exhibit A formula there would be no requirement to maintain cash and/or U.S. government securities in the customer reserve account. However, if the broker-dealer did not use the $100 held in customer A's account for this purpose, there would be no offsetting debit and, consequently, the broker-dealer would need to have on deposit in the customer reserve account cash and/or U.S. government securities in an amount at least equal to $100.

sales by customers. For example, if the broker-dealer fails, the customer debits, because they generally are over-collateralized, should be attractive assets for another broker-dealer to purchase or, if not purchased by another broker-dealer, they should be able to be liquidated to a net positive equity.[675] The proceeds of the debits sale or liquidation can be used to repay the customer cash used to finance the customer obligations. This cash plus the funds and/or U.S. government securities held in the customer reserve account should equal or exceed the total amount of customer credit items (i.e., the total amount owed by the broker-dealer to its customers).[676]

Proposed new Rule 18a-4 would contain certain provisions that are modeled on corresponding provisions of Rule 15c3-3.[677] Paragraph (a) of the proposed rule would define key terms used in the rule.[678] Paragraph (b) would require an SBSD to promptly obtain and thereafter maintain physical possession or control of all excess securities collateral (a term defined in paragraph (a)) and specify certain locations where excess securities collateral could be held and would be deemed to be in the SBSD's control.[679] Paragraph (c) would require an SBSD to maintain a special account for the exclusive benefit of security-based swap customers and have on deposit in that account at all times an amount of cash and/or qualified securities (a term defined in paragraph (a)) determined through a computation using the formula in Exhibit A to

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675 The attractiveness of the over-collateralized debits facilitates the bulk transfer of customer accounts from a failing or failed broker-dealer to another broker-dealer.

676 See Net Capital Requirements for Broker-Dealers; Amended Rules, Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512, 3513 (Jan. 25, 1982) ("The alternative approach is founded on the concept that, if the debit items in the Reserve Formula can be liquidated at or near their contract value, these assets along with any cash required to be on deposit under the [customer protection] rule, will be sufficient to satisfy all liabilities to customers (which are represented as credit items in the Reserve Formula).").

677 Compare 17 CFR 240.15c3-3, with proposed new Rule 18a-4.

678 Compare 17 CFR 240.15c3-3(a), with paragraph (a) of proposed new Rule 18a-4.

679 Compare 17 CFR 240.15c3-3(b)-(d), with paragraph (b) of proposed new Rule 18a-4.

proposed new Rule 18a-4.[680] A broker-dealer SBSD would need to treat security-based swap accounts separately from other securities accounts and, consequently, would need to perform separate possession and control and reserve account computations for security-based swap accounts and other securities accounts. The former would be subject to the possession and control and reserve account requirements in proposed new Rule 18a-4 and the latter would continue to be subject to the analogous requirements in Rule 15c3-3. This would keep separate the segregated customer property related to security-based swaps from customer property related to other securities, including property of retail securities customers.

Paragraph (d) of Rule 18a-4 would contain certain additional provisions that do not have analogues in Rule 15c3-3. First, it would require an SBSD and an MSBSP to provide the notice required by section 3E(f)(1)(A) of the Exchange Act prior to the execution of the first non-cleared security-based swap transaction with the counterparty.[681] Second, it would require the SBSD to obtain subordination agreements from counterparties that opt out of the segregation requirements in proposed new Rule 18a-4 because they either elect individual segregation pursuant to the provisions of section 3E(f) of the Exchange Act[682] or agree that the SBSD need not segregate their assets at all.[683]

As discussed in more detail below, the omnibus segregation requirements in proposed new Rule 18a-4 are designed to accommodate the operational aspects of an SBSD collecting cash, securities, and/or money market instruments from security-based swap customers to margin cleared security-based swaps and delivering cash, securities, and/or money market instruments to

680 Compare 17 CFR 240.15c3-3(e), with paragraph (c) of proposed new Rule 18a-4.

681 See 15 U.S.C. 78c-5(f)(1)(A); paragraph (d)(1) of proposed new Rule 18a-4.

682 See 15 U.S.C. 78c-5(f)(1)-(3).

683 See 15 U.S.C. 78c-5(f)(4).

registered clearing agencies to meet margin requirements of the clearing agencies with respect to the customers' transactions. Similarly, the omnibus segregation requirements are designed to accommodate the current practice of dealers in OTC derivatives to collect cash, securities, and/or money market instruments from a counterparty to cover current and potential future exposure arising from an OTC derivatives transaction with the counterparty and concurrently deliver cash, securities, and/or money market instruments to another dealer as collateral for an OTC derivatives transaction that hedges (takes the opposite side of) the OTC derivatives transaction with the counterparty. At the same time, the omnibus segregation requirements are designed to isolate, identify, and protect cash, securities, and/or money market instruments received by the SBSD as collateral for cleared and non-cleared security-based swaps, whether the collateral is held by the SBSD, a registered clearing agency, or another SBSD.

Finally, the Commission is proposing a conforming amendment to add new paragraph (p) to Rule 15c3-3 to state that a broker-dealer that is registered as an SBSD pursuant to section 15F of the Exchange Act must also comply with the provisions of Rule 18a-4.[684] This proposed amendment would clarify that a broker-dealer SBSD must comply with both Rule 15c3-3 and Rule 18a-4.

Request for Comment

The Commission generally requests comment on the approach of proposed new Rule 18a-4. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Should there be rules under section 3E(f)(1)(B)(i) of the Exchange Act with respect to how an SBSD and an MSBSP must segregate funds and other property relating to non-

[684] See proposed paragraph (p) of Rule 15c3-3.

cleared security-based swaps to supplement the individual segregation provisions in section 3E(f)? If so, describe the types of requirements the rules should impose.

2. Should there be rules under section 3E(f)(2)(B)(ii)(I) of the Exchange Act with respect to how an SBSD and an MSBSP may invest funds or other property relating to non-cleared security-based swaps to supplement the individual segregation provisions in section 3E(f)? If so, describe the types of requirements the rules should impose. For example, should the rules require that the funds may be invested only in U.S. government securities or in qualified securities as that term is defined in paragraph (a)(5) of proposed new Rule 18a-4? Explain why or why not.
3. Is it appropriate to model the segregation provisions for security-based swap customers on the provisions of Rule 15c3-3? If not, explain why and identify another segregation model.
4. Should MSBSPs be required to comply with all the omnibus segregation requirements of proposed new Rule 18a-4? If so, explain why. If not, explain why not.
5. Should the omnibus segregation requirements accommodate the ability to hold swaps in security-based swap customer accounts to facilitate a portfolio margin treatment for related or offsetting positions in the account? What practical or legal impediments may exist to doing so? If swaps could be held in the account along with security-based swaps, how would the existence of differing bankruptcy regimes for securities and commodities instruments impact the ability to unwind positions or distribute assets to customers in the event of insolvency of the SBSD?

2. Proposed Rule 18a-4

a. Possession and Control of Excess Securities Collateral

Paragraph (b)(1) of Rule 18a-4 would require an SBSD to promptly obtain and thereafter maintain physical possession or control of all excess securities collateral carried for the accounts of security-based swap customers.[685] Physical possession or control as used in Rule 15c3-3 means a broker-dealer cannot lend or hypothecate securities subject to the requirement and must hold them itself or, as is more common, in a satisfactory control location.[686] As discussed below, physical possession or control is intended to have the same meaning in proposed new Rule 18a-4.

The term security-based swap customer would be defined to mean any person from whom or on whose behalf the SBSD has received or acquired or holds funds or other property for the account of the person with respect to a cleared or non-cleared security-based swap transaction.[687] The definition would exclude a person to the extent that person has a claim for funds or other property which by contract, agreement or understanding, or by operation of law, is part of the capital of the SBSD or is subordinated to all claims of security-based swap customers of the SBSD.[688] This proposed definition of security-based swap customer is modeled on the current definition of customer in Rule 15c3-3.[689] As discussed above, an SBSD would be

685 This paragraph is modeled on paragraph (b)(1) of Rule 15c3-1. Compare 17 CFR 240.15c3-1(b)(1), with paragraph (b)(1) of proposed new Rule 18a-4.

686 See Amendments to Financial Responsibility Rules for Broker-Dealers, 72 FR 12862.

687 See paragraph (a)(6) of proposed new Rule 18a-4. Paragraph (a)(1) of proposed Rule 18a-4 would define the term cleared security-based swap to mean a security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered with the Commission pursuant to section 17A of the Exchange Act (15 U.S.C. 78q-1). Any other security-based swap would be a non-cleared security-based swap.

688 See paragraph (a)(6) of proposed new Rule 18a-4.

689 Compare 17 CFR 240.15c3-3(a)(1), with paragraph (a)(6) of proposed new Rule 18a-4. The proposed definition also is based on the definitions of "customer" in 11 U.S.C. 741(2) and 15 U.S.C. 78lll(2), which, respectively, apply to liquidations of stockbrokers under the stockbroker liquidation provisions and broker-

required to obtain subordination agreements from counterparties that elect individual segregation pursuant to the self-executing provisions of section 3E(f) of the Exchange Act[690] or that waive segregation.[691] Because these counterparties would enter into subordination agreements, they would not meet the definition of security-based swap customer and, consequently, the omnibus segregation requirements of proposed new Rule 18a-4 would not apply to their funds and other property.[692]

Proposed new Rule 18a-4 would define the term excess securities collateral to mean securities and money market instruments carried for the account of a security-based swap customer that have a market value in excess of the current exposure of the SBSD to the customer, excluding: (1) securities and money market instruments held in a qualified clearing agency account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the clearing agency resulting from a security-based swap transaction of the customer; and (2) securities and money market instruments held in a qualified registered security-based swap dealer account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the other SBSD resulting from the SBSD entering into a non-cleared security-based swap transaction with the other SBSD to offset the risk of a non-cleared security-based swap transaction between the SBSD and the customer. The proposed definition of excess securities collateral is based on the provisions of

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dealers under the SIPA. As discussed above in section II.C.1 of this release, under these liquidation provisions, customers receive special protections such as priority claims to customer property over general creditors. See 11 U.S.C. 101 et seq.; 15 U.S.C. 78aaa et seq.

690 See 15 U.S.C. 78c-5(f)(1)-(3).

691 See 15 U.S.C. 78c-5(f)(4).

692 Counterparties that elect individual segregation would not need the protections of the omnibus segregation requirements because their funds and other property would be held by an independent third-party custodian and, therefore, the third-party custodian – rather than the SBSD – would owe the securities and funds to the counterparty. Counterparties that waive segregation, in effect, have agreed that their funds and other property can be used by the SBSD for its proprietary business purposes. Therefore, they have agreed to forego the benefits of segregation.

Rule 15c3-3 requiring a broker-dealer to maintain physical possession or control of fully paid and excess margin securities (i.e., securities that are not being used to secure the obligations of the customer to the broker-dealer).[693] Under the proposed definition of excess securities collateral, securities and money market instruments of a security-based swap customer of the SBSD that are not being used to collateralize the SBSD's current exposure to the customer would need to be in the physical possession or control of the SBSD unless one of the two exceptions in the definition applies to the securities and money market instruments.

The first exception in the definition refers to securities and money market instruments held in a qualified clearing agency account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the clearing agency resulting from a security-based swap transaction of the customer. This exception is designed to accommodate the margin requirements of clearing agencies, which will require SBSDs to deliver margin collateral to the clearing agency to cover exposures arising from cleared security-based swaps of the SBSD's security-based swap customers.[694] Customer securities and money market instruments provided to the clearing agency for this purpose would not meet the definition of excess securities collateral and, therefore, would not be subject to the physical possession or control requirement.[695] This exception would allow the clearing agency to hold the securities as collateral against obligations of the SBSD's customers arising from their cleared security-based swaps.

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693 See 17 CFR 240.15c3-3(d); 17 CFR 240.15c3-3(a)(3) (defining the term fully paid securities); 17 CFR 240.15c3-3(a)(4) (defining the term margin securities); 17 CFR 240.15c3-3(a)(5) (defining the term excess margin securities).

694 As discussed above, security-based swap clearing agencies will require SBSDs to deliver margin collateral for the security-based swap transactions of the SBSD's customers that are cleared by the clearing agency.

695 While the Commission is proposing this exemption, these customer securities and money market instruments would still be required to be included in the SBSD's reserve formula calculation under proposed new Rule 18a-4a.

The term qualified clearing agency account would be defined to mean an account of an SBSD at a clearing agency established to hold funds and other property in order to purchase, margin, guarantee, secure, adjust, or settle cleared security-based swaps of the SBSD's security-based swap customers that meets the following conditions:

- The account is designated "Special Clearing Account for the Exclusive Benefit of the Cleared Security-Based Swap Customers of [name of the SBSD]";[696]
- The clearing agency has acknowledged in a written notice provided to and retained by the SBSD that the funds and other property in the account are being held by the clearing agency for the exclusive benefit of the security-based swap customers of the SBSD in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the SBSD with the clearing agency;[697] and
- The account is subject to a written contract between the SBSD and the clearing agency which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the clearing agency or any person claiming through the clearing agency, except a right, charge, security interest, lien, or claim resulting from a cleared security-based swap transaction effected in the account.[698]

These provisions are designed to ensure that securities and money market instruments of security-based swap customers related to cleared security-based swaps provided to a clearing agency are isolated from the proprietary assets of the SBSD and identified as property of the security-based swap customers.

The second exception in the definition of excess securities collateral is for securities and

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696 See paragraph (a)(3)(i) of proposed new Rule 18a-4. This provision is modeled on paragraph (e)(1) of Rule 15c3-3, which requires a broker-dealer to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers." Compare 17 CFR 240.15c3-3(e), with paragraph (a)(3)(i) of proposed new Rule 18a-4.

697 See paragraph (a)(3)(ii) of proposed new Rule 18a-4. This provision is modeled on paragraph (f) of Rule 15c3-3, which requires a broker-dealer to obtain a written notification from a bank where it maintains a customer reserve account. Compare 17 CFR 240.15c3-3(f), with paragraph (a)(3)(iii) of proposed new Rule 18a-4.

698 See paragraph (a)(3)(iii) of proposed new Rule 18a-4. This provision is modeled on paragraph (f) of Rule 15c3-3, which requires a broker-dealer to obtain a contract from a bank where it maintains a "Special Reserve Bank Account for the Exclusive Benefit of Customers." Compare 17 CFR 240.15c3-3(f), with paragraph (a)(3)(ii) of proposed new Rule 18a-4.

money market instruments held in a qualified registered security-based swap dealer account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the other SBSD resulting from the SBSD entering into a non-cleared security-based swap transaction with the other SBSD to offset the risk of a non-cleared security-based swap transaction between the SBSD and the customer. This exception is designed to accommodate the practice of dealers in OTC derivatives transactions maintaining "matched books" of transactions in which an OTC derivatives transaction with a counterparty is hedged with an offsetting transaction with another dealer. SBSDs, as dealers in security-based swaps, are expected to actively manage the risk of their non-cleared security-based swap positions by entering into offsetting transactions with other SBSDs.[699] These other SBSDs may require margin collateral from the SBSD.[700] Customer securities and money market instruments provided to another SBSD for this purpose would be excepted from the definition of excess securities collateral and, therefore, would not be subject to the physical possession or control requirement. Thus, this provision would allow an SBSD to finance customer transactions in non-cleared security-based swaps by using customer collateral to secure offsetting transactions with

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699 For example, assume an SBSD and a counterparty enter into a CDS security-based swap on XYZ Company with a notional amount of $10 million and term of five years and in which the SBSD is the seller of protection and counterparty is the buyer of protection. The SBSD could enter into a matching transaction (a CDS security-based swap on XYZ Company with a notional amount of $10 million and term of five years) with another SBSD in which the SBSD is the buyer of protection and the other SBSD is the seller of protection. This would match the transaction with the counterparty with the transaction with the other SBSD and hedge the SBSD's risk resulting from the transaction with the customer.

700 As discussed above in section II.B.2.c.i. of this release, an SBSD would not be required to collect collateral equal to the margin amount if the counterparty was another SBSD under the Alternative A account equity requirement in proposed new Rule 18a-3. See paragraph (c)(1)(iii)(B)-Alternative A of proposed new Rule 18a-3. Consequently, an SBSD would not be required to maintain a minimum level of positive equity in its account at another SBSD with respect to non-cleared security-based swaps. This would mean that the SBSD may not need to provide collateral to the other SBSD other than an amount necessary to cover the current exposure of the other SBSD, which, in turn could reduce the need to use securities and money market instruments of security-based swap customers to collateralize hedging transactions. However, under the Alternative B account equity requirement, an SBSD would be required to provide collateral equal to the margin amount to the other SBSD. See paragraph (c)(1)(iii)(B)-Alternative B of proposed new Rule 18a-3. This could increase the need to use securities and money market instruments of security-based swap customers to collateralize hedging transactions.

another SBSD, provided that the collateral is held in an account with the other SBSD that meets certain requirements.

The term qualified registered security-based swap dealer account ("qualified SBSD account") would be defined to mean an account at another SBSD registered with the Commission pursuant to section 15F of the Exchange Act that is not an affiliate of the SBSD and that meets the following conditions:

- The account is designated "Special Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of the SBSD]";[701]

- The account is subject to a written acknowledgement by the other SBSD provided to and retained by the SBSD that the funds and other property held in the account are being held by the other SBSD for the exclusive benefit of the security-based swap customers of the SBSD in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the SBSD with the other SBSD;[702]

- The account is subject to a written contract between the SBSD and the other SBSD which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the other SBSD or any person claiming through the SBSD, except a right, charge, security interest, lien, or claim resulting from a non-cleared security-based swap transaction effected in the account;[703] and

- The account and the assets in the account are not subject to any type of subordination agreement.[704]

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701 See paragraph (a)(4)(i) of proposed new Rule 18a-4. Similar to the proposed conditions for a qualified clearing agency account, this provision is modeled on paragraph (e)(1) of Rule 15c3-3, which requires a broker-dealer to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers." Compare 17 CFR 240.15c3-3(e), with paragraph (a)(4)(i) of proposed new Rule 18a-4.

702 See paragraph (a)(4)(ii) of proposed new Rule 18a-4. Similar to the proposed conditions for a qualified clearing agency account, this provision is modeled on paragraph (f) of Rule 15c3-3, which requires a broker-dealer to obtain a written notification from a bank where it maintains a "Special Reserve Bank Account for the Exclusive Benefit of Customers." Compare 17 CFR 240.15c3-3(f), with paragraph (a)(4)(ii) of proposed new Rule 18a-4.

703 See paragraph (a)(4)(iii) of proposed new Rule 18a-4. Similar to the proposed conditions for a qualified clearing agency account, this provision is modeled on paragraph (f) of Rule 15c3-3, which requires a broker-dealer to obtain a contract from a bank where it maintains a "Special Reserve Bank Account for the Exclusive Benefit of Customers." Compare 17 CFR 240.15c3-3(f), with paragraph (a)(4)(iii) of proposed new Rule 18a-4.

704 See paragraph (a)(4)(iv) of proposed new Rule 18a-4.

These conditions are largely identical to the conditions for a qualified clearing agency account and are similarly designed to ensure that securities and money market instruments of security-based swap customers relating to non-cleared security-based swaps provided to another SBSD are isolated from the proprietary assets of the SBSD and are identified as property of the security-based swap customers. Further, the account and the assets in the account could not be subject to any type of subordination agreement. This condition is designed to ensure that if the other SBSD holding the qualified SBSD account fails, the SBSD accountholder will be treated as a security-based swap customer in a liquidation proceeding and, therefore, could make a pro rata claim for customer property with other customers ahead of all other creditors.[705]

Paragraph (b)(2) of proposed new Rule 18a-4 would identify five satisfactory control locations for excess securities collateral.[706] Rule 15c3-3 identifies the same locations as satisfactory control locations.[707] Proposed new Rule 18a-4 would provide that an SBSD has

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705 See paragraph (a)(6) of proposed new Rule 18a-4 (excluding persons who subordinate their claims against the SBSD to all other creditors from the definition of security-based swap customer).

706 See paragraph (b)(2) of proposed new Rule 18a-4.

707 Compare 17 CFR 240.15c3-3(c), with paragraph (b)(2) of proposed new Rule 18a-4. Rule 15c3-3 identifies two control locations that the Commission is not proposing be identified in proposed new Rule 18a-4. First, paragraph (c)(2) of Rule 15c3-3 identifies as a control location "a special omnibus account in the name of such broker or dealer with another broker or dealer in compliance with the requirements of section 4(b) of Regulation T under the Act (12 CFR 220.4(b)), such securities being deemed to be under the control of such broker or dealer to the extent that he has instructed such carrying broker or dealer to maintain physical possession or control of them free of any charge, lien, or claim of any kind in favor of such carrying broker or dealer or any persons claiming through such carrying broker or dealer." See 17 CFR 240.15c3-3(c)(2). Stand-alone SBSDs are not expected to maintain such accounts. Second, Rule 15c3-3 identifies as a control location "a foreign depository, foreign clearing agency or foreign custodian bank which the Commission upon application from a broker or dealer, a registered national securities exchange or a registered national securities association, or upon its own motion shall designate as a satisfactory control location for securities." See 17 CFR 240.15c3-3(c)(4). See also Interpretative Release: Guidelines for Control Locations for Foreign Securities, Exchange Act Release No. 10429 (Oct. 12, 1973), 38 FR 29217, 29217 (Oct. 23, 1973). As discussed below, the last control location identified in Rule 15c3-3 and proposed to be identified in new Rule 18a-4 is such other location "as the Commission shall upon application from a broker or dealer find and designate to be adequate for the protection of customer securities." See 17 CFR 240.15c3-3(c)(7) and paragraph (b)(2)(v) of proposed new Rule 18a-4. Under the Commission's proposal, SBSDs seeking to have a foreign depository, foreign clearing agency, or foreign custodian bank identified as a satisfactory control location would need to apply to the Commission under paragraph (b)(2)(v) of proposed new Rule 18a-4.

control of excess securities collateral only if the securities and money market instruments:

- Are represented by one or more certificates in the custody or control of a clearing corporation or other subsidiary organization of either national securities exchanges, or of a custodian bank in accordance with a system for the central handling of securities complying with the provisions of Exchange Act Rule 8c–1(g) and Exchange Act Rule 15c2–1(g) the delivery of which certificates to the SBSD does not require the payment of money or value, and if the books or records of the SBSD identify the security-based swap customers entitled to receive specified quantities or units of the securities so held for such security-based swap customers collectively;[708]

- Are the subject of bona fide items of transfer; provided that securities and money market instruments shall be deemed not to be the subject of bona fide items of transfer if, within 40 calendar days after they have been transmitted for transfer by the SBSD to the issuer or its transfer agent, new certificates conforming to the instructions of the SBSD have not been received by the SBSD, the SBSD has not received a written statement by the issuer or its transfer agent acknowledging the transfer instructions and the possession of the securities and money market instruments, or the security-based swap dealer has not obtained a revalidation of a window ticket from a transfer agent with respect to the certificate delivered for transfer;[709]

- Are in the custody or control of a bank as defined in section 3(a)(6) of the Act, the delivery of which securities and money market instruments to the SBSD does not require the payment of money or value and the bank having acknowledged in writing that the securities and money market instruments in its custody or control are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank;[710]

- Are held in or are in transit between offices of the SBSD; or are held by a corporate subsidiary if the SBSD owns and exercises a majority of the voting rights of all of the voting securities of such subsidiary, assumes or guarantees all of the subsidiary's obligations and liabilities, operates the subsidiary as a branch office of the SBSD, and assumes full responsibility for compliance by the subsidiary and all of its associated persons with the provisions of the Federal securities laws as well as for all of the other acts of the subsidiary and such associated persons;[711] or

- Are held in such other locations as the Commission shall upon application from an SBSD

708 See paragraph (b)(2)(i) of proposed new Rule 18a-4. This provision is modeled on paragraph (c)(1) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(c)(1), with paragraph (b)(2)(i) of proposed new Rule 18a-4.

709 See paragraph (b)(2)(ii) of proposed new Rule 18a-4. This provision is modeled on paragraph (c)(3) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(c)(3), with paragraph (b)(2)(ii) of proposed new Rule 18a-4.

710 See paragraph (b)(2)(iii) of proposed new Rule 18a-4. This provision is modeled on paragraph (c)(5) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(c)(5), with paragraph (b)(2)(iii) of proposed new Rule 18a-4.

711 See paragraph (b)(2)(iv) of proposed new Rule 18a-4. This provision is modeled on paragraph (c)(6) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(c)(6), with paragraph (b)(2)(iv) of proposed new Rule 18a-4.

find and designate to be adequate for the protection of customer securities.[712] The identification of these locations as satisfactory control locations is designed to limit where the SBSD can hold excess securities collateral. The identified locations are places from which the securities and money market instruments can promptly be retrieved and returned to the security-based swap customers.

Paragraph (b)(3) of Rule 18a-4 would require that each business day the SBSD must determine from its books and records the quantity of excess securities collateral that the firm had in possession and control as of the close of the previous business day and the quantity of excess securities collateral the firm did not have in possession or control on that day.[713] The paragraph would provide further that the SBSD must take steps to retrieve excess securities collateral from certain specifically identified non-control locations if securities and money market instruments of the same issue and class are at these locations.[714] Specifically, paragraph (b)(3) would provide that if securities or money market instruments of the same issue and class are:

- Subject to a lien securing an obligation of the SBSD, then the SBSD, not later than the next business day on which the determination is made, must issue instructions for the release of the securities or money market instruments from the lien and must obtain physical possession or control of the securities and money market instruments within two business days following the date of the instructions;[715]

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712 See paragraph (b)(2)(v) of proposed new Rule 18a-4. This provision is modeled on paragraph (c)(7) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(c)(7), with paragraph (b)(2)(v) of proposed new Rule 18a-4. See Guidelines for Control Locations for Foreign Securities, Exchange Act Release No. 10429 (Oct. 12, 1973, 38 FR 29217 (Oct. 23, 1973) (prescribing the process under Rule 15c3-3 for a broker-dealer to apply to the Commission to utilize a foreign control location). Among other things, certain conditions must be met for the foreign control location to be deemed satisfactory. A broker-dealer must represent in an application to the Commission that the conditions are satisfied. An application submitted shall be considered accepted unless the Commission rejects the application within 90 days of receipt by the Commission. Id.

713 See paragraph (b)(3) of proposed new Rule 18a-4. The provisions in this paragraph are modeled on the provisions in paragraph (d) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(d), with paragraph (b)(3) of proposed new Rule 18a-4.

714 See paragraph (b)(3) of proposed new Rule 18a-4.

715 See paragraph (b)(3)(i) of proposed new Rule 18a-4. This provision is modeled on paragraph (d)(1) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(d)(1), with paragraph (b)(3)(i) of proposed new Rule 18a-4.

- Held in a qualified clearing agency account, then the SBSD, not later than the next business day on which the determination is made, must issue instructions for the release of the securities or money market instruments by the clearing agency and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;[716]

- Held in a qualified SBSD account maintained by another SBSD, then the SBSD, not later than the next business day on which the determination is made, must issue instructions for the release of the securities and money market instruments by the other SBSD and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;[717]

- Loaned by the SBSD, then the SBSD, not later than the next business day on which the determination is made, must issue instructions for the return of the loaned securities and money market instruments and must obtain physical possession or control of the securities or money market instruments within five business days following the date of the instructions;[718]

- Failed to receive more than 30 calendar days, then the SBSD, not later than the next business day on which the determination is made, must take prompt steps to obtain physical possession or control of the securities or money market instruments through a buy-in procedure or otherwise;[719]

- Receivable by the SBSD as a security dividend, stock split or similar distribution for more than 45 calendar days, then the SBSD, not later than the next business day on which the determination is made, must take prompt steps to obtain physical possession or

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716 See paragraph (b)(3)(ii) of proposed new Rule 18a-4. As discussed above, securities held in a qualified clearing agency account are not excess securities collateral, but only to the extent the securities are being used to meet a margin requirement of the clearing agency resulting from a security-based swap transaction of the customer. See paragraph (a)(2)(i) of proposed new Rule 18a-4. Consequently, if securities held in a qualified clearing agency account are not necessary to meet a margin requirement of the clearing agency, they would be excess securities collateral and the SBSD would need to move them to a satisfactory control location.

717 See paragraph (b)(3)(iii) of proposed new Rule 18a-4. As discussed above, securities held in a qualified SBSD account are not excess securities collateral but only to the extent the securities are being used to meet a margin requirement of the other SBSD resulting from the SBSD entering into a non-cleared security-based swap transaction with the other SBSD to offset the risk of a non-cleared security-based swap transaction between the SBSD and the customer. See paragraph (a)(2)(ii) of proposed new Rule 18a-4. Consequently, if securities held in a qualified clearing agency account are not necessary to meet a margin requirement of the other SBSD and/or are not collateralizing a transaction that offsets the risk of n non-cleared security-based swap with the customer, they would be excess securities collateral and the SBSD would need to move them to a satisfactory control location.

718 See paragraph (b)(3)(iv) of proposed new Rule 18a-4. This provision is modeled on paragraph (d)(1) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(d)(1), with paragraph (b)(3)(iv) of proposed new Rule 18a-4.

719 See paragraph (b)(3)(v) of proposed new Rule 18a-4. This provision is modeled on paragraph (d)(2) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(d)(2), with paragraph (b)(3)(v) of proposed new Rule 18a-4.

control of the securities or money market instruments through a buy-in procedure or otherwise;[720] or

- Included on the books or records of the SBSD as a proprietary short position or as a short position for another person more than 10 business days (or more than 30 calendar days if the SBSD is a market maker in the securities), then the SBSD must, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities or money market instruments.[721]

Request for Comment

The Commission generally requests comment on the proposed physical possession and control requirements in proposed new Rule 18a-4. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are possession and control requirements modeled on Rule 15c3-3 appropriate for security-based swaps? If not, explain why not.

2. Is the proposed definition of security-based swap customer appropriate? If not, explain why not and suggest modifications to the definition.

3. Is the proposed definition of excess securities collateral appropriate? If not, explain why not and suggest modifications to the definition.

4. Is the proposed exception in the definition of excess securities collateral for securities and money market instruments held in a qualified clearing agency account appropriate? If not, explain why not. Would this proposed exception raise practical or legal issues? If so, explain why.

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720 See paragraph (b)(3)(vi) of proposed new Rule 18a-4. This provision is modeled on paragraph (d)(3) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(d)(3), with paragraph (b)(3)(vi) of proposed new Rule 18a-4.

721 See paragraph (b)(3)(vii) of proposed new Rule 18a-4. This provision is modeled on a proposed amendment to Rule 15c3-3 that is still pending. See Amendments to Financial Responsibility Rules for Broker-Dealers, 72 FR at 12895. The provisions of paragraph (b)(3)(vii) of proposed new Rule 18a-4 are intended to achieve the same objectives of the proposed amendments to Rule 15c3-3. See id. at 12865-66 (explaining the basis for the proposed amendment to Rule 15c3-3).

5. Is the proposed definition of qualified clearing agency account appropriate? If not, explain why not and suggest modifications to the definition.
6. Is the proposed exception in the definition of excess securities collateral for securities and money market instruments held in a qualified registered security-based swap dealer account appropriate? If not, explain why not. Would this proposed exception raise practical or legal issues? If so, explain why.
7. Is the proposed definition of qualified registered security-based swap dealer account appropriate? For example, is the condition that the qualified registered security-based swap dealer account not be held by an affiliate of the SBSD appropriate? If the definition is not appropriate, explain why not and suggest modifications to the definition.
8. How do dealers in OTC derivatives that will be security-based swaps use offsetting transactions to hedge the risk of these positions? Would the proposed possession and control requirements for non-cleared security-based swaps adversely affect the ability of SBSDs to enter into hedging transactions? If so, explain why and suggest modifications to the requirements that could address this issue.
9. Are the control locations identified in proposed new Rule 18a-4 appropriate for security-based swaps? If not, explain why not. Should the two additional control locations in paragraphs (c)(2) and (c)(4) of Rule 15c3-3 that are not being incorporated into proposed new Rule 18a-4 be included in the rule? If so, explain why.
10. Should the process for applying to the Commission to have a location designated to be adequate for the protection of customer securities and money market instruments under paragraph (b)(2)(v) of proposed new Rule 18a-4 be similar to the current process for a broker-dealer to utilize a foreign control location under Rule 15c3-3 (i.e., a process in

which the SBSD must submit an application representing that certain conditions are met and in which an application is deemed accepted if not specifically rejected by the Commission within 90 days)? Alternatively, should the Commission be required to formally act on each application through the issuance of an order?

11. Are the steps in paragraph (b)(3) of proposed new Rule 18a-4 that an SBSD would be required to take to move securities and money market instruments from non-control locations to control locations appropriate for security-based swaps? If not, explain why not.

12. Are there any possession and control provisions in Rule 15c3-3 that are not being incorporated in proposed new Rule 18a-4 that should be included in the rule? If so, identify them and explain why they should be incorporated into proposed new Rule 18a-4.

b. Security-Based Swap Customer Reserve Account

Paragraph (c)(1) of Rule 18a-4 would require an SBSD, among other things, to maintain a special account for the exclusive benefit of security-based swap customers separate from any other bank account of the SBSD.[722] The term special account for the exclusive benefit of security-based swap customers ("Rule 18a-4 Customer Reserve Account") would be defined to mean an account at a bank that is not the SBSD or an affiliate of the SBSD and that meets the following conditions:

- The account is designated "Special Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of the SBSD]";[723]

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722 See paragraph (c) of proposed new Rule 18a-4. The provisions of paragraph (c) of proposed new Rule 18a-4 are modeled on paragraph (e) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(e), with paragraph (c) of proposed new Rule 18a-4.

723 See paragraph (a)(7)(i) of proposed new Rule 18a-4. Similar to the proposed conditions for a qualified clearing agency account and a qualified SBSD account, this provision is modeled on paragraph (e)(1) of Rule 15c3-3, which requires a broker-dealer to maintain a "Special Reserve Bank Account for the

- The account is subject to a written acknowledgement by the bank provided to and retained by the SBSD that the funds and other property held in the account are being held by the bank for the exclusive benefit of the security-based swap customers of the SBSD in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the SBSD with the bank;[724] and

- The account is subject to a written contract between the SBSD and the bank which provides that the funds and other property in the account shall at no time be used directly or indirectly as security for a loan or other extension of credit to the SBSD by the bank and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.[725]

These conditions are largely identical to the conditions for a qualified clearing agency account and qualified SBSD account and are similarly designed to ensure that cash and qualified securities deposited into the special bank account (as discussed below) are isolated from the proprietary assets of the SBSD and identified as property of the security-based swap customers.

Paragraph (c)(1) of proposed new Rule 18a-4 would provide that the SBSD must at all times maintain in a Rule 18a-4 Customer Reserve Account, through deposits into the account, cash and/or qualified securities in amounts computed in accordance with the formula set forth in Exhibit A to Rule 18a-4.[726] The formula in Exhibit A to proposed new Rule 18a-4 is modeled on the formula in Exhibit A to Rule 15c3-1, which requires a broker-dealer to add up various credit

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Exclusive Benefit of Customers" (the "Rule 15c3-3 Customer Reserve Account"). Compare 17 CFR 240.15c3-3(e), with paragraph (a)(7)(i) of proposed new Rule 18a-4.

724 See paragraph (a)(7)(ii) of proposed new Rule 18a-4. Similar to the proposed conditions for a qualified clearing agency account and a qualified SBSD account, this provision is modeled on paragraph (f) of Rule 15c3-3, which requires a broker-dealer to obtain a written notification from a bank where it maintains a Rule 15c3-3 Customer Reserve Account. Compare 17 CFR 240.15c3-3(f), with paragraph (a)(7)(ii) of proposed new Rule 18a-4.

725 See paragraph (a)(7)(iii) of proposed new Rule 18a-4. Similar to the proposed conditions for a qualified clearing agency account and a qualified SBSD account, this provision is modeled on paragraph (f) of Rule 15c3-3, which requires a broker-dealer to obtain a written contract from a bank where it maintains a "Special Reserve Bank Account for the Exclusive Benefit of Customers." Compare 17 CFR 240.15c3-3(f), with paragraph (a)(7)(iii) of proposed new Rule 18a-4.

726 See paragraph (c)(1) of proposed new Rule 18a-4; Exhibit A to proposed new Rule 18a-4.

items and debit items.[727] The credit items include credit balances in customer accounts and funds obtained through the use of customer securities.[728] The debit items include money owed by customers (e.g., from margin lending), securities borrowed by the broker-dealer to effectuate customer short sales, and required margin posted to certain clearing agencies as a consequence of customer securities transactions.[729] If, under the formula, customer credit items exceed customer debit items, the broker-dealer must maintain cash and/or qualified securities in that net amount in a Rule 15c3-3 Customer Reserve Account.

The formula in Exhibit A for determining the amount to be maintained in a Rule 18a-4 Customer Reserve Account similarly would require an SBSD to add up credit items and debit items.[730] If, under the formula, the credit items exceed the debit items, the SBSD would be required to maintain cash and/or qualified securities in that net amount in a Rule 18a-4 Customer

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727 Compare 17 CFR 240.15c3-3a, with Exhibit A to proposed new Rule 18a-4.

728 See 17 CFR 240.15c3-3a, Items 1-9. Broker-dealers are permitted to use customer margin securities to, for example, obtain bank loans to finance the funds used to lend to customers to purchase the securities. The amount of the bank loan is a credit in the formula because this is the amount that the broker-dealer would need to pay the bank to retrieve the securities. Similarly, broker-dealers may use customer margin securities to make stock loans to other broker-dealers in which the lending broker-dealer typically receives cash in return. The amount payable to the other broker-dealer on the stock loan is a credit in the formula because this is the amount the broker-dealer would need to pay the other broker-dealer to retrieve the securities.

729 See 17 CFR 240.15c3-3a, Items 10-14. Item 13 identifies as a debit item margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in accounts of securities customers. See 17 CFR 240.15c3-3a, Item 13. Similarly, Item 14 identifies as a debit item margin related to security futures products written, purchased, or sold in accounts carried for security-based swap customers required and on deposit with a clearing agency registered with the Commission under section 17A of the Exchange Act (15 U.S.C. 78q-1) or a DCO registered with the CFTC under section 5b of the CEA (7 U.S.C. 78q-1). These debits reflect the fact that customer options and security futures transactions that are cleared generate margin requirements in which the broker-dealer must deliver collateral to the Options Clearing Corporation in the case of options or a clearing agency or DCO in the case of security futures products. Identifying the collateral delivered to the Options Clearing Corporation, a clearing agency, or a DCO as a debit item permits the broker-dealer to use customer cash or securities to meet margin requirements generated by customer transactions.

730 See proposed new Rule 18a-4a. Exhibit A to Rule 15c3-3 has a number of "Notes" that provide further explanation of the credit and debit items. See 17 CFR 240.15c3-3a, Notes A-G. Exhibit A to proposed new Rule 18a-4 would have substantially similar notes. See Notes A-G to Exhibit A to proposed new Rule 18a-4.

Reserve Account.[731] The credit and debit items identified in Exhibit A to proposed new Rule 18a-4 are the same as the credit and debit items in Exhibit A to Rule 15c3-1, though Exhibit A to proposed new Rule 18a-4 would identify two additional debit items.[732] As discussed above, SBSDs will be required to deliver collateral to meet margin requirements of clearing agencies arising from cleared security-based swap transactions of their customers. In addition, SBSDs may deliver collateral to other SBSDs to meet margin requirements under proposed new Rule 18a-3 and, possibly, to meet "house" margin requirements of the other SBSD with respect to non-cleared security-based swaps the SBSD is using to hedge the risk of customer non-cleared security-based swaps. Consequently, Exhibit A to proposed new Rule 18a-4 would identify the following debit items that are not identified in Exhibit A to Rule 15c3-3:

- Margin related to cleared security-based swap transactions in accounts carried for security-based swap customers required and on deposit at a clearing agency registered with the Commission pursuant to section 17A of the Exchange Act (15 U.S.C. 78q-1); and

- Margin related to non-cleared security-based swap transactions in accounts carried for security-based swap customers held in a qualified registered SBSD account at another SBSD.

These debit items would serve the same purpose as the debit items in Exhibit A to Rule 15c3-3 that identify margin required and on deposit at the Options Clearing Corporation, a registered clearing agency, and a DCO.[733]

If the total credits exceed the total debits, an SBSD would need to maintain that amount on deposit in a Rule 18a-4 Customer Reserve Account in the form of funds and/or qualified

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[731] As discussed above, the account would need to be at a bank that is not the SBSD or an affiliate of the SBSD and that meets certain additional conditions. See paragraph (a)(7) of proposed new Rule 18a-4.

[732] Compare 17 CFR 240.15c3-3a, with Exhibit A to proposed new Rule 18a-4.

[733] See 17 CFR 240.15c3-3a, Items 13-14.

securities.[734] An SBSD would be permitted under the proposed rule to use qualified securities to meet this account deposit requirement to implement section 3E(d) of the Exchange Act.[735] Section 3E(d) provides that money of security-based swap customers received by an SBSD to margin, guarantee, or secure a cleared security-based swap may be invested in obligations of the United States, obligations fully guaranteed as to principal and interest by the United States, general obligations of a State or any subdivision of a State ("municipal securities"), and in any other investment that the Commission may by rule or regulation prescribe.[736] Section 3E(d) further provides that such investments shall be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe.[737]

The term qualified security as used in proposed new Rule 18a-4 would be defined to mean: (1) obligations of the United States; (2) obligations fully guaranteed as to principal and interest by the United States; and (3) general obligations of any State or subdivision of a State that are not traded flat or are not in default, were part of an initial offering of $500 million or greater, and were issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year-end.[738] Rule 15c3-3 contains a similar definition of qualified security, except the definition does not include municipal securities.[739]

While section 3E(d) of the Exchange Act permits the use of municipal securities, the rule imposes conditions on their use designed to ensure that only municipal securities with the most reliable valuations – and therefore greater safety and liquidity – are permitted to meet the Rule

734 See paragraph (c)(1) of proposed new Rule 18a-4.

735 15 U.S.C. 78c-5(d).

736 Id.

737 Id.

738 See paragraph (a)(5) of proposed new Rule 18a-4.

739 See 17 CFR 240.15c3-3(a)(6) (defining the term qualified security to mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States).

18a-4 Customer Reserve Account funding requirement in paragraph (c)(1) of proposed new Rule 18a-4 (consistent with the objective of the current definition of "qualified security" in Rule 15c3-3).[740] Because of the diversity and breadth of the municipal market, the availability of issuer information and the related ability to value and trade a particular municipal security can vary considerably.[741] The objective of segregation requirements is to isolate customer assets from a firm's proprietary business and, therefore, enable the firm to quickly return the assets to the customers if the firm fails. Rule 15c3-3 limits the definition of qualified securities to U.S. government securities to ensure that securities deposited in a customer reserve account can be liquidated quickly at current market values even in stressed market conditions. The proposed conditions for depositing municipal securities into the SBSD's Rule 18a-4 Customer Reserve Account are designed to help ensure that only securities that are likely to have significant issuer information available and that can be valued and liquidated quickly at current market values are permitted to meet the minimum account deposit requirement.[742]

The first proposed condition for municipal securities is that they must be general

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740 See paragraphs (a)(5)(iii)(A)-(C) of proposed new Rule 18a-4.

741 Despite its size and importance, the municipal securities market has not been subject to the same level of regulation as other sectors of the U.S. capital markets. See Commission, Report on the Municipal Securities Market (July 31, 2012) ("Municipal Securities Report"), available at http://www.sec.gov/news/studies/2012/munireport073112.pdf. The Municipal Securities Report notes concerns about access to issuer information; the presentation and comparability of information; and the existence/adequacy of disclosure controls and procedures. Id. at iv, 108-09. For example, the Municipal Securities Report notes that studies have shown that disclosure of audited annual financial statements by many municipal issuers is particularly slow. Id. at 76. By the time annual financial statements are filed or otherwise publicly available, many municipal market analysts and investors believe that the financial information has diminished usefulness or has lost relevance in assessing the current financial position of a municipal issuer. Id. Correspondingly, weaker or more distressed entities are more likely to have later audit completion times. Id. In addition, the Municipal Securities Report notes that although there have been improvements in the availability of pricing information about completed trades (i.e., post-trade information), the secondary market for municipal securities remains opaque. Investors have very limited access to information regarding which market participants would be interested in buying or selling a municipal security, and at which prices (i.e., pre-trade information). Id. at vi, 115.

742 See Municipal Securities Report at 113-115 (recognizing the municipal securities market's "relatively low liquidity" and the "relatively opaque" pre-trade information about municipal securities' prices).

obligation bonds. General obligation bonds are backed by the full faith and credit and/or taxing authority of the issuer.[743] They normally are issued to finance non-revenue producing public works projects (e.g., schools and roads) and generally are paid off with funds from taxes or fees. Issuers typically have the ability to raise taxes in order to service the debt obligations of these municipal securities. In contrast, revenue bonds are issued to fund projects that will eventually generate revenue (e.g., a toll road). The anticipated revenue is used to make payments of principal and interest owing on the bonds. Revenue bonds generally do not permit the bondholders to compel taxation or legislative appropriation of funds not pledged for the purpose of servicing the debt obligations of these municipal securities.[744] Consequently, the creditworthiness of revenue bonds depends on the success of the project being financed, whereas the creditworthiness of general obligation bonds ultimately depends on the taxing authority of the issuer. Therefore, general obligation bonds tend to have lower rates of default than other types of municipal securities.[745] In order to limit the use of municipal securities in the Rule 18a-4 Customer Reserve Account to the most creditworthy instruments,[746] the proposed definition of

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743 See Municipal Securities Report at 7.

744 Id.

745 See, e.g., Moody's Investor Services ("Moody's"), Special Comment: U.S. Municipal Bonds Defaults and Recoveries, 1970-2011, at 1 (Mar. 7, 2012), available at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_140114. See also Municipal Securities Report, at 7 (noting reports indicate that a majority of defaults in the municipal securities market are in conduit revenue bonds issued for nongovernmental purposes, such as multi-family housing, healthcare (hospitals and nursing homes), and industrial development bonds (for economic development and manufacturing purposes).

746 See Fitch Ratings ("Fitch"), Default Risk and Recovery Rates on U.S. Municipal Bonds, note 116, at 1 (Jan. 9, 2007), available at http://www.cdfa.net/cdfa/cdfaweb.nsf/ordredirect.html?open&id=fitchdefaultreport.html Fitch is not aware of any state or local municipality of size that has experienced a permanent or extended default on its general obligation bonds since the Great Depression, so that in one of its studies, Fitch assumed a 100% recovery rate on general obligation bonds). Id. See also Moody's, Special Comment: Moody's US Municipal Bond Rating Scale, 11 (Nov. 2002), available at http://www.moodys.com/sites/products/DefaultResearch/2001700000407258.pdf. Similarly, Moody's acknowledged the "anticipated near 100% recovery rate on any defaulted general obligation bond," because

qualified security would limit the use of municipal securities to general obligation bonds.

The second proposed condition for the use of municipal securities is that they must be part of an initial offering of $500 million or greater. The size of the initial offering is an indication of the size of the market for a particular issuer's municipal securities. Additionally, the secondary market for a municipal security is generally smaller than for the initial offering.[747] The $500 million threshold is designed to be large enough to ensure that the market for a particular issuer's securities is large enough that the securities can be liquidated quickly and at their current market price in order to raise cash to return to an SBSD's customers.

The third proposed condition for the use of municipal securities is that they must be issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year-end.[748] Prices for municipal securities issued by issuers that have published relatively current information about their financial condition may tend to be more transparent than prices for municipal securities issued by issuers for which such financial information is not available, because investors and analysts have more current information to assess the creditworthiness of the issuer and to inform pricing decisions.[749]

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there have been no defaults among Moody's-rated issuers of general obligation bonds since at least 1970. Id.

747 While almost all municipal bonds trade in the first month following the initial offering, only 15% trade in the second month, and even fewer trade in subsequent months. Municipal Securities Report at 113-14 (citing Richard C. Green, Burton Hollifield and Normal Schürhoff, Financial Intermediation and the Costs of Trading in an Opaque Market, 20 Rev. Fin. Stud. 275, 282 (2007)).

748 See, e.g., Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment Nos. 1 and 2 Thereto, Relating to Additional Voluntary Submissions by Issuers to the MSRB's Electronic Municipal Market Access System ("EMMA®"), Exchange Act Release No. 62183 (May 26, 2010), 75 FR 30876 (June 2, 2010) ("MSRB Rule Filing"). The MSRB stated that, "issuers that seek to make their financial information available under the voluntary annual filing undertaking also would be bringing the timing of their disclosures into closer conformity with the timeframes that investors in the registered securities market have come to rely upon." Id. at 30882.

749 See MSRB Notice 2010-15 (June 2, 2010), available at http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2010/2010-15.aspx?n=1 (requesting voluntary submissions of audited financial statements within 120 calendar days of the fiscal year-end, or as a transitional alternative available through December 31, 2013, within 150 calendar days of the fiscal year-end). Timely financial reporting

As discussed above, an SBSD would be required to add up credit items and debit items pursuant to the formula in Exhibit A to proposed new Rule 18a-1. If, under the formula, the credit items exceed the debit items, the SBSD would be required to maintain cash and/or qualified securities in that net amount in the Rule 18a-4 Customer Reserve Account. Paragraph (c)(1) of proposed new Rule 18a-4 would require an SBSD to take certain deductions for purposes of this requirement.[750] The amount of cash and/or qualified securities in the Rule 18a-4 Customer Reserve Account would need to equal or exceed the amount required pursuant to the formula in Exhibit A to proposed new Rule 18a-1after applying the deductions.

First, the SBSD would need to deduct the percentage of the value of municipal securities specified in paragraph (c)(2)(vi) of Rule 15c3-1.[751] Paragraph (c)(2)(vi) of Rule 15c3-1 prescribes the standardized haircuts a broker-dealer must apply to municipal securities when computing net capital. For the purposes of proposed new Rule 18a-4, the SBSD would need to apply the standardized haircuts to municipal securities held in the Rule 18a-4 Customer Reserve Account even if the firm is approved to use VaR models for purposes of computing its net capital under Appendix E to Rule 15c3-1, as proposed to be amended, or proposed new Rule 18a-1. The purpose of these deductions would be to account for potential market losses that may be incurred when municipal securities held in a Rule 18a-4 Customer Reserve Account are liquidated to return funds to security-based swap customers.

Second, the SBSD would need to deduct the aggregate value of the municipal securities of a single issuer to the extent the value exceeds 2% of the amount required to be maintained in

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"is critical to the functioning of an efficient trading market," especially since bond ratings are only updated when a significant change is about to occur, and credit reports represent a costly alternative. Municipal Securities Report at 74 (citing Jeff L. Payne and Kevin L. Jensen, An Examination of Municipal Audit Delay, J. Acc. & Pub. Pol'y, Vol. 21, Issue 1, 3 (2002)).

750 See paragraph (c)(1) of proposed new Rule 18a-4.

751 See 17 CFR 240.15c3-1(c)(2)(vi)(B).

the Rule 18a-4 Customer Reserve Account. The Commission preliminarily believes that this deduction would serve as a reasonable benchmark designed to avoid the potential that the SBSD might use customer funds to establish a concentrated position in municipal securities of a single issuer. A concentrated position could be more difficult to liquidate at current market values.

Third, the SBSD would need to deduct the aggregate value of all municipal securities to the extent the amount of the securities exceeds 10% of the amount required to be maintained in the Rule 18a-4 Customer Reserve Account. The Commission preliminarily believes that this deduction would serve as a reasonable benchmark designed to limit the amount of customer funds an SBSD could invest in municipal securities.[752] As noted above, the segregation provisions are designed to prevent an SBSD from using customer property for proprietary business purposes such as paying expenses. The purpose of the deposits into the Rule 18a-4 Customer Reserve Account is to create a reserve to protect the funds of security-based swap customers. The deposits are not intended as a means for the SBSD to earn investment returns by, for example, establishing positions in higher yielding municipal securities. The 10% threshold is designed to limit the ability of the SBSD to use the Rule 18a-4 Customer Reserve Account deposit requirement to invest in municipal securities, for the purpose of obtaining higher yields than U.S. government securities.

Fourth, the SBSD would be required to deduct the amount of funds held in a Rule 18a-4 Customer Reserve Account at a single bank to the extent the amount exceeds 10% of the equity capital of the bank as reported by the bank in its most recent Consolidated Report of Condition

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[752] Compare to Rule 15c3-1(c)(2)(vi)(M)(1) (imposing undue concentration charges on certain securities in the proprietary account of a broker-dealer whose market value exceeds more than 10% of the "net capital" of a broker-dealer before application of haircuts).

and Income ("Call Report").[753] This provision is consistent with a pending proposed amendment to Rule 15c3-3.[754] As the Commission stated when proposing the amendment to Rule 15c3-3:

> Broker-dealers must deposit cash or ''qualified securities'' into the customer reserve account maintained at a ''bank'' under Rule 15c3-3(e). Rule 15c3-3(f) further requires the broker-dealer to obtain a written contract from the bank in which the bank agrees not to re-lend or hypothecate securities deposited into the reserve account. Consequently, the securities should be readily available to the broker-dealer. Cash deposits, however, are fungible with other deposits carried by the bank and may be freely used in the course of the bank's commercial lending activities. Therefore, to the extent a broker-dealer deposits cash in a reserve bank account, there is a risk the cash could be lost or inaccessible for a period if the bank experiences financial difficulties. This could adversely impact the broker-dealer and its customers if the balance of the reserve deposit is concentrated at one bank in the form of cash.[755]

The deduction in proposed new Rule 18a-4 is designed to address the same risk to SBSDs that the Commission identified with respect to concentrating in a single bank cash deposits in a customer reserve account maintained under Rule 15c3-1.

Paragraph (c)(2) of proposed new Rule 18a-4 would provide that it is unlawful for an SBSD to accept or use credits identified in the items of the formula set forth in Exhibit A to proposed new Rule 18a-4 except to establish debits for the specified purposes in the items of the formula.[756] This provision would prohibit the SBSD from using customer cash and cash realized

753 With the passage of the Dodd-Frank Act, the supervision of savings associations was transferred from the Office of Thrift Supervision to the OCC for federal savings associations and to the FDIC for state savings associations on the "transfer date," which is defined as one year after enactment of the Dodd-Frank Act, subject to an additional six month extension. See section Pub. L. No. 111-203 §§ 300-378. See also List of OTS Regulations to be Enforced by the OCC and the FDIC Pursuant to the Dodd-Frank Act, OCC, FDIC, 76 FR 39246 (July 6, 2011). Supervision of savings and loan holding companies and their subsidiaries (other than depository institutions) was transferred from the OTS to the Federal Reserve. Therefore, in February 2011, the OTS, the OCC, and the FDIC proposed to require, "savings associations currently filing the Thrift Financial Report to convert to filing the Consolidated Reports of Condition and Income or Call Reports beginning with the reporting period ending on March 31, 2012." Proposed Agency Information Collection Activities; Comment Request, 76 FR 7082, 7082 (Feb. 8, 2011).

754 Amendments to Financial Responsibility Rules for Broker-Dealers, 72 FR at 12864.

755 Id.

756 See paragraph (c)(2) of proposed new Rule 18a-4. This provision is modeled on paragraph (e)(2) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(e)(2), with paragraph (c)(2) of proposed new Rule 18a-4.

from the use of customer securities for purposes other than those identified in the debit items in Exhibit A to proposed new Rule 18a-4. Thus, the SBSD would be prohibited from using customer cash to, for example, pay expenses.

Paragraph (c)(3) of proposed new Rule 18a-4 would provide that the computations necessary to determine the amount required to be maintained in the Rule 18a-4 Customer Reserve Account must be made daily as of the close of the previous business day and any deposit required to be made into the account must be made on the next business day following the computation no later than one hour after the opening of the bank that maintains the account.[757] Paragraph (c)(3) also would provide that the SBSD may make a withdrawal from the Rule 18a-4 Customer Reserve Account only if the amount remaining in the account after the withdrawal is equal to or exceeds the amount required to be maintained in the account.[758]

Proposed new Rule 18a-4 would require a daily computation as opposed to the weekly computation that is required by Rule 15c3-3. The margin requirements of clearing agencies and other SBSDs for security-based swaps are expected generally to be determined on a daily basis, which will require SBSDs to deliver collateral to, and receive the return of collateral from, clearing agencies and other SBSDs on a daily basis.[759] If the Rule 18a-4 Customer Reserve Account computation were performed on a weekly basis, the SBSD might need to fund margin requirements relating to customer security-based swaps using its own funds for up to a week because the customer cash necessary to meet the requirement is "locked up" in the Rule 18a-4

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757 See paragraph (c)(3) of proposed new Rule 18a-4.

758 Id.

759 As discussed above in section II.B.2.b.i. of this release, proposed new Rule 18a-3 would require a nonbank SBSD to calculate the equity in the account of each counterparty on a daily basis and to collect collateral needed to collateralize an account equity requirement on the next business day. See paragraphs (c)(1)(i)-(ii) of proposed new Rule 18a-3.

Customer Reserve Account and cannot be withdrawn for a number of days, which could cause liquidity strains on the SBSD.

Finally, paragraph (c)(4) of proposed new Rule 18a-4 would require an SBSD to promptly deposit funds or qualified securities into a Rule 18a-4 Customer Reserve Account of the SBSD if the amount of funds and/or qualified securities held in one or more Rule 18a-4 Customer Reserve Accounts falls below the amount required to be maintained pursuant to the rule.[760] This proposal is designed to require an SBSD to use its own resources to fund the deposit requirement if there is a shortfall in the amount of cash or qualified securities maintained in its Rule 18a-4 Customer Reserve Account.

Request for Comment

The Commission generally requests comment on the requirements for the Rule 18a-4 Customer Reserve Account in proposed new Rule 18a-4. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are Rule 18a-4 Customer Reserve Account requirements modeled on Rule 15c3-3 appropriate for security-based swaps? If not, explain why not.
2. Is the proposed definition of special account for the exclusive benefit of security-based swap customers appropriate? If not, explain why not and suggest modifications to the definition.
3. Are the proposed credit and debit items in Exhibit A to proposed new Rule 18a-4 appropriate? If not, explain why not. Are there alternative or additional credit and debit items that should be included in the formula? If so, describe them and explain why they

[760] See paragraph (c)(4) of proposed new Rule 18a-4.

should be included in the formula.

4. How would the formula computation for a broker-dealer SBSD differ from the formula computation for a stand-alone SBSD? For example, the debit items relating to financing securities transactions would not apply to stand-alone SBSDs as financing securities transactions would need to be conducted in a broker-dealer. Consequently, should there be a separate Exhibit A formula for stand-alone SBSDs?
5. Are the two additional debit items in Exhibit A to proposed new Rule 18a-4 relating to margin collateral required and on deposit at clearing agencies, DCOs, and other SBSDs appropriate? If not, explain why not.
6. Note G to Exhibit A to proposed new Rule 18a-4 is analogous to Note G to Exhibit A to Rule 15c3-3. Note G to Exhibit A to Rule 15c3-3 prescribes (and Note G to Exhibit A to proposed new Rule 18a-1 would prescribe) the conditions for when a clearing agency or DCO can qualify for purposes of including debits in the reserve formula under Item 14 (margin related to security futures products). Should these conditions apply to when a clearing agency would qualify for purposes of including debits in the Rule 18a-4 Customer Reserve Account formula under Item 15? If so, explain why. If not, explain why not. For example, could the Note G conditions, if applied to Item 15, be used instead of the proposed definition of <u>qualified clearing agency account</u> in proposed new Rule 18a-4? Would the Note G conditions be a workable alternative to the proposed definition? Would the Note G conditions achieve the same customer protection objectives as the proposed definition?
7. Is the proposed definition of <u>qualified security</u> appropriate? If not, explain why not and suggest modifications to the definition. For example, should additional types of

securities be included in the definition? If so, identify the types of securities and explain why they should be included in the definition and how their inclusion would meet the objective of segregation that customer cash is not used to make proprietary investments.

8. Is the proposed condition to the definition of qualified security that municipal securities be general obligation bonds in the definition appropriate? If not, explain why not. Identify other types of municipal securities that should be included and explain how their inclusion would be consistent with the objective that only the most highly liquid securities (i.e., securities capable of being liquidated at market value even during times of market stress) be permitted to meet the Rule 18a-4 Customer Reserve Account deposit requirement.

9. It is expected that the proposed condition that municipal securities be part of an initial offering of \$500 million or greater in the definition of qualified security would limit qualifying securities to a very small percentage of general obligation municipal security issuances.[761] Would the \$500 million threshold be appropriate? If not, explain why not. For example, should this threshold be a greater amount (e.g., \$750 million, \$1 billion, or some other amount) or a lesser amount (e.g., \$250 million, \$100 million, or some other amount)? If so, indicate the recommended threshold and explain why it would be preferable.

10. Is the proposed condition that municipal securities must be issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year-end in the definition of qualified security appropriate? If not, explain why not.

11. The MSRB Rule Filing contemplates those issuers who are engaged in the voluntary

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761 Data source: Mergent's Municipal Bond Securities Database.

annual filing undertaking will be able to provide the information to the MSRB's Electronic Muni Market Access System within 150 calendar days after the end of the applicable fiscal year prior to January 1, 2014. The 150 calendar day time frame is an interim measure and would no longer be available after January 1, 2014. Should municipal securities that otherwise meet the definition of qualified securities be permitted if the issuer submits financial information within 150 calendar days after the end of the applicable fiscal year during this transitional period that would end on January 1, 2014?

12. Is the proposed deduction for municipal securities held in a Rule 18a-4 Customer Reserve Account equal to the percentage specified in paragraph (c)(2)(vi) of Rule 15c3-1 appropriate? If not, explain why not.
13. Is the proposed deduction for municipal securities of a single issuer held in a Rule 18a-4 Customer Reserve Account in excess of 2% of the amount required to be maintained in the account appropriate? If not, explain why not. For example, should the threshold be greater (e.g., 3%, 5%, 7%, 10%, or some other amount) or lesser (e.g., 1.5%, 1%, 0.5%, or some other amount)? If so, identify the recommended threshold and explain why it would be preferable.
14. Is the proposed deduction for municipal securities held in a Rule 18a-4 Customer Reserve Account in excess of 10% of the amount required to be maintained in the account appropriate? If not, explain why not. For example, should the threshold be greater (e.g., 15%, 20%, 25%, 30%, or some other amount) or lesser (e.g., 7%, 5%, 3%, or some other amount)? If so, identify the recommended threshold and explain why it would be preferable.
15. Is the proposed deduction for the amount that funds held in a Rule 18a-4 Customer

Reserve Account at a single bank exceed 10% of the equity capital of the bank as reported by the bank in its most recent Call Report appropriate? If not, explain why not. For example, should the threshold be greater (e.g., 15%, 20%, 25%, 30%, or some other amount) or lesser (e.g., 7%, 5%, 3%, or some other amount)? If so, identify the recommended threshold and explain why it would be preferable.

16. Is it appropriate to require that the computations to determine the amount required to be maintained in the Rule 18a-4 Customer Reserve Account must be made daily as of the close of the previous business day and any deposit required to be made into the account must be made on the next business day following the computation? If not, explain why not. For example, should the computations be required on a weekly basis consistent with Rule 15c3-3? If so, explain why.

17. Are there any customer reserve account provisions in Rule 15c3-1 that are not being incorporated in proposed new Rule 18a-4 that should be included in the rule? If so, identify them and explain why they should be incorporated into proposed new Rule 18a-4.

18. More generally, are there any provisions in Rule 15c3-1 that are not being incorporated in proposed new Rule 18a-4 that should be included in the rule? If so, identify them and explain why they should be incorporated into proposed new Rule 18a-4.

c. Special Provisions for Non-cleared Security-Based Swap Counterparties

Paragraph (d) of proposed new Rule 18a-4 would require an SBSD and an MSBSP to provide the notice required by section 3E(f)(1)(A) of the Exchange Act prior to the execution of the first non-cleared security-based swap with the counterparty.[762] Paragraph (d) also would

[762] See 15 U.S.C. 78c-5(f)(1)(A); paragraph (d)(1) of proposed new Rule 18a-4.

require an SBSD to obtain subordination agreements from counterparties that opt out of the omnibus segregation requirements in proposed new Rule 18a-4 because they either elect individual segregation pursuant to the self-executing provisions of section 3E(f) of the Exchange Act[763] or agree that the SBSD need not segregate their assets at all.[764]

Notice Requirement

The provisions in section 3E(f) of the Exchange Act allow a program by which a counterparty to non-cleared security-based swaps with an SBSD or an MSBSP can choose individual segregation.[765] These provisions provide a framework of baseline requirements that can be supplemented by commercial arrangements between counterparties and SBSDs and MSBSPs. Proposed new Rule 18a-4 would augment these provisions by prescribing when the notice specified in section 3E(f)(1)(A) must be provided to the counterparty by the SBSD or MSBSP. Section 3E(f)(1)(A) provides that an SBSD and an MSBSP shall be required to notify the counterparty at the "beginning" of a non-cleared security-based swap transaction about the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty.[766] To provide greater clarity as to the meaning of "beginning" as used in the statute, paragraph (d)(1) of proposed new Rule 18a-4 would require an SBSD or MSBSP to provide the notice in writing to a counterparty prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the effective date of the rule.[767] Consequently, the notice would need to be given in writing to the counterparty prior to the execution of a transaction and, therefore, before the counterparty is

763 See 15 U.S.C. 78c-5(f)(1)-(3).

764 See 15 U.S.C. 78c-5(f)(4).

765 See 15 U.S.C. 78c-5(f)(1)-(3).

766 See 15 U.S.C. 78c-5(f)(4).

767 See paragraph (c)(1) of proposed new Rule 18a-4.

required to deliver margin collateral to the SBSD or MSBSP. The notice, therefore, would give the counterparty an opportunity to determine whether to elect individual segregation, waive segregation, or, by not electing individual segregation or waiving segregation, to have the collateral segregated pursuant to the omnibus segregation provisions of proposed new Rule 18a-4.

Subordination Agreements

Paragraph (d)(2) of proposed new Rule 18a-4 would require an SBSD to obtain agreements from counterparties that either elect individual segregation or waive segregation altogether that such counterparties subordinate all of their claims against the SBSD to the claims of security-based swap customers.[768] By entering into subordination agreements, these counterparties would not meet the definition of security-based swap customer in proposed new Rule 18a-4.[769] They also would not be entitled to share ratably with security-based swap customers in the fund of customer property held by the SBSD if it is liquidated. This provision would be consistent with text in Rule 15c3-3 concerning the exclusion of persons whose interests are subordinated from the definition of "customer."[770]

As discussed in section II.C.1. of this release, segregation requirements are designed to identify customer property as distinct from the proprietary assets of the firm and to protect the customer property by, for example, preventing the firm from using it to make proprietary investments. The goal of segregation is to facilitate the prompt return of customer property to customers either before or during a liquidation proceeding if the firm fails. However, if a

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768 See paragraph (d)(2) of proposed new Rule 18a-4.

769 See paragraph (a)(6) of proposed new Rule 18a-4.

770 See paragraph (a)(1) of Rule 15c3-3 defining "customer" for purposes of Rule 15c3-3 to specifically exclude "any other person to the extent that person has a claim for property or funds which by contract, agreement or understanding, or by operation of law, is part of the capital of the broker-dealer or is subordinated to the claims of creditors of the broker-dealer. 17 CFR 240.15c3-3(a)(1).

counterparty's property is held by a third-party custodian because the counterparty elects individual segregation or if the counterparty waives segregation, there is no need to isolate the counterparty's property since it is with the third-party custodian in the former case or the counterparty has agreed that the SBSD can use it for proprietary purposes in the latter case. The subordination provisions in proposed new Rule 18a-4 are designed to clarify the rights of counterparties that have their property held by the SBSD and elect segregation and the rights of counterparties that either elect to have their property held by a third-party custodian or waive segregation.

An SBSD would need to obtain a conditional subordination agreement from a counterparty that elects individual segregation.[771] The agreement would be conditional because the subordination agreement required under the proposed rule would not be effective in a case where the counterparty's assets are included in the bankruptcy estate of the SBSD. Specifically, the proposed rule would provide that the counterparty would need to subordinate claims but only to the extent that funds or other property provided by the counterparty to the independent third-party custodian are not treated as customer property under the stockbroker liquidation provisions in a liquidation of the security-based swap dealer.[772] Counterparties that choose individual segregation are opting to have their funds and other property held in a manner that makes the counterparty's property bankruptcy remote from the SBSD. If the arrangement is effective, the counterparties should not have any customer claims to cash, securities, or money market instruments used to margin their non-cleared security-based swap transactions in a liquidation of the SBSD, as their property will be held by the independent third party custodian. However, because there is a possibility that an individual segregation arrangement would not be effective,

[771] See paragraph (d)(2)(i) of proposed new Rule 18a-4.

[772] Id.

the subordination agreement of a counterparty that chooses individual segregation would be conditioned on the funds and other property of the counterparty not being included in the bankruptcy estate of the SBSD. If a counterparty elects individual segregation but the election is not effective in keeping the counterparty's assets bankruptcy remote, then the counterparty should be treated as a security-based swap customer with a pro rata priority claim to customer property.

An SBSD also would need to obtain an unconditional subordination agreement from a counterparty that waives segregation altogether.[773] By opting out of segregation, the counterparty agrees that cash, securities, and money market instruments delivered to the SBSD can be used by the SBSD for proprietary purposes and need not be isolated from the proprietary assets of the SBSD. Therefore, these counterparties are foregoing the protections of segregation, which include the right to share ratably with other customers in customer property held by the SBSD. If these counterparties were deemed security-based swap customers, they could have a pro rata priority claim on customer property. This result could disadvantage the security-based swap customers that did not waive segregation by diminishing the amount of customer property available to be distributed to customers.

Request for Comment

The Commission generally requests comment on the special provisions for non-cleared security-based swaps in proposed new Rule 18a-4. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is the requirement to have notice be given in writing prior to the execution of the first

773 See paragraph (d)(2)(ii) of proposed new Rule 18a-4.

non-cleared security-based swap transaction with the counterparty occurring after the effective date of the rule appropriate? If not, explain why not. Should the notice be required on a periodic basis such as monthly or annually? If so, explain why. If not, explain why not. Should the notice be required before every transaction? If so, explain why. If not, explain why not.

2. Describe the current practices and arrangements for individual segregation. For example, are these arrangements based on tri-party agreements between the SBSD, counterparty, and independent third-party custodian? If so, describe the terms of the these third-party agreements. Under these agreements, how would the SBSD perfect its security interest in the funds and other property held by the third-party custodian? What terms would the counterparty require that are designed to ensure that funds or property held by the independent third-party custodian at the time of a liquidation proceeding of the SBSD are not included in the bankruptcy estate of the SBSD?

3. Is it appropriate to require counterparties electing individual segregation to subordinate their claims to security-based swap customers? If not, explain why not and describe other measures that could be taken to ensure that security-based swap customers whose cash, securities, and money market instruments are subject to the omnibus segregation requirements have a first priority claim to these assets over counterparties whose funds and other property are individually segregated at a third party custodian.

4. Is it appropriate to require counterparties who waive all right to segregation to subordinate their claims to security-based swap customers? If not, explain why not and describe other measures that could be taken to ensure that security-based swap customers whose cash, securities, and money market instruments are subject to the omnibus

segregation requirements have a first priority claim to these assets over counterparties who waive all right to segregation.

III. GENERAL REQUEST FOR COMMENT

In responding to the specific requests for comment above, interested persons are encouraged to provide supporting data and analysis and, when appropriate, suggest modifications to proposed rule text. Responses that are supported by data and analysis provide great assistance to the Commission in considering the practicality and effectiveness of proposed new requirements as well as weighing the benefits and costs of proposed requirements. In addition, commenters are encouraged to identify in their responses a specific request for comment by indicating the section number of the release.

The Commission also seeks comment on the proposals as a whole. In this regard, the Commission seeks comment, including empirical data in support of comments, on the following:

1. Are there financial responsibility programs other than the broker-dealer financial responsibility program that could serve as a better model for establishing financial responsibility requirements for SBSDs and MSBSPs? If so, identify the program and explain how it would be a better model for implementing the provisions of the Dodd-Frank Act mandating capital and margin requirements for nonbank SBSDs and nonbank MSBSPs.
2. Should any of the proposed quantitative requirements (e.g., minimum capital thresholds, margin risk factor, standardized haircuts) be modified? If so, how? Are there new quantitative requirements that should be used? What would be the financial or other consequences for individual firms and the financial markets of such modified or new quantitative requirements and how would such consequences differ from the proposed

requirements? Please provide detailed data regarding such consequences and describe in detail any econometric or other mathematical models, or economic analyses of data, that would be relevant for evaluating or modifying any quantitative requirements.

3. How would the proposals integrate with provisions in other titles and subtitles of the Dodd-Frank Act and any regulations or proposed regulations under those other titles and subtitles?

4. How would the proposals integrate with other proposals applicable to SBSDs or MSBSPs in the Exchange Act and any applicable regulations adopted under authority in the Exchange Act?

5. As discussed throughout this release, many of the proposed amendments are based on dollar amounts that are prescribed in existing requirements. Should any of these proposed dollar amounts be adjusted to account for inflation?

6. What should the implementation timeframe be for the proposed amendments and new rules? For example, should the compliance date be 90, 120, 150, 180, or some other number of days after publication? Should the proposed requirements have different time frames before their compliance dates are triggered? For example, would it take longer to come into compliance with certain of these proposals than others? If so, rank the requirements in terms of the length of time it would take to come into compliance with them and propose a schedule of compliance dates.

IV. PAPERWORK REDUCTION ACT

Certain provisions of the proposed rule amendments and proposed new rules would contain a new "collection of information" within the meaning of the Paperwork Reduction Act of

1995 ("PRA").[774] The Commission is submitting the proposed rule amendments and proposed new rules to the Office of Management and Budget ("OMB") for review in accordance with the PRA. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The titles for the collections of information are:

(1) Rule 18a-1 and related appendices, Net capital requirements for security-based swap dealers for which there is not a prudential regulator (a proposed new collection of information);

(2) Rule 18a-2, Capital requirements for major security-based swap participants for which there is not a prudential regulator (a proposed new collection of information);

(3) Rule 18a-3, Non-cleared security-based swap margin requirements for security-based swap dealers and major security-based swap participants for which there is not a prudential regulator (a proposed new collection of information);

(4) Rule 18a-4, Segregation requirements for security-based swap dealers and major security-based swap participants (a proposed new collection of information); and

(5) Rule 15c3-1 Net capital requirements for brokers or dealers (OMB Control Number 3235-0200).

The burden estimates contained in this section do not include any other possible costs or economic effects beyond the burdens required to be calculated for PRA purposes.

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774 44 U.S.C. 3501 et seq.; 5 CFR 1320.11.

A. SUMMARY OF COLLECTIONS OF INFORMATION UNDER THE PROPOSED RULES AND RULE AMENDMENTS

1. Proposed Rule 18a-1 and Amendments to Rule 15c3-1

Section 764 of the Dodd-Frank Act added section 15F to the Exchange Act.[775] Section 15F(e)(1)(B) of the Exchange Act provides that the Commission shall prescribe capital and margin requirements for nonbank SBSDs and nonbank MSBSPs. Proposed new Rule 18a-1[776] would establish minimum capital requirements for stand-alone SBSDs and the amendments to Rule 15c3-1[777] would augment the current capital requirements for broker-dealers to address broker-dealers that register as SBSDs and to enhance the provisions applicable to ANC broker-dealers (all of which the Commission preliminarily estimates would register as SBSDs). The proposed new rule and amendments would establish a number of new collection of information requirements.

First, under proposed Rule 18a-1, a stand-alone SBSD would need to apply to the Commission to be authorized to use internal models to compute net capital.[778] As part of the application process, a stand-alone SBSD would be required to provide the Commission staff with, among other things: (1) a comprehensive description of the firm's internal risk management control system; (2) a description of the VaR models the firm will use to price positions and compute deductions for market risk; (3) a description of the firm's internal risk management controls over the VaR models, including a description of each category of person who may input data into the models; and (4) a description of the back-testing procedures that that

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775 See Pub. L. 111-203 § 764; 15 U.S.C. 78o-10.

776 See proposed new Rule 18a-1. See also section II.A. of this release.

777 See proposed amendments to Rule 15c3-1. See also section II.A. of this release.

778 See paragraphs (a)(2) and (d) of proposed new Rule 18a-1. This collection of information requirement already exists in Rule 15c3-1 and applies to broker-dealers seeking to become ANC broker-dealers.

firm will use to review the accuracy of the VaR models.[779] In addition, under proposed Rule 18a-1, a stand-alone SBSD authorized to use internal models would review and update the models it uses to compute market and credit risk, as well as backtest the models.

Second, under proposed Rule 18a-1 and amendments to Rule 15c3-1, nonbank SBSDs that are approved to use models to compute deductions for market and credit risk under Rule 18a-1 and ANC broker-dealers would be required to perform a liquidity stress test at least monthly and, based on the results of that test, maintain liquidity reserves to address funding needs.[780] The result of the test must be provided within 10 business days to senior management that has the responsibility to oversee risk management of the nonbank SBSD or ANC broker-dealer. The assumptions underlying the liquidity stress test must be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the nonbank SBSD and at least annually by senior management of the nonbank SBSD.[781] In addition, if such a nonbank SBSD or ANC broker-dealer is part of a consolidated entity using liquidity stress tests, the nonbank SBSD or ANC broker-dealer would need to justify and document any differences in the assumptions used in their liquidity stress tests from those used in the liquidity stress tests of the consolidated entity.[782] Furthermore, the nonbank SBSDs and ANC broker-dealers would be required to establish a written contingency funding plan.[783] The plan would need to address the policies and roles and responsibilities of relevant personnel for meeting the liquidity needs of the

779 See paragraph (d) of proposed new Rule 18a-1.

780 See proposed new paragraph (f) to Rule 15c3-1; paragraph (f) of proposed new Rule 18a-1.

781 See proposed new paragraph (f)(1) to Rule 15c3-1; paragraph (f)(1) of proposed new Rule 18a-1.

782 See proposed new paragraph (f)(2) of Rule 15c3-1; paragraph (f)(2) of proposed new Rule 18a-1.

783 See proposed new paragraph (f)(4) of Rule 15c3-1; paragraph (f)(3) of proposed new Rule 18a-1.

firm and communications with the public and other market participants during a liquidity stress event.[784]

Third, nonbank SBSDs, including broker-dealer SBSDs, would be required to comply with certain requirements of Rule 15c3-4.[785] Rule 15c3-4 requires OTC derivatives dealers and firms subject to its provisions, to establish, document, and maintain a system of internal risk management controls to assist the firm in managing the risks associated with business activities, including market, credit, leverage, liquidity, legal, and operational risks.[786]

Fourth, under paragraph (c)(2)(vi)(O)(1)(iii) of Rule 15c3-1 and paragraph (c)(1)(vi)(A)(3)(i) of proposed new Rule 18a-1, broker-dealers, broker-dealers registered as SBSDs, and stand-alone SBSDs not using models would be required to use an industry sector classification system that is documented and reasonable in terms of grouping types of companies with similar business activities and risk characteristics, used for credit default swap reference names for purposes of calculating "haircuts" on security-based swaps under the applicable net capital rules.[787] These firms could use a classification system of a third-party or develop their own classification system, subject to these limitations, and would need to be able to demonstrate the reasonableness of the system they use.[788]

Fifth, under paragraph (i) of proposed Rule 18a-1, stand-alone SBSDs would be required to provide the Commission with certain written notices with respect to equity withdrawals.[789]

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784 Id.

785 See 17 CFR 240.18a-1(g); 15c3-1(a)(10)(ii). See also 17 CFR 240.15c3-4.

786 Id.

787 See paragraph (c)(2)(vi)(O)(1)(iii) of Rule 15c3-1; paragraph (c)(1)(vi)(A)(3)(i) of proposed new Rule 18a-1.

788 See proposed new paragraph (c)(2)(vi)(O)(1)(iii)(A) of Rule 15c3-1; paragraph (c)(1)(vii)(A)(3)(i) of proposed new Rule 18a-1.

789 See paragraph (i) of proposed new Rule 18a-1.

Finally, under paragraph (c)(5) of Appendix D to proposed Rule 18a-1, a stand-alone SBSD would be required to file with the Commission two copies of any proposed subordinated loan agreement (including nonconforming subordinated loan agreements) at least 30 days prior to the proposed execution date of the agreement.[790] The rule would also require an SBSD to file with the Commission a statement setting forth the name and address of the lender, the business relationship of the lender to the SBSD, and whether the SBSD carried an account for the lender effecting transactions in security-based swaps at or about the time the proposed agreement was filed.[791]

2. Proposed Rule 18a-2

Proposed new Rule 18a-2 would establish capital requirements for nonbank MSBSPs.[792] In particular, a nonbank MSBSP would be required at all times to have and maintain positive tangible net worth.[793] The proposed definition of tangible net worth would allow nonbank MSBSPs to include as regulatory capital assets that would be deducted from net worth under Rule 15c3-1, such as property, plants, equipment, and unsecured receivables. At the same time, it would require the deduction of goodwill and other intangible assets.[794]

Because MSBSPs, by definition, will be entities that engage in a substantial security-based swap business, the Commission is proposing that they be required to comply with Rule 15c3-4,[795] which requires OTC derivatives dealers and other firms subject to its provisions to

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790 See paragraph (c)(5) of proposed new Rule 18a-1d.

791 Id.

792 See proposed new Rule 18a-2. See also section II.A.3 of this release.

793 See paragraph (a) of proposed new Rule 18a-2.

794 The proposed definition of tangible net worth under proposed new Rule 18a-2 is consistent with the CFTC's proposed definition of tangible net equity. See CFTC Capital Proposing Release, 76 FR at 27828 (Defining tangible net equity as "equity as determined under U.S. generally accepted accounting principles, and excludes goodwill and other intangible assets.").

795 See paragraph (c) of proposed new Rule 18a-2.

establish, document, and maintain a system of internal risk management controls to assist the firm in managing the risks associated with their business activities, including market, credit, leverage, liquidity, legal, and operational risks.[796]

3. Proposed Rule 18a-3

Proposed new Rule 18a-3 would establish minimum margin requirements for non-cleared security-based swap transactions entered into by nonbank SBSDs and nonbank MSBSPs.[797] Proposed Rule 18a-3 would prescribe the requirements for nonbank SBSDs or nonbank MSBSPs to collect or post collateral with regard to non-cleared security-based swap transactions. The provisions of proposed Rule 18a-3 contain a collection of information requirement for nonbank SBSDs. Specifically, paragraph (e) of proposed Rule 18a-3 would require a nonbank SBSD to monitor the risk of each account and establish, maintain, and document procedures and guidelines for monitoring the risk of accounts as part of the risk management control system required by Rule 15c3-4.[798] In addition, the rule would require a nonbank SBSD to review, in accordance with written procedures and at reasonable periodic intervals, its non-cleared security-based swap activities for consistency with the risk monitoring procedures and guidelines required by paragraph (e) of Rule 18a-3. The nonbank SBSD would also be required to determine whether information and data necessary to apply the risk monitoring procedures and guidelines required by paragraph (e) of Rule 18a-3 are accessible on a timely basis and whether information systems are available to adequately capture, monitor, analyze, and report relevant data and information. Finally, the rule would require that the risk monitoring procedures and guidelines must include, at a minimum, procedures and guidelines for:

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796 See 17 CFR 240.15c3-4.

797 See proposed new Rule 18a-3. See also section II.B. of this release for a more detailed description of the proposed rule.

798 See paragraph (e) to proposed new Rule 18a-3.

- Obtaining and reviewing account documentation and financial information necessary for assessing the amount of current and potential future exposure to a given counterparty permitted by the SBSD;

- Determining, approving, and periodically reviewing credit limits for each counterparty, and across all counterparties;

- Monitoring credit risk exposure to the SBSD from non-cleared security-based swaps, including the type, scope, and frequency of reporting to senior management;

- Using stress tests to monitor potential future exposure to a single counterparty and across all counterparties over a specified range of possible market movements over a specified time period;

- Managing the impact of credit exposure related to non-cleared security-based swaps on the SBSD's overall risk exposure;

- Determining the need to collect collateral from a particular counterparty, including whether that determination was based upon the creditworthiness of the counterparty and/or the risk of the specific non-cleared security-based swap contracts with the counterparty;

- Monitoring the credit exposure resulting from concentrated positions with a single counterparty and across all counterparties, and during periods of extreme volatility; and

- Maintaining sufficient equity in the account of each counterparty to protect against the largest individual potential future exposure of a non-cleared security-based swap carried in the account of the counterparty as measured by computing the largest maximum possible loss that could result from the exposure.

4. Proposed Rule 18a-4

Proposed new Rule 18a-4 would establish segregation requirements for cleared and non-cleared security-based swap transactions, which would apply to all types of SBSDs (i.e., they would apply to bank SBSDs, nonbank stand-alone SBSDs, and broker-dealer SBSDs), as well as notification requirements for SBSDs and MSBSPs.[799] The provisions of proposed Rule 18a-4

799 See proposed new Rule 18a-4. See also section II.C. of this release for a more detailed description of the proposal.

are modeled on Rule 15c3-3, the broker-dealer segregation rule.[800] Paragraph (a) of the proposed new rule would define key terms used in the rule.[801] Paragraph (b) would require an SBSD to promptly obtain and thereafter maintain physical possession or control of all excess securities collateral (a term defined in paragraph (a)) and specify certain locations where excess securities collateral could be held and deemed in the SBSD's control.[802] Paragraph (c) would require an SBSD to maintain a special account for the exclusive benefit of security-based swap customers and have on deposit in that account at all times an amount of cash and/or qualified securities (a term defined in paragraph (a)) determined through a computation using the formula in Exhibit A to proposed new Rule 18a-4.[803]

Paragraph (d) of proposed new Rule 18a-4 would contain provisions that are not modeled specifically on Rule 15c3-1. First, it would require an SBSD and an MSBSP to provide the notice required by section 3E(f)(1)(A) of the Exchange Act to a counterparty in writing prior to the execution of the first non-cleared security-based swap transaction with the counterparty.[804] Second, it would require the SBSD to obtain subordination agreements from counterparties that opt out of the segregation requirements in proposed new Rule 18a-4 because they either elect individual segregation pursuant to the self-executing provisions of section 3E(f) of the Exchange Act[805] or agree that the SBSD need not segregate their assets at all.[806]

Additionally, paragraph (a)(3) of proposed new Rule 18a-4 would define qualified clearing agency account to mean an account of an SBSD at a clearing agency established to hold

800 17 CFR 240.15c3-3.

801 Compare 17 CFR 240.15c3-3(a), with paragraph (a) of proposed new Rule 18a-4.

802 Compare 17 CFR 240.15c3-3(b)-(d), with paragraph (b) of proposed new Rule 18a-4.

803 Compare 17 CFR 240.15c3-3(e), with paragraph (c) of proposed new Rule 18a-4.

804 See 15 U.S.C. 78c-5(f)(1)(A); proposed paragraph (d)(1) of proposed new Rule 18a-4.

805 See 15 U.S.C. 78c-5(f)(1)-(3).

806 See 15 U.S.C. 78c-5(f)(4).

funds and other property in order to purchase, margin, guarantee, secure, adjust, or settle cleared security-based swaps of the SBSD's security-based swap customers that meets the following conditions (which would contain collection of information requirements):

- The account is designated "Special Clearing Account for the Exclusive Benefit of the Cleared Security-Based Swap Customers of [name of the SBSD]";[807]

- The clearing agency has acknowledged in a written notice provided to and retained by the SBSD that the funds and other property in the account are being held by the clearing agency for the exclusive benefit of the cleared security-based swap customers of the SBSD in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the SBSD with the clearing agency;[808] and

- The account is subject to a written contract between the SBSD and the clearing agency which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the clearing agency or any person claiming through the clearing agency, except a right, charge, security interest, lien, or claim resulting from a cleared security-based swap transaction effected in the account.[809]

Under paragraph (a)(4) of proposed new Rule 18a-4, a qualified SBSD account would be defined to mean an account at another SBSD registered with the Commission pursuant to section 15F of the Exchange Act that is not an affiliate of the SBSD and that meets conditions that are largely identical to the conditions for a qualified clearing agency account. Finally, paragraph (c)(1) of proposed new Rule 18a-4 would require an SBSD, among other things, to maintain a special account for the exclusive benefit of security-based swap customers separate from any

807 See paragraph (a)(3)(i) of proposed new Rule 18a-4. This provision is modeled on paragraph (e)(1) of Rule 15c3-3, which requires a broker-dealer to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers." Compare 17 CFR 240.15c3-3(e), with paragraph (a)(3)(i) of proposed new Rule 18a-4.

808 See paragraph (a)(3)(ii) of proposed new Rule 18a-4. This provision is modeled on paragraph (f) of Rule 15c3-3, which requires a broker-dealer to obtain a written notification from a bank where it maintains a customer reserve account. Compare 17 CFR 240.15c3-3(f), with paragraph (a)(3)(ii) of proposed new Rule 18a-4.

809 See paragraph (a)(3)(iii) of proposed new Rule 18a-4. This provision is modeled on paragraph (f) of Rule 15c3-3, which requires a broker-dealer to obtain a contract from a bank where it maintains a "Special Reserve Bank Account for the Exclusive Benefit of Customers." Compare 17 CFR 240.15c3-3(f), with paragraph (a)(3)(ii) of proposed new Rule 18a-4.

other bank account of the SBSD.[810] The term special account for the exclusive benefit of security-based swap customers would be defined under paragraph (a)(7) of proposed new Rule 18a-4 to mean an account at a bank that is not an affiliate of the SBSD and that meets conditions that are largely identical to the conditions for a qualified clearing agency account and qualified SBSD account.[811]

Paragraph (c)(1) of proposed new Rule 18a-4 would provide that the SBSD must at all times maintain in a Rule 18a-4 Customer Reserve Account, through deposits into the account, cash and/or qualified securities in amounts computed in accordance with the formula set forth in Exhibit A to Rule 18a-4.[812] The formula in Exhibit A to proposed new Rule 18a-4 is modeled on the formula in Exhibit A to Rule 15c3-3.[813] Paragraph (c)(3) of proposed new Rule 18a-4 would provide that the computations necessary to determine the amount required to be maintained in the special bank account must be made daily as of the close of the previous business day and any deposit required to be made into the account must be made on the next business day following the computation no later than 1 hour after the opening of the bank that maintains the account.[814]

B. PROPOSED USE OF INFORMATION

As discussed more fully above, the Commission and SROs, as applicable, would use the information collected under new Rules 18a-1, 18a-2, 18a-3 and 18a-4, as well as the amendments to Rule 15c3-1 to determine whether an SBSD, MSBSP, or ANC broker-dealer, as applicable, is in compliance with each applicable rule and to help fulfill their oversight

810 See paragraph (c) of proposed new Rule 18a-4. The provisions of paragraph (c) of proposed new Rule 18a-1 are modeled on paragraph (e) of Rule 15c3-3. Compare 17 CFR 240.15c3-3(e), with paragraph (c) of proposed new Rule 18a-4.

811 See paragraph (a)(7) of proposed new Rule 18a-4. See also Section II.C.1. of this release for a more detailed description of the proposed requirements.

812 See paragraph (c)(1) of proposed new Rule 18a-4; Exhibit A to proposed new Rule 18a-4.

813 See 17 CFR 240.15c3-3a.

814 See paragraph (c)(3) of proposed new rule 18a-4.

responsibilities. The collections of information would also help to ensure that SBSD, MSBSPs and broker-dealers are meeting their obligations under the proposed rules and rule amendments and have the required policies and procedures in place.

Proposed new Rules 18a-1 and 18a-2, as well as the proposed amendments to Rule 15c3-1 would be integral parts of the Commission's financial responsibility program for SBSDs and MSBSPs, and ANC broker-dealers, respectively. Proposed Rule 18a-1 and Rule 15c3-1 are designed to ensure that nonbank SBSDs and broker-dealers (including broker-dealer SBSDs), respectively, have sufficient liquidity to meet all unsubordinated obligations to customers and counterparties and, consequently, if the SBSD or broker-dealer fails, sufficient resources to wind-down in an orderly manner without the need for a formal proceeding. The collections of information in proposed new Rule 18a-1, Rule 18a-2 and the amendments to Rule 15c3-1 would facilitate the monitoring of the financial condition of nonbank SBSDs, nonbank MSBSPs and broker-dealers by the Commission.

Proposed new Rule 18a-3 would prescribe, among other things, requirements for nonbank SBSDs to collect collateral with regard to non-cleared security-based swap transactions. Under proposed Rule 18a-3, a nonbank SBSD would be required to establish and implement risk monitoring procedures with respect to counterparty accounts.[815] The purpose of the proposed rule is to limit risks to individual firms and systemic risk arising from non-cleared security-based swaps. The collections of information in proposed Rule 18a-3 would assist examiners in determining whether SBSDs are in compliance with requirements in the rule.

Proposed new Rule 18a-4 would establish segregation requirements for cleared and non-cleared security-based swap transactions, which would apply to all types of SBSDs (i.e., they

815 See paragraph (e) of proposed new Rule 18a-3.

would apply to bank SBSDs, nonbank stand-alone SBSDs, and broker-dealer SBSDs), as well as establish notice requirements for SBSDs and MSBSPs. Proposed new Rule 18a-4 would be an integral part of the Commission's financial responsibility program for SBSDs. Its purpose is to protect the rights of security-based swap customers and their ability to promptly obtain their property from an SBSD. The collection of information requirements in the proposed new rule would facilitate the process by which the Commission monitors how SBSDs are fulfilling their custodial responsibilities to SBSD customers. Proposed Rule 18a-4 also would require that an SBSD provide certain notices to counterparties.[816] These notices would alert counterparties to the alternatives available to them with respect to segregation of non-cleared security-based swaps. The Commission staff would use this new collection of information in its examination and oversight program.

C. RESPONDENTS

Consistent with the Entity Definitions Adopting Release, the Commission staff estimates that 50 or fewer entities ultimately may have to register with the Commission as SBSDs.[817] In addition, consistent with the Entity Definitions Adopting Release, based on available data regarding the single-name credit default swap market – which the Commission believes will comprise the majority of security-based swaps – the Commission staff estimates that the number

816 See paragraphs (a) and (c) of proposed new Rule 18a-4.

817 Entity Definitions Adopting Release, 77 FR at 30725. This estimate – which potentially overstates the number of potential entities that ultimately have to register with the Commission as SBSDs – is consistent with the data regarding activities and positions of participants in the single-name credit default swap market summarized in a memorandum of the Commission staff. See Memorandum (Mar. 15, 2012), available at http://www.sec.gov/comments/s7-39-10/s73910-154.pdf ("CDS Data Analysis"). Depending on the final capital requirements as well as other requirements for SBSDs and how businesses choose to respond to such requirements, the actual number of SBSDs may be significantly fewer. See Business Conduct Standards for Security-Based Swap Dealers and Major-Security Based Swap Participants, Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396, 42442 (July 18, 2011) ("Business Conduct Release"). See also SBSD Registration Proposing Release, 76 FR at 65808.

of MSBSPs likely will be five or fewer and, in actuality, may be zero.[818] Therefore, to capture the likely number of MSBSPs that may be subject to the collections of information for purposes of this PRA, the Commission staff estimates for purposes of this PRA that 5 entities will register with the Commission as MSBSPs. Accordingly, for the purposes of calculating PRA reporting burdens, the Commission staff estimates there are 50 SBSDs and 5 MSBSPs respondents.

The Commission previously estimated that 16 broker-dealers would likely seek to register as SBSDs.[819] The Commission is retaining this estimate for purposes of this release.[820] Accordingly, for the purposes of calculating PRA reporting burdens, the Commission staff estimates there are 16 broker-dealer SBSDs.

Because proposed Rules 18a-1 and 18a-3 would apply only to nonbank SBSDs, including nonbank subsidiaries of bank holding companies the Federal Reserve regulates, the number of respondents subject to these proposed rules would be less than the 50 entities expected to register with the Commission as an SBSD, as many of the dealers that currently engage in OTC derivative activities are banks, and would therefore be "bank SBSDs."[821] Because the Commission staff estimates that 16 broker-dealers would likely register as SBSDs, there would

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818 Entity Definitions Adopting Release, 77 FR at 30727, 30729. The number of MSBSPs likely will depend on the final capital requirements and other requirements for MSBSPs and how businesses choose to respond to such requirements. See Business Conduct Release, 76 FR at 42442. See also SBSD Registration Proposing Release, 76 FR at 65808.

819 See SBSD Registration Proposing Release, 76 FR at 65808. No comments were received on this estimate.

820 Id.

821 See, e.g., ISDA Margin Survey 2012 (May 2012), at Appendix 1, available at http://www2.isda.org/functional-areas/research/surveys/margin-surveys/ ("ISDA Margin Survey 2012"). ISDA is a global trade association for OTC derivatives. The ISDA margin survey is conducted annually to examine the state of collateral use and management among derivatives dealers and end-users. See id.; ISDA Margin Survey 2011, available at http://www2.isda.org/functional-areas/research/surveys/margin-surveys/ ("ISDA Margin Survey 2011"). Appendix 1 to the survey lists firms that responded to the survey including the largest dealer banks. See ISDA Margin Survey 2012 at Appendix 1; ISDA Margin Survey 2011 at Appendix 1. See also Economic Analysis in section V.A. of this release (discussing overview of OTC derivatives market).

be an estimated maximum of 34 bank SBSDs.[822] However, because of business planning purposes, risk management purposes, potential regulatory requirements, or other reasons, some of these entities would likely register with the Commission as nonbank stand-alone SBSDs. Therefore, as stated above, because many of the dealers that currently engage in OTC derivatives activities are banks, the Commission staff estimates that approximately 75% of the maximum estimated bank SBSDs will register as bank SBSDs, and the remainder (approximately 25%) will register as stand-alone nonbank SBSDs. As a result, for purposes of the reporting burdens, the Commission staff estimates that approximately 9 entities will register as stand-alone SBSDs.[823] Therefore, for purposes of the reporting burdens, the Commission staff estimates that approximately 25 nonbank SBSDs would be subject to Rules 18a-1 and 18a-3.[824]

Of the 9 stand-alone SBSDs, the Commission staff estimates that, based on its experience with ANC broker-dealers and OTC derivatives dealers, the majority of stand-alone SBSDs would apply to use internal models.[825] Consequently, the Commission is estimating that 6 of the 9 stand-alone SBSDs would apply to use internal models under Rule 18a-1. Because the Commission staff estimates that 6 stand-alone SBSDs would apply to the Commission to use internal models, the Commission staff estimates that three stand-alone SBSDs would not use models.[826] For purposes of estimating the number of respondents with respect to the proposed

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822 50 SBSDs – 16 broker-dealer SBSDs = 34 maximum estimated bank SBSDs.

823 34 maximum estimated bank SBSDs x 25% = 8.5, rounded to 9 stand-alone nonbank SBSDs.

824 16 broker-dealer SBSDs + 9 stand-alone SBSDs = 25 nonbank SBSDs.

825 See section II.A.2.a.iii. of this release (discussing minimum capital requirements for stand-alone SBSDs); section II.A.2.b.iii. of this release (discussing the use of VaR models). VaR models, while more risk sensitive than standardized haircuts, tend to substantially reduce the amount of the deductions to tentative net capital in comparison to the standardized haircuts because the models recognize more offsets between related positions than the standardized haircuts. Therefore, the Commission expects that stand-alone SBSDs that have the capability to use internal models to calculate net capital would chose to do so.

826 9 stand-alone SBSDs – 6 stand-alone SBSDs using internal models = 3 stand-alone SBSDs not using models.

amendments to Rule 15c3-1, the Commission staff estimates that there would be 10 respondents currently subject to the collection of information as it relates to Appendix E to Rule 15c3-1.[827] Finally, because the Commission staff estimates that 10 of the broker-dealers registered as SBSDs would be ANC broker-dealers, the Commission staff estimates that 6 broker-dealers registered as SBSDs would not use internal models.[828]

Type of Respondent	Number of Respondents
SBSDs	50
Bank SBSDs	25
Nonbank SBSDs	25
Broker-Dealer SBSDs	16
Stand-Alone SBSD	9
ANC Broker-Dealer SBSDs	10
Broker-Dealer SBSDs (Not Using Models)	6
Stand-Alone SBSDs (Using Models)	6
Stand-Alone SBSDs (Not Using Models)	3
Nonbank MSBSPs	5

The Commission generally requests comment on all aspects of these estimates of the number of respondents. Commenters should provide specific data and analysis to support any comments they submit with respect to the number of respondents, including identifying any sources of industry information that could be used to estimate the number of respondents.

D. TOTAL INITIAL AND ANNUAL RECORDKEEPING AND REPORTING BURDEN

1. Proposed Rule 18a-1 and Amendments to Rule 15c3-1

Proposed Rule 18a-1 and the proposed amendments to Rule 15c3-1 would have collection of information requirements that result in one-time and annual hour burdens for

827 These 10 broker-dealer respondents likely would also register as SBSDs because these entities are expected to engage in a broad range of activities.

828 16 broker-dealers registered as SBSDs – 10 ANC broker-dealer SBSDs = 6 broker-dealer SBSDs not using internal models.

nonbank SBSDs and ANC broker-dealers. The estimates in this section are based in part on the Commission's experience with burden estimates for similar collections of information requirements, including the current collection of information requirements for Rule 15c3-1.[829]

First, under paragraph (a)(2) of proposed Rule 18a-1, the Commission is proposing that a stand-alone SBSD be required to file an application for authorization to compute net capital using internal models.[830] The requirements for the application would be set forth in paragraph (d) of proposed Rule 18a-1, which is modeled on the application requirements of Appendix E to Rule 15c3-1.[831] ANC broker-dealers – the number of which would include broker-dealer SBSDs that seek to use internal models – currently are subject to this application requirement. Consequently, the Commission staff estimates that the proposed requirements of paragraph (d) of Rule 18a-1 would result in one-time and annual hour burdens for stand-alone SBSDs.[832]

Based on its experience with ANC broker-dealers and OTC derivatives dealers, the Commission expects that stand-alone SBSDs that apply to the Commission to use internal models to calculate net capital will already have developed models to calculate market and credit risk and will already have developed internal risk management control systems. On the other hand, the Commission notes that proposed Rule 18a-1 contains additional requirements that stand-alone SBSDs may not yet have incorporated into their models and control systems.[833]

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829 17 CFR 240.15c3-1.

830 A broker-dealer SBSD seeking Commission authorization to use internal models to compute market and credit risk charges would apply under the existing provisions of Appendix E to Rule 15c3-1, which apply to ANC broker-dealers. See 17 CFR 240.15c3-1e.

831 See 17 CFR 240.15c3-1e(a) and paragraph (d) of proposed Rule 18a-1. Consequently, the Commission is using the current collection of information for Appendix E to Rule 15c3-1 as a basis for this new collection of information.

832 The requirements that would be imposed on paragraphs (d) and (e) of proposed Rule 18a-1 are consistent with the requirements of Appendix E to Rule 15c3-1.

833 See sections II.A.2.b.iii., II.A.2.c., and II.A.2.d. of this release (describing requirements for VaR models and other requirements under proposed Rule 18a-1 for stand-alone SBSDs).

Therefore, stand-alone SBSDs would incur one-time hour burdens and start-up costs in order to develop their VaR models in accordance with the requirements of proposed Rule 18a-1, as well as to submit such models along with its application under paragraph (d) of proposed Rule 18a-1 to the Commission for approval.

These estimates are based on currently approved PRA estimates for the ANC firms and OTC derivatives dealers.[834] While these estimates are averages, the burdens may vary depending on the size and complexity of each stand-alone SBSD.

The Commission staff estimates that each of the 6 stand-alone nonbank SBSDs that apply to use the internal models would spend approximately 1,000 hours to develop and submit its VaR model and the description of its risk management control system to the Commission as well as to create and compile the various documents to be included with the application and to work with the Commission staff through the application process.[835] This includes approximately 100 hours for an in-house attorney to complete a review of the application.[836] Consequently, the Commission staff estimates that the total burden associated with the application process for the stand-alone SBSDs would result in an industry-wide one-time hour burden of approximately 6,000 hours.[837] In addition, the Commission staff allocated 75% (4,500 hours) of these one-time burden hours[838] to internal burden and the remaining 25% (1,500 hours) to external burden to

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834 See OTC Derivatives Dealers, 62 FR 67940; OTC Derivatives Dealers, 63 FR 59362; Alternative Net Capital Requirements Adopting Release, 69 FR at 34452.

835 This estimate is based on the current hour burdens under Appendix E to Rule 15c3-1.

836 Id. See also OTC Derivatives Dealers, 62 FR 67940; Alternative Net Capital Requirements Adopting Release, 69 FR at 34452.

837 6 stand-alone SBSDs x 1,000 hours = 6,000 hours.

838 The internal hours likely would be performed by an in-house attorney (1,500 hours), a risk management specialist (1,500 hours), and compliance manager (1,500 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((in-house attorney for 1,500 hours at $378 per hour) + (risk management specialist for 1,500 hours at $259 per hour) + (compliance manager for 1,500 hours at $279 per hour)) = $1,374,000. The hourly rates use for internal professionals used throughout this section IV. of the release are taken from SIFMA's Management & Professional Earnings in the Securities Industry

hire outside professionals to assist in preparing and reviewing the stand-alone SBSD's application for submission to the Commission.[839] The Commission staff estimates $400 per hour for external costs for retaining outside consultants, resulting in a one-time industry-wide external cost of $600,000.[840]

The Commission staff estimates that a stand-alone SBSD approved to use internal models would spend approximately 5,600 hours per year to review and update the models and approximately 160 hours each quarter, or approximately 640 hours per year, to backtest the models.[841] Consequently, the Commission staff estimates that the total burden associated with reviewing and back-testing the models for the 6 stand-alone SBSDs would result in an industry-wide annual hour burden of approximately 37,440 hours per year.[842] In addition, the Commission staff has allocated 75% (28,080)[843] of these burden hours to internal burden and the remaining 25% (9,360) to external burden to hire outside professionals to assist in reviewing,

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2011, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

839 6,000 hours x .75 = 4,500 hours; 6,000 hours x .25 = 1,500 hours. This allocation is based on the Commission's experience in implementing the ANC rules for broker-dealers. Larger firms tend to perform these tasks in-house due to the proprietary nature of these models as well as the high fixed-costs in hiring an outside consultant. However, smaller firms may need to hire an outside consultant to perform certain of these tasks.

840 1,500 hours x $400 per hour = $600,000. See PRA Analysis in Product Definitions Adopting Release, 77 FR at 48334 (providing an estimate of $400 an hour to engage an outside attorney). See also Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 64514 (May 18, 2011) 76 FR 33430, 33504 (June 8, 2012) (providing estimate of $400 per hour to engage outside attorneys and outside professionals).

841 These hour burdens are consistent with the current hour burdens under Appendix E to Rule 15c3-1 for ANC broker-dealers.

842 6 Stand-alone SBSDs x [5,600 hours + 640 hours] = 37,440 hours.

843 These functions likely would be performed by a risk management specialist (14,040 hours) and a senior compliance examiner (14,040 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((risk management specialist for 14,040 hours at $259 per hour) + (senior compliance examiner for 14,040 hours at $230 per hour)) = $6,865,560.

updating and backtesting the models.[844] The Commission staff estimates $400 per hour for external costs for retaining outside professionals, resulting in an industry-wide external cost of $3.7 million annually.[845]

Stand-alone SBSDs electing to file an application with the Commission to use a VaR model will incur start-up costs including information technology costs to comply with proposed Rule 18a-1. Because each stand-alone SBSD's information technology systems may be in varying stages of readiness to enable these firms to meet the requirements of the proposed rules, the cost of modifying their information technology systems could vary significantly. Based on the estimates for the ANC broker-dealers,[846] it is expected that a stand-alone SBSD would incur an average of approximately $8.0 million to modify its information technology systems to meet the VaR requirements of the proposed new Rule 18a-1, for a total one-time industry-wide cost of $48 million.[847]

Second, under paragraph (f) of proposed Rule 18a-1 and proposed new paragraph (f) of Rule 15c3-1, stand-alone SBSDs that are approved to use models to compute deductions for market and credit risk under Rule 18a-1 and ANC broker-dealers would be subject to liquidity stress test requirements. The Commission staff estimates that the proposed requirements resulting from these provisions would result in a one-time burden to applicable stand-alone SBSDs and ANC broker-dealers as they would need to develop models for the liquidity stress

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844 37,440 hours x .75 = 28,080; 37,440 hours x .25 = 9,360 hours. This allocation is based on the Commission's experience in implementing the ANC rules for broker-dealers.. Larger firms tend to perform these tasks in-house due to the proprietary nature of these models as well as the high fixed-costs in hiring an outside consultant. However, smaller firms may need to hire an outside consultant to perform these tasks.

845 9,360 hours x $400 per hour = $3,744,000. See PRA Analysis in Product Definitions Adopting Release, 77 FR 48334 (providing an estimate of $400 an hour to engage an outside attorney). See also Nationally Recognized Statistical Rating Organizations, 76 FR at 33504 (providing estimate of $400 per hour to engage outside attorneys and outside professionals).

846 Alternative Net Capital Requirements Adopting Release, 69 FR 34428.

847 6 stand-alone SBSDs x $8 million = $48 million.

test, document the results of the test to provide to senior management, document differences in the assumptions used in the liquidity stress test of the firm from those used in a consolidated entity of which the firm is a part, and develop a written contingency funding plan.[848] Based on experience supervising ANC broker-dealers,[849] the Commission staff estimates that each of the 6 stand-alone SBSDs and 10 ANC broker-dealers would spend an average of approximately 200 hours to comply with these requirements, resulting in an average industry-wide one-time internal hour burden of approximately 3,200 hours.[850]

In terms of annual hour burden, the Commission staff estimates that a stand-alone SBSD or ANC broker-dealer would spend an average of approximately 50 hours[851] per month testing and documenting the results of its liquidity stress test and reviewing its contingency funding plan, resulting in a total industry-wide annual hour burden of approximately 9,600 hours.[852]

Third, under paragraph (g) of proposed new Rule 18a-1, a stand-alone SBSD would be required to comply with Rule 15c3-4 (except for certain provisions of that rule) as if it were an

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848 See section II.A.2.d. of this release (discussing liquidity stress test and written contingency funding plan).

849 Based on Commission staff experience supervising the ANC broker-dealers, all of the ANC broker-dealers that are part of a holding company generally have a written contingency funding plan, generally at the holding company level. This proposed rule would require that each ANC broker-dealer and stand-alone SBSD using internal models maintain a written contingency funding plan at the entity level (in addition to any holding company plan). Therefore, the proposed hour burdens are averages for all firms, including the ANC broker-dealers, which may already conduct these activities within their organizations, and smaller firms, including stand-alone broker-dealers which may not currently undertake these proposed activities.

850 [10 ANC broker-dealers + 6 stand-alone SBSDs] x 200 hours = 3,200 hours. Based on Commission staff experience supervising the ANC broker-dealers, the Commission staff expects that these functions would likely be performed internally by an in-house attorney (1,600 hours) and a risk management specialist (1,600). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((in-house attorney for 1,600 hours at $378 per hour) + (risk management specialist for 1,600 hours at $259 per hour)) = $1,019,200.

851 This PRA estimate is based, in part, on the 160 hours per quarter it would take an ANC broker-dealer to review and backtest its models under the current collection of information in Rule 15c3-1. See Alternative Net Capital Requirements Adopting Release, 69 FR at 34452.

852 [6 Stand-alone SBSDs + 10 ANC broker-dealers] x 50 hours x 12 months = 9,600 hours. These functions would be performed by a senior compliance examiner (4,800 hours) and a risk management specialist (4,800 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((senior compliance examiner for 4,800 hours at $230 per hour) + (risk management specialist for 4,800 hours at $259 per hour)) = $2,347,200.

OTC derivatives dealer.[853] ANC broker-dealers currently are required to comply with Rule 15c3-4.[854] Nonbank SBSDs would be required to comply with Rule 15c3-4, which requires the establishment of a risk management control system.[855] The Commission adopted Rule 15c3-4 in 1998 as part of the OTC derivatives dealer oversight program.[856] The rule requires an OTC derivatives dealer to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.[857] It also requires OTC derivatives dealers to establish, document, and maintain procedures designed to prevent the firm from engaging in securities activities that are not permitted by OTC derivatives dealers pursuant to Rule 15a-1.[858] Rule 15c3-4 identifies a number of elements that must be part of an OTC derivatives dealer's internal risk management control system.[859] These include, for example, that the system have:

- A risk control unit that reports directly to senior management and is independent from business trading units;[860]

- Separation of duties between personnel responsible for entering into a transaction and those responsible for recording the transaction in the books and records of the OTC derivatives dealer;[861]

- Periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent certified public accountants) of the OTC derivatives dealer's risk management systems;[862] and

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853 See paragraph (g) to proposed new Rule 18a-1.

854 17 CFR 240.15c3-1(a)(7)(iii).

855 See proposed new paragraph (a)(10)(ii) of Rule 15c3-1 (17 CFR 240.15c3-1); paragraph (g) of proposed new Rule 18a-1. See also 17 CFR 240.15c3-4.

856 See 17 CFR 240.15c3-4; OTC Derivatives Dealers, 63 FR 59362.

857 See 17 CFR 240.15c3-4.

858 See 17 CFR 240.15c3-4; 17 CFR 240.15a-1.

859 See 17 CFR 240.15c3-4(c).

860 See 17 CFR 240.15c3-4(c)(1).

861 See 17 CFR 240.15c3-4(c)(2).

862 See 17 CFR 240.15c3-4(c)(3).

- Definitions of risk, risk monitoring, and risk management.[863]

Rule 15c3-4 further provides that the elements of the internal risk management control system must include written guidelines, approved by the OTC derivatives dealer's governing body, that discuss a number of matters, including for example:

- Quantitative guidelines for managing the OTC derivatives dealer's overall risk exposure;[864]
- The type, scope, and frequency of reporting by management on risk exposures;[865]
- The procedures for and the timing of the governing body's periodic review of the risk monitoring and risk management written guidelines, systems, and processes;[866]
- The process for monitoring risk independent of the business or trading units whose activities create the risks being monitored;[867]
- The performance of the risk management function by persons independent from or senior to the business or trading units whose activities create the risks;[868]
- The authority and resources of the groups or persons performing the risk monitoring and risk management functions;[869]
- The appropriate response by management when internal risk management guidelines have been exceeded;[870]
- The procedures to monitor and address the risk that an OTC derivatives transaction contract will be unenforceable;[871]

863 See 17 CFR 240.15c3-4(c)(4).

864 See 17 CFR 240.15c3-4(c)(5)(iii).

865 See 17 CFR 240.15c3-4(c)(5)(iv).

866 See 17 CFR 240.15c3-4(c)(5)(v).

867 See 17 CFR 240.15c3-4(c)(5)(vi).

868 See 17 CFR 240.15c3-4(c)(5)(vii).

869 See 17 CFR 240.15c3-4(c)(5)(viii).

870 See 17 CFR 240.15c3-4(c)(5)(ix).

871 See 17 CFR 240.15c3-4(c)(5)(x).

- The procedures requiring the documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions;[872] and

- The procedures authorizing specified employees to commit the OTC derivatives dealer to particular types of transactions.[873]

Rule 15c3-4 also requires management to periodically review, in accordance with the written procedures, the business activities of the OTC derivatives dealer for consistency with risk management guidelines.[874]

Based on the nature of the written guidelines described above, the Commission staff estimates that the requirement to comply with Rule 15c3-4 would result in one-time and annual hour burdens to nonbank SBSDs. The Commission staff estimates that the average amount of time a firm would spend implementing its risk management control system would be 2,000 hours,[875] resulting in an industry-wide one-time hour burden of 30,000 hours across the 15 nonbank SBSDs not already subject to Rule 15c3-4.[876]

The proposed rule would require a nonbank SBSD to consider a number of issues affecting its business environment when creating its risk management control system. For example, a nonbank SBSD would need to consider, among other things, the sophistication and

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872 See 17 CFR 240.15c3-4(c)(5)(xi).

873 See 17 CFR 240.15c3-4(c)(5)(xii).

874 See 17 CFR 240.15c3-4(d).

875 This estimates is based on the one-time burden estimated for an OTC derivatives dealer to implement is controls under Rule 15c3-1. See OTC Derivatives Dealers, 62 FR 67940. This also is included in the current PRA estimate for Rule 15c3-4.

876 25 nonbank SBSDs – 10 ANC broker-dealer SBSDs = 15 nonbank SBSDs. 15 nonbank SBSDs x 2,000 hours = 30,000 hours. This number is incremental to the current collection of information for Rule 15c3-1 with regard to complying with the provisions of Rule 15c3-4 and, therefore, excludes the 10 respondents included in the collection of information for that rule. These hours would likely be performed by a combination of an in-house attorney (10,000 hours), a risk management specialist (10,000 hours), and an operations specialist (10,000 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((in-house attorney for 10,000 hours at $378 per hour) + (risk management specialist for 10,000 hours at $259 per hour) + (operations specialist for 10,000 hours at $117 per hour)) = $7,540,000.

experience of relevant trading, risk management, and internal audit personnel, as well as the separation of duties among these personnel, when designing and implementing its internal control system's guidelines, policies, and procedures. This would help to ensure that the control system that is implemented would adequately address the risks posed by the firm's business and the environment in which it is being conducted. In addition, this would enable a nonbank SBSD derivatives dealer to implement specific policies and procedures unique to its circumstances.

In implementing its policies and procedures, a nonbank SBSD would be required to document and record its system of internal risk management controls. In particular, a nonbank SBSD would be required to document its consideration of certain issues affecting its business when designing its internal controls. A nonbank SBSD would also be required to prepare and maintain written guidelines that discuss its internal control system, including procedures for determining the scope of authorized activities. The Commission staff estimates that each of these 15 nonbank SBSDs[877] would spend approximately 250 hours per year reviewing and updating their risk management control systems to comply with Rule 15c3-4, resulting in an industry-wide annual hour burden of approximately 3,750 hours.[878]

Nonbank SBSDs may incur start-up costs to comply with the provisions of Rule 15c3-4 incorporated into proposed Rule 18a-1, including information technology costs. The information technology systems of nonbank SBSDs may be in varying stages of readiness to enable these firms to meet the requirements of the proposed rules so the cost of modifying their information technology systems could vary significantly. Based on the estimates for similar collections of

877 25 nonbank SBSDs – 10 ANC broker-dealer/SBSDs = 15 nonbank SBSDs.

878 15 nonbank SBSDs x 250 hours = 3,750 hours. These hour burden estimates are consistent with similar collections of information under Appendix E to Rule 15c3-1. These hours likely would be performed by a risk management specialist. Therefore, the estimated internal costs for this hour burden would be calculated as follows: risk management specialist for 3,750 hours at $259 per hour = $971,250.

information,[879] it is expected that a nonbank SBSDs would incur an average of approximately $16,000 for initial hardware and software expenses, while the average ongoing cost would be approximately $20,500 per nonbank SBSD to meet the requirements of the proposed new Rule 18a-1, for a total industry-wide initial cost of $240,000 and ongoing cost of $307,500 per year.[880]

Fourth, proposed paragraph (c)(2)(vi)(O)(1)(iii) of Rule 15c3-1 and paragraph (c)(1)(vi)(A)(3)(i) of proposed new Rule 18a-1, broker-dealer SBSDs and stand-alone SBSDs not using models would be required to use an industry sector classification system that is documented and reasonable in terms of grouping types of companies with similar business activities and risk characteristics used for credit default swap reference obligors for purposes of calculating "haircuts" on security-based swaps under applicable net capital rules.

As discussed above, the Commission staff estimates that 6 broker-dealer SBSDs and 3 nonbank SBSDs not using models would utilize the credit default swap haircut provisions under the proposed amendments to Rule 15c3-1 and proposed new Rule 18a-1, respectively. Consequently, these firms would use an industry sector classification system that is documented for the credit default swap reference obligors. The Commission expects that these firms would utilize external classifications systems because of reduced costs and ease of use as a result of the common usage of several of these classification systems in the financial services industry. The Commission staff estimates that nonbank SBSDs not using models would spend approximately 1 hour per year documenting these industry sectors, for a total annual hour burden of 9 hours.[881]

879 Risk Management Controls for Brokers or Dealers with Market Access, Exchange Act Release No. 63421 (Nov. 3, 2010), 75 FR 69792, 69814 (Nov. 15, 2010).

880 15 nonbank SBSDs x $16,000 = $240,000; 15 nonbank SBSDs x $20,500 =$307,500.

881 (3 nonbank SBSDs not using models x 1 hour) + (6 broker-dealer SBSDs x 1 hour) = 9 hours. This function would likely be performed by an internal compliance attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: internal compliance attorney for 9 hours at $322 per hour = $2,898.

Fifth, under paragraph (i) of proposed new Rule 18a-1, a nonbank SBSD would be required to file certain notices with the Commission relating to the withdrawal of equity capital.[882] Broker-dealers – which would include broker-dealer SBSDs – currently are required to file these notices under paragraph (e) of Rule 15c3-1.[883] The Commission staff estimates that the notice requirements would result in annual hour burdens to stand-alone SBSDs. The Commission staff estimates that each of the 9 stand-alone SBSDs would file approximately 2 notices annually with the Commission.[884] In addition, the Commission staff estimates that it would take a stand-alone SBSD approximately 30 minutes to file these notices, resulting in an industry-wide annual hour burden of 4.5 hours.[885]

Finally, under Appendix D to proposed new Rule 18a-1, a nonbank SBSD would be required to file a proposed subordinated loan agreement with the Commission (including nonconforming subordinated loan agreements).[886] Broker-dealers – which would include broker-dealer SBSDs – currently are subject to such a requirement. The Commission staff estimates this proposed requirement would result in one-time and annual hour burdens for stand-alone SBSDs. Based on staff experience with Rule 15c3-1, the Commission staff estimates that each of the 9 stand-alone SBSDs would spend approximately 20 hours of internal employee resources drafting or updating its subordinated loan agreement template to comply with the proposed requirement,

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882 See proposed new Rule 18a-1(i).

883 17 CFR 240.15c3-1(e).

884 This estimate is based on the number of notices currently filed by broker-dealers under the current collection of information under Rule 15c3-1.

885 [9 stand-alone SBSDs x 2 notices] x 30 minutes = 4.5 hours. This estimate is based on the 30 minutes it is estimated to take a broker-dealer to file a similar notice under Rule 15c3-1. The Commission believes the stand-alone SBSDs would likely perform these functions internally using an internal compliance attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: internal compliance attorney for 4.5 hours at $322 per hour = $1,449.

886 See proposed new paragraph (c)(5) to proposed Rule 18a-1. Broker-dealer SBSDs would be subject to the provisions of Appendix D to Rule 15c3-1. 17 CFR 240.15c3-1d.

resulting in an industry-wide one-time hour burden of approximately 180 hours.[887] In addition, based on staff experience with Rule 15c3-1, the Commission staff estimates that each stand-alone SBSD would file 1 proposed subordinated loan agreement with the Commission per year and that it would take a firm approximately 10 hours to prepare and file the agreement, resulting in an industry-wide annual hour burden of approximately 90 hours.[888]

2. Proposed Rule 18a-2

Proposed new Rule 18a-2 would establish capital requirements for nonbank MSBSPs.[889] In particular, a nonbank MSBSP would be required at all times to have and maintain positive tangible net worth.[890] Because MSBSPs, by definition, will be entities that engage in a substantial security-based swap business, under the proposed rules, they would be required to comply with Rule 15c3-4,[891] which requires OTC derivatives dealers and ANC broker-dealers to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with their business activities, including market, credit, leverage, liquidity, legal, and operational risks.[892] The Commission staff estimates that the requirement to comply with Rule 15c3-4 would result in one-time and annual hour burdens to nonbank MSBSPs. The Commission staff estimates that the average amount of time a firm would spend

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887 9 stand-alone SBSDs x 20 hours = 180 hours. This function would likely be performed by an in-house attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: in-house attorney for 180 hours at $378 per hour = $68,040.

888 9 stand-alone SBSDs x 1 loan agreement x 10 hours = 90 hours. This function would likely be performed by an in-house attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: in-house attorney for 90 hours at $378 per hour = $34,020.

889 See proposed new Rule 18a-2.

890 See paragraph (a) of proposed new Rule 18a-2.

891 See paragraph (c) of proposed new Rule 18a-2.

892 See 17 CFR 240.15c3-4.

implementing its risk management control system would be 2,000 hours,[893] resulting in an industry-wide one-time hour burden of 10,000 hours.[894]

The proposed rule would require a nonbank MSBSP to consider a number of issues affecting its business environment when creating its risk management control system. For example, a nonbank MSBSP would need to consider, among other things, the sophistication and experience of relevant trading, risk management, and internal audit personnel, as well as the separation of duties among these personnel, when designing and implementing its internal control system's guidelines, policies, and procedures. This would help to ensure that the control system that is implemented would adequately address the risks posed by the firm's business and the environment in which it is being conducted. In addition, this would enable a nonbank MSBSP to implement specific policies and procedures unique to its circumstances.

In implementing its policies and procedures, a nonbank MSBSP would be required to document and record its system of internal risk management controls. In particular, a nonbank MSBSP would be required to document its consideration of certain issues affecting its business when designing its internal controls. A nonbank MSBSP would also be required to prepare and maintain written guidelines that discuss its internal control system, including procedures for determining the scope of authorized activities. The Commission staff estimates that each of the 5 MSBSPs would spend approximately 250 hours per year reviewing and updating their risk management control systems to comply with Rule 15c3-4, resulting in an industry-wide annual

893 This estimate is based on the one-time burden estimated for an OTC derivatives dealer to implement is controls under Rule 15c3-1. OTC Derivatives Dealers, 62 FR 67940. This also is included in the current PRA estimate for Rule 15c3-4.

894 5 MSBSPs x 2,000 hours = 10,000 hours. These hours would likely be performed by a combination of an internal compliance attorney (3,333.33 hours), a risk management specialist (3,333.33 hours), and an operations specialist (3,333.33 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((internal compliance attorney for 3,333.33 hours at $322 per hour) + (risk management specialist for 3,333.33 hours at $259 per hour) + (operations specialist for 3,333.33 hours at $117 per hour)) = $2,326,664.34.

hour burden of approximately 1,250 hours.[895]

Because nonbank MSBSPs may not initially have the systems or expertise internally to meet the risk management requirements of proposed new Rule 18a-2, these firms would likely hire an outside risk management consultant to assist them in implementing their risk management systems. The Commission staff estimates that a nonbank MSBSP may hire an outside management consultant for approximately 200 hours to assist the firm for a total start-up cost to the nonbank MSBSP of $80,000 per MSBSP, or a total of $400,000 for all nonbank MSBSPs.[896]

Nonbank MSBSPs may incur start-up costs to comply with proposed Rule 18a-2, including information technology costs. The information technology systems of a nonbank MSBSP may be in varying stages of readiness to enable these firms to meet the requirements of the proposed rules so the cost of modifying their information technology systems could vary significantly. Based on the estimates for similar collections of information,[897] the Commission staff expects that a nonbank MSBSP would incur an average of approximately $16,000 for initial hardware and software expenses, while the average ongoing cost would be approximately $20,500 per nonbank MSBSP to meet the requirements of the proposed new Rule 18a-2, for a total industry-wide initial cost of $80,000 and ongoing cost of $102,500.[898]

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895 5 MSBSPs x 250 hours = 1,250 hours. These hour burden estimates are consistent with similar collections of information under Appendix E to Rule 15c3-1. These hours would likely be performed by a risk management specialist. Therefore, the estimated internal cost for this hour burden would be calculated as follows: risk management specialist for 1,250 hours at $259 per hour = $323,750.

896 5 nonbank MSBSPs x $80,000 = $400,000. See also PRA Analysis in Product Definitions Adopting Release, 77 FR at 48344 (providing an estimate of $400 an hour to engage an outside attorney); Nationally Recognized Statistical Rating Organizations, 76 FR at 33504 (providing estimate of $400 per hour to engage outside attorneys and outside professionals).

897 Risk Management Controls for Brokers or Dealers with Market Access, 75 FR at 69814.

898 5 nonbank MSBSPs x $16,000 = $80,000; 5 nonbank MSBSPs x $20,500 = $102,500.

3. Proposed Rule 18a-3

Proposed paragraph (e) of new Rule 18a-3 would require a nonbank SBSD to establish and implement risk monitoring procedures with respect to counterparty accounts.[899] Therefore, paragraph (e) to proposed Rule 18a-3 would result in one-time and annual hour burdens for nonbank SBSDs. In this regard, nonbank SBSDs would need to develop a comprehensive written risk analysis methodology for assessing the potential risk to the firm over a specified range of possible market movements over a specified time period that would meet the requirements of the rule.

Because these firms would already be required to comply with Rule 15c3-4,[900] the Commission staff estimates that each of the 25 nonbank SBSDs would spend an average of approximately 210 hours establishing the written risk analysis methodology, resulting in an industry-wide one-time hour burden of approximately 5,250 hours.[901] In addition, based on staff experience, the Commission staff estimates that a nonbank SBSD would spend an average of approximately 60 hours per year reviewing the written risk analysis methodology and updating it as necessary, resulting in an average industry-wide annual hour burden of approximately 1,500 hours.[902]

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899 See paragraph (e) of proposed new Rule 18a-3.

900 See section II.A.2.c. of this release (describing risk management provisions of Rule 15c3-4).

901 25 nonbank SBSDs x 210 hours = 5,250 hours. See generally Clearing Agency Standards for Operation and Governance, 76 FR at 14510 (estimating 210 one-time burden hours and 60 annual hours to implement policies and procedures reasonably designed to use margin requirements to limit a clearing agency's credit exposures to participants in normal market conditions and use risk-based models and parameters to set and review margin requirements.). These hours would likely be performed internally by an assistant general counsel (1,750 hours), a compliance attorney (1,750 hours), and a risk management specialist (1,750 hours). Therefore, the estimated internal cost for this hour burden would be calculated as follows: ((assistant general counsel for 1,750 hours at $407 per hour) + (risk management specialist for 1,750 hours at $259 per hour) + (compliance attorney for 1,750 hours at $322 per hour)) = $1,729,000.

902 25 stand-alone SBSDs x 60 hours = 1,500 hours. These hours would likely be performed by a compliance attorney. Therefore, the estimated internal cost for this hour burden would be calculated as follows: compliance attorney for 1,500 hours at $322 per hour = $483,000.

The 25 respondents subject to the collection of information may incur start-up costs in order to comply with this collection of information. These costs may vary depending on the size and complexity of the nonbank SBSD. In addition, the start-up costs may be less for the 16 nonbank SBSD respondents also registered as broker-dealers because these firms may already be subject to similar requirements with respect to other margin rules.[903] For the remaining 9 nonbank SBSDs, because these written procedures may be novel undertakings for these firms, the Commission staff assumes these nonbank SBSDs would have their written risk analysis methodology reviewed by outside counsel. As a result, the Commission staff estimates that these nonbank SBSDs would likely incur $2,000 in legal costs, or $18,000 in the aggregate initial burden to review and comment on these materials.[904]

4. Proposed Rule 18a-4

Under proposed new Rule 18a-4, SBSDs would be required to establish special accounts with banks and obtain written acknowledgements from, and enter into written contracts with, the banks. These special accounts would include: (1) the qualified clearing agency account under paragraph (a)(3); (2) the qualified SDSD account under paragraph (a)(4); and the special account for the exclusive benefit of security-based swap customers under paragraph (a)(7) of proposed new Rule 18a-4, (collectively, the "special accounts"). Based on staff experience with Rule 15c3-3, the Commission staff estimates that each of the 50 SBSDs would establish six special accounts at banks (two for each type of special account). Further, based on staff experience with Rule 15c3-3, the Commission staff estimates that each SBSD would spend approximately 30 hours to draft and obtain the written acknowledgement and agreement for each account, resulting

903 See, e.g., FINRA Rule 4210 and 4240. See also Business Conduct Release, 76 FR at 42445 (noting burden for paragraph (g) of proposed Rule 15Fh-3 is based on existing FINRA rules).

904 The Commission staff estimates the review of the written risk analysis methodology would require 5 hours of outside counsel time at a cost of $400 per hour. See also Business Conduct Release, 76 FR at 42445.

in an industry-wide one-time hour burden of approximately 9,000 hours.[905] The Commission staff estimates that 25%[906] of the 50 SBSDs or approximately 13 would establish a new special account each year because, for example, they change their banking relationship, for each type of special account. Therefore, the Commission staff estimates an industry-wide annual hour burden of approximately 1,170 hours.[907]

Paragraph (c)(1) of proposed new Rule 18a-4 would provide that the SBSD must at all times maintain in a special account, through deposits into the account, cash and/or qualified securities in amounts computed in accordance with the formula set forth in Exhibit A to Rule 18a-4,[908] modeled on the formula in Appendix A to Rule 15c3-3. Paragraph (c)(3) of proposed new Rule 18a-4 would provide that the computations necessary to determine the amount required to be maintained in the special bank account must be made on a daily basis. Variation in size and complexity between these SBSDs would make it very difficult to develop a meaningful figure for the amount of time required to calculate each reserve computation. Based on experience with the Rule 15c3-3 reserve computation PRA burden hours and with the OTC derivatives industry, the Commission staff estimates that it would take between one and five hours to compute each reserve computation, and that the average time spent across all the SBSDs would be approximately 2.5 hours. Accordingly, the Commission staff estimates that the

905 50 SBSDs x 6 special accounts x 30 hours = 9,000 hours. A compliance attorney would likely perform this function. Therefore, the estimated internal cost for this hour burden would be calculated as follows: compliance attorney for 9,000 hours at $322 per hour = $2,898,000.

906 This number is based on the currently approved PRA collection for Rule 15c3-3.

907 13 SBSDs x 3 types of special accounts x 30 hours = 1,170 hours. A compliance attorney would likely perform this function. Therefore, the estimated internal cost for this hour burden would be calculated as follows: compliance attorney for 1,170 hours at $322 per hour = $376,740.

908 See paragraph (c)(1) of proposed new Rule 18a-4 and Exhibit A to proposed new Rule 18a-4.

resulting annual hour burden for paragraph (c)(3) of proposed new Rule 18a-3 would be approximately 31,250 hours.[909]

Under paragraph (d)(1) of proposed new Rule 18a-4, an SBSD or an MSBSP would be required to provide a notice to a counterparty pursuant to section 3E(f) of the Exchange Act prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the effective date of the proposed rule.[910] All 50 SBSDs and 5 MSBSPs would be required to provide these notices to their counterparties. The Commission staff estimates that these 55 entities would engage outside counsel to draft and review the notice at a cost of $400 per hour for an average of 10 hours per respondent, resulting in a one-time cost burden of $220,000 for all of these 55 entities.[911]

The number of notices sent in the first year the rule is effective would depend on the number of counterparties with which each SBSD and MSBSP engages in security-based swap transactions. The number of counterparties an SBSD and MSBSP would have would vary depending on the size and complexity of the firm and its operations. The Commission staff estimates that each of the 50 SBSDs and 5 MSBSPs would have approximately 1,000 counterparties at any given time.[912] Therefore, the Commission staff estimates that

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909 50 SBSDs x 250 business days x 2.5 hours/day = 31,250 hours. This task would likely be performed by a financial reporting manager. Therefore, the estimated internal cost for this hour burden would be calculated as follows: financial reporting manager for 31,250 hours at $309 per hour = $9,656,250.

910 See paragraph (d)(1) of proposed new Rule 18a-4.

911 [50 SBSDs + 5 MSBSPs] x $400 per hour x 10 hours = $220,000. The Commission expects that these functions would likely be performed by outside counsel with an expertise in financial services law to help ensure that counterparties are receiving the proper notice under the statutory requirement.

912 The Commission previously estimated that there are approximately 8,500 market participants in security-based swap transactions. See Business Conduct Release, 76 FR at 42443. Based on the 8,500 market participants and Commission staff experience relative to the securities and OTC derivatives industry, the Commission staff estimates that each SBSD and MSBSP would have 1,000 counterparties at any given time. The number of counterparties may widely vary depending on the size of the SBSD or MSBSP. A large firm may have thousands or counterparties at one time, while a smaller firm may have substantially less than 1,000. The Commission staff also estimates, based on staff experience, that these entities would

approximately 55,000 notices would be sent in the first year the rule is effective.[913] The Commission staff estimates that thé each of the 50 SBSDs and 5 MSBSPs would spend approximately 10 minutes sending out the notice, resulting in an industry-wide one-time hour burden of approximately 9,167 hours.[914] The Commission staff further estimates that the 50 SBSDs and 5 MSBSPs would establish account relationships with 200 new counterparties per year. Therefore, the Commission staff estimates that approximately 11,000 notices would be sent annually,[915] resulting in an industry-wide annual hour burden of approximately 1,833 hours.[916]

Under proposed new Rule 18a-4(d)(2), an SBSD would be required to obtain agreements from counterparties that do not choose to require segregation of funds or other property pursuant to Section 3E(f) of the Exchange Act or paragraph (c)(3) of Rule 18a-4 in which the counterparty agrees to subordinate all of its claims against the SBSD to the claims of security-based swap customers of the SBSD.[917] The Commission staff estimates that an SBSD would spend, on average, approximately 200 hours to draft and prepare standard subordination agreements, resulting in an industry-wide one-time hour burden of 10,000 hours.[918] Because the SBSD

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establish account relationships with approximately 200 new counterparties a year, or approximately 20% of a firm's existing counterparties.

913 [50 SBSDs + 5 MSBSPs] x 1,000 counterparties = 55,000 notices.

914 (55,000 notices x 10 minutes)/60 minutes = 9,167 hours. A compliance clerk would likely send these notices. Therefore, the estimated internal cost for this hour burden would be calculated as follows: compliance clerk for 9,167 hours at $60 per hour = $550,020. The hourly rates use for internal office employees used throughout this section are taken from SIFMA's Office Salaries in the Securities Industry 2011, modified by the Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

915 [50 SBSDs + 5 MSBSPs] x 200 counterparties = 11,000 notices.

916 (11,000 notices x 10 minutes)/60 minutes = 1,833 hours. A compliance clerk would likely send these notices. Therefore, the estimated internal cost for this hour burden would be calculated as follows: compliance clerk for 1,833 hours at $60 per hour = $109,980.

917 See paragraph (d)(2) of proposed new Rule 18a-4.

918 200 hours x 50 SBSDs = 10,000 hours. An in-house attorney would likely draft these agreements because the Commission staff expects that drafting contracts would be one of the typical job functions of an in-

would enter into these agreements with security-based swap customers, after the SBSD prepares a standard subordination agreement in-house, the Commission staff also estimates that an SBSD would have outside counsel a review the standard subordination agreements and that the review would take approximately 20 hours at a cost of approximately $400 per hour. As a result, the Commission staff estimates that each SBSD would incur one-time costs of approximately $8,000,[919] resulting in an industry-wide one-time cost of approximately $400,000.[920]

As discussed above, the Commission staff estimates that each of the 50 SBSDs would have approximately 1,000 counterparties at any given time. The Commission staff further estimates that approximately 50% of these counterparties would either elect individual segregation or waive segregation altogether.[921] The Commission staff estimates that an SBSD would spend 20 hours per counterparty to enter into a written subordination agreement, resulting in an industry-wide one-time hour burden of approximately 500,000 hours.[922] Further, as discussed the Commission staff estimates that each of the 50 SBSDs would establish account relationships with 200 new counterparties per year. The Commission staff further estimates that 50% or 100 of these counterparties would either elect individual segregation or waive

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house attorney. Therefore, the estimated internal cost for this hour burden would be calculated as follows: in-house attorney for 10,000 hours at $378 per hour = $3,780,000.

919 $400 x 20 hours = $8,000.

920 $8,000 x 50 = $400,000.

921 Based on discussions with market participants, the Commission staff understands that many large buy-side financial end users currently ask for individual segregation and the Commission staff assumes that many of these end users will continue to do so. However, Commission staff believes that some smaller end users may not choose to incur additional cost that may come with individual segregation. Therefore, the Commission staff estimates that approximately 50% of counterparties will either elect individual segregation or waiver segregation altogether.

922 50 SBSDs x 500 counterparties x 20 hours = 500,000 hours. These functions would likely be performed by a compliance attorney (250,000 hours) and a compliance clerk (250,000 hours). Therefore, the estimated internal cost for this hour burden would be calculated as follows: ((compliance attorney for 250,000 hours at $322 per hour) + (compliance clerk for 250,000 hours at $60 per hour)) = $95,500,000.

segregation altogether. Therefore, the Commission staff estimates an industry-wide annual hour burden of approximately 100,000 hours.[923]

E. COLLECTION OF INFORMATION IS MANDATORY

The collections of information pursuant to the proposed amendments and new rules are mandatory, as applicable, for ANC broker-dealers, SBSDs, and MSBSPs.

F. CONFIDENTIALITY

The Commission expects to receive confidential information in connection with the proposed collections of information. To the extent that the Commission receives confidential information pursuant to these collections of information, the Commission is committed to protecting the confidentiality of such information to the extent permitted by law.[924]

G. RETENTION PERIOD FOR RECORDKEEPING REQUIREMENTS

ANC broker-dealers are required to preserve for a period of not less than three years, the first two years in an easily accessible place, certain records required under Rule 15c3-4 and certain records under Appendix E to Rule 15c3-1.[925] Rule 17a-4 specifies the required retention

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923 50 SBSDs x 100 counterparties x 20 hours = 100,000 hours. These functions would likely be performed by a compliance attorney (50,000 hours) and a compliance clerk 50,000 hours). Therefore, the estimated internal cost for this hour burden would be calculated as follows: ((compliance attorney for 50,000 hours at $322 per hour) + (compliance clerk for 50,000 hours at $60 per hour)) = $19,100,000.

924 See, e.g., 15 U.S.C. 78x (governing the public availability of information obtained by the Commission); 5 U.S.C. 552 et seq. (Freedom of Information Act – "FOIA"). See also paragraph (d)(1) of proposed new Rule 18a-1(d). FOIA provides at least two pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8).

925 See 17 CFR 17a-4(b)(9), (10), and (12).

periods for a broker-dealer.[926] Many of a broker-dealer's records must be retained for three years; certain other records must be retained for longer periods.[927]

As noted above, the recordkeeping burdens with respect to some requirements in proposed new Rules 18a-1 through 18a-4 will be addressed in the SBSD and MSBSP recordkeeping requirements, which will the subject of a separate release.

H. REQUEST FOR COMMENT

Pursuant to 44 U.S.C. 3306(c)(2)(B), the Commission requests comment on the proposed collections of information in order to:

- Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility;

- Evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information;

- Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and

- Evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct their comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, D.C. 20503, and should also send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, D.C. 20549-1090, and refer to File No. S7-08-12. OMB is required to make a decision concerning the collections of

926 17 CFR 240.17a-4.

927 Id.

information between 30 and 60 days after publication of this document in the Federal Register; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-08-12, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, D.C. 20549.

V. ECONOMIC ANALYSIS

The Commission is sensitive to the costs and benefits of its rules. Some of these costs and benefits stem from statutory mandates, while others are affected by the discretion exercised in implementing the mandates. The following economic analysis seeks to identify and consider the benefits and costs – including the effects on efficiency, competition, and capital formation – that would result from the proposed capital, margin, and segregation rules for SBSDs and MSBSPs and from the proposed amendments to Rule 15c3-1. The costs and benefits considered in proposing these new rules and amendments are discussed below and have informed the policy choices described throughout this release.

The Commission discusses below a baseline against which the rules may be evaluated. For the purposes of this economic analysis, the baseline is the OTC derivatives markets as they exist today prior to the effectiveness of the statutory and regulatory provisions that will govern these markets in the future pursuant to the Dodd-Frank Act. With respect to the proposed amendments to Rule 15c3-1, the baseline for purposes of this economic analysis is the current capital regime for broker-dealers under Rule 15c3-1.[928]

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[928] 17 CFR 240.15c3-1.

While the Commission does not have comprehensive information on the U.S. OTC derivatives markets, the Commission is using the limited data currently available in considering in this economic analysis the effects of the proposals, including their intended benefits and anticipated possible costs.[929] Additionally, the Commission requests that commenters identify sources of data and information as well as provide data and information to assist the Commission in analyzing the economic consequences of the proposed rules. More generally, the Commission requests comment on all aspects of this initial economic analysis, including on whether the analysis has: (1) identified all benefits and costs, including all effects on efficiency, competition, and capital formation; (2) given due consideration to each benefit and cost, including each effect on efficiency, competition, and capital formation; and (3) identified and considered reasonable alternatives to the proposed new rules and rule amendments.

If these proposed rules and rule amendments are adopted, their benefits and costs would affect competition, efficiency, and capital formation in the security-based swap market broadly, with the impact not being limited to SBSDs and MSBSPs. Section 3(f) of the Exchange Act provides that whenever the Commission engages in rulemaking under the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[930] In addition, section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the effect such rules would have on competition.[931] Section 23(a)(2)

929 Information that is available for the purposes of this economic analysis includes an analysis of the market for single-name credit default swaps performed by the Commission's Division of Risk, Strategy, and Financial Innovation. See CDS Data Analysis.

930 15 U.S.C. 78c(f).

931 15 U.S.C. 78w(a)(2).

of the Exchange Act also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[932]

As discussed more fully in section II. above, the Commission is proposing: (1) Rules 18a-1 and 18a-2, and amendments to Rule 15c3-1, to establish capital requirements for nonbank SBSDs and nonbank MSBSPs; (2) Rule 18a-3 to establish customer margin requirements applicable to nonbank SBSDs and nonbank MSBSPs for non-cleared security-based swaps; and (3) Rule 18a-4 to establish segregation requirements for SBSDs and notification requirements with respect to segregation for SBSDs and MSBSPs.[933] Some of the proposed amendments to Rule 15c3-1 would apply to broker-dealers that are not registered as SBSDs or MSBSPs to the extent that they hold positions in security-based swaps and swaps. The Commission also is proposing to amend Rule 15c3-1 to increase the minimum capital requirements for ANC broker-dealers. Finally, the Commission is proposing a liquidity requirement for ANC broker-dealers and for nonbank stand-alone SBSDs that use internal models to compute net capital.

The sections below present an overview of the OTC derivatives markets, a discussion of the general costs and benefits of the proposed financial responsibility requirements, and a discussion of the costs and benefits of each proposed amendment and new rule. The sections that follow also incorporate a consideration of the potential effects of the proposed amendments and new rules on competition, efficiency, and capital formation.

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932 Id.

933 The Commission is also proposing a conforming amendment to Rule 15c3-3 to clarify that broker-dealer SBSDs must comply with Rule 15c3-3 and Rule 18a-4, as applicable.

A. BASELINE OF ECONOMIC ANALYSIS

1. Overview of the OTC Derivatives Markets – Baseline for Proposed Rules 18a-1 through 18a-4

As stated above, to assess the costs and benefits of these rules, a baseline must be established against which the rules may be evaluated. For the purposes of this economic analysis, the baseline is the OTC derivatives markets[934] as they exist today prior to the effectiveness of the statutory and regulatory provisions that will govern these markets in the future pursuant to the Dodd-Frank Act.[935] The markets as they exist today are dominated, both globally and domestically, by a small number of firms, generally entities affiliated with or within large commercial banks.[936]

The OTC derivatives markets have been described as opaque because, for example, transaction-level data about OTC derivatives trading generally is not publicly available.[937] This economic analysis is supported, where possible, by data currently available to the Commission from The Depository Trust & Clearing Corporation Trade Information Warehouse ("DTCC-TIW"). This evaluation takes into account data regarding the security-based swap market and especially data regarding the activity – including activity that may be suggestive of dealing

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934 OTC derivatives may include forwards, swaps and options on foreign exchange, and interest rate, equity and commodity derivatives.

935 The baseline, however, for amendments to Rule 15c3-1 is the current financial responsibility regime for broker-dealers under this rule.

936 See, e.g., ISDA Margin Survey 2012.

937 See Orice M. Williams, GAO, Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps at 2, 5, 27. See also Robert E. Litan, The Brookings Institution, The Derivatives Dealers' Club and Derivatives Market Reform: A Guide for Policy Makers, Citizens and Other Interested Parties 15-20 (Apr. 7, 2010), available at available at http://www.brookings.edu/~/media/research/files/papers/2010/4/07%20derivatives%20litan/0407_derivatives_litan.pdf; Security-Based Swap Data Repository Registration, Duties, and Core Principles, Exchange Act Release No. 63347 (Nov. 19, 2010), 75 FR 77306, 77354 (Dec. 10, 2010); IOSCO, The Credit Default Swap Market, Report FR05/12, (June 2012), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD385.pdf (stating although the amount of public information on CDS has increased over recent years, the CDS market is still quite opaque).

behavior – of participants in the single-name credit default swap market.[938] While a large segment of the security-based swap market is comprised of single-name credit default swaps, these derivatives do not comprise the entire security-based swap market.[939] Moreover, credit default swaps are a small percentage of the overall OTC derivatives market, which, in addition to security-based swaps, includes foreign currency swaps and interest rate swaps.

Available information about the global OTC derivatives markets suggests that swap transactions, in contrast to security-based swap transactions, dominate trading activities, notional amounts, and market values.[940] For example, the BIS estimates that the total notional amounts outstanding and gross market value of global OTC derivatives were over $648 trillion and $27.2 trillion, respectively, as of the end of 2011.[941] Of these totals, the BIS estimates that foreign exchange contracts, interest rate contracts, and commodity contracts comprised approximately 88% of the total notional amount and 84% of the gross market value.[942] Credit default swaps, including index credit default swaps, comprised approximately 4.4% of the total notional amount

938 The CDS Data Analysis provides reasonably comprehensive information regarding the credit default swap activities and positions of U.S. market participants, but the Commission notes that the data does not encompass those credit default swaps that both: (i) do not involve U.S. counterparties; and (ii) are based on non-U.S. reference entities. Reliance on this data should not be interpreted to indicate our views as to the nature or extent of the application of Title VII to non-U.S. persons; instead, it is anticipated that issues regarding the extraterritorial application of Title VII will be addressed in a separate release.

939 In addition, it is reasonable to believe that the implementation of Title VII itself will change the security-based swap market, and, with the full implementation of Title VII – which in part is conditioned on the implementation of the proposed financial responsibility program – more information will be available for this analysis.

940 See BIS, Statistical Release: OTC derivatives statistics at end-December 2011, 5 (May 2012), available at http://www.bis.org/publ/otc_hy1205.pdf (reflecting data reported by central banks in 14 countries: Belgium, Canada, France, Germany, England, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States, Australia, and Spain).

941 Id. at 12 ("Nominal or notional amounts outstanding are defined as the gross nominal or notional value of all deals concluded and not yet settled on the reporting date…Gross market values are defined as the sums of the absolute values of all open contracts with either positive or negative replacement values evaluated at market prices prevailing on the reporting date…gross market values supply information about the potential scale of market risk in derivatives transactions. Furthermore, gross market value at current market prices provides a measure of economic significance that is readily comparable across markets and products.").

942 Id.

and 5.8% of the gross market value. Equity-linked contracts, including forwards, swaps and options, comprised approximately an additional 1.0% of the total notional amount and 2.5% of the gross market value.[943]

Because the financial responsibility program for SBSDs and MSBSPs would apply to dealers and participants in the security-based swap markets, they are expected to affect a substantially smaller portion of the U.S. OTC derivatives markets than the proposed financial responsibility rules for swap dealers and major swap participants proposed by the CFTC and prudential regulators.[944] In addition, though the proposed capital, segregation and margin rules apply to all security-based swaps, not just single-name credit default swaps, the data on single-name credit default swaps are currently sufficiently representative of the market to help inform this economic analysis because currently an estimated 95% of all security-based swap transactions appear likely to be single-name credit default swaps.[945] The majority of these single-name credit default swaps, both in terms of aggregate total notional amount and total volume by product type, are based on corporate and sovereign reference entities.[946]

While the number of transactions is larger in single-name credit default swaps than in index credit default swaps, the aggregate total notional amount of the latter exceeds that of

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943 Id. Similarly, the OCC has found that interest rate products comprised 81% of the total notional amount of OTC derivatives held by bank dealers whereas credit derivative contracts comprised 6.4% and equity contracts comprised 1% of that notional amount. See OCC, Quarterly Report on Bank Trading and Derivatives Activities, Fourth Quarter 2011, available at http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq411.pdf.

944 See CFTC Margin Proposing Release, 76 FR 27802; Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564.

945 See Entity Definitions Adopting Release, 77 FR at 30636. See also Product Definitions Adopting Release, 77 FR 48205 (defining the term security-based swap).

946 Data compiled by the Commission's Division of Risk, Strategy, and Financial Innovation on credit default transactions from the DTCC-TIW between January 1, 2011 and December 31, 2011.

single-name credit default swaps.[947] For example, the total aggregate notional amount for single-name credit default swaps was $6.2 trillion, while the aggregate total notional amount for index credit default swaps was $16.8 trillion over the sample period of January 1, 2011 to December 31, 2011. For the same sample period, however, single-name credit default swaps totaled 69% of transactional volume, while index credit default swaps comprised 31% of the total transactional volume.[948] The majority of trades in both notional amount and volume for both single-name and index credit default swaps over the 2011 sample period were new trades in contrast to assignments, increases, terminations or exits.[949] The analysis of the 2011 data further shows that by total notional amount and total volume the majority of single-name and index credit default contracts have a tenor of 5 years.[950] In addition, the data from the sample period indicates that the geographical distribution of counterparties' parent country domiciles in single name contracts are concentrated in the United States, United Kingdom, and Switzerland.[951]

As described more fully in the CDS Data Analysis,[952] based on 2011 transaction data, Commission staff identified entities currently transacting in the credit default swap market that may register as SBSDs by analyzing various criteria of their dealing activity. The results suggest that there is currently a high degree of concentration of potential dealing activity in the single-name credit default swap market. For example, using the criterion that dealers are likely to transact with many counterparties who themselves are not dealers, the analysis of the 2011 data show that only 28 out of 1,084 market participants have three or more counterparties that

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947 Id. This data also shows the average mean and median single-name and index credit default swap notional transaction size in millions is 6.47 and 4.12, and 39.22 and 14.25, respectively.

948 Id.

949 Id.

950 Id.

951 Id.

952 See CDS Data Analysis.

themselves are not recognized as dealers by ISDA.[953] In addition, the analysis suggests that dealers appear, based on the percentage of trades between buyer and seller principals, in the majority of all trades on either one or both sides in single-name and index credit default swaps.[954]

This concentration to a large extent appears to reflect the fact that those larger entities are well-capitalized and therefore possess competitive advantages in engaging in OTC security-based swap dealing activities by providing potential counterparties with adequate assurances of financial performance.[955] As such, it is reasonable to conclude that currently there likely are high barriers to entry in terms of capitalization in connection with security-based swap dealing activity.[956]

Other than OTC derivatives dealers, which are subject to significant limitations on their activities, broker-dealers historically have not participated in a significant way in security-based swap trading for at least two reasons. First, because the Exchange Act has not previously

953 Id. at Table 3c. The analysis of this transaction data is imperfect as a tool for identifying dealing activity, given that the presence or absence of dealing activity ultimately turns upon the relevant facts and circumstances of an entity's security-based swap transactions, as informed by the dealer-trader distinction. Criteria based on the number of an entity's counterparties that are not recognized as dealers nonetheless appear to be useful for identifying apparent dealing activity in the absence of full analysis of the relevant facts and circumstances, given that engaging in security-based swap transactions with non-dealers would be consistent with the conduct of seeking to profit by providing liquidity to others, as anticipated by the dealer-trader distinction.

954 Data compiled by the Commission's Division of Risk, Strategy, and Financial Innovation on credit default transactions from the DTCC-TIW between January 1, 2011 and December 31, 2011. Additionally, according to the OCC, at the end of the first quarter of 2012, derivatives activity in the U.S. banking system continues to be dominated by a small group of large financial institutions. Four large commercial banks represent 93% of the total banking industry notional amounts and 81% of industry net current credit exposure. See OCC, Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2012, available at http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq112.pdf.

955 See, e.g., Craig Pirrong, Rocket Science, Default Risk and The Organization of Derivatives Markets, Working Paper 17-18 (2006), available at http://www.cba.uh.edu/spirrong/Derivorg1.pdf (noting that counterparties seek to reduce risk of default by engaging in credit derivative transactions with well-capitalized firms). See also Entity Definitions Adopting Release, 77 FR at 30739-30742.

956 See id. at 18-19 (noting lack of success among new entrants into derivatives dealing market due to perception that AAA rating for subsidiary is less desirable than a slightly lower rating for a larger entity, and suggesting that there are "economies of scale in bearing default risk" that may induce "substantial concentration in dealer activities"). See also Entity Definitions Adopting Release, 77 FR at 30739-30742.

defined security-based swaps as "securities," they have not been required to be traded through registered broker-dealers.[957] And second, a broker-dealer engaging in security-based swap activities is currently subject to existing regulatory requirements with respect to those activities, including capital, margin, segregation, and recordkeeping requirements. Specifically, the existing broker-dealer capital requirements make it relatively costly to conduct these activities in broker-dealers, as discussed in section II.A.2. of this release. As a result, security-based swap activities are currently mostly concentrated in entities that are affiliated with the parent companies of broker-dealers, but not in broker-dealers themselves.[958]

End users enter into OTC derivatives transactions to take investment positions or to hedge commercial and financial risk. These non-dealer end users of OTC derivatives are, for example, commercial companies, governmental entities, financial institutions, investment vehicles, and individuals. Available data suggests that the largest end users of credit default swaps are, in descending order, hedge funds, asset managers, and banks, which may have a commercial need to hedge their credit exposures to a wide variety of entities or may take an active view on credit risk.[959] Based on the available data, the Commission further estimates that commercial end users currently participate in the security-based swap markets on a very limited basis.[960]

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957 See definition of "security" in section 3(a)(10) of the Exchange Act and "security-based swap" in section 3(a)(68) of the Exchange Act.

958 See ISDA Margin Survey 2012.

959 This information is based on available market data from DTCC-TIW compiled by the Commission's Division of Risk, Strategy, and Financial Innovation. For example, data compiled by the Commission's Division of Risk, Strategy, and Financial Innovation on credit default transactions from the DTCC-TIW between January 1, 2011 and December 31, 2011 suggests that for single-name credit default swap transactions, dealer to dealer transactions composed 68.26% of trades between buyer and seller principals over the sample period.

960 For example, data compiled by the Commission's Division of Risk, Strategy, and Financial Innovation on credit default transactions from the DTCC-TIW between January 1, 2011 and December 31, 2011 suggest that the total percentage of trades between buyer and seller principals over the sample period for single-

Finally, this baseline for proposed new Rules 18a-1 through 18a-4 will be further discussed in the applicable sections of the release below.

Request for Comment

The Commission generally requests comment about its preliminary estimates of the scale and composition of the OTC derivatives market, including the relative size of the security-based swap segment of that market. In addition, the Commission requests that commenters provide data and sources of data to quantify:

1. The average daily and annual volume of OTC derivatives transactions;
2. The volume of transactions in each class of OTC derivatives (e.g., interest rate swaps, index credit default swaps, single-name credit default swaps, currency swaps, commodity swaps, and equity-based swaps);
3. The total notional amount of all pending swap transactions;
4. The total current exposure of all pending swap transactions;
5. The total notional amount of all pending security-based swap transactions;
6. The total current exposure of all pending security-based swap transactions;
7. The types and numbers of dealers in OTC derivatives (e.g., banks, broker-dealers, unregulated entities);
8. The capital levels of dealers, particularly those not subject to regulatory capital requirements;
9. The types and numbers of dealers in OTC derivatives dealers that engage in both a swap and security-based swap business;

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name credit default swaps was only 0.03% of the total trade counterparty distribution for non-financial end users, which are composed of non-financial companies and family trusts.

10. The types and numbers of dealers in OTC derivatives that engage only in a swap business;
11. The types and numbers of dealers in OTC derivatives that engage only in a security-based swaps business;
12. The classes of end users (e.g., commercial end users, financial end users, and others) and the number of end users in each class;
13. The types of OTC derivatives transactions that each class of end user commonly engages in;
14. The amount of assets posted for OTC derivatives to collateralize current exposure;
15. The amount of assets posted for OTC derivatives to collateralize potential future exposure;
16. The type of assets used as collateral; and
17. The amount of assets that are held under the different types of collateral arrangements (e.g., held by the dealer but not segregated, held by the dealer in omnibus segregation, held by a third-party custodian).

2. Baseline for Amendments to Rule 15c3-1

As discussed in more detail above, the Commission is proposing amendments to Rule 15c3-1.[961] These amendments would establish minimum net capital requirements for broker-dealers that register as SBSDs, increase the minimum net capital requirements for ANC broker-dealers, narrow the current treatment of credit risk charges for ANC broker-dealers to apply only to uncollateralized receivables from commercial end users arising from security-based swaps, and establish liquidity requirements for ANC broker-dealers and nonbank SBSDs using internal

[961] See section II.B. of this release.

models. Some of those proposed amendments to Rule 15c3-1 would also apply to broker-dealers not registering as SBSDs or MSBSPs to the extent they hold security-based swap positions or non-security-based swap positions.

As discussed in section II.A.1. of this release, the existing broker-dealer capital requirements are contained in Rule 15c3-1[962] and seven appendices to Rule 15c3-1.[963] The baseline for this economic analysis with respect to the proposed amendments to Rule 15c3-1 is the broker-dealer capital regime as it exists today.

Specifically, current Rule 15c3-1 requires broker-dealers to maintain a minimum level of net capital (meaning highly liquid capital) at all times.[964] The rule requires that a broker-dealer perform two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain;[965] and (2) a computation of the amount of net capital the broker-dealer is maintaining.[966] The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of aggregate debit items ratio.[967]

In computing net capital, the broker-dealer must, among other things, make certain adjustments to net worth such as deducting illiquid assets and taking other capital charges and

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962 17 CFR 240.15c3-1.

963 17 CFR 240.15c3-1a (Options); 17 CFR 240.15c3-1b (Adjustments to net worth and aggregate indebtedness for certain commodities transactions); 17 CFR 240.15c3-1c (Consolidated computations of net capital and aggregate indebtedness for certain subsidiaries and affiliates; 17 CFR 240.15c3-1d (Satisfactory subordination agreements); 17 CFR 240.15c3-1e (Deductions for market and credit risk for certain brokers or dealers); 17 CFR 240.15c3-1f (Optional market and credit risk requirements for OTC derivatives dealers); 17 CFR 240.15c3-1g (Conditions for ultimate holding companies of certain brokers or dealers).

964 See 17 CFR 240.15c3-1.

965 See 17 CFR 240.15c3-1(a).

966 See 17 CFR 240.15c3-1(c)(2). The computation of net capital is based on the definition of "net capital" in paragraph (c)(2) of Rule 15c3-1. Id.

967 See 17 CFR 240.15c3-1(a).

adding qualifying subordinated loans.[968] "Tentative net capital" is defined as the amount remaining after these deductions.[969] The final step in computing net capital is to deduct from the mark-to-market values of the proprietary positions (e.g. in securities, money market instruments, and commodities) that are included in its tentative net capital prescribed percentages ("standardized haircuts").[970] The standardized haircuts are designed to account for the market risk inherent in these proprietary positions and to create a buffer of liquidity to protect against other risks associated with the securities business.[971] With Commission approval, ANC broker-dealers and OTC derivative dealers are permitted to calculate deductions for market risk and credit risk from tentative net capital using internal models in lieu of the standardized haircuts.[972] Because the use of internal models to compute net capital generally can substantially reduce the deductions for proprietary positions compared to standardized haircuts and only certain risks are addressed by these internal models, current Rule 15c3-1 imposes substantially higher minimum capital requirements for ANC broker-dealers and OTC derivatives dealers as compared to other types of broker-dealers.[973] For example, under current Rule 15c3-1, ANC broker-dealers are required to at all times maintain tentative net capital of not less than $1 billion and net capital of

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968 See 17 CFR 240.15c3-1(c)(2)(i)-(xiii).

969 See 17 CFR 240.15c3-1(c)(15).

970 See 17 CFR 240.15c3-1(c)(2)(vi).

971 See, e.g., Uniform Net Capital Rule, 42 FR 31778 ("[Haircuts] are intended to enable net capital computations to reflect the market risk inherent in the positioning of the particular types of securities enumerated in [the rule]").

972 See 17 CFR 240.15c3-1(a)(5) and (a)(7); 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f. As part of the application to use internal models, an entity seeking to become an ANC broker-dealer or an OTC derivatives dealer must identify the types of positions it intends to include in its model calculation. See CFR 240.15c3-3e(a)(1)(iii); 17 CFR 240.15c3-1f(a)(1)(ii). After approval, the ANC broker-dealer or O derivatives dealer must obtain Commission approval to make a material change to the model, including change to the types of positions included in the model. See 17 CFR 240.15c3-1e(a)(8); 17 CFR 240.15 f(a)(3).

973 See 17 CFR 240.15c3-1(a)(5) and (a)(7).

not less than $500,000,[974] and they are required to provide notice to the Commission if their tentative net capital falls below $5 billion.[975] The current rule requires that a broker-dealer must ensure that its net capital exceeds its minimum net capital requirement at all times.[976]

Finally, the baseline of the current capital regime will be further discussed in the applicable sections of the release below.

B. ANALYSIS OF THE PROPOSALS AND ALTERNATIVES

1. Overview - The Proposed Financial Responsibility Program

Generally, the financial responsibility requirements the Commission is proposing today are intended to enhance the financial integrity of SBSDs and MSBSPs. As discussed more fully below, in proposing these requirements, the Commission is seeking to appropriately consider both the potential benefits of minimizing the risk that the failure of one firm will cause financial distress to other firms and disrupt financial markets and the U.S. financial system and the potential costs to that firm, the financial markets, and the U.S. financial system if SBSDs and MSBPs are required to comply with overly restrictive capital, margin and segregation requirements. This introductory section reviews at a general level certain considerations regarding the economic analysis of the proposed rules that is set forth in greater detail below.

As discussed in section I. of the release, the current broker-dealer financial responsibility equirements serve as the template for the proposals for several reasons. First, the financial kets in which SBSDs and MSBSPs are expected to operate are similar to the financial ts in which broker-dealers operate in the sense that they are driven in significant part by that buy and sell on a regular basis and that take principal risk. Second, like nonbank

17 CFR 240.15c3-1(a)(7)(i).

17 CFR 240.15c3-1(a)(7)(ii).

17 CFR 240.15c3-1(a).

dealers in securities but unlike bank SBSDs, nonbank SBSDs will not be able to rely on a backstop provider of liquidity but rather need to be able to liquidate assets quickly in the event of a counterparty default. Third, the broker-dealer financial responsibility requirements have existed for many years and have facilitated the prudent operation of broker-dealers.[977] Fourth, some broker-dealers likely will be registered as nonbank SBSDs so as to be able to offer customers a broader range of services than would be permitted as a stand-alone SBSD. Therefore, establishing consistent financial responsibility requirements would avoid potential competitive disparities between stand-alone SBSDs and broker-dealer SBSDs. And fifth, by placing an emphasis on maintaining liquid assets and requiring the segregation of customer funds, the current broker-dealer financial responsibility requirements have generally been successful in limiting losses to customers due to broker-dealer defaults.[978] Consequently, the current broker-dealer financial responsibility requirements provide a reasonable template for building a financial responsibility program for SBSDs and MSBSPs.

However, the Commission recognizes that there may be other appropriate approaches to establishing financial responsibility requirements – including, for example, requirements based on the Basel Standard in the case of entities that are part of a bank holding company, as has been

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977 For example, one of the objectives of the broker-dealer financial responsibility requirements is to protect customers from the consequences of the financial failure of a broker-dealer in terms of safeguarding customer securities and funds held by the broker-dealer. In this regard, SIPC, since its inception in 1971, has initiated customer protection proceedings for only 324 broker-dealers, which is less than 1% of the approximately 39,200 broker-dealers that have been members of SIPC during that timeframe. During the same period, only $1.1 billion of the $117.5 billion of cash and securities distributed for accounts of customers came from the SIPC fund rather than debtors' estates. See SIPC 2011 Annual Report.

978 For example, of the more than 625,200 claims satisfied in completed or substantially completed cases since SIPC's inception in 1971, as of December 31, 2011, a total of 351 were for cash and securities whose value was greater than the limits of protection afforded by SIPA. The 351 claims, unchanged during 2011, represent less than one-tenth of one percent of all claims satisfied. The unsatisfied portion of claims, $47.2 million, is unchanged in 2011. These remaining claims approximate three-tenths of one percent of the total value of securities and cash distributed for accounts of customers in those cases. See SIPC 2011 Annual Report. These figures do not include the SIPA liquidations of Bernard L. Madoff Investment Securities LLC and Lehman Brothers Inc., which are not complete.

proposed by the CFTC.[979] Generally, the bank capital model requires the holding of specified levels of capital as a percentage of "risk weighted assets."[980] In general, it does not require a full capital deduction for unsecured receivables, given that banks, as lending entities, are in the business of extending credit to a range of counterparties.

This approach could promote a consistent view and management of capital within a bank holding company structure. However, it would not be a net liquid assets standard. In addition, applying capital rules designed for banks to a non-bank entity would raise various practical and policy issues that are not directly implicated by the proposed approach. First, it would need to be clear whether a regulator with primary responsibility for the non-bank entity would defer to bank regulators with respect to the interpretation of Basel standards as applied to the entity, or instead develop its own interpretation of those standards. Further, it would need to be clear how trading and other risks of the non-bank entity and its bank affiliate or affiliates would be expected to be managed, whether such risks would be managed holistically at the holding company level or separately at the entity level, and what limitations, if any, would apply to transfers of risks from a bank to its non-bank entity affiliate, or vice versa. In addition, to the extent that bank capital standards would permit the non-bank entity to hold more illiquid assets as regulatory capital, an additional liquidity standard might be required at the entity level in order to assure that the entity maintained sufficient liquidity to support its trading activity. Similarly, if the non-bank entity were an SBSD that held assets for customers, the impact of any reduced liquidity associated with the application of bank capital standards on the ability of the entity to quickly wind down

979 CFTC Capital Proposing Release, 76 FR 27802.

980 The prudential regulators also have proposed capital rules that would require a covered swap entity to comply with the regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime. Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27568. The prudential regulators note that they have "had risk-based capital rules in place for banks to address over-the-counter derivatives since 1989 when the banking agencies implemented their risk-based capital adequacy standards...based on the first Basel Accord." Id.

operations and distribute assets to customers would need to be considered. The Commission specifically seeks comment as to whether to adapt Basel capital standards to non-bank affiliates of banks, and how such a regime would work in practice – including how it would address the issues described above and similar challenges.

The Commission also recognizes that in determining appropriate financial responsibility requirements – whether based on current broker-dealer rules or other alternative approaches described above – it must assess and consider a number of different costs and benefits, and the determinations it ultimately makes can have a variety of economic consequences for the relevant firms, markets, and the financial system as a whole. On the one hand, the capital and margin requirements in particular are broadly intended to work in tandem to strengthen the financial system by reducing the potential for default to an acceptable level and limiting the amount of leverage that can be employed by SBSDs and other market participants. Requiring particular firms to hold more capital or exchange more margin may reduce the risk of default by one or more market participants and reduce the amount of leverage employed in the system generally, which in turn may have a number of important benefits. The failure of an SBSD could result in immediate financial loss to its counterparties or customers, particularly those that are not able to avoid losses by liquidating collateral or those that have delivered assets for custody by the SBSD. Since the primary benefit of the capital and margin requirements is to reduce the probability of a SBSD failure, potential counterparties may be more willing to transact when they have greater assurance that they will be paid following a credit event. Depending on the size of the SBSD and its interconnectedness with other market participants, such a default also could have adverse spillover or contagion effects that could create instability for the financial markets more generally, such as limiting the willingness of healthy market participants to extend credit to each other, and thus substantially reduce liquidity and valuations for particular types of financial instruments.[981] Further, to the extent that market participants generally perceive that the prudential requirements are sufficient to protect them from losses due to a counterparty's default, the security-based swap market may experience increased trading activity, reduced transaction costs, improved liquidity, enhanced capital formation, and an improved ability to manage risk.

On the other hand, as described below, higher financial responsibility requirements for individual firms also give rise to direct costs for the firms involved and potentially significant collective costs for the markets and the financial system as a whole. For example, overly restrictive requirements that increase the cost of trading by individual firms could reduce their willingness to engage in such trading, adversely affecting liquidity in the security-based swaps markets and increasing transaction costs for market participants. Similarly, capital requirements that are set high enough to limit or restrict the willingness or ability of new firms to enter the market may impair or reduce competition in the markets, which in turn could also adversely affect liquidity and price discovery and increase transaction costs. Any such reduction in liquidity or price discovery, or increase in transaction costs, could adversely affect efficiency and impose direct costs on those market participants who rely on security-based swaps to manage or hedge the risks arising from their business activities that may support or promote capital formation. Even if the cost of overly restrictive financial responsibility requirements were shouldered only by those market participants that are subject to them, the excess amount of

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981 See, e.g., Markus K. Brunnermeier and Lasse Heje Pedersen, Market Liquidity and Funding Liquidity, Review of Financial Studies, 22 Review of Financial Studies 2201 (2009); Denis Gromb and Dimitri Vayanos, A Model of Financial Market Liquidity Based on Intermediary Capital, 8 Journal of the European Economic Association 456 (2010).

capital or margin tied up as a result of those requirements would not be available for potentially more efficient uses, which thereby could impair effective capital allocation and formation.

Although, in establishing appropriate financial responsibility requirements that are neither insufficient nor excessive, the Commission must seek to consider these and other potential benefits and costs, the Commission notes that it is difficult to quantify such benefits and costs. For example, although the adverse spillover effects of defaults on liquidity and valuations were evident during the financial crisis,[982] it is difficult to quantify the effects of measures intended to reduce the default probability of the individual intermediary, the ensuing prevention of contagion, and the adverse effects on liquidity and valuation. More broadly, it is difficult to quantify the costs and benefits that may be associated with steps to mitigate or avoid a future financial crisis. Similarly, although capital, margin, or segregation requirements may, among other things, affect liquidity and transaction costs in the security-based swap markets, and result in a different allocation of capital than may otherwise occur, it is difficult to quantify the extent of these effects, or the resulting effect on the financial system more generally.

These difficulties are further aggravated by the fact that only limited public data related to the security-based swap market, in general, and to security-based swap market participants in particular, exist, all of which could assist in quantifying certain benefits and costs. It also is difficult to demonstrate empirically that the customer protections associated with the proposed financial responsibility requirements would alter the likelihood that any specific market participant would suffer injury, or the degree to which the participant would suffer injury, from participating in an under- or over-regulated security-based swap market.

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982 See aggregate derivatives claims on Lehman Brothers Special Finance initially filed by the top 30 financial institution counterparties was estimated to be approximately $22 billion, available at http://chapter11.epiqsystems.com/LBH/document/GetDocument.aspx?DocumentId=1386611 and http://chapter11.epiqsystems.com/LBH/document/GetDocument.aspx?DocumentId=1430484.

In light of these challenges, much of the discussion of the proposed rules in this economic analysis will remain qualitative in nature, although where possible the economic analysis attempts to quantify these benefits and costs. The inability to quantify these benefits and costs, however, does not mean that the benefits and costs of the proposals are any less significant. In addition, as noted above, the proposed rules include a number of specific quantitative requirements – such as numerical thresholds, limits, deductions and ratios. The Commission recognizes that the specificity of each such quantitative requirement could be read by some to imply a definitive conclusion based on quantitative analysis of that requirement and its alternatives. These quantitative requirements have not been derived directly from econometric or mathematical models. Instead, they reflect a preliminary assessment by the Commission, based on qualitative analysis, regarding the appropriate financial standard for an identified issue, drawing (as noted above) from the Commission's long-term experience in administering its existing broker-dealer financial responsibility regime as well as its general experience in regulating broker-dealers and markets and from comparable quantitative requirements in its own rules and those of other regulators. Accordingly, the discussion generally describes in a qualitative way the primary costs, benefits and other economic effects that the Commission has identified and taken into account in developing these specific quantitative requirements. The Commission emphasizes that it invites comment, including relevant data and analysis, regarding all aspects of the various quantitative requirements reflected in the proposed rules.

Finally, the Commission notes that the proposals ultimately adopted, like other requirements under the Dodd-Frank Act, could have a substantial impact on international commerce and the relative competitive position of intermediaries operating in various, or multiple, jurisdictions. U.S. or foreign firms could be advantaged or disadvantaged depending on how the rules ultimately adopted by the Commission compare with corresponding requirements in other jurisdictions. Such differences could in turn affect cross-border capital flows and the ability of global firms to most efficiently allocate capital among legal entities to meet the demands of their counterparties. The Commission intends to address the potential international implications of the proposed capital, margin and segregation requirements, together with the full spectrum of other issues relating to the application of Title VII to cross-border security-based swap transactions, in a separate proposal.

a. Nonbank SBSDs

In addition to fulfilling a statutory requirement, it is expected that the proposed capital, margin and segregation rules should be beneficial to market participants by advancing market transparency, risk reduction and counterparty protection as Title VII of the Dodd-Frank Act intended.[983] It can be further expected that these benefits manifest themselves over the long-term and benefit the market as a whole. To the extent that the proposed rules increase the safety and soundness of entities that register as nonbank SBSDs and not just codify current practice, the proposals should specifically reduce the likelihood of default by an intermediary with substantial positions in security-based swaps and possible negative spillover effects. This would further imply that without the proposed rules in place, such an event could result in significant losses to counterparties whose exposures to the defaulting dealer are not sufficiently secured, which, depending on the size of individual counterparty exposures, could lead to defaults of those counterparties. Such events could then deter intermediaries from entering into financing

983 See section I. of this release.

transactions,[984] even with creditworthy counterparties, which could ultimately adversely affect valuation and liquidity in the broader financial markets.[985]

Apart from the positive impact on the safety and soundness of the security-based swap market, the proposed new rules and rule amendments could create the potential for regulatory arbitrage to the extent that they differ from corresponding rules other regulators adopt. As noted above in section I. of this release, the Commission is proposing capital and margin requirements for nonbank SBSDs that differ in some respects from the prudential regulators' proposed capital and margin requirements for bank SBSDs.[986] Depending on the final rules the Commission adopts, the financial responsibility requirements could make it more or less costly to conduct security-based swaps trading in banks as compared to nonbank SBSDs. For example, if the application of the proposed 8% margin risk factor substantially increases capital requirements for nonbank SBSDs compared to the risk-based capital requirements imposed by the prudential regulators on the same activity, bank holding companies could be incentivized to conduct these activities in their bank affiliates.[987] On the other hand, if the Commission does not require nonbank SBSDs to collect initial margin in their transactions with each other, as is generally current market practice,[988] while the prudential regulators require the collection of initial margin for the same trades as their proposed rules suggest, intermediaries could have an incentive to

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984 See, e.g., Markus K. Brunnermeier and Lasse Heje Pedersen, Market Liquidity and Funding Liquidity, Review of Financial Studies at 22; Denis Gromb and Dimitri Vayanos, A Model of Financial Market Liquidity Based on Intermediary Capital at 8.

985 See aggregate derivatives claims on Lehman Brothers Special Finance initially filed by the top 30 financial institution counterparties was estimated to be approximately $22 billion, available at http://chapter11.epiqsystems.com/LBH/document/GetDocument.aspx?DocumentId=1386611 and http://chapter11.epiqsystems.com/LBH/document/GetDocument.aspx?DocumentId=1430484.

986 See section I. of this release.

987 See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564.

988 See generally ISDA Margin Survey 2011.

conduct business through nonbank entities.[989] These differences could create competitive inequalities and affect the allocation of trading activities within a holding company structure.

The proposed financial responsibility requirements for SBSDs would also result in costs to individual market participants and may affect the amount of capital available to support security-based swap transactions generally.[990] As described in section V.B.1 immediately above, if SBSDs are required to maintain an excessive amount of capital, that amount may result in certain costs for the markets and the financial system, including the potential for the reduced availability of security-based swaps for market participants who would otherwise use such transactions to hedge the risks of their business, or engage in other activities that would promote capital formation. In addition, in some cases, these costs may include costs to financial conglomerates to restructure their security-based swap activities or move them into affiliates that register as SBSDs.[991] Nonbank SBSDs as well as other market participants would also incur costs to hire compliance personnel and to establish internal systems, procedures and controls designed to ensure compliance with the new requirements. Some of these costs were discussed in the PRA analysis in section IV of this release Finally, the full cost impact of the proposed financial responsibility requirements will depend to some extent on other rules related to SBSDs (e.g., registration) that the Commission has not yet adopted.[992]

Costs related to specific sections of the proposed new rules and rule amendments are discussed below. Some of these costs may be largely fixed in nature; other costs (such as minimum capital requirements and margin costs) may be variable as they reflect the level of the

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989 See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564.

990 See section II. of this release.

991 See SBSD Registration Proposing Release, 76 FR 65784.

992 Id.

nonbank SBSD's security-based swap activity. End users also may incur increased transaction costs in connection with the proposals as SBSDs are likely to pass on the financial burden of any increased capital, margin or segregation requirements to customers.[993]

This economic analysis considers the overall benefits and costs of the proposed new rules and amendments, keeping in mind that the benefits may be distributed across market participants, accrue over the long-term, and are difficult to quantify or to measure as easily as certain costs.

Request for Comment

The Commission generally requests comment about its analysis of the general costs and benefits of the proposed rules. The Commission requests data to quantify and estimates of the costs and the value of the benefits of the proposals described above. The Commission also requests data to quantify the impact of the proposals against the baseline. In addition, the Commission requests comment in response to the following questions:

1. In general terms, how effectively would the proposed rules limit systemic risk arising from security-based swap transactions? Please explain.
2. In general, how would the proposed rules and rule amendments impact the capital of entities that would need to register as nonbank SBSDs? For example, would they require these entities to hold more capital? If so, what would be the impact of the availability of sources of funding to these entities?
3. How important is parity of treatment between nonbank SBSDs and bank SBSDs in terms of regulatory requirements, and how should parity be understood? For example, should

993 If the rules succeed in improving competition among dealers in the security-based swap market rules this pass-through behavior should be less of a concern.

nonbank SBSDs and bank SBSDs be required to hold the same amounts of capital to support a certain level of security-based swaps business?

4. To what extent would the proposed regulatory requirements impact the amount of liquidity provided for or required by security-based swap market participants, and to what extent will that affect the funding cost for the financial sector in particular and the economy in general? Please quantify.

b. Nonbank MSBSPs

As with their application to nonbank SBSDs, in addition to fulfilling a statutory requirement, it is expected that the proposed capital, margin and notification requirements under the segregation rules for MSBSPs will advance market transparency, risk reduction and counterparty protection as Title VII of the Dodd-Frank Act intended.[994] However, in contrast to capital and margin requirements for nonbank SBSDs, the proposed rules for nonbank MSBSPs are intended to limit the impact on counterparties of a potential default by a nonbank MSBSP, rather than to create prudential standards that would render the possibility of its failure more remote. Capital standards of the type that would apply to SBSDs[995] may not be practical for nonbank MSBSPs, depending on their individual business models and whether they are subject to any other prudential requirements. Accordingly, the proposals are intended to ensure that nonbank MSBSPs meet a minimum capital standard by maintaining a positive tangible net worth,[996] collateralize their current exposures to end users, and post collateral to counterparties that covers at least the amount of the current exposure of those counterparties to them.[997]

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994 See section I. of this release.

995 See proposed new Rule 18a-1.

996 See proposed new Rule 18a-2.

997 See proposed new Rule 18a-3.

These proposed requirements are expected to have a relatively smaller aggregate effect than the proposed financial responsibility requirements for nonbank SBSDs because they are likely to affect relatively fewer entities. The Commission expects that only 5 or fewer entities will register as nonbank MSBSPs with the Commission.[998] Another approach, discussed further below, would subject MSBSPs to a capital regime similar to that proposed for nonbank SBSDs.

The proposed financial responsibility requirements for MSBSPs would also result in costs to individual market participants and may affect the amount of capital available to support security-based swap transactions overall and the financial markets generally. To the extent that the proposed capital and margin requirements are too restrictive, it could limit capital formation and the use of security-based swaps to hedge risks associated with the MSBSP's business activities.[999]

The proposed requirements may also impose more limited compliance burdens on MSBSPs. For example, nonbank MSBSPs as well as other market participants would also incur costs to hire compliance personnel and to establish internal systems, procedures and controls designed to ensure compliance with the new requirements.[1000] Some of these costs are discussed in the PRA analysis in section IV. of this release. Finally, the full cost impact of the proposed financial responsibility requirements will depend to some extent on other rules related to MSBSPs (e.g., registration) that the Commission has not yet adopted.[1001]

Costs related to specific sections of the proposed new rules and rule amendments are discussed below. Some of these costs may be largely fixed in nature; other costs (such as

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998 See section IV.C. of this release.

999 See section II. of this release.

1000 See section V.C. of this release.

1001 See SBSD Registration Proposing Release, 76 FR 65784.

minimum capital requirements and margin costs) may be variable as they reflect the level of the nonbank MSBSP's security-based swap activity.

Request for Comment

The Commission generally requests comment about its analysis of the general costs and benefits of the proposed rules on MSBSPs. The Commission requests data to quantify and estimates of the costs and the value of the benefits of the proposals for MSBSPs described above.

2. The Proposed Capital Rules

a. Nonbank SBSDs and ANC Broker-dealers.

As discussed above in section II.A. of this release, proposed new Rule 18a-1 would prescribe capital requirements for stand-alone SBSDs, and proposed amendments to Rule 15c3-1 would prescribe capital requirements for broker-dealer SBSDs and increase existing capital requirements for ANC broker-dealers.[1002] The proposed amendments to Rule 15c3-1 would apply to broker-dealers that are not registered as SBSDs to the extent they hold positions in security-based swaps and swaps. In addition, the Commission is proposing liquidity requirements for ANC broker-dealers and stand-alone SBSDs that use internal models to compute net capital.[1003] Finally, the Commission is proposing to require that all nonbank SBSDs comply with Rule 15c3-4, which requires the establishment of a risk management control system.[1004]

As described above, the capital and other financial responsibility requirements for broker-ealers generally provide a reasonable template for crafting the corresponding requirements for nbank SBSDs. For example, among other considerations, the objectives of capital standards

See proposed new Rule 18a-1.

See proposed paragraph (f) to Rule 15c3-1; paragraph (f) of proposed new Rule 18a-1.

See proposed new paragraph (a)(10)(ii) of Rule 15c3-1; paragraph (g) of proposed new Rule 18a-1. See also 17 CFR 240.15c3-4.

for both types of entities are similar. Rule 15c3-1 is a net liquid assets test that is designed to require a broker-dealer to maintain sufficient liquid assets to meet all obligations to customers and counterparties and have adequate additional resources to wind-down its business in an orderly manner without the need for a formal proceeding if it fails financially. The objective of the proposed capital standards for nonbank SBSDs is the same.

In addition, as discussed in section II.A.1. above, the Dodd-Frank Act divided responsibility for SBSDs and MSBSPs by providing the prudential regulators with authority to prescribe the capital and margin requirements for bank SBSDs and the Commission with authority to prescribe capital and margin requirements for nonbank SBSDs.[1005] This division also suggests it may be appropriate to model the capital requirements for nonbank SBSDs on the capital standards for broker-dealers, while the capital requirements for bank SBSDs are modeled on capital standards for banks (as reflected in the proposal by the prudential regulators).[1006]

As discussed in section II.A.1. above, certain differences in the activities of securities firms, banks, and commodities firms, differences in the products at issue, or the balancing of relevant policy choices and considerations, appear to support this distinction between nonbank SBSDs and bank SBSDs. First, based on the Commission staff's understanding of the activities of nonbank dealers in OTC derivatives, nonbank SBSDs are expected to engage in a securities business with respect to security-based swaps that is more similar to the dealer activities of broker-dealers than to the activities of banks; indeed, some broker-dealers likely will be registered as nonbank SBSDs.[1007] Second, existing capital standards for banks and broker-

1005 See 15 U.S.C. 78o-10, in general; 15 U.S.C. 78o-10(e)(2)(A)-(B), in particular.

1006 The prudential regulators have proposed capital requirements for bank SBSDs and bank swap dealers th are based on the capital requirements for banks. See Prudential Regulator Margin and Capital Proposi Release, 76 FR at 27582.

1007 Id.

dealers reflect, in part, differences in their funding models and access to certain types of financial support, and those same differences also will exist between bank SBSDs and nonbank SBSDs. For example, banks obtain funding through customer deposits and can obtain liquidity through the Federal Reserve's discount window; whereas broker-dealers do not – and nonbank SBSDs will not – have access to these sources of funding and liquidity. Third, Rule 15c3-1 currently contains provisions designed to address dealing in OTC derivatives by broker-dealers and, therefore, to some extent already can accommodate this type of activity (although, as discussed below, proposed amendments to Rule 15c3-1 would be designed to more specifically address the risks of security-based swaps and the potential for increased involvement of broker-dealers in the security-based swaps markets).[1008] For these reasons, the proposed capital standard for nonbank SBSDs is a net liquid assets test modeled on the broker-dealer capital standard in Rule 15c3-1.

The net liquid assets test is designed to allow a broker-dealer to engage in activities that are part of conducting a securities business (e.g., taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors). For example, Rule 15c3-1 allows securities positions to count as allowable net capital, subject to standardized or internal model-based haircuts.[1009] The rule, however, does not permit most unsecured receivables to count as allowable net capital.[1010]

This aspect of the rule severely limits the ability of broker-dealers to engage in activities, such as unsecured lending, that generate unsecured receivables. The rule also does not permit fixed assets or other illiquid assets to count as allowable net capital, which creates disincentives

1008 See 17 CFR 240.15c3-1f and 17 CFR 240.15c3-1e. See also Alternative Net Capital Requirements Adopting Release, 69 FR 34428; OTC Derivatives Dealers, 63 FR 59362.

1009 See 17 CFR 240.15c3-1(c)(2)(vi); 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f.

1010 See 17 CFR 240.15c3-1(c)(2)(iv).

for broker-dealers to own real estate and other fixed assets that cannot be readily converted into cash. For these reasons, Rule 15c3-1 incentivizes broker-dealers to confine their business activities and devote capital to activities such as underwriting, market making, and advising on and facilitating customer securities transactions.

Proposed new Rule 18a-1 and the proposed amendments to Rule 15c3-1 would provide a number of benefits, as well as impose certain costs on nonbank SBSDs, broker-dealer SBSDs, and broker-dealers, which are described below. In considering costs, in cases where the Commission is proposing amendments to Rule 15c3-1, the baseline is the current broker-dealer capital regime under Rule 15c3-1.[1011] The proposed rule also will have possible effects on competition, efficiency, and capital formation, which will be discussed further below.

i. Minimum Capital Requirements

The following table provides a summary of the proposed minimum capital requirements under the proposed new Rule 18a-1 and proposed amendments to Rule 15c3-1:

Proposed Minimum Capital Requirements

Type of Registrant	Tentative Net Capital	Net Capital	
		Fixed Dollar	Financial Ratio
Stand-alone SBSD (not using internal models)	N/A	$20 million	8% margin factor
Stand-alone SBSD (using internal models)	$100 million	$20 million	8% margin factor
Broker-dealer SBSD (not using internal models)	N/A	$20 million	8% margin factor+ Rule 15c3-1 ratio
Broker-dealer SBSD (using internal models)	$5 billion	$1 billion	8% margin factor+ Rule 15c3-1 ratio

Stand-alone SBSDs and broker-dealer SBSDs that are not approved to use internal models, that is, are neither ANC broker-dealers nor OTC derivatives dealers, would be required to maintain net capital of the larger of $20 million or 8% of the firm's margin factor. The proposed $20 million fixed-dollar minimum requirement would be consistent with the fixed-

1011 17 CFR 240.15c3-1.

dollar minimum requirement applicable to OTC derivatives dealers and already familiar to existing market participants.[1012] OTC derivatives dealers are limited purpose broker-dealers that are authorized to trade in certain derivatives, including security-based swaps, use internal models to calculate net capital, and they are required to maintain minimum tentative net capital of $100 million and minimum net capital of $20 million.[1013] These current fixed-dollar minimums have been the minimum capital standards for OTC derivative dealers for over a decade and to date, there have been no indications that these minimums are not adequately meeting the objective of requiring OTC derivatives dealers to maintain sufficient levels of regulatory capital to account for the risks inherent in their activities.

However, the proposed $20 million fixed-dollar minimum requirement for stand-alone SBSDs not using internal models to calculate net capital would be substantially higher than the fixed-dollar minimums in Rule 15c3-1 currently applicable to broker-dealers that do not use internal models.[1014] The proposed more stringent minimum capital requirement of $20 million for stand-alone SBSDs not approved to use models reflects the facts that these firms: (1) unlike broker-dealers, will be able to deal in security-based swaps, which, in general, pose risks that are different from, and in some respects greater than, those arising from dealing in securities; but (2)

1012 See 17 CFR 240.15c3-1(a)(5). The CFTC proposed a $20 million fixed-dollar minimum net capital requirement for FCMs that are registered as swap dealers, regardless of whether the firm is approved to use internal models to compute regulatory capital. See CFTC Capital Proposing Release, 76 FR 27802. Further, the CFTC proposed a $20 million fixed-dollar "tangible net equity" minimum requirement for swap dealers and major swap participants that are not FCMs and are not affiliated with a U.S. bank holding company. Finally, the CFTC proposed a $20 million fixed-dollar Tier 1 capital minimum requirement for swap dealers and major swap participants that are not FCMs and are affiliated with a U.S. bank holding company (the term "Tier 1 capital" refers to the regulatory capital requirement for U.S. banking institutions). Id.

1013 See 17 CFR 240.15c3-1(a)(5).

1014 For example, a broker-dealer that carries customer accounts has a fixed-dollar minimum requirement of $250,000; a broker-dealer that does not carry customer accounts but engages in proprietary securities trading (defined as more than ten trades a year) has a fixed-dollar minimum requirement of $100,000; and a broker-dealer that does not carry accounts for customers or otherwise receive or hold securities and cash for customers, and does not engage in proprietary trading activities, has a fixed-dollar minimum requirement of $5,000. See 17 CFR 240.15c3-1(a)(2).

unlike OTC derivative dealers have direct customer relationships and have custody of customer funds.[1015] Therefore, without the increased requirements, a failure of a stand-alone SBSD would, ceteris paribus, be more likely than a failure of an OTC derivatives dealer and, as a consequence of the relationships with customers, would have a broader adverse impact on a larger number of market participants, including customers and counterparties.[1016] Consequently, these heightened requirements should enhance the safety and soundness of the nonbank SBSDs, and thereby reduce systemic risk, as well as increase market participants' confidence in the security-based swap markets. Stand-alone SBSDs not approved to use internal models would not, however, be subject to a minimum tentative net capital requirement, which is applied to only firms that use internal models to account for risks not fully captured by the models.[1017]

Stand-alone SBSDs using models would be required to maintain minimum net capital of the higher of $20 million or the 8% margin factor, as well as a minimum tentative net capital of $100 million, a requirement that also applies to OTC derivatives dealers. Models to calculate deductions from tentative net capital for proprietary positions take only market and credit risk into account and therefore generally lead to lower deductions and higher levels of net capital.[1018]

1015 See 17 CFR 240.3b-12; 17 CFR 240.15a-1.

1016 The proposal is consistent with the CFTC's proposed capital requirements for nonbank swap dealers, which impose $20 million fixed-dollar minimum requirements regardless of whether the firm is approved to use internal models to compute regulatory capital. See CFTC Capital Proposing Release, 76 FR 27802.

1017 OTC derivatives dealers are subject to a $100 million minimum tentative net capital requirement. ANC broker-dealers are currently subject to a $1 billion minimum tentative net capital requirement. The minimum tentative net capital requirements are designed to address risks that may not be captured when using internal models rather than standardized haircuts to compute net capital. See OTC Derivatives Dealers, 63 FR at 59384; Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities; Proposed Rule, Exchange Act Release No. 48690 (Oct. 24, 2003), 68 FR 62872, 62875 (Nov. 6, 2003).

1018 See, e.g., Alternative Net Capital Requirements Adopting Release, 69 FR at 34455 (describing benefits of alternative net capital requirements for broker-dealers using models stating a "major benefit for the broker-dealer will be lower deductions from net capital for market and credit risk that we expect will result from the use of the alternative method."). Therefore, it is likely that for new entrants to capture substantial volume in security-based swaps they will need to use VaR models. See also OTC Derivatives Dealer

The minimum tentative net capital requirement for firms using models is intended to provide an additional assurance of adequate capital to reflect this concern.

However, because the tentative net capital calculation does not take account of market risk deductions, the minimum $100 million tentative net capital requirement might be a less effective standard in cases where a dealer maintains a substantial amount of less liquid positions that require relatively large deductions for market risk. As an alternative, the Commission could impose a minimum requirement that increases according to the nature and size of the positions held, for example, 25% of the market risk deductions that are required to be taken in determining actual net capital. This approach could better scale the tentative net capital requirement according to the risk of the proprietary positions held by an SBSD. On the other hand, a variable tentative net capital test would not serve as an accurate measure of risk if the model did not appropriately capture all material risks of the positions or the assumptions underlying the use of the model were no longer appropriate. The variable tentative net capital test also could increase the tentative net capital requirement in some cases to a level that could limit or discourage the entry of firms that do not presently compete in the security-based swap markets. Further, as noted above, the minimum net capital requirement in each case would increase in accordance with an increase in the amount of business conducted as a result of the 8% margin factor. The Commission is specifically seeking comment on this alternative in section II.A.1. of this release.

Under the proposed amendments to Rule 15c3-1, ANC broker-dealers would be required to maintain: (1) tentative net capital of not less than $5 billion; and (2) net capital of not less than the greater of $1 billion or the financial ratio amount required pursuant to paragraph (a)(1) of

Release, 63 FR 59362 (discussing benefits of minimum capital requirements as an additional measure of protection).

Rule 15c3-1 plus the 8% margin factor.[1019] These relatively high minimum capital requirements for ANC dealers (as compared with the requirements for other types of broker-dealers) reflect the substantial and diverse range of business activities engaged in by ANC broker-dealers and their importance as intermediaries in the securities markets.[1020] Further, the heightened capital requirements reflect the fact that, as noted above, VaR models are more risk sensitive but also generally permit substantially reduced deductions to tentative net capital as compared to the standardized haircuts as well as the fact that VaR models may not capture all risks.[1021]

Based on financial information reported by the ANC broker-dealers in their monthly FOCUS Reports filed with the Commission, the six current ANC broker-dealers maintain capital levels in excess of these proposed increased minimum requirements. For example, at the end of 2011, the interquartile range of net capital and tentative net capital levels among the six ANC broker-dealers were from \$1.11 billion to \$7.77 billion and from \$1.32 billion to \$9.69 billion, respectively. Further, ANC broker-dealers are currently required to notify the Commission if their tentative net capital falls below \$5 billion.[1022] This notification provision is used by the Commission to trigger increased supervision of the firm's operations and to take any necessary corrective action and is similar to corollary "early warning" requirements for OTC derivatives dealers.[1023] Consequently, this \$5 billion "early warning" level currently acts as the de facto minimum tentative net capital requirement since the ANC broker-dealers seek to avoid providing

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1019 See proposed amendments to paragraph (a)(7)(i) of Rule 15c3-1.

1020 As noted above, the six ANC broker-dealers collectively hold in excess of one trillion dollars' worth of customer securities.

1021 See Alternative Net Capital Requirements Adopting Release, 69 FR 34428.

1022 17 CFR 240.15c3-1(a)(ii).

1023 OTC derivatives dealers are required to provide notification promptly (but within 24 hours) if their tentative net capital falls below 120% of the firm's required minimum tentative net capital amount. See 17 CFR 240.17a-11(c)(3). Rule 17a-11 also requires ANC broker-dealers and OTC derivatives dealers to provide same day notification if their tentative net capital falls below required minimums. See 17 CFR 240.17a-11(b)(2).

this regulatory notice that their tentative net capital has fallen below the early warning level.[1024]

Although increases to minimum tentative and minimum net capital requirements are being proposed, the proposals may not present a material cost to the current ANC broker-dealers, because they already hold more than the proposed minimum requirements in the amendments to Rule 15c3-1. The more relevant number is the proposed increase in the early warning notification threshold from $5 billion to $6 billion. The existing early warning requirement for OTC derivatives dealers triggers a notice when the firm's tentative net capital falls below an amount that is 120% of the firm's required minimum tentative net capital amount of $100 million ($120 million = 1.2 × $100 million).[1025] The proposed new "early warning" threshold for ANC broker-dealers of $6 billion (= 1.2 × $5 billion) in tentative net capital is modeled on this requirement. In general, because the amount of actual net capital is subject to volatility commensurate with market volatility in proprietary instruments, the Commission expects ANC broker-dealers to maintain a reasonable cushion in excess of the minimum. Since, based on the Commission staff's supervision of the ANC broker-dealers, the current ANC broker-dealers report tentative net capital levels generally well in excess of $6 billion, the costs to the ANC broker-dealers to comply with this new requirement are not expected to be material.[1026] However, these costs may be prohibitive to new entrants that wish to register as broker-dealer SBSDs using internal models if they currently do not, or cannot, maintain these proposed capital levels. As noted below, such barriers to entry may prevent or reduce competition among SBSDs, which in turn can lead to higher transaction costs and less liquidity than would otherwise exist.

1024 See 17 CFR 240.15c3-1(a)(7)(i).

1025 See 17 CFR 240.17a-11(c)(3).

1026 Id.

In addition to the proposed minimum fixed tentative and minimum net capital requirements, the proposed 8% margin factor would be part of determining a nonbank SBSD's minimum net capital requirement.[1027] The 8% margin factor is intended to establish a minimum capital requirement that scales with the level of a nonbank SBSD's security-based swap activity and to limit the amount of leverage a nonbank SBSD can employ by requiring an increase in capital commensurate with the amount of leverage extended.

The 8% margin factor ratio requirement also is similar to an existing requirement in the CFTC's net capital rule for FCMs,[1028] and the CFTC has proposed a similar requirement for swap dealers and major swap participants registered as FCMs.[1029] Under the CFTC's proposal, an FCM would be required to maintain adjusted net capital[1030] that is equal to or greater than 8% of the risk margin required for customer and non-customer exchange-traded futures and swaps positions that are cleared by a DCO.[1031] Because exchange-traded futures, however, are

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1027 Since the 8% margin factor would be additive to the minimum capital requirements for ANC broker-dealers conducting a security-based swap business, the cost impact to an ANC broker-dealer using its current minimum capital requirements under Rule 15c3-1 and 15c3-1e as a baseline, would at minimum, increase by the 8% margin factor.

1028 See 17 CFR 1.17(a)(1)(i)(B).

1029 See CFTC Capital Proposing Release, 76 FR 27802. The 8% calculation under the CFTC's proposal relates to cleared swaps or futures transactions, whereas the 8% margin factor proposed in new Rule 18a-1 would be based on cleared and non-cleared security-based swaps.

1030 The CFTC has proposed that swap dealers and major swap participants that are also FCMs would be required to meet the existing FCM requirement to hold minimum levels of adjusted net capital, and also would be required to calculate the required minimum level as the greatest of the following: (1) a fixed dollar amount which under the CFTC's proposed rules would be $20 million; (2) the amount required for FCMs that also act as retail foreign exchange dealers; (3) 8% of the proposed risk margin; (4) the amount required by a registered futures association of which the FCM is a member; or (4) for an FCM, that is also a broker-dealer, the amount required by Commission rules. See CFTC Capital Proposing Release, 76 FR 27802

1031 See CFTC Capital Proposing Release, 76 FR 27802. The CFTC's proposed 8% margin requirement is intended to establish a minimum capital requirement that corresponds to the level of risk arising from the FCM's swap activity. Id. at 27807. One commenter objected to the inclusion of the 8% test in the CFTC's capital proposal, noting that margin and capital are complementary concepts in that both incorporate counterparty risk, and accordingly, the higher the initial margin requirement for a particular swap, the less regulatory capital a swap dealer should need to carry the client's position. The commenter believed that the CFTC's 8% charge would lead to allocations of dealer and client funding and capital to client portfolios in amounts disproportionately large in comparison to the risks of the relevant transactions. This commenter generally more liquid and give rise to lower margins than non-cleared security-based swaps with the same notional amount, the proposed 8% margin factor (which includes margin for both cleared and non-cleared swaps) would require allocating substantially more capital to support a non-cleared security-based swap contract compared to a futures contract. Requiring such additional capital could impose the types of costs on these firms and the markets more generally that are described above in section V.B.1. of this release. On the other hand, applying the 8% margin factor to non-cleared security-based swaps (rather than just cleared security-based swaps) would permit the nonbank SBSD's minimum capital requirement to vary based on this aspect of its business, which can entail similar leverage and present greater credit risk than cleared security-based swaps. This would have the benefit of further promoting the goals of the financial responsibility rules described above in section V.B.1. of this release.

Based on FOCUS Report information as of year-end 2011, approximately ten broker-dealers, including the current ANC broker-dealers, maintain tentative net capital in excess of $5 billion,[1032] approximately 31 broker-dealers maintain net capital in excess of $1 billion, approximately 145 broker-dealers maintain tentative net capital in excess of $100 million, and approximately 270 broker-dealers maintain net capital in excess of $20 million.

Although the proposed increase in minimum capital and early warning requirements for ANC broker-dealers will not affect firms that already have this classification, it would reduce the number of additional firms (from 31 to 4, according to FOCUS Report data) that would currently

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recommended to the CFTC that the CFTC defer incorporating swaps into the 8% margin multiplier for capital until after margin and capital requirements are finalized and the CFTC and market participants have had an opportunity to evaluate margin levels and the interrelationship between swap margin and capital. Letter from John M. Damgard, President, Futures Industry Association, Robert G. Pickel, Chief Executive Officer, ISDA and Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, to the CFTC (July 7, 2011) ("FIA/ISDA/SIFMA Comment Letter to the CFTC").

1032 These 10 broker-dealers also maintain tentative net capital in excess of $6.0 billion based on FOCUS Report information as of year-end 2011.

qualify for this designation and hence represents a significant potential cost for additional registrants. As noted above, these costs may be prohibitive to new entrants that wish to register as ANC broker-dealer SBSDs using internal models. If these additional costs were not imposed or were lower, there might be greater opportunities for more competition in the security-based swap markets, which in turn could lower transaction costs and increase liquidity in these markets. However, setting capital levels that allow new entrants that do not have sufficient capital to engage in the diverse business of ANC broker dealers could be disruptive to the market. In addition, to the extent that potential new entrants are able to operate effectively in these markets as stand-alone SBSDs (i.e., swap dealers that are not registered as broker-dealers), they would be eligible for lower minimum capital requirements and competition could further increase without compromising the heightened requirements for ANC broker-dealers.

With respect to the derivatives markets in particular, it is difficult to quantify the impact of the proposed capital requirements against the baseline of the OTC derivatives markets as they exist today because prior to the adoption of Title VII, swaps and security-based swaps were by and large unregulated.[1033] As discussed above in section V.A. of this release, however, most trading in security-based swaps and other derivatives is currently conducted by large banks and their affiliates. Among these entities are the current ANC broker-dealers. Other broker-dealers affiliated with firms presently conducting business in security-based swaps may be among the 270 broker-dealers that maintain net capital in excess of $20 million. Consequently, broker-dealers presently trading in security-based swaps may not need to raise significant new amounts of capital in order to register as nonbank SBSDs. At the same time, the proposed minimum

[1033] See Product Definitions Adopting Release, 77 FR 48207.

capital requirements could discourage entry by entities other than the approximately 270 broker-dealers that already have capital in excess of the required minimums.

As discussed above in section II.A.1. of this release, the Commission is seeking comment on possible modifications to the capital requirements in ways that may lessen potential compliance costs. First, to the extent that a nonbank SBSD that is approved to use models may be required to register as a broker-dealer solely to conduct certain brokerage activity, e.g., sending customer orders for execution to a security-based swap execution facility, the Commission could modify the capital requirements by setting lower minimum capital requirements for such firms than apply to ANC broker-dealers. Further, the requirements for OTC derivatives dealers could be amended to allow these firms to conduct a broader range of activities. This modification could increase the ability of firms that are not capitalized at minimum capital requirements proposed for the ANC firms to use models and compete for business in security-based swaps.

The Commission also could consider modifications that would increase the flexibility for a broader group of firms to conduct a derivatives business that extends beyond security-based swaps. For example, the Commission could determine to allow a firm to register jointly as an OTC derivatives dealer and SBSD. This modification could allow the registrant to conduct a broader range of derivatives activities than dealing only in security-based swaps, and to be able to use internal models for capital purposes without being subject to much higher capital requirements that apply to ANC broker-dealers. On the other hand, there could be practical difficulties in merging the registration regimes. For example, because OTC derivatives dealers are prohibited from having custody of customers' assets, while nonbank SBSDs would be permitted to do so, subject to compliance with new Rule 18a-4, dual registrants could be required to maintain separate sets of compliance processes and procedures, based on product type.

Alternatively, the Commission could provide conditional relief on a case-by-case basis to allow a firm that is registered as an SBSD to conduct dealing activity in derivatives other than security-based swaps. This also could provide a means for an entity to do business in a broad set of derivative instruments, subject to the basic capital standards that would apply to SBSDs. This approach also could allow the Commission to fashion exemptive relief on a case-by-case basis, pending further consideration of how and whether to reconcile the SBSD and OTC derivatives dealer regimes. On the other hand, allowing SBSDs to deal in products that OTC derivatives dealers can deal in, without the restrictions that apply to their activities, could undermine the purpose for the restrictions. The Commission is specifically soliciting comment on these potential approaches above in section II.A.1.

ii. Standardized Haircuts

As discussed in section II.A.2.b.ii. of this release, under proposed new Rule 18a-1 and the amendments to Rule 15c3-1, a nonbank SBSD would be required to apply standardized haircuts to its proprietary positions, unless the Commission approved it to use internal models for specific positions. In general, all haircut regimes are intended to be conservative estimates of risk as they tend to overcompensate for the actual risks and hence generally impose higher costs in terms of capital compared to VaR models.[1034]

As discussed in section II.A.2.b.ii. of this release, for positions that are not security-based swaps, broker-dealer SBSDs and stand-alone SBSDs also would be required to apply the

1034 Commenters to the proposed CFTC capital rule for swap dealers stated that they believe that model-based approaches are generally superior to grid-based approaches. One commenter argued that grid-based approaches are generally insufficiently risk sensitive, are not part of integrated risk management systems, and are hard to keep up-to-date to include innovative product and trading strategies. FIA/ISDA/SIFMA Comment Letter to the CFTC. Grid-based approaches, however, provide alternatives to firms that are unable to or chose not to use models.

standardized haircuts currently set forth in Rule 15c3-1.[1035] Standardized "haircuts" for credit default swaps would be based on a maturity grid approach. Modeled after similar "haircut" approaches currently employed under Rule 15c3-1, the proposed approach for credit default swaps is designed to be more risk-sensitive than a haircut approach that determines market deductions based on the type of each position without recognizing offsets among securities with similar risk characteristics (the proposed rules also permit firms to reduce the required haircut for certain netted positions). The number of maturity and spread categories in the proposed grid for credit default swaps is based on staff experience with the maturity grids for other securities in Rule 15c3-1 and, in part, on FINRA Rule 4240.[1036] While the haircut grid design takes into account that positions in credit defaults swaps with larger spreads or longer tenors are riskier and hence should be supported by larger haircuts, the Commission is specifically seeking comment on the design of the grid and particularly whether the haircuts appropriately reflect the risk inherent in long and short positions of credit defaults swaps across the spread and tenor spectrum.

Security-based swaps that are not credit default swaps can be divided into two broad categories: those that reference equity securities and those that reference debt instruments. Since each type of security-based swap can be viewed as being equivalent to a highly-levered synthetic position in the referenced instrument and therefore has the same price volatility as the referenced instrument, the standardized haircut for these categories of security-based swaps would be the

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1035 See 17 CFR 240.15c3-1(c)(2)(vi); paragraph (c)(1)(vii) of proposed new Rule 18a-1. See also section II.A.2.b.vi. of this release (discussing the treatment of swaps).

1036 See Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Amend FINRA Rule 4240 (Margin Requirements for Credit Default Swaps), Exchange Act Release No. 66527 (Mar. 7, 2012) (File No. SR-FINRA-2012-015) (in which FINRA amended the maturity grid in Rule 4240 in the interest of regulatory clarity and efficiency, and based upon FINRA's experience in the administration of the rule). While FINRA Rule 4240 is one reference point, the maturity grid it specifies does not appear to have been widely used by market participants, in part because a significant amount of business in the current credit default swap market is conducted by entities that are not members of FINRA.

deduction currently prescribed in Rule 15c3-1 applicable to the instrument referenced by the security-based swap multiplied by the contract's notional amount.[1037] It is likely that a nonbank SBSD that maintains substantial positions in such instruments would maintain portfolios of multiple instruments in such categories with offsetting long and short positions to hedge its risk.

Under the Commission's proposed standardized haircuts for these categories of security-based swaps, nonbank SBSDs would also be able to recognize the offsets currently permitted under Rule 15c3-1.[1038] In particular, as discussed below, nonbank SBSDs would be permitted to treat equity security-based swaps under the provisions of Appendix A to Rule 15c3-1, which produces a single haircut for portfolios of equity options and related positions.[1039] This method would permit a nonbank SBSD to compute deductions for a portfolio of equity security-based swaps using a comprehensive risk perspective by accounting for the risk of the entire portfolio, rather than the risk of each position within the portfolio.[1040] Appendix A provides a relatively less costly mechanism for a nonbank SBSD to calculate haircuts (in contrast to the standardized haircuts) since it is used for other equity derivatives and generally may reduce haircuts for a nonbank SBSD by allowing a swap referencing an equity security to be considered as part of a related portfolio. This, in turn, may permit a nonbank SBSD to more efficiently deploy this capital savings in other areas of its operations, as well as enhance operational efficiencies.

Similarly, nonbank SBSDs would be permitted to treat a debt security-based swap in the

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[1037] See proposed new paragraph (c)(2)(vi)(O)(2) of Rule 15c3-1; paragraph (c)(1)(vi)(B) of proposed new Rule 18a-1. For example, if a dealer maintained a position in a security-based swap with a notional amount of $1 million that provided the dealer with long exposure to a nonconvertible debt security maturing in 2½ years (assuming no offsetting short positions), the dealer would look to Rule 15c3-1(c)(2)(vi)(F) to find the applicable haircut percentage (5%) and the firm would be required to take a capital deduction of $50,000.

[1038] See proposed new paragraph (c)(2)(vi)(O)(2) of Rule 15c3-1; paragraph (c)(1)(vi)(B) of proposed new Rule 18a-1.

[1039] See 17 CFR 240.15c3-1a; Appendix A to proposed new Rule 18a-1.

[1040] See section II.A.2.b.ii. of this release.

same manner as debt instruments are treated in the Rule 15c3-1 grids in terms of allowing offsets between long and short positions where the instruments are in the same maturity categories, subcategories, and in some cases, adjacent categories.[1041] Consequently, nonbank SBSDs could recognize the offsets and hedges that those provisions permit to reduce the deductions on portfolios of debt security-based swaps, and thereby reduce their capital costs. This, in turn, may permit a nonbank SBSD to more efficiently deploy this capital savings in other areas of its operations.

The proposed approaches, like other types of standardized haircuts, likely will require a higher amount of capital to conduct security-based swaps business, in contrast to a VaR model. While the standardized haircuts and proposed CDS grid recognize certain offsets, standardized haircuts generally result in higher costs of capital because the standardized approaches do not recognize other ways in which a nonbank SBSD may mitigate its exposures, including unwinding unprofitable trades, entering into certain hedges that would not be recognized under the proposed capital rules, and portfolio diversification. The higher amounts that may result from using the standardized haircut and a grid-based approach[1042] may be acceptable for nonbank SBSDs that occasionally trade in security-based swaps but not in a substantial enough volume to justify the initial and ongoing systems and personnel costs to develop, implement, and monitor the performance of internal models. On the other hand, firms that conduct a substantial business in securities-based swaps in general will need to use the more cost-efficient models to measure and manage the risks of their positions over time.

The benefit of the standardized haircut approach of measuring market risk, besides its inherent simplicity, is that it may reduce the likelihood of default or failure by nonbank SBSDs

1041 See 17 CFR 240.15c3-1(c)(2)(vi).

1042 See section II.A.2.b.2. of this release.

that have not demonstrated that they have the risk management capabilities, of which VaR models are an integral part, or capital levels to support the use of VaR models. Therefore, the standardized haircut approach, in turn, may improve customer protections and reduce systemic risk. In addition, a standardized haircut approach may reduce costs for the nonbank SBSD related to the risk of failing to observe or correct a problem with the use of VaR models that could adversely impact the firm's financial condition, because the use of VaR models would require the allocation by the nonbank SBSD of additional firm resources and personnel.

Conversely, if the proposed standardized haircuts are too conservative, they could make the conduct of security-based swaps business too costly, preventing or impairing the ability of firms to engage in security-based swaps, increasing transaction costs, reducing liquidity, and reducing the availability of security-based swaps for risk mitigation by end users.

iii. Capital Charge in Lieu of Margin Collateral

As discussed in section II.A.2.b.v. of this release, the Commission is proposing certain capital charges in lieu of margin. Generally, margin collateral is designed to serve as a buffer to account for a decrease in the market value of the counterparty's positions between the time of default and liquidation. If the amount of the margin collateral is insufficient to make up the difference, the nonbank SBSD will incur losses. The proposal requires the nonbank SBSD to hold sufficient net capital to enable it to, first, withstand such losses and to cover counterparty exposures that are not sufficiently secured with liquid collateral, and, second, to create a strong incentive for dealers to collateralize these exposures. Consequently, this proposed capital charge may serve as an alternative to margin collateral, enhance the financial soundness of the nonbank SBSD and, in turn, ultimately reduce systemic risk.

With respect to cleared security-based swaps, the rules would impose a capital charge if a nonbank SBSD collects margin collateral from a counterparty in an amount that is less than the deduction that would apply to the security-based swap if it were a proprietary position of the nonbank SBSD (i.e., less than an amount determined by using the standardized haircuts in Rule 15c3-1, as proposed to be amended, and in proposed new Rule 18a-1 or a VaR model, as applicable).[1043] As discussed in section II.A.2.b.v. of this release, the proposed capital charge, therefore, is designed to protect the nonbank SBSDs against this risk, and thereby, serves to increase the safety and soundness of the nonbank SBSD.

This proposed charge, however, could impose additional capital costs on cleared transactions where the amount of the additional costs would depend on the differences between amounts required under Rule 18a-1 and margin amounts the clearing agency sets. It is difficult to estimate the cost impact of this proposal because there is currently a lack of trading for customers in cleared security-based swaps that could be used for comparative purposes.[1044] In addition, requiring nonbank SBSDs to take a capital charge equal to the difference between the haircut amount and the clearing agency margin could reduce incentives to use cleared security-based swap contracts, which would be inconsistent with the goal of reducing systemic risk. However, incentives to clear security-based swaps will be substantially affected by a variety of other factors, including the amount of margin required for non-cleared contracts, and clearing volume will also be affected by mandatory clearing determinations by the Commission under Section 763(a) of the Dodd-Frank Act. In general, it is unclear whether the additional costs to

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1043 See proposed paragraph (c)(2)(xiv)(A) of Rule 15c3-1; paragraph (c)(1)(viii)(A) of proposed Rule 18a-1.

1044 See Process for Submissions of Security-Based Swaps, 77 FR 41602 (although the volume of interdealer CDS cleared to date is quite large, many security-based swap transactions are still ineligible for central clearing, and many transactions in security-based swaps eligible for clearing at a CCP continue to settle bilaterally. Voluntary clearing of security-based swaps in the U.S. is currently limited to CDS products. Central clearing of security-based swaps began in March 2009 for index CDS products, in December 2009 for single-name corporate CDS products, and in November 2011 for single-name sovereign CDS products. At present, there is no central clearing in the U.S. for security-based swaps that are not CDS products, such as those based on equity securities.). Id.

conduct business on a cleared basis would materially affect the volume of business that SBSDs conduct on an uncleared basis when they have the choice to do so.

As discussed in section II.A.2.b.v. of the release, with respect to non-cleared security-based swaps, the Commission is proposing capital charges to address three exceptions in proposed new Rule 18a-3 (nonbank SBSD margin rule), including margin not collected from commercial end users, margin collateral collected but segregated pursuant to section 3E(f) of the Exchange Act, and margin that has not been collected for a legacy swap.[1045] The rule is designed to reduce systemic risk by requiring capital to cover counterparty exposures, because the capital levels will serve in lieu of margin as a buffer in case of counterparty defaults. If the nonbank SBSD did not hold capital in lieu of margin, a counterparty default could lead to the default of the nonbank SBSD itself. This capital charge should have the benefit of reducing the likelihood of default of the nonbank SBSD due to under-margined counterparty exposure. Conversely it will increase the cost of capital for nonbank SBSDs that engage in non-cleared security-based swaps because they must use their own capital to support the counterparty's transaction, which in turn could reduce the liquidity of such security-based swaps. However, the proposed rule imposes a charge only if a firm fails to collect margin under Rule 18a-3, and thus no additional costs would be imposed on a nonbank SBSDs that collects margin. Therefore, the proposed rule is designed to create a strong incentive for nonbank SBSDs to collect margin and collateralize counterparty exposures.

The charge for collateral segregated in individual accounts under Section 3E(f) of the Exchange Act reflects the potential that collateral collected by an SBSD but held in a third-party

1045 This proposed rule also provides the nonbank SBSDs certain flexibility in determining whether to collect margin from certain counterparties exempt from certain requirements of proposed Rule 18a-3 and thus attempts to appropriately consider both the concerns of commercial end users and other entities/transactions exempt from proposed new Rule 18a-3 and the need to enhance the financial soundness of the nonbank SBSD.

custodian account may not be readily liquidated immediately following a counterparty's default. Accordingly, this aspect of the rule would create an additional capital cost to SBSDs that hold collateral in independent third-party accounts.[1046] If these costs are passed on to counterparties electing an independent segregation option, they could deter counterparties from electing the option and reduce their flexibility in determining the optimal way to hold their collateral.

The third proposed capital charge would apply to margin not collected in the case of legacy non-cleared security-based swaps. This proposal should benefit nonbank SBSDs and their counterparties in that it is designed to avoid the difficulties of requiring a nonbank SBSD to renegotiate security-based swap contracts to come into compliance with the new margin collateral requirements, which would be a complex and costly task. Based on discussions with market participants, this proposal, however, may impose substantial costs in the form of capital charges on firms that have legacy contracts.[1047] Because broker-dealers, however, currently do not conduct significant business in security-based swaps, and any newly-registered SBSDs may not enter into security-based swap transactions before the effectiveness of these proposed rules and, therefore, not have any legacy security-based swaps, this cost of capital may be immaterial. However, the costs could be significant if legacy security-based swaps are assigned to a security-based swap dealer.

1046 See discussion above in section II.A.2.b.v. of this release. See also discussion above in section V.B.1. of this release (discussing quantification of costs).

1047 As discussed above in section II.B.2. of this release, this exception would be designed to address the impracticality of renegotiating contracts governing security-based swap transactions that predate the effectiveness of proposed new Rule 18a-3 in order to come into compliance with the account equity requirements in the rule. See discussion above in section V.A.1. of this release (discussing quantification of costs).

iv. Credit Risk Charge

As discussed in section II.A.2.b.iv. of this release, consistent with existing rules affecting broker-dealers,[1048] proposed Rule 18a-1 and the amendments to Rule 15c3-1 rule would require firms to take a 100% charge for the amount of any unsecured receivable, including any uncollateralized receivable currently owed under a security-based swap. As an alternative to taking this capital charge in lieu of margin to a <u>commercial end user</u>, as discussed in section II.A.2.b.iv. of the release, ANC broker-dealers and stand-alone SBSDs using internal models would be permitted instead to take a credit risk charge using a methodology in Appendix E to Rule 15c3-1 for uncollateralized receivables arising from security-based swaps with (and only with) <u>commercial end users</u> in lieu of the 100% deduction otherwise required by the rules.[1049]

The proposed rule is designed to provide an alternative, less costly way (in lieu of the 100% deduction otherwise required by the rules) to recognize credit exposure incurred in transactions with <u>commercial end users</u> for those nonbank SBSDs approved to use internal models. Nonbank SBSDs would be permitted to use this approach because they are required to implement processes for analyzing credit risk to OTC derivative counterparties and to develop mathematical models for estimating credit exposures arising from OTC derivatives transactions and determining risk-based capital charges for those exposures.[1050]

The rule, however, will increase costs[1051] for nonbank SBSDs that do substantial trading

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1048 <u>See</u> 17 CFR 240.15c3-1(c)(2)(iv)(B)-(D); proposed new Rule 18a-1(c)(1)(iii)(B)-(D).

1049 <u>See</u> paragraph (e)(2) of proposed new Rule 18a-1. Paragraph (c)(1) of Appendix E to Rule 15c3-1 requires an ANC broker-dealer to take a counterparty exposure charge in an amount equal to: (i) the net replacement value in the account of each counterparty that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default; and (ii) for a counterparty not otherwise described in paragraph (c)(1)(i) of Appendix E, the credit equivalent amount of the broker's or dealer's exposure to the counterparty, as defined in paragraph (c)(4)(i) of this Appendix E, multiplied by the credit risk weight of the counterparty, as defined in paragraph (c)(4)(vi) of Appendix E, multiplied by 8%. 17 CFR 240.15c3-1e(c)(1).

1051 <u>See</u> section V.B.1. of this release (discussing quantification of costs).

with commercial end users and do not collect margin for transactions in non-cleared security-based swaps from them. Available data suggests that commercial end users presently do not conduct substantial trading in non-cleared security-based swaps.[1052] Therefore, the proposed credit risk charge may not have an immediate cost impact on nonbank SBSDs when compared to the baseline of the OTC derivatives markets as they exist today. However, costs, in terms of higher capital charges and opportunity costs, could become significant if commercial end users begin to trade security-based swaps in greater volume and exposures to the nonbank SBSDs remain uncollateralized.

To the extent that commercial end users do trade in security-based swaps, the ability of a nonbank SBSD to use internal models likely would give it a significant cost advantage over nonbank SBSDs not using models once the initial infrastructure investment to use the models has been made. In addition, ANC broker-dealers currently are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (i.e., they can add back the amount of the uncollateralized current exposure).[1053] This treatment would be narrowed under the proposed capital requirements for nonbank SBSDs as well as for ANC broker-dealers to the extent that it would apply only to uncollateralized receivables from commercial end users arising from security-based swaps. In contrast, uncollateralized receivables from other types of counterparties would be subject to a 100% deduction from net worth to limit the potential that the rules would permit a substantial amount of unsecured exposures for ANC broker-dealers and nonbank SBSDs.[1054]

1052 See generally CDS Data Analysis; ISDA Margin Survey 2012.

1053 See 17 CFR 240.15c3-1e(c). OTC derivatives dealers are permitted to treat such uncollateralized receivables in a similar manner. See 17 CFR 240.15c3-1f.

1054 See proposed amendments to paragraphs (a) and (c) of Rule 15c3-1e. See section II.A.2.b.iv. of this release (discussing credit risk charges).

According to FOCUS Reports and staff experience supervising the ANC broker-dealers, ANC broker-dealers have not engaged in a large volume of OTC derivatives transactions since the rules were adopted in 2004. Therefore, they have not had significant amounts of unsecured receivables that would be subject to the credit risk charge provisions in Appendix E to Rule 15c3-1. However, when the Dodd-Frank OTC derivatives reforms are implemented, ANC broker-dealers could significantly increase their holdings of OTC derivatives. An increase in derivatives exposure that is uncollateralized would increase the exposure of the ANC broker-dealers to their derivatives counterparties. In turn, however, this proposed amendment should strengthen the capital position of the ANC broker-dealers, and thereby reduce the likelihood of default of one of these entities. Because ANC broker-dealers currently do not trade in significant amounts of OTC derivatives, and therefore, do not currently have significant amounts of unsecured receivables related to OTC derivatives transactions, the cost impact as compared to the baseline of the current capital regime for broker-dealers should not be material for these firms.

v. Funding Liquidity Stress Test Requirement

As discussed in section II.A.2.d. of this release, the Commission is proposing a funding liquidity stress requirement[1055] to be conducted by the ANC broker-dealers and stand-alone SBSDs that use internal models at least monthly that takes into account certain assumed conditions lasting for 30 consecutive days. These required assumed conditions would be:

- A stress event that includes a decline in creditworthiness of the firm severe enough to trigger contractual credit-related commitment provisions of counterparty agreements;[1056]

1055 Compare BCBS, Basel III: International framework for liquidity risk measurement, standards and monitoring (Dec. 2010), available at http://www.bis.org/publ/bcbs188.pdf.

1056 See Federal Reserve Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 FR 594, 608 (Jan. 5, 2012) (noting that effective liquidity stress testing should be conducted over a variety of time horizons to adequately capture rapidly developing events, and other conditions and outcomes that may materialize in the near or long term).

- The loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding, including intercompany advances and unfunded committed lines of credit;

- The potential for a material net loss of secured funding;

- The loss of the ability to procure repurchase agreement financing for less liquid assets;

- The illiquidity of collateral required by and on deposit at clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets;

- A material increase in collateral required to be maintained at registered clearing agencies of which the firm is a member; and

- The potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the firm, including those related to customer businesses of the firm.[1057]

These proposed minimum elements are designed to ensure that ANC broker-dealers and stand-alone SBSDs using internal models employ a stress test that is severe enough to produce an estimate of a potential funding loss of a magnitude that might be expected in a severely stressed market.

The benefit of the proposed liquidity stress test requirement is an additional level of protection against disruptions in the ability to obtain funding for a firm with significant proprietary positions in securities or derivatives.[1058] The proposed liquidity requirement is intended to increase the likelihood that a firm could withstand a general loss of confidence in the

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1057 See proposed new paragraph (f)(1) to Rule 15c3-1 and paragraph (f)(1) of proposed new Rule 18a-1.

1058 See letter from Christopher Cox, Chairman, Commission, to Dr. Nout Wellink, Chairman, BCBS (Mar. 20, 2008), available at http://www.sec.gov/news/press/2008/2008-48_letter.pdf (highlighting importance of liquidity management in meeting obligations during stressful market conditions). See also Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 FR 594, 608 (Jan. 5, 2012) (proposing that liquidity stress testing must be tailored to reflect a covered company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors stating that stress testing will be directly tied to the covered company's business profile and the regulatory environment in which it operates.). The minimum factors described above are intended to specifically address factors relevant to the regulatory environment in which ANC broker-dealers and stand-alone SBSD using internal models operate.

firm itself, or the markets more generally and stay solvent for up to 30 days, during which time it could either regain the ability to obtain funding in the ordinary course or else better position itself for resolution, with less collateral impact on other market participants and the financial system. As such, this proposal may reduce the likelihood and severity of a fire sale and, therefore, mitigate spillover effects and lower systemic risk.[1059] This, in turn, may increase confidence in the security-based swap markets and may lead to an increase in trading in this market.

This proposal, however, would impose additional opportunity costs of capital, and other costs on ANC broker-dealers and nonbank SBSDs directly related to the amount of the required liquidity reserve because a nonbank SBSD would be unable to deploy the assets that are maintained for the liquidity reserve in other, potentially more efficient ways.

In addition, smaller firms may incur more implementation costs, because, in general, large firms already run stress tests and maintain a liquidity reserve based on those tests.[1060] In addition, the required assumed conditions are designed to be consistent with the liquidity stress tests performed by ANC broker-dealers (based on staff experience in supervising the ANC broker-dealers) and to address the types of outflows experienced by ANC broker-dealers and other broker-dealers in times of stress. Therefore, while the opportunity cost of the liquidity requirements might be substantial, they are not expected to impose liquidity standards that are materially different from what is observed now among the ANC broker-dealers and thus should not represent an undue burden at this time.

1059 See Andrei Shleifer and Robert Vishny, Fire Sales in Finance and Macroeconomics, 25 Journal of Economic Perspectives 29-48 (Winter 2011) (surveying literature on fire sales, which implies that if financial institutions are not liquidity restraints during fire sales, price and liquidity spirals should less likely occur).

1060 See 17 CFR 240.15c3-4.

Finally, under the proposals, an ANC broker-dealer and a stand-alone SBSD using internal models would be required to establish a written contingency funding plan. The plan would need to clearly set out the strategies for addressing liquidity shortfalls in emergency situations,[1061] and would need to address the policies, roles, and responsibilities for meeting the liquidity needs of the firm and communicating with the public and other market participants during a liquidity stress event.[1062]

This proposal may reduce the likelihood of default of a nonbank SBSD that uses internal models or an ANC broker-dealer, and thus, in turn, reduce systemic risk. Based on staff experience supervising ANC broker-dealers and monitoring the ultimate holding companies of these firms, most of these entities have a written contingency funding plan, generally, at the holding company level. To the extent that these firms are required to implement a written contingency funding plan at the nonbank SBSD level or ANC level, these firms may incur personnel, technology or other operational costs to develop and implement such a plan.[1063]

vi. Risk Management Procedures

As discussed in section II.A.2.c. above, nonbank SBSDs would be required to comply with the risk management provisions of Rule 15c3-4, as if they were OTC derivatives dealers, because the risks of trading by nonbank SBSDs in security-based swaps, including market, credit, operational, and legal risks, are similar to the risks faced by OTC derivatives dealers in trading other types of OTC derivatives.[1064] These requirements may reduce the risk of

1061 See proposed new paragraph (f)(4) of Rule 15c3-1; paragraph (f)(4) of proposed Rule 18a-1.

1062 See proposed new paragraph (f)(4) of Rule 15c3-1; paragraph (f)(4) of proposed Rule 18a-1.

1063 See section V.C. of this release.

1064 For example, individually negotiated OTC derivative products, including security-based swaps, generally are not very liquid. Market participants face risks associated with the financial and legal ability of counterparties to perform under the terms of specific transactions. The additional exposure to credit risk, significant losses by nonbank SBSDs. The internal risk management control system requirements also should reduce the risk that the problems of one firm will spread because each nonbank SBSD should have a better understanding of the nonbank's exposures and the risks of those exposures. The nonbank SBSDs may incur costs in better modifying documents and their information technology systems to meet these requirements, but these costs could vary significantly among nonbank SBSDs depending on the degree to which their risk management systems are documented and on size of each firm and the types of business it engages in.[1065]

b. Capital Requirements for MSBSPs

As discussed in section II.A.3. of the release, proposed new Rule 18a-2 would require nonbank MSBSPs to have and maintain positive tangible net worth at all times.[1066] Entities that may need to register as MSBSPs may engage in a diverse range of business activities very different from, and broader than, the securities activities conducted by broker-dealers (otherwise they would be required to register as an SBSD and/or broker-dealer). Because nonbank MSBSPs, by definition, will be entities that have substantial exposure to security-based swaps, they would also be required to comply with Rule 15c3-4,[1067] which requires OTC derivatives dealers and ANC broker-dealers to establish, document, and maintain a system of internal risk management.[1068] This proposal is designed to promote sound risk management practices with respect to the risks associated with trading in OTC derivatives. Nonbank MSBSPs may incur implementation costs, such as technology costs to comply with the risk management practices

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liquidity risk, and other risks makes it necessary for OTC derivatives market participants to implement a risk management control system.

1065 See section V.C. of this release.

1066 See paragraph (a) of proposed new Rule 18a-2.

1067 See paragraph (c) of proposed new Rule 18a-2.

1068 See 17 CFR 240.15c3-4.

proposed by the rule. These are discussed in section V.C. below.

Risk management controls at nonbank MSBSPs may promote the stability of these firms and, consequently, the stability of the entire financial system. This, in turn, may protect the financial industry from systemic risk.

The Commission could instead impose capital requirements that are the same as, or modeled on, those that are being proposed for nonbank SBSDs, which could more effectively reduce the risk of failure of MSBSPs and thereby reduce systemic risk. In general, nonbank SBSDs and MSBSPs can be expected to differ in terms of the range and types of their counterparty relationships and, by definition, MSBSPs will not maintain two-sided exposure to a range of instruments that is characteristic of dealer activity. The systemic impact of the failure of an MSBSP will depend on various factors, including the ability of its counterparties to readily liquidate assets posted by the MSBSP as collateral, without suffering a loss. Although the Commission is proposing to require MSBSPs to post collateral to eliminate their current exposure to counterparties in security-based swaps, the collateral may not be sufficient to avoid losses during a period of market volatility. At the same time, imposing a capital regime on MSBSPs that is based on a net liquid assets test could impact the ability of an MSBSP to pursue business activities and strategies unrelated to its activities involving financial instruments. For example, these entities may engage in commercial activities that require them to have substantial fixed assets to support manufacturing and/or result in them having significant assets comprised of unsecured receivables. Requiring them to adhere to a net liquid assets test could result in their having to obtain significant additional capital or engage in costly restructurings. The Commission is specifically seeking comment on this approach in section II.A.3. of this release.

As stated above, at present, entities that may be required to be registered as MSBSPs are expected to be companies that engage in a diverse range of business. For these reasons, it would be difficult to quantify how much additional capital, if any, or costs the capital requirements under proposed new Rule 18a-3 would require these entities to maintain or incur and compare these amounts against the current baseline of the OTC derivatives market as it exists today.[1069] Given that proposed new Rule 18a-2 would only require that a nonbank MSBSP maintain a positive tangible net worth at all times, and 5 or fewer entities are expected to register as nonbank MSBSPs,[1070] these costs are not expected to be material because it is not expected that these firms would have to alter their existing business practice in any substantial way to comply with the proposed positive tangible net worth test.

c. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The proposed financial responsibility requirements should reduce the risk of a failure of any major market participant in the security-based swap market, which in turn reduces the possibility of a general market failure, and thus promotes confidence for market participants to transact in security-based swaps for investment and hedging purposes. The proposed capital requirements are designed to promote confidence in nonbank SBSDs among customers, counterparties, and the entities that provide financing to nonbank SBSDs and, thereby, lessen the potential that these market participants may seek to rapidly withdraw assets and financing from SBSDs during a time of market stress. This heightened confidence is expected to increase trading activity and promote competition among dealers. The proposed financial responsibility requirements, in significant part, will affect efficiency and capital formation through their impact

1069 See section V.A.1. of this release.

1070 See section IV. of this release.

on competition.[1071] Specifically, markets that are competitive can, ceteris paribus, be expected to promote a more efficient allocation of capital.

Any new entrant will increase the number of competing entities, and the extent to which competition increases will depend on the number of additional entrants and their success in attracting business from established market participants. As discussed in section IV. of this release, the Commission expects up to 50 entities to register as SBSDs. The number of registered firms will depend, among other factors, on whether potential new entrants determine that the cost impact of the proposed financial responsibility requirements would allow them to compete effectively for business. To the extent that costs associated with the proposed rules are high however, they may negatively affect competition within the security-based swap markets. This may, for example, lead smaller dealers or entities for whom dealing is not a core business to exit the market because compliance with the proposed minimum capital requirements is not feasible because of cost considerations. The same costs might also deter the entry of new SBSDs or MSBSPs into the market, and if sufficiently high, increase concentration among nonbank SBSDs.

The possibility of using VaR to calculate haircuts may permit a nonbank SBSD to more efficiently deploy capital in other parts of its operations (because VaR models could reduce capital charges and thereby could make additional capital available), which should be a factor in the decision to enter the security-based swap markets in general and through which type of registrant in particular. Because of the reduced charges for market and credit risk, a nonbank SBSD may be able to reallocate capital from the nonbank SBSD to affiliates that may receive a

1071 See also Entity Definitions Adopting Release, 77 FR at 30742.

higher return than the nonbank SBSD.[1072] Therefore, the success of new entrants in competing for security-based swap business also will likely depend on the extent to which they obtain the Commission's approval to use a VaR model.[1073] Hence, the Commission expects a positive impact on competition especially among SBSDs that use internal models, whether they are stand-alone SBSDs or ANC broker-dealers.

However, some of the entities that presently compete in the market may opt to conduct these activities in registered broker-dealer affiliates; this development would not increase the number of competitors. But other firms that currently do not deal in security-based swaps or do not do so in any significant degree, may choose to compete either as a stand-alone SBSD or as a broker-dealer SBSD. This may increase the number of competing firms.

The proposals ultimately adopted, like other requirements established under the Dodd-Frank Act, could have a substantial impact on international commerce and the relative competitive position of intermediaries operating in various, or multiple, jurisdictions. In particular, intermediaries operating in the U.S. and in other jurisdictions could be advantaged or disadvantaged if corresponding requirements are not established in other jurisdictions or if the Commission's rules are substantially more or less stringent than corresponding requirements in other jurisdictions. This could, among other potential impacts, affect the ability of intermediaries and other market participants based in the U.S. to participate in non-U.S. markets, the ability of non-U.S.-based intermediaries and other market participants to participate in U.S. markets, and

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[1072] See Alternative Net Capital Requirements Adopting Release, 69 FR 34428.

[1073] See, e.g., Alternative Net Capital Requirements Adopting Release, 69 FR at 34455 (describing benefits of alternative net capital requirements for broker-dealers using models stating a "major benefit for the broker-dealer will be lower deductions from net capital for market and credit risk that we expect will result from the use of the alternative method.") Therefore, it is likely that for new entrants to capture substantial volume in security-based swaps they will need to use VaR models. See also OTC Derivatives Dealer Release, 63 FR 59362 (discussing benefits of minimum capital requirements as an additional measure of protection).

whether and how international firms make use of global "booking entities" to centralize risks related to security-based swaps. As discussed in section I. of this release, these issues have been the focus of numerous comments to the Commission and other regulators, Congressional inquiries, and other public dialogue.

Accordingly, substantial differences between the U.S. and foreign jurisdictions in the costs of complying with the financial responsibility requirements for security-based swaps between U.S. and foreign jurisdictions could reduce cross-border capital flows and hinder the ability of global firms to most efficiently allocate capital among legal entities to meet the demands of their counterparties. As discussed in section I. of this release, the potential international implications of the proposed capital, margin, and segregation requirements warrant further consideration.[1074] The Commission intends to publish a comprehensive release seeking public comment on the full spectrum of issues relating to the application of Title VII to cross-border security-based swap transactions and non-U.S. persons that act in capacities regulated under the Dodd-Frank Act.

The willingness of end users to trade with a nonbank SBSD dealer will depend on their evaluation of the risks of trading with that particular firm compared to more established firms, and their ability to negotiate favorable price and other terms. As discussed in section V.A. of this release, end users of security-based swaps are mostly comprised of hedge funds and other asset management and financial firms. Many of these entities are sophisticated participants that trade in substantial volume and generally post collateral for their security-based swap positions.[1075] These end users are relatively well-positioned to negotiate price and other terms

1074 See BCBS, IOSCO, Margin Requirements for Non-centrally-cleared Derivatives (July 2012), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf (consultative document seeking comment on a paper on margin requirements for non-centrally-cleared derivatives).

1075 See, e.g., Independent Amounts at 6.

with competing dealers and to take advantage of greater choice of nonbank SBSD counterparties. These same participants, when transacting in the securities markets, often trade with a variety of competing dealers, including through prime brokerage relationships. To the extent that the proposals result in increased competition, participants in the security-based swap markets should be able to take advantage of this increased competition and negotiate improved terms, resulting generally in narrower spreads and better prices.

In addition, benefits may be expected to also arise from the ability of nonbank SBSDs, which now conduct substantial business in security-based swaps, to consolidate those operations within their affiliated U.S. broker-dealers. This flexibility may yield efficiencies for clients conducting business in securities and security-based swaps, including netting benefits,[1076] a reduction in the number of account relationships required with affiliated entities, and a reduction in the number of governing agreements. These potential benefits are at some tension with benefits from an increase in the number of competitors, to the extent that netting benefits will be maximized by holding a large portfolio of positions at the same entity,[1077] rather than trading with a variety of competing dealers. Further, because the proposals would permit the conduct of a security-based swap business in an entity jointly registered as a broker-dealer SBSD,[1078] they would facilitate the potential for those firms to offer portfolio margin for a variety of positions. From the standpoint of a holding company with multiple financial affiliates, aggregating security-based swaps business in a single entity, such as a broker-dealer SBSD, could help to

[1076] See, e.g., paragraph (c)(5) of proposed new Rule 18a-3(c)(5). See letter from Stuart J. Kaswell, Executive Vice President, Managing Director and General Counsel, Managed Funds Association, to David A. Stawick, Secretary of the CFTC (July 11, 2011) ("Effective netting agreements lower systemic risk by reducing both the aggregate requirement to deliver margin and trading costs for market participants.").

[1077] See Darrell Duffie and Haoxiang Zhu, Does a Central Clearing Party Reduce Counterparty Risk, Stanford University Working Paper (Mar. 6, 2010) (showing that netting in the context of CCPs results in significant reductions in counterparty exposures).

[1078] See, e.g., amendments to Rule 15c3-1 (proposing minimum net capital requirements for broker-dealers engaging in a security-based swap business).

simplify and streamline risk management, allow more efficient use of capital, as well as operational efficiencies, and avoid the need for multiple netting and other agreements.

While these arguments generally suggest the possibility of positive effects of the proposed rules on competition, efficiency and capital formation, financial responsibility requirements that impose too many competitive burdens pose the risk of imposing excessive regulatory costs that could deter the efficient allocation of capital. Such rules also may be expected to reduce the capital formation benefits that otherwise would be associated with security-based swaps. Specifically, financial responsibility requirements that are overly stringent may prevent entries in the security-based swap markets and thereby may either increase spreads and trading costs or even reduce the availability of security-based swaps. In both instances, end users would face higher cost to meet their business needs.

Apart from their impact on the extent of dealer competition and efficiencies for end users, the proposed new rules and rule amendments could create the potential for regulatory arbitrage to the extent that they differ from corresponding rules other regulators adopt. As noted above in section I. of this release, the proposals of the prudential regulators and the CFTC were considered in developing the Commission's proposed capital, margin, and segregation requirements for SBSDs and MSBSPs. The Commission's proposals differ in some respects from proposals of the prudential regulators and the CFTC. While some differences are based on differences in the activities of securities firms, banks, and commodities firms, or differences in the products at issue, other differences may reflect an alternative approach to balancing the relevant policy choices and considerations. Depending on the final rules the Commission adopts, the financial responsibility requirements could make it more or less costly to conduct security-based swaps trading in banks as compared to nonbank SBSDs. For example, high capital requirements may discourage certain entities from participating in the security-based swap markets, particularly if the regulatory costs for nonbank SBSDs are high. Likewise, if the application of the proposed 8% margin risk factor substantially increases capital requirements for nonbank SBSDs compared to risk-based capital requirements imposed by the prudential regulators on the same activity, bank holding companies could be incentivized to conduct these activities in their bank affiliates.[1079] These differences could create competitive inequalities and affect the allocation of trading activities within a holding company structure.

Finally, in significant part, the effect of the proposals for nonbank MSBSPs on efficiency and capital formation will also be linked to the effect of these requirements on competition,[1080] as competitive markets, ceteris paribus, can be expected to promote a more efficient allocation of capital.

Conversely, if the proposals for MSBSPs are accompanied by too many competitive burdens, the proposals risk the imposition of excessive regulatory costs that could deter the efficient allocation of capital. Such rules also may be expected to reduce the capital formation benefits that otherwise would be associated with security-based swaps. Requirements for nonbank MSBSPs that are overly stringent may prevent entries in the security-based swap markets and thereby may reduce the availability of security-based swaps, forcing end users to use less effective financial instruments to meet their business needs.

Request for Comment

The Commission generally requests comment about its analysis of the general costs and benefits of the proposed capital rules for SBSDs and MSBSPs. In addition, the Commission requests comment in response to the following questions:

1079 See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564.

1080 See also Entity Definitions Adopting Release, 77 FR at 30742.

1. Would the minimum capital requirements represent a barrier to entry to firms that may otherwise seek to trade security-based swaps as SBSDs? If so, which types of firms would be foreclosed?

2. Is it correct to assume that firms that have the risk management capability to act as a dealer in security-based swaps generally would also meet or be readily able to meet the proposed capital minimums?

3. To what extent will firms that receive approval to use VaR models be able to dominate trading in security-based swaps, whether because of costs to other firms in applying a haircut methodology to security-based swaps or for other reasons?

4. What would be the impact of market concentration on reduction in systemic risk? For example, would concentration of positions in a relatively few firms exacerbate systemic risk by exaggerating the impact of the failure of a single firm? Conversely, would high capital requirements better protect against systemic risk by reducing the risk of failure of a nonbank SBSD?

5. Do the proposed capital requirements for nonbank SBSDs proportionately reflect the increased risk associated with the use of internal models and trading in a portfolio of instruments, including securities, security-based swaps, and other derivatives?

6. The Commission requests comment on how much additional capital would be required, if any, as a result of the proposed 8% margin factor based on a sample portfolio of security-based swaps and how the result compares to the amount these firms currently hold against the same risk.

7. Under the proposed 8% margin factor, the relation between exposure and capital is linear. Is this type of formal approach appropriate for risks associated with security-based

swaps? Should the risk margin factor be increased at higher levels of exposure, or should it increase on some other basis?

8. How would firms' current risk management practices for calculating their exposures to counterparties compare to the proposed 8% margin factor, if nonbank SBSDs were only required to comply with a fixed minimum net capital standard?

9. From a systemic risk perspective, should the proposed capital rules for nonbank SBSDs encourage the conduct of security-based swaps trading outside of broker-dealer affiliates?

10. From a systemic risk perspective, are the proposed increases in the minimum net capital (from \$500 million to \$1 billion) and minimum tentative net capital (\$1 billion to \$5 billion) requirements for ANC broker-dealers adequate? From a systematic risk perspective, is the proposed increase in the "early warning" level from \$5 billion to \$6 billion for ANC broker-dealers adequate?

11. Would the proposed CDS grid impose any additional costs on nonbank SBSDs in comparison to the current haircut charges for similar debt securities under Rule 15c3-1?

12. Would a nonbank SBSD incur additional costs resulting from the proposed liquidity stress test based on current practice? The Commission requests that commenters quantify the extent of the additional cost the proposed stress test would yield based on hypothetical firm portfolios, and provide the Commission with such data.

13. Are the factors proposed in the liquidity funding stress test adequate? If not, are there other factors that should be included?

14. How would proposed new Rule 18a-2 impact entities that may be required to register as MSBSPs?

15. Would proposed new Rule 18a-2 require nonbank MSBSPs to hold additional capital, in comparison to current capital levels maintained at these firms? If yes, please quantify the amount.

16. What additional costs, if any, would a nonbank MSBSP incur in making adjustments to risk management practices to conform to the specific provisions of Rule 15c3-4?

17. If stand-alone SBSDs would not be able to claim flow-through capital benefits for consolidated subsidiaries or affiliates under Rule 18a-1c, in contrast to Appendix C of existing Rule 15c3-1, would stand-alone SBSDs be competitively disadvantaged? If yes, please explain.

18. Would the Commission's proposals lead to greater competition among intermediaries for security-based swaps business, greater concentration, or neither? How important are the goals of reduction in systemic risk versus promotion of competition in crafting rules in this area, and to what extent are they competing goals? If they are not competing goals, how should the achievement of both goals inform the Commission's overall approach?

19. Will the Commission's proposals affect the competitive position of U.S. firms in the global security-based swaps market? How in general would they impact global trading in these products? How could the Commission best address any anti-competitive effects? For example, should the Commission permit U.S. firms trading with off-shore counterparties to collect margin based on the rules of the jurisdiction where the counterparty is located, provided the Commission determines that those rules are comparable to the U.S. regime? How would comparability be determined?

20. The Commission specifically requests comment on the potential impact of interagency differences in specific aspects of capital and margin requirements. Which specific

aspects of the proposed rules could have the most impact in determining the type of legal entity in which trading is conducted? What would be the market or economic effects?

3. The Proposed Margin Rule – Rule 18a-3

As discussed in section II.B. of this release, pursuant to section 15F(e) of the Exchange Act, proposed new Rule 18a-3 would establish margin requirements for nonbank SBSDs and nonbank MSBSPs with respect to transactions with counterparties in non-cleared security-based swaps.[1081] As discussed in more detail below, the proposed rule would require nonbank SBSDs to collect collateral from their counterparties to non-cleared security-based swaps to cover both current exposure and potential future exposure to the counterparty (i.e., the rule would require the account to have prescribed minimum levels of equity); however, there would be exceptions to these requirements for certain types of counterparties. Proposed new Rule 18a-3 would have a number of benefits as well as impose certain costs on nonbank SBSDs, nonbank MSBSPs, as well as other market participants, including commercial end users. The proposed rule also would have possible effects on competition, efficiency, and capital formation, which will be discussed further below.

The two types of credit exposure arising from OTC derivatives are current exposure and potential future exposure. The current exposure is the amount that the counterparty would be obligated to pay the dealer if all the OTC derivatives contracts with the counterparty were terminated (i.e., it is the amount of the current receivable from the counterparty). This form of credit risk arises from the potential that the counterparty may default on the obligation to pay the current receivable. The potential future exposure is the amount that the current exposure may increase in the favor of the dealer in the future. This form of credit risk arises from the potential

1081 See proposed new Rule 18a-3.

that the counterparty may default before providing the dealer with additional collateral to cover the incremental increase in the current exposure or the current exposure will increase after a default when the counterparty has ceased to provide additional collateral to cover such increases and before the dealer can liquidate the position.

Rule 18a-3 is intended to support a goal of the Dodd-Frank Act by promoting centralized clearing of sufficiently standardized products,[1082] which, in turn, may help to mitigate credit risk.[1083] Specifically, Rule 18a-3, by creating stringent margin requirements for non-cleared contracts, is meant to create incentives for participants to clear security-based swaps, where available and appropriate for their needs.[1084] Central clearing can provide systemic benefits by limiting systemic leverage and aggregating and managing risks by a central counterparty.[1085] At the same time, realization of these benefits assumes that central counterparties are appropriately capitalized and sufficiently collateralize their exposures to their clearing members. Under the proposed rule, the market will benefit from the required collateralization of non-cleared security-

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1082 The Dodd-Frank Act seeks to ensure that, wherever possible and appropriate, derivatives contracts formerly traded exclusively in the OTC market be cleared. See, e.g., Senate Committee on Banking, Housing, and Urban Affairs, The Restoring American Financial Stability Act of 2010, S. Rep. No. 111-176, 34 (stating that "[s]ome parts of the OTC market may not be suitable for clearing and exchange trading due to individual business needs of certain users. Those users should retain the ability to engage in customized, non-cleared contracts while bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible.").

1083 For example, when an OTC derivatives contract between two counterparties that are members of a CCP is executed and submitted for clearing, it is typically replaced by two new contracts – separate contracts between the CCP and each of the two original counterparties. At that point, the original counterparties are no longer counterparties to each other. Instead, each acquires the CCP as its counterparty, and the CCP assumes the counterparty credit risk of each of the original counterparties that are members of the CCP. See Stephen Cecchetti, Jacob Gyntelberg, and Mark Hollanders, Central counterparties for over-the-counter derivatives, BIS Quarterly Review (Sept. 2009), available at http://www.bis.org/publ/qtrpdf/r_qt0909f.pdf. Structured and operated appropriately, CCPs may improve the management of counterparty risk and may provide additional benefits such as multilateral netting of trades. See also Process for Submissions of Security-Based Swaps, 77 FR at 41603.

1084 See Daniel Heller and Nicholas Vause, Expansion of Central Clearing, BIS Quarterly Review (June 2011) (arguing expansion of central clearing within or across segments of the derivatives markets could economize both on margin and non-margin resources).

1085 See Process for Submissions of Security-Based Swaps, 77 FR 41602.

based swaps. Specifically, the required collateralization should improve counterparty risk management, reduce the risk of contagion from a defaulting counterparty, and ultimately reduce systemic risk.

While available data suggests that clearing of security-based swaps has been increasing, significant segments of the security-based swap markets remain uncleared, even where a CCP is available to clear the product in question on a voluntary basis.[1086] The mandatory clearing determinations made pursuant to Exchange Act section 3C(a)(1) will alter current clearing practices at the time such determinations are made. The Commission has not yet made any mandatory clearing determinations under the authority of section 3C(a)(1) of the Exchange Act and cannot estimate at this time how much of the security-based swap markets may ultimately be subject to such determinations.

Other costs resulting from proposed new Rule 18a-3 may result from reducing the availability of liquid assets for purposes other than posting collateral. Data available to the Commission suggests that existing collateral practices vary widely by type of market participant and counterparty.[1087] For example, the ISDA Margin Survey 2012, which provides global estimates regarding the use of collateral in the OTC derivatives business based on a survey of ISDA members as of the end of 2011,[1088] stated that 71% of all OTC derivatives transactions were subject to collateral agreements; the average percentage was 96% for the largest dealers

1086 See Process for Submissions of Security-Based Swaps, 77 FR 41602.

1087 See, e.g., ISDA Margin Survey 2012. Proposed new Rule 18a-3 would distinguish by counterparty type in that the rule would provide specific exemptions from the rule for certain counterparties, such as commercial end users. See section II.B. of this release.

1088 ISDA Margin Survey 2012. The ISDA Margin Survey 2012 also states that the estimated amount of collateral in circulation in the non-cleared OTC derivatives market at the end of 2011 was approximately \$3.6 trillion, which is up 24% from last year's estimated amount of \$2.9 trillion.

responding to the survey.[1089] The percent of trades subject to collateral agreements was higher, however, for credit derivatives (93.4% of all trades) and about the same as the general average for equity derivatives (72.7%).[1090]

The ISDA Margin Survey 2011 reported on the extent of collateralization (percentage of net exposures) by type of counterparty.[1091] The amount reported for all counterparties and all OTC derivatives was 73.1%.[1092] The ISDA Margin Survey 2011 also indicates that the collateralization levels by large dealers of their net exposures to their bank and broker-dealer dealer counterparties was 88.6%.[1093] For hedge funds, the average collateralization levels were 178%, reflecting a greater tendency to collect initial margin from those participants.[1094] Finally, exposures to non-financial corporations (37.3%) and sovereign governments (17.6%) had much lower levels of coverage.[1095]

The data from the ISDA Margin Survey 2011 and the ISDA Margin Survey 2012 support the premises that margin practices widely vary, that larger dealers tend to collateralize their net exposures, that exposures to financial end users tend to be collateralized with both variation

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1089 Id. The threshold for classification as a "large" program under the ISDA survey is more than 3,000 agreements. Overall, 84% of all OTC derivatives transactions executed by the largest dealers were subject to collateral agreements. Hedge fund exposures tend to be the most highly collateralized of all types of counterparty exposures with average collateralization levels exceeding 100% of net exposures, a figure that reflects "Independent Amounts" (initial margin) posted by such firms. ISDA Margin Survey 2011 at Table 3.3.

1090 ISDA Margin Survey 2012 at Table 3.2. The fourteen largest reporting firms reported an average 96.1% of credit derivatives trades were subject to collateral arrangements during 2011, and 85.5% of equity derivatives trades were subject to collateral agreements. Id.

1091 See ISDA Margin Survey 2011. This information was not reported in the ISDA Margin Survey 2012.

1092 Id.

1093 Id.

1094 Id.

1095 Id.

(current exposure) and initial margin (potential future exposure), and that much of the exposure to non-financial end users generally is not collateralized.[1096]

Rule 18a-3 is generally modeled on the broker-dealer margin rules in terms of establishing an account equity requirement; requiring nonbank SBSDs to collect collateral to meet the requirement; and, subject to haircuts, allowing a range of securities for which there is a ready market to be used as collateral.[1097] The goals of modeling proposed new Rule 18a-3 on the broker-dealer margin rules are to create a framework that will limit counterparty exposure of nonbank SBSDs while promoting consistency with existing rules. This consistency may also facilitate the ability to provide portfolio margining of security-based swaps with other types of securities, and in particular single name credit default swaps along with bonds that serve as reference obligations for the credit default swaps.

In the securities markets, margin rules have been set by relevant regulatory authorities (the Federal Reserve and the SROs) since the 1930s.[1098] The requirement that an SRO file proposed margin rules with the Commission has promoted the establishment of consistent margin levels across the SROs, which mitigates the risk that SROs (as well as their member

1096 See generally ISDA Margin Survey 2011; ISDA Margin Survey 2012. The results of the survey, however, could be substantially different if limited only to U.S. participants, because the data contained in the ISDA Margin Survey 2011 and ISDA Margin Survey 2012 is global. Id. For example, 47% of the institutions responding to the ISDA Margin Survey 2012 were based in Europe, the Middle East, or Africa, and 31% were based in the Americas. ISDA Margin Survey 2012 at Chart 1.1.

1097 Broker-dealers are subject to margin requirements in Regulation T promulgated by the Federal Reserve (12 CFR 220.1, et seq.), in rules promulgated by the SROs (see, e.g., FINRA Rules 4210-4240), and with respect to security futures, in rules jointly promulgated by the Commission and the CFTC (17 CFR 242.400-406).

1098 The Federal Reserve originally adopted Regulation T pursuant to section 7 of the Exchange Act shortly after the enactment of the Exchange Act. See 1934 Fed. Res. Bull. 675. The purposes of the Federal Reserve's margin rules include: (1) regulation of the amount of credit directed into securities speculation and away from other uses; (2) protection of the securities markets from price fluctuations and disruptions caused by excessive margin credit; (3) protection of investors against losses arising from undue leverage in securities transactions; and (4) protection of broker-dealers from the financial exposure involved in excessive margin lending to customers. See Charles F. Rechlin, Securities Credit Regulation §1:3 (2d ed. 2008).

firms) will compete by implementing lower margin levels and helps ensure that margin levels are set at sufficiently prudent levels to reduce systemic risk.[1099] Basing proposed Rule 18a-3 on the broker-dealer margin rules is intended to achieve these same objectives in the market for security-based swaps. This consistency between margin requirements for securities and security-based swaps should ultimately benefit participants in the securities markets, reduce the potential for regulatory arbitrage, and lead to consistent interpretation and enforcement of applicable regulatory requirements across U.S. securities markets.

The discussion below focuses on the impact of specific provisions of proposed new Rule 18a-3 and their potential benefits and costs. With respect to certain provisions, the Commission has identified alternatives to the proposed approach and is seeking comment on the relative costs and benefits of adopting the alternatives, in comparison to the proposed approach. As to whether nonbank SBSDs should be required to collect initial margin in transactions with each other, the Commission is expressly proposing alternative formulations of the rule.

a. Calculation of Margin Amount

Proposed new Rule 18a-3 would require a nonbank SBSD to perform two calculations (and a nonbank MSBSP to perform one calculation) as of the close of each business day with respect to each account carried by the firm for a counterparty to a non-cleared security-based swap transaction.[1100] Even if the counterparty is not required to deliver collateral, the calculation(s) would assist the nonbank SBSD or the nonbank MSBSPs in managing its credit risk (and determining how much needs to be collateralized) and understanding the extent of its

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1099 Pursuant to Section 19(b)(1) of the Exchange Act, each SRO must file with the Commission any proposed change in, addition to, or deletion from the rules of the exchange electronically on a Form 19b-4 through the Electronic Form 19b-4 Filing System, which is a secure website operated by the Commission. 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4.

1100 See paragraphs (c)(1)(i)(A), (B), and (c)(2)(i) of proposed new Rule 18a-3.

uncollateralized credit exposure to the counterparty and across all counterparties. These required calculations also would provide examiners with enhanced information about non-cleared security-based swaps, allowing the Commission and other appropriate regulators to gain "snapshot" information at a point in time for examination purposes.

As described in section II.B. of the release, paragraph (d) of proposed new Rule 18a-3 would prescribe a standardized method for calculating the margin amount as well as a model-based method if the non-bank SBSD is approved to use internal models.[1101] The benefits of consistent treatment of the standardized haircut and internal models as between the proposed capital rules and proposed new Rule 18a-3 may increase operational efficiencies and reduce costs at the nonbank SBSD by permitting the use of congruent systems and processes to comply with both capital and margin requirements.[1102]

As is the case with the impact of standardized haircuts on regulatory capital, as described in section II.B. of the release, nonbank SBSDs required to use standardized haircuts under Rule 18a-3(d) to determine the margin amount generally will be required to collect higher margin amounts from counterparties for non-cleared security-based swap transactions than nonbank SBSDs that are approved to use internal models will need to collect, because VaR models generally result in lower charges than the standardized haircut provisions.[1103]

In addition, this proposed requirement would impose additional operational and technology costs to install or upgrade systems needed to perform daily calculations under proposed new Rule 18a-3. These costs may vary because broker-dealers registering as nonbank

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1101 See paragraph (d) of proposed new Rule 18a-3. "Margin amount" is generally initial margin or potential future exposure. These terms may be used interchangeably throughout this section.

1102 See proposed new Rule 18a-1; proposed new Rule 18a-3; proposed amendments to Rule 15c3-1.

1103 See Alternative Net Capital Requirements Adopting Release, 69 FR 34428.

SBSDs may already have systems in place, as current margin rules[1104] for securities require daily margin calculations for customer accounts, while new entrants may incur higher operational or other systems costs to comply with this requirement. Finally, secondary costs (such as reduced profits) could arise if commercial end users or other counterparties reduce trading in non-cleared security-based swaps because of the increased collateral requirements required by Rule 18a-3, or if these entities determine to trade instead with non-U.S. entities.

b. Account Equity Requirements

As described in section II.B. to this release, a nonbank SBSD and nonbank MSBSP generally would need to collect cash and/or securities to meet the account equity requirements in proposed new Rule 18a-3.[1105] This proposal recognizes that counterparties may engage in a wide range of trading strategies that include security-based swaps. Because of the relation between security-based swaps and other securities positions, permitting various types of securities to count as collateral may be more practical for margin arrangements involving security-based swaps than for other types of derivatives. This flexibility to accept a broad range of securities, along with consistency with existing margin requirements,[1106] takes advantage of efficiencies that result from correlations between securities and security-based swaps.[1107] However, it may increase the risk that SBSDs will incur a shortfall if, as a result, they hold less liquid collateral that cannot be quickly sold for an amount that covers the nonbank SBSD's exposure to the

1104 See, e.g., FINRA Rule 4220 (Daily Record of Required Margin); 12 CFR 220.4.

1105 By requiring most counterparties to deliver collateral, the proposed margin requirements are intended to prevent counterparties from employing undue leverage in their portfolios of security-based swaps, which can exacerbate the magnitude of losses in relation to the financial resources of the counterparty in the case of default.

1106 See the Federal Reserve's Regulation T, 12 CFR 220.1, et seq. and SRO margin rules, such as FINRA Rule 4210 and CBOE Rule 12.3. The consideration in adopting final rules will be informed by the comments received.

1107 The ISDA Margin Survey 2012 states with regard to the types of assets used as collateral, that the use of cash and government securities as collateral remains predominant, constituting 90.4% of collateral received and 96.8% of collateral delivered. ISDA Margin Survey 2012 at 8, Table 2.1.

counterparty.[1108] This risk may be mitigated by the collateral haircut and other requirements regarding the liquidity of collateral under the proposed rule.[1109]

As an alternative, the Commission could limit eligible collateral to the most highly liquid categories, as proposed by the prudential regulators and the CFTC and described in section II.B.2.c. of this release.[1110] This alternative could limit the potential that an SBSD would incur a loss following default of a counterparty based on changes in market values of less liquid collateral that occur before the SBSD is able to sell the collateral, and therefore could limit the potential for a default by the SBSD to other counterparties. On the other hand, if Rule 18a-3 required a counterparty to deliver additional collateral beyond assets already held in the counterparty's account because the existing assets did not qualify as eligible collateral, the rule could have the effect of increasing the counterparty's exposure to the SBSD and draining liquidity from the counterparty in a way that may not be necessary to account for the nonbank SBSD's potential future exposure to the counterparty, and may increase costs for both the nonbank SBSD and its counterparties.[1111] Also, granting counterparties the flexibility to post a variety of collateral types to meet margin requirements may result in reduced costs for end users and could encourage increased trading of security-based swaps, thereby increasing competition. The extent of increased trading of non-cleared security-based swaps, however, may depend on

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1108 Gary Gorton and Guillermo Ordoñez, Collateral Crises, Yale University Working Paper (Mar. 2012) (arguing that during normal times collateral values are less precise, but during volatile times are reassessed). This reassessment can possibly lead to large negative shocks in their values, which by deduction can lead to market disruptions if collateral needs to be liquidated.

1109 See paragraphs (c)(3)-(c)(4) of proposed new Rule 18a-3.

1110 Commenters argued that the scope of eligible collateral should be significantly expanded by arguing that there are other assets that are highly liquid and suitable for credit support if a counterparty fails and if eligible collateral remains narrowly defined, the liquidity of eligible assets could be highly affected and sourcing of adequate margin could become difficult. See, e.g., CFTC SIFMA/ISDA Letter.

1111 This alternative may also increase demand for highly liquid collateral and potentially cause shortages in the supply of cash and government bonds. See IMF, Global Financial Stability Report: The Quest for Lasting Stability 96 and 120 (Apr. 2012), available at http://www.imf.org/External/Pubs/FT/GFSR/2012/01/pdf/text.pdf.

the extent to which portfolio margin treatment would materially increase the amount of net equity that counterparties would have available to serve as collateral, compared to the amount that would result if they were limited to very highly liquid securities, such as U.S. Treasury securities.

i. Commercial end users

As discussed in section II.B.2.c.i. of this release, under proposed new Rule 18a-3, a nonbank SBSD would not be required to collect cash or securities to cover the negative equity (current exposure) or margin amount (potential future exposure) in the account of a counterparty that is a commercial end user.[1112]

As discussed above in section II.A.2.b.v. of this release, this proposed exception to the requirement to collect collateral is intended to benefit commercial end users in order to address concerns that have been expressed by them and others that the imposition of margin requirements on commercial companies that use derivatives to mitigate the risk of business activities that are not financial in nature could unduly disrupt their ability to enter into such hedging transactions. The proposed exception for commercial end users also is intended to account for the different risk profiles of commercial end users as compared with financial end users.[1113] This exception may increase efficiencies by allowing such end users to more cost efficiently manage business risks and thereby better compete in their respective industries.

1112 See paragraph (b)(2) of proposed new Rule 18a-3 (defining the term commercial end user).

1113 See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27571 ("Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity."). See also CFTC Margin Proposing Release, 76 FR at 27735 ("The Commission believes that financial entities, which are generally not using swaps to hedge or mitigate commercial risk, potentially pose greater risk to CSEs than non-financial entities.").

At the same time, to the extent of any dealer exposure to commercial end users, the proposed exception for commercial end users could lead to uncollateralized exposure by nonbank SBSDs to commercial end users. To address this concern and because collecting collateral is an important means of mitigating risk, Rule 18a-1 would require nonbank SBSDs not approved to use internal models to take a capital charge equal to the margin amount calculated for the commercial end user to the extent the firm does not collect cash or securities equal to that amount.[1114] Requiring a firm to hold capital in lieu of margin[1115] in these cases is designed to reflect both the needs of commercial end users and concerns that permitting nonbank SBSDs to assume credit exposure without the protection of margin could lead to the assumption of inappropriate risks. In this way the proposal is intended to ensure the safety and soundness of nonbank SBSDs and be proportionate to the amount of uncollateralized exposures to commercial end users.[1116]

The extent of the impact of the intended benefit to commercial end users, however, would depend on whether nonbank SBSDs choose to trade with commercial end user counterparties on an uncollateralized basis, notwithstanding the capital charges under Rule 18a-1. In addition, nonbank SBSDs subject to this capital charge are expected to, at least partially, pass the increased cost of capital through to commercial end users in the form of increased transaction pricing.[1117] Accordingly, any potential economic benefit associated with an exception from Rule

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1114 See proposed paragraph (c)(2)(xiv) of Rule 15c3-1; paragraph (c)(1)(xiv) of proposed Rule 18a-1.

1115 See section II.A.2.b.v. of this release (discussing proposed charge capital in lieu of margin collateral).

1116 As discussed above in section II.A. of this release, nonbank SBSDs that have been approved to use internal models for credit risk would take a much smaller capital charge, i.e., 8% of net replacement value multiplied by the counterparty factor. These firms also would be permitted to take a smaller charge with respect to the unsecured receivables from commercial end user counterparties, which may provide a competitive advantage for nonbank SBSDs that are capable of and have received approval to model credit risk.

1117 Even under these conditions, a nonbank SBSD still retains the option to collect margin from its counterparties.

18a-3 for commercial end users in non-cleared security-based swaps may be offset to the extent that nonbank SBSDs determine to pass on any costs incurred as a result of the additional capital charges.[1118] In summary, the Commission does not expect those costs will be material, unless commercial end users begin to account for meaningful volume in non-cleared security-based swap trading.

As an alternative, the Commission could limit this proposed exception for commercial end users and require nonbank SBSDs to collect collateral from commercial end users with regard to their transactions in non-cleared security-based swaps. This alternative would protect the nonbank SBSDs by requiring that transactions with commercial end users be collateralized. However, in contrast to the Commission's proposal, this alternative would limit the flexibility of nonbank SBSDs and commercial end users to negotiate the terms of their non-cleared security-based swap transactions. In considering this approach, the Commission would need to consider the benefit of any additional protections to SBSDs against losses in transactions with commercial end users in light of increased costs to such end users or less accessibility to them of hedging instruments.

ii. SBSDs – Alternatives A and B

As described in section II.B. to the release, the Commission is proposing specific alternative margin requirements with respect to counterparties that are nonbank SBSDs. Under Alternative A, which would create an exception from proposed new Rule 18a-3, a nonbank SBSD would need collateral only to cover the current exposure (negative equity) in the account

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1118 See Antonio S. Mello and John E. Parsons, Margins, Liquidity and the Cost of Hedging, MIT Center for Energy and Environmental Policy Research Working Paper 2012-005 (May 2012) (presenting a replication argument to show that a non-margined swap is equivalent to a package of (1) a margined swap, plus (2) a contingent line of credit). The paper concludes that a mandate to clear and therefore to margin derivatives trades forces dealers to market these two components separately, but otherwise makes no additional demand on non-financial corporations, and therefore, a clearing and margin mandate does not add any real costs to a non-financial corporation seeking to hedge its commercial risk). Id.

of a counterparty that is another SBSD. Under Alternative B, a nonbank SBSD would be required to collect collateral to cover both the current exposure (negative equity) and the potential future exposure (margin amount) in the account of a counterparty that is another SBSD[1119] and further segregate the margin amount in an account carried by an independent third-party custodian pursuant to the requirements of Section 3E(f) of the Exchange Act.[1120] Alternative B is consistent with the proposals of the prudential regulators and the CFTC.[1121]

As discussed in section V.A. above, the baseline of this economic analysis is the OTC derivatives markets as they exist today. The CDS Data Analysis suggests there is currently a high degree of concentration of potential dealing activity in the single-name credit default swap market. Based on discussions with market participants, the Commission staff understands that dealers in security-based swaps presently collect variation margin covering current exposure but generally do not collect initial margin covering potential future exposure from other dealers.[1122] Accordingly, relative to the existing market for security-based swaps, Alternative A would not create additional costs for dealers resulting from transactions with other dealers in security-based swaps. Alternative B would impose substantially greater costs to inter-dealer transactions compared to the baseline.

Alternatives A and B would both require the exchange of variation margin; the difference between the alternatives therefore is, first and foremost, whether to require nonbank SBSD counterparties to exchange initial margin. The cost impact would depend on how significant

1119 Alternative B is not an exception to the account equity requirements in proposed new Rule 18a-3 because it would require the nonbank SBSD to collect collateral to cover the negative equity and margin amount in an account of another SBSD.

1120 See 15 U.S.C. 78c-5(f).

1121 See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564; CFTC Margin Proposing Release, 76 FR 23732.

1122 See generally ISDA Margin Survey 2011; ISDA Margin Survey 2012.

initial margin is in relation to variation margin, which will vary by type of contract, extent of market volatility, and other factors. The goal for either alternative is to reduce systemic risk without imposing undue additional cost to the extent that the ability of counterparties to trade security-based swaps is severely compromised. However, the benefit of collecting the margin amount under Alternative B would be the further protection of a nonbank SBSD from market exposure during the period of unwinding a position from a defaulting counterparty when that counterparty, by definition, would not be able to post additional variation margin.

Requiring a nonbank SBSD to post initial margin, however, could significantly impact its liquidity and therefore limit the ability of the nonbank SBSD to trade in security-based swaps. Permitting a firm to retain a pool of liquid assets that would not otherwise be used to post initial margin could permit the nonbank SBSD to use this capital more efficiently, for example by increasing its investment in information technology or increasing its investments that offer a higher rate of return. The potential benefit of Alternative B is that it would limit the aggregate amount of leverage in the financial system associated with security-based swaps. A principal purpose of Title VII of the Dodd-Frank Act, including those provisions that apply to capital and margin requirements for dealers, is to reduce systemic risk, particularly risks associated with relatively opaque bilateral, non-cleared derivative transactions. Requiring dealers to collateralize their potential future exposure to each other by exchanging both initial and variation margin may further reduce systemic risk by reducing leverage and the potential that a default by a single large dealer could translate to defaults of counterparty dealers with potential ripple effects throughout the system.

On the other hand, the requirement to exchange initial margin would not only impose costs to the extent that it would result in substantially less capital available to support the security-based swap business or other dealer activity, but also it could contribute to the instability of a nonbank SBSD. The instability stems from the possibility that assets posted to the custodian account might in the case of a counterparty default not be immediately returned to a nonbank SBSD to absorb losses or meet other liquidity demands. In this regard, the ability of a dealer counterparty to demand and obtain the return of initial margin held by a third-party custodian could be subject to various uncertainties, including the potential for counterparty disputes that might be subject to court resolution. During periods of general market instability or loss of confidence, even a brief delay in being able to access liquid assets could prove decisive.[1123]

The prudential regulators and the CFTC have received comment letters regarding the liquidity impact of their proposed rules, as well as public research reports attempting to estimate the liquidity impact.[1124] Each of these commenters used different methods, data and assumptions to arrive at a liquidity impact estimate and respond to the amount of initial margin required by the prudential regulators' and CFTC's proposed margin rules. Overall, each of these commenters concluded that the liquidity impact of the proposed initial margin rules proposed by

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1123 See Manmohan Singh, Velocity of Pledged Collateral: Analysis and Implications, IMF Working Paper, WP/11/256 (Nov. 2011) (stating that the decline in leverage and re-use of collateral may be viewed positively from a financial stability perspective, but from a monetary policy perspective, however, the lubrication in the global financial markets is now lower as the velocity of money-type instruments has declined.). Singh argues that the "velocity of collateral," analogous to the concept of the "velocity of money" indicates the liquidity impact of collateral. A security that is owned by an economic agent and can be pledged as re-usable collateral leads to chains. Therefore, Singh argues that a shortage of acceptable collateral would have a negative cascading impact on lending similar to the impact on the money supply of a reduction in the monetary base. Id. at 16. See also Manmohan Singh and James Aitken, The (sizable) Role of Rehypothecation in the Shadow Banking System, IMF Working Paper WP/10/172 (July 2010).

1124 See OCC Economics Department, Unfunded Mandates Reform Act – Impact Analysis for Swaps Margin and Capital Rule, (Apr. 15, 2011) ("OCC Unfunded Mandates Report"); SIFMA/ISDA Comment Letter to the Prudential Regulators; J.P. Morgan Letter; Bank of America-Merrill Lynch, No Margin for Error, Part 3: Dodd-Frank Implements QE3, Credit Derivatives Strategist (Nov. 5, 2011) ("BAML Report").

the CFTC and the prudential regulators was significant.[1125] One such estimate, however, noted that the numbers should be viewed as an "order of magnitude estimate" and that "[o]ne cannot predict which entities will use derivatives in the future nor the amounts and types of products that will be used."[1126] Consequently, while it is difficult to estimate the costs imposed by requiring dealers to post initial margin, commenters to the CFTC and prudential regulators' proposed margin rules and others have estimated that the cost would be significant. These estimates are discussed in detail below.[1127]

One commenter to the prudential regulators' proposed margin rule stated that imposing segregated initial margin requirements on trades between swap entities would result in a tremendous cost to the financial system in the form of a massive liquidity drain.[1128] This commenter estimated that the effect of the proposed rule would result in a cost of $428 billion in initial margin for swap dealers.[1129] Another commenter predicted that the initial margin requirements will result in a huge drain of liquid assets from the U.S. economy because they would require very large amounts of collateral to be posted as initial margin and placed in segregated custodial accounts.[1130] This commenter attempted to quantify this amount by calculating the amounts of initial margin that the firm would have to collect from 34 of its largest professional dealer counterparties by reference to the "Lookup Table" percentages of notional

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1125 See Manmohan Singh, Collateral, Netting and Systemic Risk in the OTC Derivatives Market, IMF Working Paper WP 10/99 (1999) (a study by the IMF arguing that moving OTC derivatives to centralized clearing would require between $170 and $220 billion in initial margin collateral).

1126 SIFMA/ISDA Comment Letter to the Prudential Regulators at 38.

1127 See BCBS, IOSCO, Margin Requirements for Non-centrally-cleared Derivatives. The Working Group on Margin Requirements is conducting a Quantitative Impact Study to better quantify the impact of the proposed margin requirements set forth in the consultative paper. See id. at Part C.

1128 SIFMA/ISDA Comment Letter to the Prudential Regulators.

1129 Id. at 36.

1130 J.P. Morgan Letter.

approach set forth in Appendix A to the prudential regulators' margin rulemaking.[1131] Application of this approach to the commenter's existing portfolio with those 34 counterparties yielded an estimated amount of initial margin that the firm would have to collect equal to $1.4 trillion.[1132] The commenter noted that since the interdealer initial margin requirements are reciprocal, it would also be obligated to post $1.4 trillion.[1133]

In addition, the OCC Unfunded Mandates Report estimated that the initial margin collected under the prudential regulators' proposed margin rule in one year could total $2.56 trillion.[1134] The report pointed out, however, that several factors are likely to reduce the impact of the proposed rule, including a move to central clearing and the fact that dealers are likely to use internal models that permit netting. The report estimated that currently roughly 20% of swap contracts trade through clearing houses.[1135] Assuming that the proportion of cleared to non-cleared swaps will at a minimum remain at one in five, the report further estimated the required funds to cover the initial margin requirement under the proposed rule to be $2.05 trillion (0.80 x $2.56 trillion).[1136]

1131 J.P. Morgan Letter; Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27592.

1132 J.P. Morgan Letter at 5.

1133 Id. In the J.P. Morgan Letter, however, it was noted that it is likely that most swap dealers would use the model based approach, and not the "lookup table", to calculate initial margin which would likely produce smaller initial margin amounts. In the letter, it was argued that there is substantial uncertainty about the model approval process and timing and accordingly the large amounts resulting from application of the lookup table are relevant. Id.

1134 OCC Unfunded Mandates Report at 5. The report also used the "lookup table" to estimate the initial margin impact of the prudential regulators' proposed margin rule, and noted the proposed rule would apply to any swap that is a national bank, a federally chartered branch or agency of a foreign bank, or a federal savings association. Id. at 2.

1135 OCC Unfunded Mandates Report at 5.

1136 Id. The report also estimated that the actual cost of the initial margin requirement is the opportunity cost of collateral that under the prudential regulators' rule must be segregated into a custodial account with a presumably lower rate of return.

Finally, the BAML Report stated that its calculations suggested that the regulatory changes may eventually result in initial margin requirements of $200 billion to $600 billion for US banks, as current derivatives portfolios turn over.[1137]

In summary, as stated above, commenters concluded that the liquidity impact of the initial margin rules proposed by the CFTC and the prudential regulators was significant.[1138] However, one commenter acknowledged that the numbers should be viewed as an "order of magnitude estimate" and that "[o]ne cannot predict which entities will use derivatives in the future nor the amounts and types of products that will be used."[1139] The Commission seeks comment on the liquidity impact of its proposals below and in section II.B. of this release.

c. Margin Requirements for Nonbank-MSBSPs

As described in section II.B. of this release, a nonbank MSBSP would be required to calculate as of the close of each business day the amount of equity in the account of each counterparty to a non-cleared security-based swap.[1140] On the next business day following the calculation, the nonbank MSBSP would be required to either collect or deliver cash, securities, and/or money instruments to the counterparty depending on whether there was negative or positive equity in the account of the counterparty.[1141] Specifically, if the account had negative equity on the previous business day, the nonbank MSBSP would be required to collect cash, securities, and or money market instruments in an amount equal to the negative equity.[1142]

1137 BAML Report at 5.

1138 See also Manmohan Singh, Collateral, Netting and Systemic Risk in the OTC Derivatives Market.

1139 SIFMA/ISDA Comment Letter to the CFTC at 38.

1140 See paragraph (c)(2)(i) of proposed new Rule 18a-3.

1141 See paragraph (c)(2)(ii) of proposed new Rule 18a-3. As indicated, the nonbank MSBSP would need to deliver cash, securities, and/or money market instruments and, consequently, other types of assets would not be eligible as collateral.

1142 See paragraph (c)(2)(ii)(A) of proposed new Rule 18a-3. In this case, the nonbank MSBSP would have current exposure to the counterparty in an amount equal to the negative equity.

Conversely, if the account had positive equity on the previous business day, the nonbank MSBSP would be required to deliver cash, securities, and/or money market instruments to the counterparty in an amount equal to the positive equity.[1143]

Nonbank MSBSPs are not expected to maintain two-sided markets or otherwise engage in activities that would require them to register as an SBSD.[1144] They will, however, by definition, maintain substantial positions in particular categories of security-based swaps.[1145] These positions could create significant risk to counterparties to the extent the counterparties have uncollateralized current exposure to the nonbank SBSD. In addition, they could pose significant risk to the nonbank MSBSP to the extent it has uncollateralized current exposure to its counterparties. The proposed account equity requirements for nonbank MSBSPs seek to address these risks by imposing a requirement that nonbank MSBSPs on a daily basis must "neutralize" the credit risk between the nonbank MSBSP and the counterparty either by collecting or delivering cash, securities, and/or money market instruments in an amount equal to the positive or negative equity in the account.

The collection of collateral from counterparties would strengthen the liquidity of the nonbank MSBSP by collateralizing its current exposure to counterparties. The delivery of collateral to counterparties to collateralize their current exposure to the nonbank MSBSP would lessen the impact on the counterparties if the nonbank MSBSP failed.

The requirement for nonbank MSBSPs to post current exposure to certain counterparties under proposed new Rule 18a-3 would impose an incremental opportunity cost for these nonbank MSBSPs only to the extent that they do not currently post collateral to cover current

1143 See paragraph (c)(2)(ii)(B) of proposed new Rule 18a-3.

1144 See Entity Definitions Adopting Release, 77 FR 30596.

1145 See 15 U.S.C. 78c(a)(67); Entity Definitions Adopting Release, 77 FR 30596.

exposure. The requirement that nonbank MSBSPs collect variation margin from certain counterparties also would represent an incremental cost to those counterparties users to the extent they do not currently post such margin.

As stated above, proposed new Rule 18a-3 contains an exception for trades between nonbank MSBSPs and commercial end users, so those end users would not face additional costs because of this exception.

Instead of the proposed approach, the Commission could adopt margin requirements for nonbank MSBSPs that are consistent with those proposed for nonbank SBSDs, by requiring them to collect initial margin from all non-dealer counterparties. This approach could better protect the MSBSP from loss in the event of a counterparty default, and thereby lessen the possibility of a default by the MSBSP. On the other hand, such a requirement would increase the credit exposure of counterparties to the MSBSP by the amount of the initial margin that they provide to the MSBSP and could increase their risk of loss if the MSBSP were to fail and they were unsuccessful in obtaining the return of amounts owed to them. The Commission is seeking comment on this alternative.

d. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The proposed margin requirements to collect collateral from their counterparties to non-cleared security-based swaps to cover both current exposure and potential future exposure are designed to insulate security-based swap market participants from the negative fallout of a defaulting counterparty. Basing proposed Rule 18a-3 on the broker-dealer margin rules is intended to achieve those objectives in the market for security-based swaps. Moreover, the consistency between margin requirements for securities and security-based swaps should ultimately promote efficiency in the securities markets, and in turn, enhance competition in the security-based swap markets.

The proposed rule offers built-in flexibilities that should enhance the efficiency in the application of the rule. For example, granting counterparties the flexibility to post a variety of collateral types to meet margin requirements may result in increased efficiencies for end users, and could encourage increased trading of security-based swaps and thereby increase competition. Furthermore, the proposed exception for commercial end users is intended to account for the different risk profiles of commercial end users as compared with financial end users.[1146] This exception may increase efficiencies by allowing SBSDs to optimally choose to collect collateral or take a capital charge, which in turn might allow end users to more cost efficiently manage business risks and thereby better compete in their respective industries.

However, the flexibility to use models to calculate margins instead of applying the standard haircuts could have an adverse impact on competition if the differences in these margin amounts are sufficiently large. If this was the case, a nonbank SBSD not approved to use models will find it difficult to compete with an SBSD approved to use models. However, it is conceivable that SBSDs not approved to use models would tend to do business only in cleared security-based swaps and SBSDs that use models would compete in both cleared and non-cleared security-based swaps. This separation could have a negative impact on competition in non-cleared security-based swaps. If, however, SBSDs that are approved to use models manage counterparty risk more efficiently, the market for non-cleared security-based swaps might be

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1146 See Prudential Regulator Margin and Capital Proposing Release, 76 FR at 27571 ("Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity."). See also CFTC Margin Proposing Release, 76 FR at 27735 ("The Commission believes that financial entities, which are generally not using swaps to hedge or mitigate commercial risk, potentially pose greater risk to CSEs than non-financial entities.").

systemically less risky than it would be if SBSDs not using models participated actively in that market. It is unclear whether the benefit from the reduction in systemic risk would outweigh the potential cost of the reduced competition.

There also is a trade-off between Alternatives A and B for SBSDs. Under Alternative A the reduced demand on posting and collecting collateral should lead to more efficient allocation of capital and hence improve competition, but it comes at the cost of being less resilient to counterparty defaults and hence might overall increase systemic risk. In addition, if the Commission does not require nonbank SBSDs to collect initial margin in their transactions with each other, as is generally current market practice,[1147] while the prudential regulators require the collection of initial margin for the same trades as their proposed rules suggest, intermediaries could have an incentive to conduct business through nonbank entities.[1148] Under Alternative B, the requirement to exchange initial margin would impose costs on the nonbank SBSD in the form of a capital charge to the extent the nonbank SBSD must post initial margin. This could result in substantially less liquidity available to the nonbank SBSD to support its security-based swap business or other dealer activity, but to the extent it limits the amount of uncleared SBSD transactions among nonbank SBSDs as a whole, it could lead to lower systemic risk. Moreover, if this requirement results in a significant increase in costs because of the required capital charge, nonbank SBSDs could be motivated to conduct trading either in bank SBSDs or offshore because they would not need to take the capital charge. Especially in the latter case, this may not only adversely affect domestic competition if the only dealers able to absorb the increased expenses are the ones currently participating in the market, it also could increase systemic risk worldwide if the regulatory environment in foreign jurisdictions are less stringent.

1147 See generally ISDA Margin Survey 2011.

1148 See Prudential Regulator Margin and Capital Proposing Release, 76 FR 27564.

Request for Comment

The Commission generally requests comment about its analysis of the costs and benefits of proposed Rule 18a-3. In addition, the Commission requests comment in response to the following questions:

1. In many respects, the proposed rules reflect an interplay between capital and margin requirements. How should each set of rules take account of the other? For example, does the proposed alternative capital charge in lieu of collecting margin from commercial end users appropriately account for the increased exposure to the dealer? Does it over-state the exposure?

2. What would be the general market impact of requiring that dealers post both variation and initial margin in transactions with each other? Commenters are asked to supply data on the volume of interdealer transactions in security-based swaps and the aggregate dollar impact of this proposal. How does the impact of requiring dealers to exchange both variation and initial margin compare with the aggregate dollar impact of requiring that nonbank SBSDs collect only variation margin?

3. With regard to Alternatives A and B regarding interdealer margin, the Commission requests that commenters provide the following data points to the Commission:

    - The relative amounts of variation and initial margin for sample dealer portfolios of security-based swaps;
    - The industry dollar impact and liquidity impact of requiring lock up of initial margin for dealer portfolios; and
    - How the amount of initial margin would compare to overall dealer capital.

4. The Commission also requests comment on the potential legal limitations involved in obtaining a return of collateral that has been posted to a third party custodian, the costs involved, and whether there are ways to overcome these limitations.

5. The Commission requests comment on the costs and benefits, if the Commission, as an alternative to proposed new Rule 18a-3, permitted nonbank SBSDs to apply to the Commission to use internal models solely to compute the margin amount in paragraph (d) to Rule 18a-3 (without seeking approval to use internal models for capital purposes). Would this alternative impact the Commission's oversight responsibility of nonbank SBSDs?
6. What is the cost impact, if any, of permitting nonbank SBSDs to accept securities as collateral that may be less liquid than Treasury securities in the case of severe market disruptions? Would this cost be mitigated by the haircut and collateral requirements in proposed Rule 18a-3?
7. What would be the costs and benefits of an initial margin requirement between nonbank SBSDs counterparties dependent on the firm's minimum net capital requirement (e.g., based on firm size)?
8. Proposed Rule 18a-3(d) would require that firms approved to use VaR models calculate margin amount using a 99%, 10 business-day period. How would this proposal affect sample portfolios of security-based swaps based on existing internal firm models and current market practices, including margin practices at registered clearing agencies? The Commission requests data from market participants to assist it in evaluating this proposal.
9. Would the margin requirements under proposed new Rule 18a-3 incentivize counterparties to trade in cleared security-based swaps? If certain security-based swaps cannot be cleared, would the proposed margin requirements render the use of these non-cleared contracts inefficient?

10. Will nonbank MSBSPs incur operational, technology or other costs to calculate the amount of equity in the account of a counterparty, as required under paragraph (c)(2)(i) of proposed new Rule 18a-3?

4. Proposed Segregation Rule – Rule 18a-4

Proposed new Rule 18a-4 would establish segregation requirements for cleared and non-cleared security-based swap transactions, which would apply to bank SBSDs, nonbank stand-alone SBSDs, and broker-dealer SBSDs.[1149] The goal of proposed new Rule 18a-4 is to protect customer assets by ensuring that cash and securities that SBSDs hold for security-based swap customers are isolated from the proprietary assets of the SBSD and identified as property of such customers.[1150] This approach would facilitate the prompt return of customer property to customers either before or during liquidation proceedings if the firm fails,[1151] and is therefore expected to provide market participants who enter into security-based swap transactions with an SBSD the confidence that their accounts will remain separate from the SBSD in the event of bankruptcy.[1152] As such, proposed new Rule 18a-4 will have a number of benefits as well as impose certain costs on SBSDs and MSBSPs, as well as other market participants. The proposed rules are expected to have possible effects on competition, efficiency, and capital formation, which are discussed below.

As discussed earlier in this release, Rule 18a-4 is in substantial part modeled on provisions of Rule 15c3-3 that require a carrying broker-dealer to take two primary steps to

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1149 See proposed new Rule 18a-4. See also section II.C. of this release for a more detailed description of the proposal. The provisions of proposed new Rule 18a-4 are modeled on the broker-dealer segregation rule, Rule 15c3-3. 17 CFR 240.15c3-3.

1150 See proposed new Rule 18a-4.

1151 See generally Michael P. Jamroz, The Customer Protection Rule, 57 Bus. Law. 1069 (May 2002). See also section II.C. of this release for a more detailed description of the proposal.

1152 See 15 U.S.C. 78c-5.

safeguard these assets. The first step required by Rule 15c3-3 is that a carrying broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities.[1153] The second step is that a carrying broker-dealer must maintain a reserve of funds or qualified securities in a customer reserve account at a bank that is equal in value to the net cash owed to customers, computed in accordance with the Exhibit A formula.[1154] The corollary provisions of Rule 18a-4 are likewise intended to require that customer funds are adequately protected from loss in the event of the SBSD's failure. Further, this protection would be provided to customers who have not affirmatively elected to require individual account segregation of their assets under section 3E(f) of the Exchange Act.

Paragraph (a) of the proposed new rule would define key terms used in the rule.[1155] Paragraph (b) would require an SBSD to promptly obtain and thereafter maintain physical possession or control of all excess securities collateral (a term defined in paragraph (a)) and specify certain locations where excess securities collateral could be held and deemed in the SBSD's control.[1156] Paragraph (c) would require an SBSD to maintain a special account for the exclusive benefit of security-based swap customers and have on deposit in that account at all times an amount of cash and/or qualified securities (a term defined in paragraph (a)) determined through a computation using the formula in Exhibit A to proposed new Rule 18a-4.[1157]

Paragraph (d) of proposed new Rule 18a-4 would contain provisions that are designed to mplement the individual account segregation requirements of section 3E(f) of the Exchange Act,

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See 17 CFR 240.15c3-3(d).

17 CFR 240.15c3-3(e). The term "qualified security" is defined in Rule 15c3-3 to mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States. See 17 CFR 240.15c3-3(a)(6).

Compare 17 CFR 240.15c3-3(a), with paragraph (a) of proposed new Rule 18a-4.

Compare 17 CFR 240.15c3-3(b)-(d), with paragraph (b) of proposed new Rule 18a-4.

Compare 17 CFR 240.15c3-3(e), with paragraph (e) of proposed new Rule 18a-4.

and therefore, are not modeled specifically on Rule 15c3-3. First, it would require an SBSD and an MSBSP to provide the notice required by section 3E(f)(1)(A) of the Exchange Act prior to the execution of the first non-cleared security-based swap transaction with the counterparty.[1158] Second, it would require the SBSD to obtain subordination agreements from counterparties that opt out of the segregation requirements in proposed new Rule 18a-4 because they either elect individual segregation pursuant to the self-executing provisions of section 3E(f) of the Exchange Act[1159] or agree that the SBSD need not segregate their assets at all.[1160]

Available information suggests that customer assets related to OTC derivatives are currently not consistently segregated from dealer proprietary assets. With respect to non-cleared derivatives, available information suggests that there is no uniform segregation practice but that collateral for most accounts is not segregated.[1161] According to the ISDA Margin Survey 2012, where independent amounts (initial margin) is collected, ISDA members reported that most (approximately 72.2%) was commingled with variation margin and not segregated, and only 4.8% of the amount received was segregated with a third party custodian.[1162]

In the absence of a segregation requirement, the likelihood that security-based swap customers would suffer losses upon a dealer default may substantially increase. The proposed segregation requirements would limit for security-based swap customers these potential losses if

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1158 See 15 U.S.C. 78c-5(f)(1)(A); paragraph (d)(1) of proposed new Rule 18a-4.

1159 See 15 U.S.C. 78c-5(f)(1)-(3).

1160 See 15 U.S.C. 78c-5(f)(4).

1161 See generally ISDA Margin Survey 2012.

1162 ISDA Margin Survey 2012. The survey also notes that while the holding of the independent amounts a[illegible] variation margin together continues to be the industry standard both contractually and operationally, it i[illegible] interesting to note that the ability to segregate has been made increasingly available to counterparties o[illegible] the past three years on a voluntary basis, and has led to adoption of 26% of independent amount receiv[illegible] and 27.8% of independent amount delivered being segregated in some respects. Id. at 10. See also Independent Amounts.

an SBSD fails.[1163] The extent to which assets are in fact protected by proposed Rule 18a-4 would depend on how effective they are in practice in allowing assets to be readily returned to customers.

It is difficult to measure these benefits against the current baseline of the OTC derivatives market as it exists today, as discussed in section V.A.1. of this release. Rule 15c3-3, on which proposed Rule 18a-4 is modeled, however, may generally provide a reasonable template for crafting the corresponding requirements for nonbank SBSDs.[1164] Furthermore, the ensuing increased confidence of market participants when transacting in security-based swaps, as compared to the OTC derivatives market as it exists today, should enhance liquidity and generally benefit market participants.

Further, modeling the provisions of Rule 18a-4 on existing Rule 15c3-3 will generally promote consistent treatment of collateral in circumstances where a broker-dealer SBSD conducts business in securities and security-based swaps with the same counterparty, and in these cases it will facilitate the ability of firms to offer portfolio margin treatment. In addition, "omnibus segregation" requirements of proposed Rule 18a-4 are intended to reduce costs for SBSDs and their customers by providing a less expensive segregation alternative to individual account segregation.[1165]

Currently, because of a lack of trading in cleared security-based swaps for customers,[1166] there is no definitive baseline against which to measure the various costs associated with segregation requirements for those trades. Further, overall costs of segregating collateral for

1163 CFTC and Commission, Statement on MF Global about the deficiencies in customer futures segregated accounts held at the firm (Oct. 31, 2011).

1164 See 17 CFR 240.15c3-3. See SIPC 2011 Annual Report.

1165 See section 3E(f)(1)(B) of the Exchange Act.

1166 See Process for Submissions of Security-Based Swaps, 77 FR 41602.

cleared security-based swaps will be heavily affected by the clearing agency rules, which will govern how margin required by, and held at, a clearing agency with respect to customer positions must be segregated.[1167]

As stated above, proposed new Rule 18a-4 also is intended to provide SBSDs and their counterparties a less expensive segregation alternative to individual account segregation. Higher costs for individual segregation derive from, among other things, higher fees charged by custodians to monitor individual account assets and to account for potentially greater legal risks and liabilities of custodians to account beneficiaries or dealers, as well as higher operational costs to account for collateral on an individual customer basis. A commenter to the CFTC raised concerns with the length of time and the costs to comply with an individual segregation mandate. Specifically, the commenter raised concerns regarding the number of collateral arrangements that would be required. The commenter estimated, based on discussion with its members, that "a rough estimate of the time it would take to establish the necessary collateral arrangements is 1 year and eleven months, with an associated cost of $141.8 million, per covered swap entity."[1168] To account for these higher costs, SBSDs likely may increase fees for customers that choose individual rather than omnibus segregation. If higher fees make it prohibitively expensive for some counterparties to elect individual segregation, the proposed omnibus segregation scheme under Rule 18a-4 could be a more cost-effective solution.

Rule 18a-4 will impose on SBSDs operational costs, as well as costs related to the use of customer funds, compared to the baseline, given that dealers in general do not presently segregate customer collateral for security-based swaps, and to the extent collateral is segregated, it is not done so on the terms that would be required by proposed new Rule 18a-4. The

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1167 See Clearing Agency Standards for Operation and Governance, 76 FR 14472.

1168 SIFMA/ISDA Comment Letter to the Prudential Regulators.

operational costs include costs to establish qualifying bank accounts and to perform the calculations required to determine the amount that is required at any one time to be maintained in the reserve account.[1169] In cases where an SBSD is jointly registered as a broker-dealer, the costs of adapting existing systems to account for security-based swap transactions may not be material in light of the similarities between the systems and procedures required by Rule 15c3-3 and those that would be required by proposed new Rule 18a-4.

A further cost would be imposed on SBSDs to the extent that collateral they hold that could otherwise be rehypothecated would no longer be eligible for this purpose.[1170] An SBSD would incur a cost of funds equal to the borrowing cost of the dealer if the dealer was unable to use customer collateral to finance its business activities. The extent of this cost would depend on how much collateral associated with security-based swaps and held by dealers today consists of initial margin that they can rehypothecate, i.e., that is not now segregated as would be required under Rule 18a-4 (the rule would not require the segregation of variation margin).[1171]

a. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The proposed segregation requirements for SBSDs are designed to protect and preserve counterparty collateral held at SBSDs. More specifically, the goal of proposed new Rule 18a-4 is to protect customer assets by ensuring that cash and securities that SBSDs hold for security-based swap customers are isolated from the proprietary assets of the SBSD and identified as

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1169 See proposed new Rule 18a-4. See section V.C. of this release for a discussion of implementation costs. See also section V.B. of this release.

1170 See SIFMA/ISDA Comment Letter to the Prudential Regulators ("First, because the collateral cannot be rehypothecated, and because the collateral amounts will be very large, CSEs will be limited to investing very large amounts of eligible collateral in assets that generate low returns.").

1171 See Manmohan Singh, Velocity of Pledged Collateral: Analysis and Implications; Manmohan Singh and James Aitken, The (sizable) Role of Rehypothecation in the Shadow Banking System.

property of such customers.[1172] These protections may provide market participants who enter into security-based swap transactions with an SBSD the assurance that their accounts will remain separate from the SBSD in the event of bankruptcy.[1173] These proposed protections could reduce the risk of loss of collateral to individual counterparties and, thereby, promote participation in the security-based swap markets. This may result in enhanced competition and more efficient price discovery.

Therefore, proposed segregation rules that promote, or do not unduly restrict, competition may be accompanied by regulatory benefits that minimize the risk of market failure and thus promote efficiency within the market. Such competitive markets would increase the efficiency with which market participants could transact in security-based swaps for speculative, trading, hedging and other purposes. Conversely, increased costs associated with the proposed segregation rules could result in high barriers to entry and negatively affect competition for SBSDs in the security-based swap markets.

Further, modeling the provisions of Rule 18a-4 on existing Rule 15c3-3 will generally promote consistent treatment of collateral in circumstances where a broker-dealer SBSD conducts business in securities and security-based swaps with the same counterparty, increasing efficiencies for counterparties. Finally, the proposed "omnibus segregation" requirements of proposed Rule 18a-4 are intended to provide a less expensive segregation alternative to individual account segregation.[1174] This proposed requirement could also result in increased

1172 See proposed new Rule 18a-4.

1173 See 15 U.S.C. 78c-5.

1174 See 15 U.S.C. 78c(f)(1)(B).

efficiencies, and, in turn, facilitate capital formation through the availability of additional capital for counterparties as a result of decreased costs.

Request for Comment

The Commission generally requests comment about its analysis of the costs and benefits of the proposed segregation rules. In addition, the Commission requests comment in response to the following questions:

1. To what extent do counterparties presently require that their assets associated with security-based swaps be independently segregated?
2. What would be the overall market impact of a right by customers to demand individual segregation? How would costs to end users be impacted? Would those costs differ depending on the type of end user or size of its positions with the SBSD?
3. How would the existence of omnibus versus independent accounts factor into the ability easily to resolve a defaulting SBSD?
4. Would the proposed segregation requirements prove to be difficult to implement for existing contracts?

C. IMPLEMENTATION CONSIDERATIONS

As discussed above, proposed Rules 18a-1 through 18a-4, as well as the proposed amendments to Rule 15c3-1, would impose certain costs on SBSDs and MSBSPs. The Commission expects that the highest economic cost impact as a result of the proposed new rules and rule amendments would likely result from the additional capital nonbank SBSDs and nonbank SBSDs may have to hold as a result of the proposed capital rules, and the additional margin that SBSDs, MSBSPs, and other market participants may have to post and/or collect as a result of proposed margin requirements.

The proposed new rules and rule amendments, however, as discussed above, would impose certain implementation burdens and related costs on SBSDs, MSBSPs and other market participants. These costs may include start-up costs, including personnel and other costs, such as technology costs, to comply with the proposed new rules and rule amendments. As discussed in section IV.D. of this release, the Commission has estimated the burdens and related costs of these implementation requirements for SBSDs and MDBSPs.[1175] These costs are summarized below.

A stand-alone SBSD that applies to use internal models would be required under proposed new Rule 18a-1 to create and compile various documents to be included with the application, including documents related to the development of its VaR models, and to provide additional documentation to, and respond to questions from, Commission staff throughout the application process.[1176] These firms also would be required to review and backtest these models annually. The requirements are estimated to impose one-time and annual costs in the aggregate of approximately \$1.97 million[1177] and \$10.6 million, respectively.[1178] These firms would also incur technology costs of \$48.0 million in the aggregate.[1179]

Stand-alone SBSDs that use internal models and ANC broker-dealers would be required to develop a liquidity stress test and a written contingency plan under proposed new Rule 18a-1 and proposed amendments to Rule 15c3-1, and periodically review them.[1180] These requirements

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1175 See section IV.D. of this release (discussing total initial and annual recordkeeping and reporting burden of the proposed rules and rule amendments).

1176 See section IV.A.1. of this release.

1177 This consists of external costs of \$600,000, plus internal costs of \$1.37 million. See section IV.D.1. of this release.

1178 This consists of external costs of \$3.7 million, plus internal costs of \$6.9 million. See section IV.D.1. of this release.

1179 See section IV.D.1. of this release.

1180 See section IV.A.1. of this release.

would impose one-time and annual costs in the aggregate of approximately $1.0 million[1181] and $2.3 million,[1182] respectively.

Rule 18a-1 also would require stand-alone SBSDs to establish, document, and maintain a system of internal risk management controls required under Rule 15c3-4, as well as to review and update these controls.[1183] This requirement would impose one-time and annual costs in the aggregate of $7.5 million[1184] and $971,000, respectively.[1185] These firms also may incur aggregate initial and ongoing information technology costs of $240,000 and $307,500, respectively.[1186]

Finally, nonbank SBSDs and broker-dealers, as applicable, may incur one-time and ongoing costs related to filing notices and subordination agreements and documenting industry sector classifications under proposed new Rule 18a-1, and amendments to Rule 15c3-1.[1187] These requirements would impose one-time and annual costs in the aggregate of $68,040[1188] and $38,367, respectively.[1189]

Rule 18a-2 also would require nonbank MSBSPs to establish, document, and maintain a system of internal risk management controls required under Rule 15c3-4, as well as to review

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1181 See section IV.D.1. of this release.

1182 Id.

1183 See section IV.A.1. of this release.

1184 See section IV.D.1. of this release.

1185 Id.

1186 Id.

1187 See section IV.A.1. of this release.

1188 See section IV.D.1 of this release (one-time cost to draft subordinated loan agreement template under Appendix D to proposed new Rule 18a-1).

1189 Id. (annual costs of $2,898, $1,449 and $34,020 related to documenting industry sector classifications for credit default swap haircuts under Rule 18a-1, equity withdrawal notices under paragraph (i) under Rule 18a-1, and preparing and filing proposed subordinated loan agreements with the Commission under Appendix D to Rule 18a-1).

and update these controls.[1190] This requirement would impose one-time and annual costs in the aggregate of \$2.7 million[1191] and \$324,000[1192] for nonbank MSBSPs, respectively. These nonbank MSBSPs also may incur initial and ongoing information technology costs of \$80,000 and \$102,500, respectively.[1193]

Rule 18a-3 would require nonbank SBSDs to establish a written risk analysis methodology, which would need to be reviewed and updated.[1194] This requirement would impose one-time and annual costs in the aggregate of \$1.7 million[1195] and \$483,000, respectively.[1196]

Finally, SBSDs and MSBSPs would incur various one-time and ongoing costs in the aggregate in order to comply with the segregation and notification requirements of proposed new Rule 18a-4.[1197] Each SBSD would incur one-time and annual costs in establishing special bank accounts required by the rule. This requirement would impose one-time and annual costs of \$2.9 million[1198] and \$377,000[1199] in the aggregate on SBSDs, respectively. In addition, SBSDs would be required to perform a reserve computation required by Appendix A to proposed new Rule 18a-4, which would impose on these firms annual costs in the aggregate of \$9.7 million.[1200]

1190 See section IV.A.2. of this release.

1191 This consists of external costs of \$400,000, plus internal costs of \$2.3 million. See section IV.D.2. of this release.

1192 See section IV.D.2. of this release.

1193 Id.

1194 See section IV.A.3. of this release.

1195 See section IV.D.3. of this release. This consists of external costs of \$18,000, plus internal costs of \$1.7 million.

1196 Id.

1197 See section IV.A.4. of this release.

1198 See section IV.D.4. of this release.

1199 Id.

1200 Id.

In addition, both SBSDs and MSBSPs would be required to prepare and send to their counterparties segregation-related notices pursuant to section 3E(f) of the Exchange Act.[1201] This requirement would impose one-time and annual costs in the aggregate to SBSDs and MSBSPs of $770,000[1202] and $110,000, respectively.[1203]

Finally, proposed new Rule 18a-4 would require each SBSD to draft, prepare, and enter into subordination agreements with certain counterparties.[1204] This requirement would impose on these firms one-time and annual costs in the aggregate of $99.7 million[1205] and $19.1 million,[1206] respectively.

D. GENERAL REQUEST FOR COMMENT

The Commission requests data to quantify, and estimates of, the costs and the value of the benefits of the proposed rules described above. Commenters should provide estimates of these costs and benefits, as well as any costs and benefits not already defined, that may result from the adoption of the proposed rules. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposals. The Commission requests comment on any effect the proposed new rules and rule amendments may have on efficiency, competition, and capital formation, including the competitive or anticompetitive effects the proposals may have on market participants. In addition, the Commission requests comment on whether other provisions of the Dodd-Frank Act for which

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1201 See section IV.A.4. of this release.

1202 See section IV.D.4. of this release. This consists of external costs of $220,000, plus internal costs of $550,020.

1203 Id.

1204 See section IV.A.4. of this release.

1205 See section IV.D.4. of this release. This consists of external costs of $400,000, plus internal costs of $3,780,000 and $95,580,000.

1206 Id.

Commission rulemaking is required are likely to have an effect on the costs and benefits of the proposed rules. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposed rules.

VI. REGULATORY FLEXIBILITY ACT CERTIFICATION

The Regulatory Flexibility Act ("RFA")[1207] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)[1208] of the Administrative Procedure Act,[1209] as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."[1210] Section 605(b) of the RFA states that this requirement shall not apply to any proposed rule or proposed rule amendment, which, if adopted, would not have a significant economic impact on a substantial number of small entities.[1211]

For purposes of Commission rulemaking in connection with the RFA, a small entity includes: (1) when used with reference to an "issuer" or a "person," other than an investment company, an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of $5 million or less,[1212] or (2) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange

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1207 5 U.S.C. 601 et seq.

1208 5 U.S.C. 603(a).

1209 5 U.S.C. 551 et seq.

1210 Although section 601(b) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term "small entity" for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10. See Statement of Management on Internal Accounting Control, Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982).

1211 See 5 U.S.C. 605(b).

1212 See 17 CFR 240.0-10(a).

Act,[1213] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[1214] Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (1) for entities in credit intermediation and related activities,[1215] firms with $175 million or less in assets; (2) for non-depository credit intermediation and certain other activities,[1216] firms with $7 million or less in annual receipts; (3) for entities in financial investments and related activities,[1217] firms with $7 million or less in annual receipts; (4) for insurance carriers and entities in related activities,[1218] firms with $7 million or less in annual receipts; and (5) for funds, trusts, and other financial vehicles,[1219] firms with $7 million or less in annual receipts.[1220]

1213 See 17 CFR 240.17a-5(d).

1214 See 17 CFR 240.0-10(c).

1215 Including commercial banks, savings institutions, credit unions, firms involved in other depository credit intermediation, credit card issuing, sales financing, consumer lending, real estate credit, and international trade financing.

1216 Including firms involved in secondary market financing, all other non-depository credit intermediation, mortgage and nonmortgage loan brokers, financial transactions processing, reserve and clearing house activities, and other activities related to credit intermediation.

1217 Including firms involved in investment banking and securities dealing, securities brokerage, commodity contracts dealing, commodity contracts brokerage, securities and commodity exchanges, miscellaneous intermediation, portfolio management, providing investment advice, trust, fiduciary and custody activities, and miscellaneous financial investment activities.

1218 Including direct life insurance carriers, direct health and medical insurance carriers, direct property and casualty insurance carriers, direct title insurance carriers, other direct insurance (except life, health and medical) carriers, reinsurance carriers, insurance agencies and brokerages, claims adjusting, third party administration of insurance and pension funds, and all other insurance related activities.

1219 Including pension funds, health and welfare funds, other insurance funds, open-end investment funds, trusts, estates, and agency accounts, real estate investment trusts, and other financial vehicles.

1220 See 13 CFR 121.201 (Jan. 1, 2010).

Based on available information about the security-based swap market,[1221] the market, while broad in scope, is largely dominated by entities such as those that would be covered by the SBSD and MSBSP definitions. Subject to certain exceptions, section 3(a)(71)(A) of the Exchange Act defines security-based swap dealer to mean any person who: (1) holds itself out as a dealer in security-based swaps; (2) makes a market in security-based swaps; (3) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or (4) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps. Section 3(a)(67)(A) of the Exchange Act defines major security-based swap participant to be any person: (1) who is not an SBSD; and (2) who maintains a substantial position in security-based swaps for any of the major security-based swap categories, as such categories are determined by the Commission, excluding both positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or that is a financial entity that is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking regulator; and maintains a substantial position in outstanding security-based swaps in

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1221 See CDS Data Analysis.

any major security-based swap category, as such categories are determined by the Commission.[1222]

Based on feedback from industry participants about the security-based swap markets, entities that will qualify as SBSDs and MSBSPs, whether registered broker-dealers or not, will likely exceed the thresholds defining "small entities" set out above. Thus, it is unlikely that proposed Rules 18a-1 to 18a-4 and the amendments to Rule 15c3-1 would have a significant economic impact on any small entity.

The Commission estimates that there are approximately 808 broker-dealers that were "small" for the purposes Rule 0-10. The amendments to Rule 15c3-1 relating to the standardized haircuts for swaps and security-based swaps, as well as the proposed CDS maturity grid would apply to all broker-dealers with such proprietary positions. These proposed amendments, therefore, would apply to all "small" broker-dealers in that they would be subject to the requirements in the proposed amendments. It is likely, however, that these proposed amendments would have no, or little, impact on "small" broker-dealers, since most, if not all, of these firms generally would not hold these types of positions.

For the foregoing reasons, the Commission certifies that the proposed new Rules 18a-1 through 18a-4, amendments to Rule 15c3-1, and amendments to Rule 15c3-3 would not have a significant economic impact on any small entity for purposes of the RFA.

1222 See also Entity Definitions Adopting Release, 77 FR 30596 ("The SEC continues to believe that the types of entities that would engage in more than a de minimis amount of dealing activity involving security-based swaps – which generally would be major banks – would not be 'small entities' for purposes of the RFA. Similarly, the SEC continues to believe that the types of entities that may have security-based swap positions above the level required to be a 'major security-based swap participant' would not be a 'small entity' for purposes of the RFA. Accordingly, the SEC certifies that the final rules defining 'security-based swap dealer' or 'major security-based swap participant' would not have a significant economic impact on a substantial number of small entities for purposes of the RFA."). Id. at 30743.

The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to illustrate the extent of the impact.

VII. STATUTORY BASIS AND TEXT OF THE PROPOSED AMENDMENTS

Pursuant to the Exchange Act, 15 U.S.C. 78a et seq., and particularly, sections 3(b), 3E, 15, 15F, 23(a), and 36 (15 U.S.C. 78c(b), 78c-5, 78o, 78o-10, 78w(a), and 78mm), thereof, the Commission is proposing to amend §§ 240.15c3-1, 240.15c3-1a, 240.15c3-1b, 240.15c3-1d, 240.15c3-1e, and 240.15c3-3, and proposing §§ 240.18a-1, 240.18a-1a, 240.18a-1b, 240.18a-1c, 240.18a-1d, 240.18a-2, 240.18a-3, 240.18a-4, and 240.18a-4a under the Exchange Act.

List of Subjects in 17 CFR Parts 240

Brokers, Fraud, Reporting and recordkeeping requirements, Securities

Text of Amendment

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 240 — GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority citation for part 240 is revised, the sectional authorities for §§240.15c3-1 and 240.15c3-3 are revised, add sectional authorities for §§ 240.15c3-1a, 240.15c3-1e, 240.15c3-3, 240.18a-1, 240.18a-1a, 240.18a-1b, 240.18a-1c, 240.18a-1d, 240-18a-2, 240.18a-3 and 240.18a-4 in numerical order to read as follows.

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-10 78o-4, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; 12 U.S.C. 5221(e)(3), 15 U.S.C. 8302, and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Section 240.15c3-1 is also issued under 15 U.S.C. 78o(c)(3), 78o-10(d), and 78o-10(e).

Section 240.15c3-3 is also issued under 15 U.S.C. 78c-5, 78o(c)(2), 78(c)(3), 78q(a), 78w(a); sec. 6(c), 84 Stat. 1652; 15 U.S.C. 78fff.

* * * * *

Sections 240.18a-1, 240.18a-1a, 240.18a-1b, 240.18a-1c, 240.18a-1d, 240.18a-2, and 240.18a-3 are also issued under 15 U.S.C. 78o-10(d) and 78o-10(e).

Section 240.18a-4 is also issued under 15 U.S.C. 78c-5(f).

* * * * *

2. Section 240.15c3-1 is amended by:

a. Revising the title of paragraph (a)(7) to read as follows "ALTERNATIVE NET CAPITAL COMPUTATION FOR BROKER-DEALERS AUTHORIZED TO USE MODELS".

b. In paragraph (a)(7) revising the phrase "and using the credit risk standards of Appendix E to compute a deduction for credit risk on certain credit exposures arising from transactions in derivatives instruments, instead of the provisions of paragraph (c)(2)(iv) of this section" and in its place adding the phrase "and using the credit risk standards of Appendix E to compute a deduction for credit risk for security-based swap transactions with commercial end users as defined in § 240.18a-3(b)(2), instead of the provisions of paragraphs (c)(2)(iv) and (c)(2)(xiv)(B)(1) of this section".

c. Revising paragraph (a)(7)(i);

d. In paragraph (a)(7)(ii), revise "$5 billion" and in its place add "$6 billion";

e. Adding new paragraph (a)(10);

f. Adding new paragraph (c)(2)(vi)(O);

g. Re-designating paragraph (c)(2)(xii) as paragraph (c)(2)(xii)(A) and adding new paragraph (c)(2)(xii)(B);

h. Adding new paragraph (c)(2)(xiv);

i. Adding new paragraph (c)(16);

j. Adding new paragraph (f);

k. In paragraph (c)(2)(ii) of Appendix E, replacing "less than 50%" with "less than or equal to 50%".

The revisions and additions read as follows:

§ 240.15c3-1 Net capital requirements for brokers or dealers.

* * * * *

(a) * * *

(7) * * *

(i) At all times maintain tentative net capital of not less than $5 billion and net capital of not less than the greater of $1 billion or the sum of the ratio requirement under paragraph (a)(1) of this section and eight percent (8%) of the risk margin amount;

* * * * *

<u>Broker-Dealers Registered as Security-Based Swap Dealers</u>

(10) A broker or dealer registered with the Commission as a security-based swap dealer, other than a broker or dealer subject to the provisions of (a)(7) of this section, must:

(i) At all times maintain net capital of not less than the greater of $20 million or the sum of the ratio requirement under paragraph (a)(1) of this section and eight percent (8%) of the risk margin amount; and

(ii) Comply with § 240.15c3-4 as though it were an OTC derivatives dealer with respect to all of its business activities, except that paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of § 240.15c3-4 shall not apply.

* * * * *

(c) * * *

(2) * * *

(vi)(O) <u>Security-based swaps</u>. (<u>1</u>) <u>Credit default swaps</u>. (<u>i</u>) <u>Short positions (selling protection)</u>. In the case of a security-based swap that is a short credit default swap, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

Length of Time to Maturity of CDS Contract	**Basis Point Spread**					
	100 or less	**101-300**	**301-400**	**401-500**	**501-699**	**700 or more**
12 months or less	1.00%	2.00%	5.00%	7.50%	10.00%	15.00%
13 months to 24 months	1.50%	3.50%	7.50%	10.00%	12.50%	17.50%
25 months to 36 months	2.00%	5.00%	10.00%	12.50%	15.00%	20.00%
37 months to 48 months	3.00%	6.00%	12.50%	15.00%	17.50%	22.50%
49 months to 60 months	4.00%	7.00%	15.00%	17.50%	20.00%	25.00%
61 months to 72 months	5.50%	8.50%	17.50%	20.00%	22.50%	27.50%
73 months to 84 months	7.00%	10.00%	20.00%	22.50%	25.00%	30.00%
85 months to 120 months	8.50%	15.00%	22.50%	25.00%	27.50%	40.00%
121 months and longer	10.00%	20.00%	25.00%	27.50%	30.00%	50.00%

(ii) Long positions (purchasing protection). In the case of a security-based swap that is a long credit default swap, deducting 50% of the deduction that would be required by paragraph (c)(2)(vi)(O)(1)(i) of this section if the security-based swap was a short credit default swap.

(iii) Long and short positions. (A) Long and short credit default swaps. In the case of security-based swaps that are long and short credit default swaps referencing the same entity (in the case of credit default swap securities-based swaps referencing a corporate entity) or obligation (in the case of credit default swap securities-based swaps referencing an asset-backed security), that have the same credit events which would trigger payment by the seller of protection, that have the same basket of obligations which would determine the amount of payment by the seller of protection upon the occurrence of a credit event, that are in the same or adjacent spread category, and that are in the same or adjacent maturity category and have a maturity date within three months of the other maturity category, deducting the percentage of the notional amount specified in the higher maturity category under paragraphs (c)(2)(vi)(O)(1)(i) or (c)(2)(vi)(O)(1)(ii) on the excess of the long or short position. In the case of security-based swaps that are long and short credit default swaps referencing corporate entities in the same industry sector and the same spread and maturity categories prescribed in paragraph (c)(2)(vi)(O)(1)(i) of this section, deducting 50% of the amount required by paragraphs (c)(2)(vi)(O)(1)(i) of this section on the short position plus the deduction required by paragraph (c)(2)(vi)(O)(1)(ii) of this section on the excess long position, if any. For the purposes of this section, the broker or dealer must use an industry sector classification system that is reasonable in terms of grouping types of companies with similar business activities and risk characteristics and the broker-dealer must document the industry sector classification system used pursuant to this section.

(B) Long security and long credit default swap. In the case of a security-based swap that is a long credit default swap referencing a debt security and the broker or dealer is long the same debt security, deducting 50% of the amount specified in paragraph (c)(2)(vi) or paragraph (c)(2)(vii) of this section for the bond, provided that the broker or dealer can deliver the debt security to satisfy the obligation of the broker or dealer on the credit default swap.

(C) Short security and short credit default swap. In the case of a security-based swap that is a short credit default swap referencing a bond or a corporate entity, and the broker or dealer is short the bond or a bond issued by the corporate entity, deducting the amount specified in paragraph (c)(2)(vi) or paragraph (c)(2)(vii) of this section for the bond. In the case of a security-based swap that is a short credit default swap referencing an asset-backed security and the broker or dealer is short the asset-backed security, deducting the amount specified in paragraph (c)(2)(vi) or paragraph (c)(2)(vii) of this section for the asset-backed security.

(2) Security-based swaps that are not credit default swaps. In the case of any security-based swap that is not a credit default swap, deducting the amount calculated by multiplying the notional amount of the security-based swap and the percentage specified in paragraph (c)(2)(vi) of this section applicable to the reference security. A broker or dealer may reduce the deduction under this paragraph (c)(2)(vi)(O)(2) by an amount equal to any reduction recognized for a comparable long or short position in the reference security under paragraph (c)(2)(vi) of this section and, in the case of a security-based swap referencing an equity security, the method specified in § 240.15c3-1a.

* * * * *

(xii) * * *

(B) Deducting the amount of cash required in the account of each security-based swap customer to meet the margin requirements of a clearing agency, Examining Authority, or the Commission, after application of calls for margin, marks to the market, or other required deposits which are outstanding one business day or less.

* * * * *

(xiv) Deduction from net worth in lieu of collecting margin amounts for security-based swaps. (A) Cleared security-based swap transactions. Deducting the amount of the margin difference for each account carried by the broker or dealer for another person that holds cleared security-based swap transactions. The margin difference is the amount of the deductions that the positions in the account would incur pursuant to paragraph (c)(2)(vi)(O) of this section if owned by the broker or dealer less the margin value of collateral held in the account.

(B) Non-cleared security-based swap transactions. (1) Commercial end users. Deducting, with respect to a counterparty that is a commercial end user as that term is defined in § 240.18a-3(b)(2), the margin amount calculated pursuant to § 240.18a-3(c)(1)(i)(B) for the account of the counterparty at the broker or dealer less any positive equity in that account as that term is defined in § 240.18a-3(b)(7).

(2) Margin collateral held by third-party custodian. Deducting, with respect to a counterparty that is not a commercial end user as that term is defined in § 240.18a-3(b)(2) and that elects to have collateral segregated in an account at an independent third-party custodian pursuant to section 3E(f) of the Act (15 U.S.C. 78c-5(f)), the margin amount calculated pursuant to § 240.18a-3(c)(1)(i)(B) for the account of the counterparty less any positive equity in the account as that term is defined in § 240.18a-3(b)(7).

(3) Security-based swap legacy accounts. Deducting, with respect to a security-based swap legacy account as that term is defined in § 240.18a-3(b)(9) of a counterparty that is not a commercial end user as that term is defined in § 240.18a-3(b)(2), the margin amount calculated pursuant § 240.18a-3(c)(1)(i)(B) for the account less any positive equity in the account as that term is defined in § 240.18a-3(b)(7).

* * * * *

(16) The term risk margin amount means the sum of:

(i) The greater of the total margin required to be delivered by the broker or dealer with respect to security-based swap transactions cleared for security-based swap customers at a clearing agency or the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to paragraph (c)(2)(vi)(O) of this section; and

(ii) The total margin amount calculated by the broker or dealer with respect to non-cleared security-based swaps pursuant to § 240.18a-3(c)(1)(i)(B).

* * * * *

(f) Liquidity requirements. (1) Liquidity stress test. A broker or dealer whose application, including amendments, has been approved, in whole or in part, to calculate net capital under Appendix E of this section must run a liquidity stress test at least monthly, the results of which must be provided within ten business days to senior management that has responsibility to oversee risk management at the broker or dealer. The assumptions underlying the liquidity stress test must be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the broker or dealer and at least annually by senior management of the broker or dealer. The liquidity stress test must include, at a minimum, the following assumed conditions lasting for 30 consecutive days:

(A) A stress event that includes a decline in creditworthiness of the broker or dealer severe enough to trigger contractual credit-related commitment provisions of counterparty agreements;

(B) The loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding, including intercompany advances and unfunded committed lines of credit;

(C) The potential for a material net loss of secured funding;

(D) The loss of the ability to procure repurchase agreement financing for less liquid assets;

(E) The illiquidity of collateral required by and on deposit at registered clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets;

(F) A material increase in collateral required to be maintained at registered clearing agencies of which it is a member; and

(G) The potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the broker or dealer, including those related to customer businesses of the broker or dealer.

(2) Stress test of consolidated entity. The broker or dealer must justify and document any differences in the assumptions used in the liquidity stress test of the broker or dealer from those used in the liquidity stress test of the consolidated entity of which the broker or dealer is a part.

(3) Liquidity reserves. The broker or dealer must maintain at all times liquidity reserves based on the results of the liquidity stress test. The liquidity reserves used to satisfy the liquidity stress test must be:

(A) Cash, obligations of the United States, or obligations fully guaranteed as to principal and interest by the United States; and

(B) Unencumbered and free of any liens at all times.

Securities in the liquidity reserve can be used to meet delivery requirements as long as cash or other acceptable securities of equal or greater value are moved into the liquidity pool contemporaneously.

(4) Contingency funding plan. The broker or dealer must have a written contingency funding plan that addresses the broker's or dealer's policies and the roles and responsibilities of relevant personnel for meeting the liquidity needs of the broker or dealer and communications with the public and other market participants during a liquidity stress event.

* * * * *

3. Section 240.15c3-1a is amended by:

a. In paragraph (a)(4), revising the first sentence to read "The term underlying instrument refers to long and short positions, as appropriate, covering the same foreign currency, the same security, security future, or security-based swap, or a security which is exchangeable for or convertible into the underlying security within a period of 90 days.";

b. In paragraph (a)(4), revising the last sentence to read "The term underlying instrument shall not be deemed to include securities options, futures contracts, options on futures contracts, qualified stock baskets, or unlisted instruments (other than security-based swaps)."; and

c. Adding new paragraph (b)(1)(v)(C)(5).

The addition to read as follows:

* * *

(b) * * *

(1) * * *

(v) * * *

(C) * * *

(5) In the case of portfolio types involving security futures and equity options on the same underlying instrument and positions in that underlying instrument, there will be a minimum charge of 25% times the multiplier for each security-future and equity option.

* * * * *

4. Section 240.15c3-1b is amended by adding a paragraph (b) to read as follows:

(b) Every broker or dealer in computing net capital pursuant to § 240.15c3-1 must comply with the following:

(1) Swaps. In the case of any swap for which the deductions in Appendix E of this section do not apply:

(i) Credit default swaps referencing broad-based securities indices.

(A) Short positions (selling protection). In the case of a swap that is a short credit default swap referencing a broad-based securities index, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

Length of Time to Maturity of CDS Contract	Basis Point Spread					
	100 or less	101-300	301-400	401-500	501-699	700 or more
12 months or less	0.67%	1.33%	3.33%	5.00%	6.67%	10.00%
13 months to 24 months	1.00%	2.33%	5.00%	6.67%	8.33%	11.67%
25 months to 36 months	1.33%	3.33%	6.67%	8.33%	10.00%	13.33%
37 months to 48 months	2.00%	4.00%	8.33%	10.00%	11.67%	15.00%
49 months to 60 months	2.67%	4.67%	10.00%	11.67%	13.33%	16.67%
61 months to 72 months	3.67%	5.67%	11.67%	13.33%	15.00%	18.33%
73 months to 84 months	4.67%	6.67%	13.33%	15.00%	16.67%	20.00%
85 months to 120 months	5.67%	10.00%	15.00%	16.67%	18.33%	26.67%
121 months and longer	6.67%	13.33%	16.67%	18.33%	20.00%	33.33%

(B) Long positions (purchasing protection). In the case of a swap that is a long credit default swap referencing a broad-based securities index, deducting 50% of the deduction that would be required by paragraph (b)(1)(i)(A) of this Appendix B if the swap was a short credit default swap.

(C) Long and short positions.

(i) Long and short credit default swaps. In the case of swaps that are long and short credit default swaps referencing the same broad-based security index, have the same credit events which would trigger payment by the seller of protection, have the same basket of obligations which would determine the amount of payment by the seller of protection upon the occurrence of a credit event, that are in the same or adjacent spread category, and that are in the same or adjacent maturity category and have a maturity date within three months of the other maturity category, deducting the percentage of the notional amount specified in the higher maturity category under paragraph (b)(1)(i)(A) or (b)(1)(i)(B) of this Appendix B on the excess of the long or short position.

(ii) Long basket of obligors and long credit default swap. In the case of a swap that is a long credit default swap referencing a broad-based securities index and the broker or dealer is long a basket of debt securities comprising all of the components of the securities index, deducting 50% of the amount specified in § 240.15c3-1(c)(2)(vi) for the component securities, provided the broker or dealer can deliver the component securities to satisfy the obligation of the broker or dealer on the credit default swap.

(iii) Short basket of obligors and short credit default swap. In the case of a swap that is a short credit default swap referencing a broad-based securities index and the broker or dealer is short a basket of debt securities comprising all of the components of the securities index, deducting the amount specified in § 240.15c3-1(c)(2)(vi) for the component securities.

(2) All other swaps. (i) In the case of any swap that is not a credit default swap, deducting the amount calculated by multiplying the notional value of the swap by the percentage specified in:

(A) § 240.15c3-1 applicable to the reference asset if § 240.15c3-1 specifies a percentage deduction for the type of asset;

(B) 17 CFR 1.17 applicable to the reference asset if 17 CFR 1.17 specifies a percentage deduction for the type of asset and § 240.15c3-1 does not specify a percentage deduction for the type of asset; or

(C) In the case of an interest rate swap, § 240.15c3-1(c)(2)(vi)(A) based on the maturity of the swap, provided that the percentage deduction must be no less than 0.5%.

(ii) A security-based swap dealer may reduce the deduction under this paragraph (b)(2)(ii) by an amount equal to any reduction recognized for a comparable long or short position in the reference asset or interest rate under § 240.15c3-1 or 17 CFR 1.17.

5. Section 240.15c3-1d is amended by:

a. In the second sentence of paragraph (b)(7), adding at the end of the sentence the phrase "', or if, in the case of a broker or dealer operating pursuant to paragraph (a)(10) of § 240.15c3–1, its net capital would be less than either $24 million or 10% of the risk margin amount under § 240.15c3–1";

b. In the first sentence of paragraph (b)(8)(i), adding after the phrase "if greater, or" the phrase "', in the case of a broker or dealer operating pursuant to paragraph (a)(10) of § 240.15c3–1, its net capital would be less than either $24 million or 10% of the risk margin amount under § 240.15c3–1, or";

c. In paragraph (b)(10)(ii)(B), adding after the phrase "if greater," the phrase "or, in the case of a broker or dealer operating pursuant to paragraph (a)(10) of § 240.15c3–1, its net capital is less than either $20 million or 8% of the risk margin amount under § 240.15c3–1,";

d. In paragraph (c)(2), adding at the end of the sentence the phrase "', or, in the case of a broker or dealer operating pursuant to paragraph (a)(10) of § 240.15c3–1, its net capital would be less than either $24 million or 10% of the risk margin amount under § 240.15c3–1"; and

e. In paragraph (c)(5)(i)(B), adding after the phrase "if greater, or less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of this section," the phrase "', or, in the case of a broker or dealer operating pursuant to paragraph (a)(10) of §

240.15c3–1, its net capital would be less than either $24 million or 10% of the risk margin amount under § 240.15c3–1,".

6. Section 240.15c3-1e is amended by:

a. In the first sentence of paragraph (a) before the first ":", replacing the phrase "transactions in derivatives instruments" with the phrase "security-based swap transactions with commercial end users as defined in § 240.18a-3(b)(2)"; and

b. In the first sentence of paragraph (c) before the first ":", replacing the phrase "transactions in derivatives instruments" with the phrase "security-based swap transactions with commercial end users as defined in § 240.18a-3(b)(2)".

c. In paragraph (e)(1) replacing the phrase "$5 billion" with the phrase "$6 billion".

7. Section 240.15c3-3 is amended by adding new paragraph (p) to read as follows:

§ 240.15c3-3 Customer protection—reserves and custody of securities.

* * * * *

(p) Security-based swaps. A broker or dealer that is registered as a security-based swap dealer pursuant to section 15F of the Act (15 U.S.C. 78o-8) must also comply with the provisions of § 240.18a-4.

8. Section 240.18a-1 is added to read as follows:

§ 240.18a-1 Net capital requirements for security-based swap dealers for which there is not a prudential regulator.

Note to § 240.18a-1: Rule 18a-1 and its appendices do not apply to a security-based swap dealer that has a prudential regulator as such a security-based swap dealer is subject to the capital requirement of the prudential regulator. In addition, Rule 18a-1 and its appendices do not apply to a security-based swap dealer that also is registered as a broker or dealer pursuant to section 15(b) of the Act (15 U.S.C. 78o(b)) as such a security-based swap dealer is subject to the net capital requirements in § 240.15c3-1 and its appendices.

(a) Minimum requirements. Every registered security-based swap dealer must at all times have and maintain net capital no less than the greater of the highest minimum requirements applicable to its business under paragraphs (a)(1) or (a)(2) of this section, and tentative net capital no less than the minimum requirement under paragraph (a)(2) of this section.

(1) A security-based swap dealer must at all times maintain net capital of not less than the greater of $20 million or eight percent (8%) of the risk margin amount.

(2) In accordance with paragraph (d) of this section, the Commission may approve, in whole or in part, an application or an amendment to an application by a security-based swap dealer to calculate net capital using the market risk standards of paragraph (d) to compute a deduction for market risk on some or all of its positions, instead of the provisions of paragraphs (c)(1)(iv), (c)(1)(vi), and (c)(1)(vii) of this section, and using the credit risk standards of paragraph (d) to compute a deduction for credit risk for security-based swap transactions with commercial end users as defined in § 240.18a-3(b)(2), instead of the provisions of paragraphs (c)(1)(iii) and (c)(1)(viii)(B)(1) of this section, subject to any conditions or limitations on the security-based swap dealer the Commission may require as necessary or appropriate in the public interest or for the protection of investors. A security-based swap dealer that has been approved to calculate its net capital under paragraph (d) of this section must at all times maintain tentative net capital of not less than $100 million and net capital of not less than the greater of $20 million or eight percent (8%) of the risk margin amount; and

(b) A security-based swap dealer must at all times maintain net capital in addition to the amounts required under paragraph (a)(1) or (a)(2) of this section, as applicable, in an amount equal to 10 percent of:

(i) The excess of the market value of United States Treasury Bills, Bonds and Notes subject to reverse repurchase agreements with any one party over 105 percent of the contract prices (including accrued interest) for reverse repurchase agreements with that party;

(ii) The excess of the market value of securities issued or guaranteed as to principal or interest by an agency of the United States or mortgage related securities as defined in section 3(a)(41) of the Act subject to reverse repurchase agreements with any one party over 110 percent of the contract prices (including accrued interest) for reverse repurchase agreements with that party; and

(iii) The excess of the market value of other securities subject to reverse repurchase agreements with any one party over 120 percent of the contract prices (including accrued interest) for reverse repurchase agreements with that party.

(c) Definitions. For purpose of this section:

(1) The term net capital shall be deemed to mean the net worth of a security-based swap dealer, adjusted by:

(i) Adjustments to net worth related to unrealized profit or loss and deferred tax provisions.

(A) Adding unrealized profits (or deducting unrealized losses) in the accounts of the security-based swap dealer;

(B)(1) In determining net worth, all long and all short positions in listed options shall be marked to their market value and all long and all short securities and commodities positions shall be marked to their market value.

(2) In determining net worth, the value attributed to any unlisted option shall be the difference between the option's exercise value and the market value of the underlying security. In the case of an unlisted call, if the market value of the underlying security is less than the exercise value of such call it shall be given no value and in the case of an unlisted put if the market value of the underlying security is more than the exercise value of the unlisted put it shall be given no value.

(C) Adding to net worth the lesser of any deferred income tax liability related to the items in (1), (2), and (3) below, or the sum of (1), (2) and (3) below;

(1) The aggregate amount resulting from applying to the amount of the deductions computed in accordance with paragraphs (c)(1)(vii) and (c)(1)(viii) of this section and Appendices A and B, § 240.18a-1a and § 240.18a-1b, the appropriate Federal and State tax rate(s) applicable to any unrealized gain on the asset on which the deduction was computed.

(2) Any deferred tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section;

(3) Any deferred tax liability related to unrealized appreciation in value of any asset(s) which has been otherwise deducted from net worth in accordance with the provisions of this section; and

(D) Adding, in the case of future income tax benefits arising as a result of unrealized losses, the amount of such benefits not to exceed the amount of income tax liabilities accrued on the books and records of the security-based swap dealer, but only to the extent such benefits could have been applied to reduce accrued tax liabilities on the date of the capital computation, had the related unrealized losses been realized on that date.

(E) Adding to net worth any actual tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section.

(ii) Subordinated liabilities. Excluding liabilities of the security-based swap dealer that are subordinated to the claims of creditors pursuant to a satisfactory subordinated loan agreement, as defined in Appendix D (§ 240.18a-1d).

(iii) Assets not readily convertible into cash. Deducting fixed assets and assets which cannot be readily converted into cash, including, among other things:

(A) Fixed assets and prepaid items. Real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and other expenses; goodwill, organization expenses;

(B) Certain unsecured and partly secured receivables. All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to the market or other required deposits that are outstanding for more than one business day; and the market value of stock loaned in excess of the value of any collateral received therefore.

(C) Insurance claims. Insurance claims that, after seven (7) business days from the date the loss giving rise to the claim is discovered, are not covered by an opinion of outside counsel that the claim is valid and is covered by insurance policies presently in effect; insurance claims that after twenty (20) business days from the date the loss giving rise to the claim is discovered and that are not accompanied by an opinion of outside counsel described above, have not been acknowledged in writing by the insurance carrier as due and payable; and insurance claims acknowledged in writing by the carrier as due and payable outstanding longer than twenty (20) business days from the date they are so acknowledged by the carrier; and

(D) Other deductions. All other unsecured receivables; all assets doubtful of collection less any reserves established therefore; the amount by which the market value of securities failed to receive outstanding thirty (30) calendar days exceeds the contract value of such fails to receive, and the funds on deposit in a "segregated trust account" in accordance with 17 CFR 270.27d-1 under the Investment Company Act of 1940, but only to the extent that the amount on deposit in such segregated trust account exceeds the amount of liability reserves established and maintained for refunds of charges required by sections 27(d) and 27(f) of the Investment Company Act of 1940; Provided, That any amount deposited in the "special account for the exclusive benefit of security-based swap customers" established pursuant to § 240.18a-4 and clearing deposits shall not be so deducted.

(E)(1) For purposes of this paragraph:

(i) The term reverse repurchase agreement deficit shall mean the difference between the contract price for resale of the securities under a reverse repurchase agreement and the market value of those securities (if less than the contract price).

(ii) The term repurchase agreement deficit shall mean the difference between the market value of securities subject to the repurchase agreement and the contract price for repurchase of the securities (if less than the market value of the securities).

(iii) As used in paragraph (c)(1)(iii)(E)(1) of this section, the term contract price shall include accrued interest.

(iv) Reverse repurchase agreement deficits and the repurchase agreement deficits where the counterparty is the Federal Reserve Bank of New York shall be disregarded.

(2)(i) In the case of a reverse repurchase agreement, the deduction shall be equal to the reverse repurchase agreement deficit.

(ii) In determining the required deductions under paragraph (c)(1)(iii)(E)(2)(i) of this section, the security-based swap dealer may reduce the reverse repurchase agreement deficit by:

(A) Any margin or other deposits held by the security-based swap dealer on account of the reverse repurchase agreement;

(B) Any excess market value of the securities over the contract price for resale of those securities under any other reverse repurchase agreement with the same party;

(C) The difference between the contract price for resale and the market value of securities subject to repurchase agreements with the same party (if the market value of those securities is less than the contract price); and

(D) Calls for margin, marks to the market, or other required deposits that are outstanding one business day or less.

(3)(i) In the case of repurchase agreements, the deduction shall be:

(A) The excess of the repurchase agreement deficit over 5 percent of the contract price for resale of United States Treasury Bills, Notes and Bonds, 10 percent of the contract price for the resale of securities issued or guaranteed as to principal or interest by an agency of the United States or mortgage related securities as defined in section 3(a)(41) of the Act and 20 percent of the contract price for the resale of other securities; and

(B) The excess of the aggregate repurchase agreement deficits with any one party over 25 percent of the security-based swap dealer's net capital before the application of paragraphs (c)(1)(vii) and (c)(1)(viii) of this section (less any deduction taken with respect to repurchase agreements with that party under paragraph (c)(1)(iii)(E)(3)(i)(A) of this section) or, if greater;

(C) The excess of the aggregate repurchase agreement deficits over 300 percent of the security-based swap dealer's net capital before the application of paragraphs (c)(1)(vii) and (c)(1)(viii) of this section.

(ii) In determining the required deduction under paragraph (c)(1)(iii)(E)(3)(i) of this section, the security-based swap dealer may reduce a repurchase agreement by:

(A) Any margin or other deposits held by the security-based swap dealer on account of a reverse repurchase agreement with the same party to the extent not otherwise used to reduce a reverse repurchase agreement deficit;

(B) The difference between the contract price and the market value of securities subject to other repurchase agreements with the same party (if the market value of those securities is less than the contract price) not otherwise used to reduce a reverse repurchase agreement deficit; and

(C) Calls for margin, marks to the market, or other required deposits that are outstanding one business day or less to the extent not otherwise used to reduce a reverse repurchase agreement deficit.

(F) Securities borrowed. One percent of the market value of securities borrowed collateralized by an irrevocable letter of credit.

(G) Any receivable from an affiliate of the security-based swap dealer (not otherwise deducted from net worth) and the market value of any collateral given to an affiliate (not otherwise deducted from net worth) to secure a liability over the amount of the liability of the security-based swap dealer unless the books and records of the affiliate are made available for examination when requested by the representatives of the Commission in order to demonstrate the validity of the receivable or payable. The provisions of this subsection shall not apply where the affiliate is a registered security-based swap dealer, registered broker or dealer, registered government securities broker or dealer, bank as defined in section 3(a)(6) of the Act, insurance company as defined in section 3(a)(19) of the Act, investment company registered under the Investment Company Act of 1940, federally insured savings and loan association, or futures commission merchant or swap dealer registered pursuant to the Commodity Exchange Act.

(iv) Non-marketable securities. Deducting 100 percent of the carrying value in the case of securities or evidence of indebtedness in the proprietary or other accounts of the security-based swap dealer, for which there is no ready market, as defined in paragraph (c)(4) of this section, and securities, in the proprietary or other accounts of the security-based swap dealer, that cannot be publicly offered or sold because of statutory, regulatory or contractual arrangements or other restrictions.

(v) Deducting from the contract value of each failed to deliver contract that is outstanding five business days or longer (21 business days or longer in the case of municipal securities) the percentages of the market value of the underlying security that would be required by application of the deduction required by paragraph (c)(1)(vii) of this section. Such deduction, however, shall be increased by any excess of the contract price of the failed to deliver contract over the market value of the underlying security or reduced by any excess of the market value of the underlying security over the contract value of the failed to deliver contract, but not to exceed the amount of such deduction. The Commission may, upon application of the security-based swap dealer, extend for a period up to 5 business days, any period herein specified when it is satisfied that the extension is warranted. The Commission upon expiration of the extension may extend for one additional period of up to 5 business days, any period herein specified when it is satisfied that the extension is warranted.

(vi) Security-based swaps. Deducting the percentages specified in paragraphs (c)(1)(vi)(A) and (c)(1)(vi)(B) of this section (or the deductions prescribed in § 240.18a-1a) of the notional amount of any security-based swaps in the proprietary account of the security-based swap dealer.

(A) Credit default swaps.

(1) Short positions (selling protection). In the case of a security-based swap that is a short credit default swap, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

Length of Time to Maturity of CDS Contract	**Basis Point Spread**					
	100 or less	**101-300**	**301-400**	**401-500**	**501-699**	**700 or more**
12 months or less	1.00%	2.00%%	5.00%	7.50%	10.00%	15.00%
13 months to 24 months	1.50%	3.50%	7.50%	10.00%	12.50%	17.50%
25 months to 36 months	2.00%	5.00%	10.00%	12.50%	15.00%	20.00%
37 months to 48 months	3.00%	6.00%	12.50%	15.00%	17.50%	22.50%
49 months to 60 months	4.00%	7.00%	15.00%	17.50%	20.00%	25.00%
61 months to 72 months	5.50%	8.50%	17.50%	20.00%	22.50%	27.50%
73 months to 84 months	7.00%	10.00%	20.00%	22.50%	25.00%	30.00%
85 months to 120 months	8.50%	15.00%	22.50%	25.00%	27.50%	40.00%
121 months and longer	10.00%	20.00%	25.00%	27.50%	30.00%	50.00%

(2) Long positions (purchasing protection). In the case of a security-based swap that is a long credit default swap, deducting 50% of the deduction that would be required by paragraph (c)(1)(vi)(A)(1) of this section if the security-based swap was a short credit default swap.

(3) Long and short positions. (i) Long and short credit default swaps. In the case of security-based swaps that are long and short credit default swaps referencing the same obligor or obligation, that are in the same spread category, and that are in the same maturity category or are in the next maturity category and have a maturity date within three months of the other maturity category, deducting the percentage of the notional amount specified in the higher maturity category under paragraphs (c)(1)(vi)(A)(1) or (c)(1)(vi)(A)(2) on the excess of the long or short position. In the case of security-based swaps that are long and short credit default swaps referencing obligors or obligations of obligors in the same industry sector and the same spread and maturity categories prescribed in paragraph (c)(1)(vi)(A)(1) of this section, deducting 50% of the amount required by paragraph (c)(1)(vi)(A)(1) of this section on the short position plus the deduction required by paragraph (c)(1)(vi)(A)(2) of this section on the excess long position, if any. For the purposes of this section, the security-based swap dealer must use an industry sector classification system that is reasonable in terms of grouping types of companies with similar business activities and risk characteristics and document the industry sector classification system used pursuant to this section.

(ii) Long security and long credit default swap. In the case of a security-based swap that is a long credit default swap referencing a debt security and the security-based swap dealer is long the same debt security, deducting 50% of the amount specified in § 240.15c3-1(c)(2)(vi) or (vii) for the bond, provided that the security-based swap dealer can deliver the bond to satisfy the obligation of the security-based swap dealer on the credit default swap.

(iii) Short security and short credit default swap. In the case of a security-based swap that is a short credit default swap referencing a bond or a corporate entity and the security-based swap dealer is short the bond or a bond issued by the corporate entity, deducting the amount specified in § 240.15c3-1(c)(2)(vi) or (vii) for the bond. In the case of a security-based swap that is a short credit default swap referencing an asset-backed security and the security-based swap dealer is short the asset-backed security, deducting the amount specified in § 240.15c3-1(c)(2)(vi) or (vii) for the asset-backed security.

(B) All other security-based swaps. In the case of any security-based swap that is not a credit default swap, deducting the amount calculated by multiplying the notional amount of the security-based swap and the percentage specified in § 240.15c3-1(c)(2)(vi) applicable to the reference security. A security-based swap dealer may reduce the deduction under this paragraph (c)(1)(vi)(B) by an amount equal to any reduction recognized for a comparable long or short position in the reference security under § 240.15c3-1(c)(2)(vi) and, in the case of a security-based swap referencing an equity security, the method specified in § 240.18a-1a.

(vii) All other securities, money market instruments or options. Deducting the percentages specified in § 240.15c3-1(c)(2)(vi) of the market value of all securities, money market instruments, and options in the proprietary accounts of the security-based swap dealer.

(viii) Deduction from net worth in lieu of collecting margin amounts for security-based swaps. (A) Cleared security-based swap transactions. Deducting the amount of the margin difference for each account carried by the security-based swap dealer for another person that holds cleared security-based swap transactions. The margin difference is the amount of the deductions that the positions in the account would incur pursuant to paragraph (c)(1)(vi) of this section if owned by the security-based swap dealer less the margin value of collateral held in the account.

(B) Non-cleared security-based swap transactions. (1) Commercial end users. Deducting, with respect to a counterparty that is a commercial end user as that term is defined in § 240.18a-

3(b)(2), the margin amount calculated pursuant to § 240.18a-3(c)(1)(i)(B) for the account of the counterparty less any positive equity in the account as that term is defined in § 240.18a-3(b)(7).

(2) Margin collateral held by third-party custodian. Deducting, with respect to a counterparty that is not a commercial end user as that term is defined in § 240.18a-3(b)(2) and that elects to have collateral segregated in an account at an independent third-party custodian pursuant to section 3E(f) of the Act (15 U.S.C. 78c-5(f)), the margin amount calculated pursuant to § 240.18a-3(c)(1)(i)(B) for the account of the counterparty at the security-based swap dealer less any positive equity in that account as that term is defined in § 240.18a-3(b)(7).

(3) Security-based swap legacy accounts. Deducting, with respect to a security-based swap legacy account as that term is defined in § 240.18a-3(b)(9) of a counterparty that is not a commercial end user as that term is defined in § 240.18a-3(b)(2), the margin amount calculated pursuant § 240.18a-3(c)(1)(i)(B) for the account less any positive equity in the account as that term is defined in § 240.18a-3(b)(7).

(ix) Deduction from net worth for certain undermargined accounts. Deducting the amount of cash required in the account of each security-based swap customer to meet the margin requirements of a clearing agency or the Commission, after application of calls for margin, marks to the market, or other required deposits which are outstanding one business day or less.

(2) The term exempted securities shall mean those securities deemed exempted securities by section 3(a)(12) of the Securities Exchange Act of 1934 and the rules thereunder.

(3) Customer. The term customer shall mean any person from whom, or on whose behalf, a security-based swap dealer has received, acquired or holds funds or securities for the account of such person, but shall not include a security-based swap dealer, a broker or dealer, a registered municipal securities dealer, or a general, special or limited partner or director or

officer of the security-based swap dealer, or any person to the extent that such person has a claim for property or funds which by contract, agreement, or understanding, or by operation of law, is part of the capital of the security-based swap dealer.

(4) Ready market. The term ready market shall include a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.

(5) The term tentative net capital means the net capital of the security-based swap dealer before deductions for market and credit risk computed pursuant to this section and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in derivative instruments which would otherwise be deducted. Tentative net capital shall include securities for which there is no ready market, as defined in paragraph (c)(4) of this section, if the use of mathematical models has been approved for purposes of calculating deductions from net capital for those securities pursuant to paragraph (d) of this section.

(6) The term risk margin amount means the sum of:

(i) The greater of the total margin required to be delivered by the security-based swap dealer with respect to security-based swap transactions cleared for security-based swap customers at a clearing agency or the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to paragraph (c)(1)(vi) of this section; and

(ii) The total margin amount calculated by the security-based swap dealer with respect to non-cleared security-based swaps pursuant to § 240.18a-3(c)(1)(i)(B).

(d) Application to use models to compute deductions for market and credit risk.

(1) A security-based swap dealer may apply to the Commission for authorization to compute deductions for market risk under this paragraph (d) in lieu of computing deductions pursuant to paragraphs (c)(1)(iv), (c)(1)(vi), and (c)(1)(vii) of this section and to compute deductions for credit risk pursuant to this paragraph (d) on credit exposures arising from transactions in derivatives instruments (if this paragraph (d) is used to calculate deductions for market risk on these instruments) in lieu of computing deductions pursuant to paragraph (c)(1)(iii) of this section.

(i) A security-based swap dealer shall submit the following information to the Commission with its application:

(A) An executive summary of the information provided to the Commission with its application and an identification of the ultimate holding company of the security-based swap dealer;

(B) A comprehensive description of the internal risk management control system of the security-based swap dealer and how that system satisfies the requirements set forth in § 240.15c3-4;

(C) A list of the categories of positions that the security-based swap dealer holds in its proprietary accounts and a brief description of the methods that the security-based swap dealer will use to calculate deductions for market and credit risk on those categories of positions;

(D) A description of the mathematical models to be used to price positions and to compute deductions for market risk, including those portions of the deductions attributable to specific risk, if applicable, and deductions for credit risk; a description of the creation, use, and maintenance of the mathematical models; a description of the security-based swap dealer's internal risk management controls over those models, including a description of each category of persons who may input data into the models; if a mathematical model incorporates empirical correlations across risk categories, a description of the process for measuring correlations; a description of the backtesting procedures the security-based swap dealer will use to backtest the mathematical models used to calculate maximum potential exposure; a description of how each mathematical model satisfies the applicable qualitative and quantitative requirements set forth in this paragraph (d); and a statement describing the extent to which each mathematical model used to compute deductions for market risk and credit risk will be used as part of the risk analyses and reports presented to senior management;

(E) If the security-based swap dealer is applying to the Commission for approval to use scenario analysis to calculate deductions for market risk for certain positions, a list of those types of positions, a description of how those deductions will be calculated using scenario analysis, and an explanation of why each scenario analysis is appropriate to calculate deductions for market risk on those types of positions;

(F) A description of how the security-based swap dealer will calculate current exposure;

(G) A description of how the security-based swap dealer will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable;

(H) For each instance in which a mathematical model to be used by the security-based swap dealer to calculate a deduction for market risk or to calculate maximum potential exposure for a particular product or counterparty differs from the mathematical model used by the ultimate holding company to calculate an allowance for market risk or to calculate maximum potential exposure for that same product or counterparty, a description of the difference(s) between the mathematical models; and

(I) Sample risk reports that are provided to management at the security-based swap dealer who are responsible for managing the security-based swap dealer's risk.

(2) The application of the security-based swap dealer shall be supplemented by other information relating to the internal risk management control system, mathematical models, and financial position of the security-based swap dealer that the Commission may request to complete its review of the application;

(3) The application shall be considered filed when received at the Commission's principal office in Washington, D.C. A person who files an application pursuant to this section for which it seeks confidential treatment may clearly mark each page or segregable portion of each page with the words "Confidential Treatment Requested." All information submitted in connection with the application will be accorded confidential treatment, to the extent permitted by law;

(4) If any of the information filed with the Commission as part of the application of the security-based swap dealer is found to be or becomes inaccurate before the Commission approves the application, the security-based swap dealer must notify the Commission promptly and provide the Commission with a description of the circumstances in which the information was found to be or has become inaccurate along with updated, accurate information;

(5) The Commission may approve the application or an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission may require if the Commission finds the approval to be necessary or appropriate in the public interest or for the protection of investors, after determining, among other things, whether the security-based swap

dealer has met the requirements of this paragraph (d) and is in compliance with other applicable rules promulgated under the Act;

(6) A security-based swap dealer shall amend its application to calculate certain deductions for market and credit risk under this paragraph (d) and submit the amendment to the Commission for approval before it may change materially a mathematical model used to calculate market or credit risk or before it may change materially its internal risk management control system;

(7) As a condition for the security-based swap dealer to compute deductions for market and credit risk under this paragraph (d), the security-based swap dealer agrees that:

(i) It will notify the Commission 45 days before it ceases to compute deductions for market and credit risk under this paragraph (d); and

(ii) The Commission may determine by order that the notice will become effective after a shorter or longer period of time if the security-based swap dealer consents or if the Commission determines that a shorter or longer period of time is necessary or appropriate in the public interest or for the protection of investors; and

(8) Notwithstanding paragraph (d)(7) of this section, the Commission, by order, may revoke a security-based swap dealer's exemption that allows it to use the market risk standards of this paragraph (d) to calculate deductions for market risk, and the exemption to use the credit risk standards of this paragraph (d) to calculate deductions for credit risk on certain credit exposures arising from transactions in derivatives instruments if the Commission finds that such exemption is no longer necessary or appropriate in the public interest or for the protection of investors. In making its finding, the Commission will consider the compliance history of the security-based swap dealer related to its use of models, the financial and operational strength of

the security-based swap dealer and its ultimate holding company, and the security-based swap dealer's compliance with its internal risk management controls.

(9) VaR models. To be approved, each value-at-risk ("VaR") model must meet the following minimum qualitative and quantitative requirements:

(i) Qualitative requirements.

(A) The VaR model used to calculate market or credit risk for a position must be integrated into the daily internal risk management system of the security-based swap dealer;

(B) The VaR model must be reviewed both periodically and annually. The periodic review may be conducted by the security-based swap dealer's internal audit staff, but the annual review must be conducted by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.); and

(C) For purposes of computing market risk, the security-based swap dealer must determine the appropriate multiplication factor as follows:

(1) Beginning three months after the security-based swap dealer begins using the VaR model to calculate market risk, the security-based swap dealer must conduct backtesting of the model by comparing its actual daily net trading profit or loss with the corresponding VaR measure generated by the VaR model, using a 99 percent, one-tailed confidence level with price changes equivalent to a one business-day movement in rates and prices, for each of the past 250 business days, or other period as may be appropriate for the first year of its use;

(2) On the last business day of each quarter, the security-based swap dealer must identify the number of backtesting exceptions of the VaR model using clean profit and loss, that is, the number of business days in the past 250 business days, or other period as may be appropriate for

the first year of its use, for which the actual net trading loss, if any, exceeds the corresponding VaR measure; and

(3) The security-based swap dealer must use the multiplication factor indicated in Table 1 of this paragraph (d) in determining its market risk until it obtains the next quarter's backtesting results;

TABLE 1—MULTIPLICATION FACTOR BASED ON THE NUMBER OF BACKTESTING EXCEPTIONS OF THE VAR MODEL

Number of exceptions	Multiplication factor
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

(4) For purposes of incorporating specific risk into a VaR model, a security-based swap dealer must demonstrate that it has methodologies in place to capture liquidity, event, and default risk adequately for each position. Furthermore, the models used to calculate deductions for specific risk must:

(i) Explain the historical price variation in the portfolio;

(ii) Capture concentration (magnitude and changes in composition);

(iii) Be robust to an adverse environment;

(iv) Capture name-related basis risk;

(v) Capture event risk; and

(vi) Be validated through backtesting.

(5) For purposes of computing the credit equivalent amount of the security-based swap dealer's exposures to a counterparty, the security-based swap dealer must determine the appropriate multiplication factor as follows:

(i) Beginning three months after it begins using the VaR model to calculate maximum potential exposure, the security-based swap dealer must conduct backtesting of the model by comparing, for at least 80 counterparties with widely varying types and sizes of positions with the firm, the ten business day change in its current exposure to the counterparty based on its positions held at the beginning of the ten-business day period with the corresponding ten-business day maximum potential exposure for the counterparty generated by the VaR model;

(ii) As of the last business day of each quarter, the security-based swap dealer must identify the number of backtesting exceptions of the VaR model, that is, the number of ten-business day periods in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the change in current exposure to a counterparty exceeds the corresponding maximum potential exposure; and

(iii) The security-based swap dealer will propose, as part of its application, a schedule of multiplication factors, which must be approved by the Commission based on the number of backtesting exceptions of the VaR model. The security-based swap dealer must use the multiplication factor indicated in the approved schedule in determining the credit equivalent amount of its exposures to a counterparty until it obtains the next quarter's backtesting results, unless the Commission determines, based on, among other relevant factors, a review of the security-based swap dealer's internal risk management control system, including a review of the VaR model, that a different adjustment or other action is appropriate.

(ii) Quantitative requirements.

(A) For purposes of determining market risk, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices;

(B) For purposes of determining maximum potential exposure, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a one-year movement in rates and prices; or based on a review of the security-based swap dealer's procedures for managing collateral and if the collateral is marked to market daily and the security-based swap dealer has the ability to call for additional collateral daily, the Commission may approve a time horizon of not less than ten business days;

(C) The VaR model must use an effective historical observation period of at least one year. The security-based swap dealer must consider the effects of market stress in its construction of the model. Historical data sets must be updated at least monthly and reassessed whenever market prices or volatilities change significantly; and

(D) The VaR model must take into account and incorporate all significant, identifiable market risk factors applicable to positions in the accounts of the security-based swap dealer, including:

(1) Risks arising from the non-linear price characteristics of derivatives and the sensitivity of the market value of those positions to changes in the volatility of the derivatives' nderlying rates and prices;

(2) Empirical correlations with and across risk factors or, alternatively, risk factors fficient to cover all the market risk inherent in the positions in the proprietary or other trading

accounts of the security-based swap dealer, including interest rate risk, equity price risk, foreign exchange risk, and commodity price risk;

(3) Spread risk, where applicable, and segments of the yield curve sufficient to capture differences in volatility and imperfect correlation of rates along the yield curve for securities and derivatives that are sensitive to different interest rates; and

(4) Specific risk for individual positions.

(iii) Additional conditions.

(A) As a condition for the security-based swap dealer to use this paragraph (d) to calculate certain of its capital charges, the Commission may impose additional conditions on the security-based swap dealer, which may include, but are not limited to restricting the security-based swap dealer's business on a product-specific, category-specific, or general basis; submitting to the Commission a plan to increase the security-based swap dealer's net capital or tentative net capital; filing more frequent reports with the Commission; modifying the security-based swap dealer's internal risk management control procedures; or computing the security-based swap dealer's deductions for market and credit risk in accordance with paragraphs (c)(1)(iv), (c)(1)(vii), (c)(1)(viii), or (c)(1)(iii), as appropriate. If the Commission finds it is necessary or appropriate in the public interest or for the protection of investors, the Commission may impose additional conditions on the security-based swap dealer, if:

(1) The security-based swap dealer is required by § 240.18a-8 to provide notice to the Commission that the security-based swap dealer's tentative net capital is less than $100 million;

(2) The security-based swap dealer fails to meet the reporting requirements set forth in § 240.18a-8;

(3) Any event specified in § 240.18a-8 occurs;

(4) There is a material deficiency in the internal risk management control system or in the mathematical models used to price securities or to calculate deductions for market and credit risk or allowances for market and credit risk, as applicable, of the security-based swap dealer;

(5) The security-based swap dealer fails to comply with this paragraph (d); or

(6) The Commission finds that imposition of other conditions is necessary or appropriate in the public interest or for the protection of investors.

(e) Models to compute deductions for market risk and credit risk.

(1) Market risk. A security-based swap dealer whose application, including amendments, has been approved under paragraph (d) of this section, shall compute a deduction for market risk in an amount equal to the sum of the following:

(i) For positions for which the Commission has approved the security-based swap dealer's use of VaR models, the VaR of the positions multiplied by the appropriate multiplication factor determined according to paragraph (d) of this section, except that the initial multiplication factor shall be three, unless the Commission determines, based on a review of the security-based swap dealer's application or an amendment to the application under paragraph (d) of this section, including a review of its internal risk management control system and practices and VaR models, that another multiplication factor is appropriate;

(ii) For positions for which the VaR model does not incorporate specific risk, a deduction for specific risk to be determined by the Commission based on a review of the security-based swap dealer's application or an amendment to the application under paragraph (d) of this section and the positions involved;

(iii) For positions for which the Commission has approved the security-based swap dealer's application to use scenario analysis, the greatest loss resulting from a range of adverse movements in relevant risk factors, prices, or spreads designed to represent a negative movement greater than, or equal to, the worst ten-day movement of the four years preceding calculation of the greatest loss, or some multiple of the greatest loss based on the liquidity of the positions subject to scenario analysis. If historical data is insufficient, the deduction shall be the largest loss within a three standard deviation movement in those risk factors, prices, or spreads over a ten-day period, multiplied by an appropriate liquidity adjustment factor. Irrespective of the deduction otherwise indicated under scenario analysis, the resulting deduction for market risk must be at least $25 per 100 share equivalent contract for equity positions, or one-half of one percent of the face value of the contract for all other types of contracts, even if the scenario analysis indicates a lower amount. A qualifying scenario must include the following:

(A) A set of pricing equations for the positions based on, for example, arbitrage relations, statistical analysis, historic relationships, merger evaluations, or fundamental valuation of an offering of securities;

(B) Auxiliary relationships mapping risk factors to prices; and

(C) Data demonstrating the effectiveness of the scenario in capturing market risk, including specific risk; and

(iv) For all remaining positions, the deductions specified in § 240.15c3-1(c)(2)(vi), § 240.15c3-1(c)(2)(vii), and applicable appendices to § 240.15c3-1.

(2) Credit risk. A security-based swap dealer whose application, including amendments, has been approved under paragraph (d) of this section with respect to positions in security-based swaps may compute a deduction for credit risk on security-based swap transactions with commercial end users as defined in § 240.18a-3(b)(2) in an amount equal to the sum of the following:

(i) A counterparty exposure charge in an amount equal to the sum of the following:

(A) The net replacement value in the account of each counterparty that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default; and

(B) For a counterparty not otherwise described in paragraph (e)(2)(i)(A) of this section, the credit equivalent amount of the security-based swap dealer's exposure to the counterparty, as defined in paragraph (e)(2)(iv)(A) of this section, multiplied by the credit risk weight of the counterparty, as determined in accordance with paragraph (e)(2)(iv)(F) of this section, multiplied by 8%;

(ii) A concentration charge by counterparty in an amount equal to the sum of the following:

(A) For each counterparty with a credit risk weight of 20% or less, 5% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the security-based swap dealer;

(B) For each counterparty with a credit risk weight of greater than 20% but less than 50%, 20% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the security-based swap dealer; and

(C) For each counterparty with a credit risk weight of greater than 50%, 50% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the security-based swap dealer; and

(iii) A portfolio concentration charge of 100% of the amount of the security-based swap dealer's aggregate current exposure for all counterparties in excess of 50% of the tentative net capital of the security-based swap dealer.

(iv) Terms.

(A) The credit equivalent amount of the security-based swap dealer's exposure to a counterparty is the sum of the security-based swap dealer's maximum potential exposure to the counterparty, as defined in paragraph (e)(2)(iv)(B) of this section, multiplied by the appropriate multiplication factor, and the security-based swap dealer's current exposure to the counterparty, as defined in paragraph (e)(2)(iv)(C) of this section. The security-based swap dealer must use the multiplication factor determined according to paragraph (d)(9)(i)(C)(5) of this section, except that the initial multiplication factor shall be one, unless the Commission determines, based on a review of the security-based swap dealer's application or an amendment to the application approved under paragraph (d) of this section, including a review of its internal risk management control system and practices and VaR models, that another multiplication factor is appropriate;

(B) The maximum potential exposure is the VaR of the counterparty's positions with the security-based swap dealer, after applying netting agreements with the counterparty meeting the requirements of paragraph (e)(2)(iv)(D) of this section, taking into account the value of collateral from the counterparty held by the security-based swap dealer in accordance with paragraph (e)(2)(iv)(E) of this section, and taking into account the current replacement value of the counterparty's positions with the security-based swap dealer;

(C) The current exposure of the security-based swap dealer to a counterparty is the current replacement value of the counterparty's positions with the security-based swap dealer, after applying netting agreements with the counterparty meeting the requirements of paragraph (e)(2)(iv)(D) of this section and taking into account the value of collateral from the counterparty held by the security-based swap dealer in accordance with paragraph (e)(2)(iv)(E) of this section;

(D) Netting agreements. A security-based swap dealer may include the effect of a netting agreement that allows the security-based swap dealer to net gross receivables from and gross payables to a counterparty upon default of the counterparty if:

(1) The netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings;

(2) The gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and

(3) For internal risk management purposes, the security-based swap dealer monitors and controls its exposure to the counterparty on a net basis.

(E) Collateral. When calculating maximum potential exposure and current exposure to a counterparty, the fair market value of collateral pledged and held may be taken into account provided:

(1) The collateral is marked to market each day and is subject to a daily margin maintenance requirement;

(2) The security-based swap dealer maintains physical possession or sole control of the collateral;

(3) The collateral is liquid and transferable;

(4) The collateral may be liquidated promptly by the firm without intervention by any other party;

(5) The collateral agreement is legally enforceable by the security-based swap dealer against the counterparty and any other parties to the agreement;

(6) The collateral does not consist of securities issued by the counterparty or a party related to the security-based swap dealer or to the counterparty;

(7) The Commission has approved the security-based swap dealer's use of a VaR model to calculate deductions for market risk for the type of collateral in accordance with paragraph (d) of this section; and

(8) The collateral is not used in determining the credit rating of the counterparty.

(F) Credit risk weights of counterparties. A security-based swap dealer that computes its deductions for credit risk pursuant to paragraph (e)(2) of this section shall apply a credit risk weight for transactions with a counterparty of either 20%, 50%, or 150% based on an internal credit rating the security-based swap dealer determines for the counterparty.

(1) As part of its initial application or in an amendment, the security-based swap dealer may request Commission approval to apply a credit risk weight of either 20%, 50%, or 150% based on internal calculations of credit ratings, including internal estimates of the maturity adjustment. Based on the strength of the security-based swap dealer's internal credit risk management system, the Commission may approve the application. The security-based swap dealer must make and keep current a record of the basis for the credit risk weight of each counterparty;

(2) As part of its initial application or in an amendment, the security-based swap dealer may request Commission approval to determine credit risk weights based on internal calculations, including internal estimates of the maturity adjustment. Based on the strength of the security-based swap dealer's internal credit risk management system, the Commission may approve the application. The security-based swap dealer must make and keep current a record of the basis for the credit risk weight of each counterparty; and

(3) As part of its initial application or in an amendment, the security-based swap dealer may request Commission approval to reduce deductions for credit risk through the use of credit derivatives.

(f) Liquidity requirements. (1) Liquidity stress test. A security-based swap dealer that computes net capital under paragraph (a)(2) of this Rule 18a-1 must perform a liquidity stress test at least monthly, the results of which must be provided within ten business days to senior management that has responsibility to oversee risk management at the security-based swap dealer. The assumptions underlying the liquidity stress test must be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the security-based swap dealer and at least annually by senior management of the security-based swap dealer. The liquidity stress test must include, at a minimum, the following assumed conditions lasting for 30 consecutive days:

(A) A stress event includes a decline in creditworthiness of the broker or dealer severe enough to trigger contractual credit-related commitment provisions of counterparty agreements;

(B) The loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding, including intercompany advances and unfunded committed lines of credit;

(C) The potential for a material net loss of secured funding;

(D) The loss of the ability to procure repurchase agreement financing for less liquid assets;

(E) The illiquidity of collateral required by and on deposit at clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets;

(F) A material increase in collateral required to be maintained at registered clearing agencies of which it is a member; and

(G) The potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the security-based swap dealer, including those related to customer businesses of the security-based swap dealer.

(2) Stress test of consolidated entity. The security-based swap dealer must justify and document any differences in the assumptions used in the liquidity stress test of the security-based swap dealer from those used in the liquidity stress test of the consolidated entity of which the security-based swap dealer is a part.

(3) Liquidity reserves. The security-based swap dealer must maintain at all times liquidity reserves based on the results of the liquidity stress test. The liquidity reserves used to satisfy the liquidity stress test must be:

(A) Cash, obligations of the United States, or obligations fully guaranteed as to principal and interest by the United States; and

(B) Unencumbered and free of any liens at all times.

Securities in the liquidity reserve can be used to meet delivery requirements as long as cash or other acceptable securities of equal or greater value are moved into the liquidity pool contemporaneously.

(4) Contingency funding plan. The security-based swap dealer must have a written contingency funding plan that addresses the security-based swap dealer's policies and the roles and responsibilities of relevant personnel for meeting the liquidity needs of the security-based

swap dealer and communications with the public and other market participants during a liquidity stress event.

(g) Internal risk management control systems. A security-based swap dealer must comply with § 240.15c3-4 as if it were an OTC derivatives dealer with respect to all of its business activities, except that paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8) and (d)(9) of § 240.15c3-4 shall not apply.

(h) Debt-equity requirements. No security-based swap dealer shall permit the total of outstanding principal amounts of its satisfactory subordination agreements (other than such agreements which qualify under this paragraph (h) as equity capital) to exceed 70 percent of its debt-equity total, as hereinafter defined, for a period in excess of 90 days or for such longer period which the Commission may, upon application of the security-based swap dealer, grant in the public interest or for the protection of investors. In the case of a corporation, the debt-equity total shall be the sum of its outstanding principal amounts of satisfactory subordination agreements, par or stated value of capital stock, paid in capital in excess of par, retained earnings, unrealized profit and loss or other capital accounts. In the case of a partnership, the debt-equity total shall be the sum of its outstanding principal amounts of satisfactory subordination agreements, capital accounts of partners (exclusive of such partners' securities accounts) subject to the provisions of paragraph (i) of this section, and unrealized profit and loss. Provided, however, that a satisfactory subordinated loan agreement entered into by a partner or stockholder which has an initial term of at least three years and has a remaining term of not less than 12 months shall be considered equity for the purposes of this paragraph (h) if:

(1) It does not have any of the provisions for accelerated maturity provided for by paragraphs (b)(8)(i), (9)(i) or (9)(ii) of Appendix D of this section and is maintained as capital

subject to the provisions restricting the withdrawal thereof required by paragraph (i) of this section; or

(2) The partnership agreement provides that capital contributed pursuant to a satisfactory subordination agreement as defined in Appendix D of this section shall in all respects be partnership capital subject to the provisions restricting the withdrawal thereof required by paragraph (i) of this section.

(i) Notice provisions relating to limitations on the withdrawal of equity capital.

(1) No equity capital of the security-based swap dealer or a subsidiary or affiliate consolidated pursuant to Appendix C of this section may be withdrawn by action of a stockholder or a partner or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, employee or affiliate without written notice given in accordance with paragraph (i)(1)(iv) of this section:

(i) Two business days prior to any withdrawals, advances or loans if those withdrawals, advances or loans on a net basis exceed in the aggregate in any 30 calendar day period, 30 percent of the security-based swap dealer's excess net capital. A security-based swap dealer, in an emergency situation, may make withdrawals, advances or loans that on a net basis exceed 30 percent of the security-based swap dealer's excess net capital in any 30 calendar day period without giving the advance notice required by this paragraph, with the prior approval of the Commission. Where a security-based swap dealer makes a withdrawal with the consent of the Commission, it shall in any event comply with paragraph (i)(1)(ii) of this section; or

(ii) Two business days after any withdrawals, advances or loans if those withdrawals, advances or loans on a net basis exceed in the aggregate in any 30 calendar day period, 20 percent of the security-based swap dealer's excess net capital.

(iii) This paragraph (i)(1) does not apply to:

(A) Securities or commodities transactions in the ordinary course of business between a security-based swap dealer and an affiliate where the security-based swap dealer makes payment to or on behalf of such affiliate for such transaction and then receives payment from such affiliate for the securities or commodities transaction within two business days from the date of the transaction; or

(B) Withdrawals, advances or loans which in the aggregate in any thirty calendar day period, on a net basis, equal $500,000 or less.

(iv) Each required notice shall be effective when received by the Commission in Washington, D.C., the regional office of the Commission for the region in which the security-based swap dealer has its principal place of business, and the Commodity Futures Trading Commission if such security-based swap dealer is registered with that Commission.

(2) <u>Limitations on withdrawal of equity capital</u>. No equity capital of the security-based swap dealer or a subsidiary or affiliate consolidated pursuant to Appendix C of this section may be withdrawn by action of a stockholder or a partner or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, employee or affiliate, if after giving effect thereto and to any other such withdrawals, advances or loans and any Payments of Payments Obligations (as defined in Appendix D of this section) under

satisfactory subordinated loan agreements which are scheduled to occur within 180 days following such withdrawal, advance or loan if:

(i) The security-based swap dealer's net capital would be less than 120 percent of the minimum dollar amount required by paragraph (a) of this section; and

(ii) The total outstanding principal amounts of satisfactory subordinated loan agreements of the security-based swap dealer and any subsidiaries or affiliates consolidated pursuant to Appendix C of this section (other than such agreements which qualify as equity under paragraph (h) of this section) would exceed 70% of the debt-equity total as defined in paragraph (h) of this section.

(3) Temporary restrictions on withdrawal of net capital.

(i) The Commission may by order restrict, for a period up to twenty business days, any withdrawal by the security-based swap dealer of equity capital or unsecured loan or advance to a stockholder, partner, member, employee or affiliate under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors if the Commission, based on the information available, concludes that such withdrawal, advance or loan may be detrimental to the financial integrity of the security-based swap dealer, or may unduly jeopardize the security-based swap dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the security-based swap dealer to loss.

(ii) An order temporarily prohibiting the withdrawal of capital shall be rescinded if the Commission determines that the restriction on capital withdrawal should not remain in effect. A hearing on an order temporarily prohibiting withdrawal of capital will be held within two business days from the date of the request in writing by the security-based swap dealer.

(4) Miscellaneous provisions.

(i) Excess net capital is that amount in excess of the amount required under paragraph (a) of this section. For the purposes of paragraphs (i)(1) and (i)(2) of this section, a security-based swap dealer may use the amount of excess net capital and deductions required under paragraphs (c)(1)(vii) and (c)(1)(viii) and Appendix A of this section reported in its most recently required filed Form X-18A-7 for the purposes of calculating the effect of a projected withdrawal, advance or loan relative to excess net capital or deductions. The security-based swap dealer must assure itself that the excess net capital or the deductions reported on the most recently required filed Form X-18A-7 have not materially changed since the time such report was filed.

(ii) The term equity capital includes capital contributions by partners, par or stated value of capital stock, paid-in capital in excess of par, retained earnings or other capital accounts. The term equity capital does not include securities in the securities accounts of partners and balances in limited partners' capital accounts in excess of their stated capital contributions.

(iii) Paragraphs (i)(1) and (i)(2) of this section shall not preclude a security-based swap dealer from making required tax payments or preclude the payment to partners of reasonable compensation, and such payments shall not be included in the calculation of withdrawals, advances, or loans for purposes of paragraphs (i)(1) and (i)(2) of this section.

(iv) For the purpose of this paragraph (i) of this section, any transactions between a security-based swap dealer and a stockholder, partner, employee or affiliate that results in a diminution of the security-based swap dealer's net capital shall be deemed to be an advance or loan of net capital.

9. Section 240.18a-1a is added to read as follows:

§ 240.18a-1a Options (Appendix A to 17 CFR 240.18a-1).

(a)(1) Definitions. The term unlisted option means any option not included in the definition of listed option provided in § 240.15c3-1(c)(2)(x).

(2) The term option series refers to listed option contracts of the same type (either a call or a put) and exercise style, covering the same underlying security with the same exercise price, expiration date, and number of underlying units.

(3) The term related instrument within an option class or product group refers to futures contracts and options on futures contracts covering the same underlying instrument. In relation to options on foreign currencies, a related instrument within an option class also shall include forward contracts on the same underlying currency.

(4) The term underlying instrument refers to long and short positions, as appropriate, covering the same foreign currency, the same security, security future, or security-based swap, or a security which is exchangeable for or convertible into the underlying security within a period of 90 days. If the exchange or conversion requires the payment of money or results in a loss upon conversion at the time when the security is deemed an underlying instrument for purposes of this Appendix A, the security-based swap dealer will deduct from net worth the full amount of the conversion loss. The term underlying instrument shall not be deemed to include securities options, futures contracts, options on futures contracts, qualified stock baskets, or unlisted instruments (other than security-based swaps).

(5) The term options class refers to all options contracts covering the same underlying instrument.

(6) The term product group refers to two or more option classes, related instruments, underlying instruments, and qualified stock baskets in the same portfolio type (see paragraph

(b)(1)(ii) of this section) for which it has been determined that a percentage of offsetting profits may be applied to losses at the same valuation point.

(b) The deduction under this Appendix A must equal the sum of the deductions specified in paragraphs (b)(1)(iv)(C) of this section.

Theoretical Pricing Charges

(1)(i) Definitions.

(A) The terms theoretical gains and losses mean the gain and loss in the value of individual option series, the value of underlying instruments, related instruments, and qualified stock baskets within that option's class, at 10 equidistant intervals (valuation points) ranging from an assumed movement (both up and down) in the current market value of the underlying instrument equal to the percentage corresponding to the deductions otherwise required under § 240.15c3-1 for the underlying instrument (see paragraph (b)(1)(iii) of this section). Theoretical gains and losses shall be calculated using a theoretical options pricing model that satisfies the criteria set forth in paragraph (b)(1)(i)(B) of this section.

(B) The term theoretical options pricing model means any mathematical model, other than a security-based swap dealer's proprietary model, the use of which has been approved by the Commission. Any such model shall calculate theoretical gains and losses as described in paragraph (b)(1)(i)(A) of this section for all series and issues of equity, index and foreign currency options and related instruments, and shall be made available equally and on the same terms to all security-based swap dealers. Its procedures shall include the arrangement of the vendor to supply accurate and timely data to each security-based swap dealer with respect to its services, and the fees for distribution of the services. The data provided to security-based swap dealers shall also contain the minimum requirements set forth in paragraphs (b)(1)(iv)(C) of this section and the product group offsets set forth in paragraphs (b)(1)(iv)(B) of this section. At a minimum, the model shall consider the following factors in pricing the option:

(1) The current spot price of the underlying asset;

(2) The exercise price of the option;

(3) The remaining time until the option's expiration;

(4) The volatility of the underlying asset;

(5) Any cash flows associated with ownership of the underlying asset that can reasonably be expected to occur during the remaining life of the option; and

(6) The current term structure of interest rates.

(C) The term major market foreign currency means the currency of a sovereign nation for which there is a substantial inter-bank forward currency market.

(D) The term qualified stock basket means a set or basket of stock positions which represents no less than 50% of the capitalization for a high-capitalization or non-high-capitalization diversified market index, or, in the case of a narrow-based index, no less than 95% of the capitalization for such narrow-based index.

(ii) With respect to positions involving listed option positions in its proprietary or other account, the security-based swap dealer shall group long and short positions into the following portfolio types:

(A) Equity options on the same underlying instrument and positions in that underlying instrument;

(B) Options on the same major market foreign currency, positions in that major market foreign currency, and related instruments within those options' classes;

(C) High-capitalization diversified market index options, related instruments within the option's class, and qualified stock baskets in the same index;

(D) Non-high-capitalization diversified index options, related instruments within the index option's class, and qualified stock baskets in the same index; and

(E) Narrow-based index options, related instruments within the index option's class, and qualified stock baskets in the same index.

(iii) Before making the computation, each security-based swap dealer shall obtain the theoretical gains and losses for each option series and for the related and underlying instruments within those options' class in the proprietary or other accounts of that security-based swap dealer. For each option series, the theoretical options pricing model shall calculate theoretical prices at 10 equidistant valuation points within a range consisting of an increase or a decrease of the following percentages of the daily market price of the underlying instrument:

(A) +(-)15% for equity securities with a ready market, narrow-based indexes, and non-high-capitalization diversified indexes;

(B) +(-)6% for major market foreign currencies;

(C) +(-) 20% for all other currencies; and

(D) +(-)10% for high-capitalization diversified indexes.

(iv)(A) The security-based swap dealer shall multiply the corresponding theoretical gains and losses at each of the 10 equidistant valuation points by the number of positions held in a particular option series, the related instruments and qualified stock baskets within the option's class, and the positions in the same underlying instrument.

(B) In determining the aggregate profit or loss for each portfolio type, the security-based swap dealer will be allowed the following offsets in the following order, provided, that in the case of qualified stock baskets, the security-based swap dealer may elect to net individual stocks between qualified stock baskets and take the appropriate deduction on the remaining, if any, securities:

(1) First, a security-based swap dealer is allowed the following offsets within an option's class:

(i) Between options on the same underlying instrument, positions covering the same underlying instrument, and related instruments within the option's class, 100% of a position's gain shall offset another position's loss at the same valuation point;

(ii) Between index options, related instruments within the option's class, and qualified stock baskets on the same index, 95%, or such other amount as designated by the Commission, of gains shall offset losses at the same valuation point;

(2) Second, a security-based swap dealer is allowed the following offsets within an index product group:

(i) Among positions involving different high-capitalization diversified index option classes within the same product group, 90% of the gain in a high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in a different high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class;

(ii) Among positions involving different non-high-capitalization diversified index option classes within the same product group, 75% of the gain in a non-high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in another non-high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class or product group;

(iii) Among positions involving different narrow-based index option classes within the same product group, 90% of the gain in a narrow-based market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in another narrow-based market index option, related instruments, and qualified stock baskets within that index option's class or product group;

(iv) No qualified stock basket should offset another qualified stock basket; and

(3) Third, a security-based swap dealer is allowed the following offsets between product groups: Among positions involving different diversified index product groups within the same market group, 50% of the gain in a diversified market index option, a related instrument, or a qualified stock basket within that index option's product group shall offset the loss at the same valuation point in another product group;

(C) For each portfolio type, the total deduction shall be the larger of:

(1) The amount for any of the 10 equidistant valuation points representing the largest theoretical loss after applying the offsets provided in paragraph (b)(1)(iv)(B) if this section; or

(2) A minimum charge equal to 25% times the multiplier for each equity and index option contract and each related instrument within the option's class or product group, or $ 25 for each option on a major market foreign currency with the minimum charge for futures contracts and options on futures contracts adjusted for contract size differentials, not to exceed market value in the case of long positions in options and options on futures contracts; plus

(3) In the case of portfolio types involving index options and related instruments offset by a qualified stock basket, there will be a minimum charge of 5% of the market value of the qualified stock basket for high-capitalization diversified and narrow-based indexes; and

(4) In the case of portfolio types involving index options and related instruments offset by a qualified stock basket, there will be a minimum charge of 7 1/2% of the market value of the qualified stock basket for non-high-capitalization diversified indexes.

(5) In the case of portfolio types involving security futures and equity options on the same underlying instrument and positions in that underlying instrument, there will be a minimum charge of 25% times the multiplier for each security-future and equity option.

10. Section 240.18a-1b is added to read as follows:

§ 240.18a-1b Adjustments to net worth for certain commodities transactions (Appendix B to 17 CFR 240.18a-1).

(a) Every registered security-based swap dealer in computing net capital pursuant to § 240.18a-1 shall comply with the following:

(1) Where a security-based swap dealer has an asset or liability which is treated or defined in paragraph § 240.18a-1, the inclusion or exclusion of all or part of such asset or liability for net capital shall be in accordance with § 240.18a-1, except as specifically provided otherwise in this Appendix B. Where a commodity related asset or liability is specifically treated or defined in 17 CFR 1.17 and is not generally or specifically treated or defined in § 240.18a-1 or this Appendix B, the inclusion or exclusion of all or part of such asset or liability for net capital shall be in accordance with 17 CFR 1.17.

(2) In computing net capital as defined in paragraph (c)(1) of § 240.18a-1, the net worth of a security-based swap dealer shall be adjusted as follows with respect to commodity-related transactions:

(i) Unrealized profit or loss for certain commodities transactions.

(A) Unrealized profits shall be added and unrealized losses shall be deducted in the commodities accounts of the security-based swap dealer, including unrealized profits and losses on fixed price commitments and forward contracts; and

(B) The value attributed to any commodity option which is not traded on a contract market shall be the difference between the option's strike price and the market value for the physical or futures contract which is the subject of the option. In the case of a long call commodity option, if the market value for the physical or futures contract which is the subject of the option is less than the strike price of the option, it shall be given no value. In the case of a long put commodity option, if the market value for the physical commodity or futures contract which is the subject of the option is more than the striking price of the option, it shall be given no value.

(ii) Deduct any unsecured commodity futures or option account containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only: Provided, however, Deficits or debit ledger balances in unsecured customers', non-customers' and proprietary accounts, which are the subject of calls for margin or other required deposits need not be deducted until the close of business on the business day following the date on which such deficit or debit ledger balance originated;

(iii) Deduct all unsecured receivables, advances and loans except for:

(A) Management fees receivable from commodity pools outstanding no longer than thirty (30) days from the date they are due;

(B) Receivables from foreign clearing organizations;

(C) Receivables from registered futures commission merchants or brokers, resulting from commodity futures or option transactions, except those specifically excluded under paragraph (a)(2)(ii) of this Appendix B.

(iv) Deduct all inventories (including work in process, finished goods, raw materials and inventories held for resale) except for readily marketable spot commodities; or spot commodities which adequately collateralize indebtedness under 17 CFR 1.17(c)(7);

(v) Guarantee deposits with commodities clearing organizations are not required to be deducted from net worth;

(vi) Stock in commodities clearing organizations to the extent of its margin value is not required to be deducted from net worth;

(vii) Deduct from net worth the amount by which any advances paid by the security-based swap dealer on cash commodity contracts and used in computing net capital exceeds 95 percent of the market value of the commodities covered by such contracts.

(viii) Do not include equity in the commodity accounts of partners in net worth.

(ix) In the case of all inventory, fixed price commitments and forward contracts, except for inventory and forward contracts in the inter-bank market in those foreign currencies which are purchased or sold for further delivery on or subject to the rules of a contract market and covered by an open futures contract for which there will be no charge, deduct the applicable percentage of the net position specified below:

(A) Inventory which is currently registered as deliverable on a contract market and covered by an open futures contract or by a commodity option on a physical -- No charge.

(B) Inventory which is covered by an open futures contract or commodity option -- 5% of the market value.

(C) Inventory which is not covered -- 20% of the market value.

(D) Fixed price commitments (open purchases and sales) and forward contracts which are covered by an open futures contract or commodity option -- 10% of the market value.

(E) Fixed price commitments (open purchases and sales) and forward contracts which are not covered by an open futures contract or commodity option -- 20% of the market value.

(x) Deduct for undermargined customer commodity futures accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or, if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin, or other required deposits which are outstanding three business days or less. If there are no such maintenance margin requirements or clearing organization margin requirements on such accounts, then deduct the amount of funds required to provide margin equal to the amount necessary after application of calls for margin, or other required deposits outstanding three days or less to restore original margin when the original margin has been depleted by 50 percent or more. Provided, To the extent a deficit is deducted from net worth in accordance with paragraph (a)(2)(ii) of this Appendix B, such amount shall not also be deducted under this paragraph (a)(2)(x). In the event that an owner of a customer account has deposited an asset other than cash to margin, guarantee or secure his account, the value attributable to such asset for purposes of this paragraph shall be the lesser of (A) the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or (B) the market value of such asset after application of the percentage deductions specified in paragraph (a)(2)(ix) of this Appendix B or, where appropriate, specified in paragraph (c)(1)(iv), (c)(1)(vi), or (c)(1)(vii) of § 240.18a-1 of this chapter;

(xi) Deduct for undermargined non-customer and omnibus commodity futures accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or, if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin, or other required deposits which are outstanding two business days or less. If there are no such maintenance margin requirements or clearing organization margin requirements, then deduct the amount of funds required to provide margin equal to the amount necessary after application of calls for margin, or other required deposits outstanding two days or less to restore original margin when the original margin has been depleted by 50 percent or more. Provided, To the extent a deficit is deducted from net worth in accordance with paragraph (a)(2)(ii) of this Appendix B such amount shall not also be deducted under this paragraph (a)(2)(xi). In the event that an owner of a non-customer or omnibus account has deposited an asset other than cash to margin, guarantee or secure his account, the value attributable to such asset for purposes of this paragraph shall be the lesser of (A) the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or (B) the market value of such asset after application of the percentage deductions specified in paragraph (a)(2)(ix) of this Appendix B or, where appropriate, specified in paragraph (c)(1)(iv), (c)(2)(vi), or (c)(1)(vii) of § 240.18a-1 of this chapter;

(xii) In the case of open futures contracts and granted (sold) commodity options held in proprietary accounts carried by the security-based swap dealer which are not covered by a position held by the security-based swap dealer or which are not the result of a "changer trade" made in accordance with the rules of a contract market, deduct:

(A) For a security-based swap dealer which is a clearing member of a contract market for the positions on such contract market cleared by such member, the applicable margin requirement of the applicable clearing organization;

(B) For a security-based swap dealer which is a member of a self-regulatory organization, 150% of the applicable maintenance margin requirement of the applicable board of trade or clearing organization, whichever is greater; or

(C) For all other security-based swap dealers, 200% of the applicable maintenance margin requirement of the applicable board of trade or clearing organization, whichever is greater; or

(D) For open contracts or granted (sold) commodity options for which there are no applicable maintenance margin requirements, 200% of the applicable initial margin requirement; Provided, the equity in any such proprietary account shall reduce the deduction required by this paragraph (a)(2)(xii) if such equity is not otherwise includable in net capital.

(xiii) In the case of a security-based swap dealer which is a purchaser of a commodity option which is traded on a contract market, the deduction shall be the same safety factor as if the security-based swap dealer were the grantor of such option in accordance with paragraph (a)(2)(xii), but in no event shall the safety factor be greater than the market value attributed to such option.

(xiv) In the case of a security-based swap dealer which is a purchaser of a commodity option not traded on a contract market which has value and such value is used to increase net capital, the deduction is ten percent of the market value of the physical or futures contract which is the subject of such option but in no event more than the value attributed to such option.

(xv) A loan or advance or any other form of receivable shall not be considered "secured" for the purposes of paragraph (a)(2) of this Appendix B unless the following conditions exist:

(A) The receivable is secured by readily marketable collateral which is otherwise unencumbered and which can be readily converted into cash: Provided, however, That the receivable will be considered secured only to the extent of the market value of such collateral after application of the percentage deductions specified in paragraph (a)(2)(ix) of this Appendix B; and

(B)(1) The readily marketable collateral is in the possession or control of the security-based swap dealer; or

(2) The security-based swap dealer has a legally enforceable, written security agreement, signed by the debtor, and has a perfected security interest in the readily marketable collateral within the meaning of the laws of the State in which the readily marketable collateral is located.

(xvi) The term cover for purposes of this Appendix B shall mean cover as defined in 17 CFR 1.17(j).

(xvii) The term customer for purposes of this Appendix B shall mean customer as defined in 17 CFR 1.17(b)(2). The term non-customer for purposes of this Appendix B shall mean non-customer as defined in 17 CFR 1.17(b)(4).

(b) Every registered security-based swap dealer in computing net capital pursuant to § 240.18a-1 shall comply with the following:

(1) Swaps. Where a swap-related asset or liability is specifically treated or defined in 17 CFR 1.17 and is not generally or specifically treated or defined in § 240.15c3-1 or this Appendix B, the inclusion or exclusion of all or part of such asset or liability for net capital shall be in accordance with 17 CFR 1.17.

(i) Credit default swaps referencing broad-based securities indices.

(A) Short positions (selling protection). In the case of a swap that is a short credit default swap referencing a broad-based securities index, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

Length of Time to Maturity of CDS Contract	Basis Point Spread					
	100 or less	101-300	301-400	401-500	501-699	700 or more
12 months or less	0.67%	1.33%	3.33%	5.00%	6.67%	10.00%
13 months to 24 months	1.00%	2.33%	5.00%	6.67%	8.33%	11.67%
25 months to 36 months	1.33%	3.33%	6.67%	8.33%	10.00%	13.33%
37 months to 48 months	2.00%	4.00%	8.33%	10.00%	11.67%	15.00%
49 months to 60 months	2.67%	4.67%	10.00%	11.67%	13.33%	16.67%
61 months to 72 months	3.67%	5.67%	11.67%	13.33%	15.00%	18.33%
73 months to 84 months	4.67%	6.67%	13.33%	15.00%	16.67%	20.00%
85 months to 120 months	5.67%	10.00%	15.00%	16.67%	18.33%	26.67%
121 months and longer	6.67%	13.33%	16.67%	18.33%	20.00%	33.33%

(B) Long positions (purchasing protection). In the case of a swap that is a long credit default swap referencing a broad-based securities index, deducting 50% of the deduction that would be required by paragraph (b)(1)(i)(A) of this Appendix B if the swap was a short credit default swap.

(C) Long and short positions.

(i) Long and short credit default swaps. In the case of swaps that are long and short credit default swaps referencing the same obligor or obligation, that are in the same spread category, and that are in the same maturity category or are in the next maturity category and have a maturity date within three months of the other maturity category, deducting the percentage of the notional amount specified in the higher maturity category under paragraph (b)(1)(i)(A) of this Appendix B on the excess of the long or short position.

(ii) Long basket of obligors and long credit default swap. In the case of a swap that is a long credit default swap referencing a broad-based securities index and the security-based swap dealer is long a basket on the same underlying obligors, deducting 50% of the amount specified in § 240.15c3-1(c)(2)(vi) for the components of the basket, provided the security-based swap dealer can deliver the components of the basket to satisfy the obligation of the security-based swap dealer on the credit default swap.

(iii) Short basket of obligors and short credit default swap. In the case of a swap that is a short credit default swap referencing a broad-based securities index and the security-based swap dealer is short a basket on the same underlying obligors, deducting the amount specified in § 240.15c3-1(c)(2)(vi) for the components of the basket.

(2) All other swaps. (i) In the case of any swap that is not a credit default swap, deducting the amount calculated by multiplying the notional value of the swap by the percentage specified in:

(A) § 240.15c3-1 applicable to the reference asset if § 240.15c3-1 specifies a percentage deduction for the type of asset;

(B) 17 CFR 1.17 applicable to the reference asset if 17 CFR 1.17 specifies a percentage deduction for the type of asset and § 240.15c3-1 does not specify a percentage deduction for the type of asset; or

(C) In the case of an interest rate swap, § 240.15c3-1(c)(2)(vi)(A) based on the maturity of the swap, provided that the percentage deduction must be no less than 1%.

(ii) A security-based swap dealer may reduce the deduction under this paragraph (b)(2)(ii) by an amount equal to any reduction recognized for a comparable long or short position in the reference asset or interest rate under 17 CFR 1.17 or § 240.15c3-1.

11. Section 240.18a-1c is added to read as follows:

§ 240.18a-1c Consolidated Computations of Net Capital for Certain Subsidiaries and Affiliates of Security-Based Swap Dealers (Appendix C to 17 CFR 240.18a-1).

Every security-based swap dealer in computing its net capital pursuant to § 240.18a-1 shall include in its computation all liabilities or obligations of a subsidiary or affiliate that the security-based swap dealer guarantees, endorses, or assumes either directly or indirectly.

12. Section 240.18a-1d is added to read as follows:

§ 240.18a-1d Satisfactory Subordinated Loan Agreements (Appendix D to 17 CFR 240.18a-1).

(a) Introduction.

(1) This Appendix sets forth minimum and non-exclusive requirements for satisfactory subordinated loan agreements. The Commission may require or the security-based swap dealer may include such other provisions as deemed necessary or appropriate to the extent such provisions do not cause the subordinated loan agreement to fail to meet the minimum requirements of this Appendix D.

(2) Certain definitions. For purposes of § 240.18a-1 and this Appendix D:

(i) The term "subordinated loan agreement" shall mean the agreement or agreements evidencing or governing a subordinated borrowing of cash.

(ii) The term "Payment Obligation" shall mean the obligation of a security-based swap dealer to repay cash loaned to the security-based swap dealer pursuant to a subordinated loan agreement and "Payment" shall mean the performance by a security-based swap dealer of a Payment Obligation.

(iii) The term "lender" shall mean the person who lends cash to a security-based swap dealer pursuant to a subordinated loan agreement.

(b) Minimum requirements for subordinated loan agreements.

(1) Subject to paragraph (a) of this section, a subordinated loan agreement shall mean a written agreement between the security-based swap dealer and the lender, which (i) has a minimum term of one year, and (ii) is a valid and binding obligation enforceable in accordance with its terms (subject as to enforcement to applicable bankruptcy, insolvency, reorganization, moratorium and other similar laws) against the security-based swap dealer and the lender and their respective heirs, executors, administrators, successors and assigns.

(2) Specific amount. All subordinated loan agreements shall be for a specific dollar amount which shall not be reduced for the duration of the agreement except by installments as specifically provided for therein and except as otherwise provided in this Appendix D.

(3) Effective subordination. The subordinated loan agreement shall effectively subordinate any right of the lender to receive any Payment with respect thereto, together with accrued interest or compensation, to the prior payment or provision for payment in full of all claims of all present and future creditors of the security-based swap dealer arising out of any matter occurring prior to the date on which the related Payment Obligation matures consistent with the provisions of § 240.18a-1 and § 240.18a-1d, except for claims which are the subject of

subordinated loan agreements that rank on the same priority as or junior to the claim of the lender under such subordinated loan agreements.

(4) Proceeds of subordinated loan agreements. The subordinated loan agreement shall provide that the cash proceeds thereof shall be used and dealt with by the security-based swap dealer as part of its capital and shall be subject to the risks of the business.

(5) Certain rights of the security-based swap dealer. The subordinated loan agreement shall provide that the security-based swap dealer shall have the right to deposit any cash proceeds of a subordinated loan agreement in an account or accounts in its own name in any bank or trust company;

(6) Permissive prepayments. A security-based swap dealer at its option but not at the option of the lender may, if the subordinated loan agreement so provides, make a Payment of all or any portion of the Payment Obligation thereunder prior to the scheduled maturity date of such Payment Obligation (hereinafter referred to as a "Prepayment"), but in no event may any Prepayment be made before the expiration of one year from the date such subordinated loan agreement became effective. No Prepayment shall be made, if, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated loan agreements then outstanding the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such Prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such Prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the security-based swap dealer, either its net capital would fall below $24 million, its net capital would fall below 10% of the risk margin amount under § 240.18a-1, or, if the security-based swap dealer is approved to calculate net capital under § 240.18a-1(d), its tentative net

capital would fall to an amount below $120 million. Notwithstanding the above, no Prepayment shall occur without the prior written approval of the Commission.

(7) Suspended repayment. The Payment Obligation of the security-based swap dealer in respect of any subordinated loan agreement shall be suspended and shall not mature if, after giving effect to Payment of such Payment Obligation (and to all Payments of Payment Obligations of such security-based swap dealer under any other subordinated loan agreement(s) then outstanding that are scheduled to mature on or before such Payment Obligation) either its net capital would fall below $24 million, its net capital would fall below 10% of the risk margin amount under § 240.18a-1, or, if the security-based swap dealer is approved to calculate net capital under § 240.18a-1(d), its tentative net capital would fall to an amount below $120 million. The subordinated loan agreement may provide that if the Payment Obligation of the security-based swap dealer thereunder does not mature and is suspended as a result of the requirement of this paragraph (b)(7) for a period of not less than six months, the security-based swap dealer shall thereupon commence the rapid and orderly liquidation of its business, but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of § 240.18a-1 and § 240.18a-1d.

(8) Accelerated maturity – obligation to repay to remain subordinate.

(i) Subject to the provisions of paragraph (b)(7) of this appendix, a subordinated loan agreement may provide that the lender may, upon prior written notice to the security-based swap dealer and the Commission given not earlier than six months after the effective date of such subordinated loan agreement, accelerate the date on which the Payment Obligation of the security-based swap dealer, together with accrued interest or compensation, is scheduled to mature to a date not earlier than six months after the giving of such notice, but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of § 240.18a-1 and § 240.18a-1d.

(ii) Notwithstanding the provisions of paragraph (b)(7) of this appendix, the Payment Obligation of the security-based swap dealer with respect to a subordinated loan agreement, together with accrued interest and compensation, shall mature in the event of any receivership, insolvency, liquidation, bankruptcy, assignment for the benefit of creditors, reorganization whether or not pursuant to the bankruptcy laws, or any other marshalling of the assets and liabilities of the security-based swap dealer but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of § 240.18a-1 and § 240.18a-1d.

(9) Accelerated maturity of subordinated loan agreements on event of default and event of acceleration – obligation to repay to remain subordinate.

(i) A subordinated loan agreement may provide that the lender may, upon prior written notice to the security-based swap dealer and the Commission of the occurrence of any Event of Acceleration (as hereinafter defined) given no sooner than six months after the effective date of such subordinated loan agreement, accelerate the date on which the Payment Obligation of the security-based swap dealer, together with accrued interest or compensation, is scheduled to mature, to the last business day of a calendar month which is not less than six months after notice of acceleration is received by the security-based swap dealer and the Commission. Any subordinated loan agreement containing such Events of Acceleration may also provide, that if upon such accelerated maturity date the Payment Obligation of the security-based swap dealer is suspended as required by paragraph (b)(7) of this Appendix D and liquidation of the security-based swap dealer has not commenced on or prior to such accelerated maturity date, then notwithstanding paragraph (b)(7) of this appendix the Payment Obligation of the security-based swap dealer with respect to such subordinated loan agreement shall mature on the day immediately following such accelerated maturity date and in any such event the Payment Obligations of the security-based swap dealer with respect to all other subordinated loan agreements then outstanding shall also mature at the same time but the rights of the respective lenders to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of this Appendix D. Events of Acceleration which may be included in a subordinated loan agreement complying with this paragraph (b)(9) shall be limited to:

(A) Failure to pay interest or any installment of principal on a subordinated loan agreement as scheduled;

(B) Failure to pay when due other money obligations of a specified material amount;

(C) Discovery that any material, specified representation or warranty of the security-based swap dealer which is included in the subordinated loan agreement and on which the subordinated loan agreement was based or continued was inaccurate in a material respect at the time made;

(D) Any specified and clearly measurable event which is included in the subordinated loan agreement and which the lender and the security-based swap dealer agree (1) is a significant indication that the financial position of the security-based swap dealer has changed materially and adversely from agreed upon specified norms or (2) could materially and adversely affect the ability of the security-based swap dealer to conduct its business as conducted on the date the subordinated loan agreement was made; or (3) is a significant change in the senior management of the security-based swap dealer or in the general business conducted by the security-based swap dealer from that which obtained on the date the subordinated loan agreement became effective;

(E) Any continued failure to perform agreed covenants included in the subordinated loan agreement relating to the conduct of the business of the security-based swap dealer or relating to the maintenance and reporting of its financial position; and

(ii) Notwithstanding the provisions of paragraph (b)(7) of this appendix, a subordinated loan agreement may provide that, if liquidation of the business of the security-based swap dealer has not already commenced, the Payment Obligation of the security-based swap dealer shall mature, together with accrued interest or compensation, upon the occurrence of an Event of Default (as hereinafter defined). Such agreement may also provide that, if liquidation of the business of the security-based swap dealer has not already commenced, the rapid and orderly liquidation of the business of the security-based swap dealer shall then commence upon the happening of an Event of Default. Any subordinated loan agreement which so provides for maturity of the Payment Obligation upon the occurrence of an Event of Default shall also provide that the date on which such Event of Default occurs shall, if liquidation of the security-based swap dealer has not already commenced, be the date on which the Payment Obligations of the security-based swap dealer with respect to all other subordinated loan agreements then outstanding shall mature but the rights of the respective lenders to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of this Appendix (D). Events of Default which may be included in a subordinated loan agreement shall be limited to:

(A) The net capital of the security-based swap dealer falling to an amount below either of \$20 million or 8% of the risk margin amount under § 240.18a-1, or, if the security-based swap dealer is approved to calculate net capital under § 240.18a-1(d), its tentative net capital falling below $100 million, throughout a period of 15 consecutive business days, commencing on the day the security-based swap dealer first determines and notifies the Commission, or the Commission first determines and notifies the security-based swap dealer of such fact;

(B) The Commission revoking the registration of the security-based swap dealer;

(C) The Commission suspending (and not reinstating within 10 days) the registration of the security-based swap dealer;

(D) Any receivership, insolvency, liquidation, bankruptcy, assignment for the benefit of creditors, reorganization whether or not pursuant to bankruptcy laws, or any other marshalling of the assets and liabilities of the security-based swap dealer.

A subordinated loan agreement that contains any of the provisions permitted by this paragraph (b)(9) shall not contain the provision otherwise permitted by clause (i) of paragraph (b)(8).

(c) Miscellaneous provisions.

(1) Prohibited cancellation. The subordinated loan agreement shall not be subject to cancellation by either party; no Payment shall be made with respect thereto and the agreement shall not be terminated, rescinded or modified by mutual consent or otherwise if the effect thereof would be inconsistent with the requirements of § 240.18a-1 and § 240.18a-1d.

(2) Every security-based swap dealer shall immediately notify the Commission if, after giving effect to all Payments of Payment Obligations under subordinated loan agreements then outstanding that are then due or mature within the following six months without reference to any projected profit or loss of the security-based swap dealer, either its net capital would fall below $24 million, its net capital would fall below 10% of the risk margin amount under § 240.18a-1,

or, if the security-based swap dealer is approved to calculate net capital under § 240.18a-1(d), its tentative net capital would fall to an amount below $120 million.

(3) Certain legends. If all the provisions of a satisfactory subordinated loan agreement do not appear in a single instrument, then the debenture or other evidence of indebtedness shall bear on its face an appropriate legend stating that it is issued subject to the provisions of a satisfactory subordinated loan agreement which shall be adequately referred to and incorporated by reference.

(4) Revolving subordinated loan agreements. A security-based swap dealer shall be permitted to enter into a revolving subordinated loan agreement that provides for prepayment within less than one year of all or any portion of the Payment Obligation thereunder at the option of the security-based swap dealer upon the prior written approval of the Commission. The Commission, however, shall not approve any prepayment if:

(i) After giving effect thereto (and to all Payments of Payment Obligations under any other subordinated loan agreements then outstanding, the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the security-based swap dealer, either its net capital would fall below $24 million, its net capital would fall below 10% of the risk margin amount under § 240.18a-1, or, if the security-based swap dealer is approved to calculate net capital under § 240.18a-1(d), its tentative net capital would fall to an amount below $120 million; or

(ii) Pre-tax losses during the latest three-month period equaled more than 15% of current excess net capital.

Any subordinated loan agreement entered into pursuant to this paragraph (c)(4) shall be subject to all the other provisions of this Appendix D. Any such subordinated loan agreement shall not be considered equity for purposes of paragraph (h) of § 240.18a-1, despite the length of the initial term of the loan.

(5) Filing. Two copies of any proposed subordinated loan agreement (including nonconforming subordinated loan agreements) shall be filed at least 30 days prior to the proposed execution date of the agreement with the Commission. The security-based swap dealer shall also file with the Commission a statement setting forth the name and address of the lender, the business relationship of the lender to the security-based swap dealer, and whether the security-based swap dealer carried an account for the lender for effecting transactions in security-based swaps at or about the time the proposed agreement was so filed. All agreements shall be examined by the Commission prior to their becoming effective. No proposed agreement shall be a satisfactory subordinated loan agreement for the purposes of this section unless and until the Commission has found the agreement acceptable and such agreement has become effective in the form found acceptable.

13. Section 240.18a-2 is added to read as follows:

§ 240.18a-2 Capital requirements for major security-based swap participants for which there is not a prudential regulator.

(a) Every major security-based swap participant for which there is not a prudential regulator must at all times have and maintain positive tangible net worth.

(b) The term tangible net worth means the net worth of the major security-based swap participant as determined in accordance with generally accepted accounting principles in the

United States, excluding goodwill and other intangible assets. In determining net worth, all long and short positions in security-based swaps, swaps, and related positions must be marked to their market value. A major security-based swap participant must include in its computation of tangible net worth all liabilities or obligations of a subsidiary or affiliate that the participant guarantees, endorses, or assumes either directly or indirectly.

(c) Every major security-based swap participant must comply with § 240.15c3-4 as though it were an OTC derivatives dealer with respect to its security-based swap and swap activities, except that paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of § 240.15c3-4 shall not apply.

14. Section 240.18a-3 is added to read as follows:

§ 240.18a-3 Non-cleared security-based swap margin requirements for security-based swap dealers and major security-based swap participants for which there is not a prudential regulator.

(a) Every security-based swap dealer and major security-based swap participant for which there is not a prudential regulator must comply with this section.

(b) Definitions. For the purposes of this section:

(1) The term account means an account carried by a security-based swap dealer or major security-based swap participant for a counterparty that holds non-cleared security-based swaps.

(2) The term commercial end user means any person (other than a natural person) that:

(i) Engages primarily in commercial activities that are not financial in nature and that is not a financial entity as that term is defined in 3C(g)(3) of the Act (15 U.S.C. 78o-3(g)(3)); and

(ii) Is using non-cleared security-based swaps to hedge or mitigate risk relating to the commercial activities.

(3) The term counterparty means a person with whom the security-based swap dealer or major security-based swap participant has entered into a non-cleared security-based swap transaction.

(4) The term equity means the total current fair market value of securities positions in an account of a counterparty (excluding the time value of an over-the-counter option), plus any credit balance and less any debit balance in the account after applying a qualifying netting agreement with respect to gross derivatives payables and receivables.

(5) The term margin means the amount of positive equity in an account of a counterparty.

(6) The term negative equity means equity of less than $0.

(7) The term positive equity means equity of greater than $0.

(8) The term non-cleared security-based swap means a security-based swap that is not, directly or indirectly, cleared by a clearing agency registered pursuant to section 17A of the Act.

(9) The term security-based swap legacy account means an account that holds no security-based swaps entered into after the effective date of this section and that only is used to hold security-based swaps entered into prior to the effective date of this section and collateral for those security-based swaps.

(c) Margin requirements.

(1) Security-based swap dealers.

(i) Calculation required. A security-based swap dealer must calculate with respect to each account of a counterparty as of the close of each business day:

(A) The amount of equity in the account of the counterparty; and

(B) The margin amount for the account of the counterparty calculated pursuant to paragraph (d) of this section.

(ii) Account equity requirements. Except as provided in paragraph (c)(1)(iii) of this section, a security-based swap dealer must collect from a counterparty by noon of each business day cash, securities, and/or money market instruments in an amount at least equal to, as applicable:

(A) The negative equity in the account calculated as of the previous business day; and

(B) The margin amount calculated under paragraph (c)(1)(i)(B) of this section as of the previous business day to the extent that amount is greater than the amount of positive equity in the account on the previous business day.

(iii) Exceptions. (A) Commercial end users. The requirements of paragraph (c)(1)(ii) of this section do not apply to an account of a counterparty that is a commercial end user.

Alternative A to § 240.18a-3(c)(1)(iii)(B)

(B) Security-based swap dealers. The requirements of paragraph (c)(1)(ii)(B) of this section do not apply to an account of a counterparty that is a security-based swap dealer.

Alternative B to § 240.18a-3(c)(1)(iii)(B)

(B) Security-based swap dealers. Cash, securities and money market instruments posted by a counterparty that is a security-based swap dealer to meet the requirements of paragraph (c)(1)(ii)(B) of this section must be carried by an independent third-party custodian pursuant to the requirements of section 3E(f) of the Act.

(C) Counterparties that require third-party custodians. The requirements of paragraph (c)(1)(ii)(B) of this section do not apply to an account of a counterparty that is not a commercial end user and that requires the cash, securities, and money market instruments delivered to meet the margin amount to be carried by an independent third-party custodian pursuant to the requirements of section 3E(f) of the Act, provided cash, securities, and money market instruments necessary to meet the requirements of paragraph (c)(1)(ii)(B) of this section are delivered to the independent third-party custodian.

(D) Security-based swap legacy accounts. The requirements of paragraph (c)(1)(ii)(B) of this section do not apply to a legacy security-based swap account of a counterparty that is not a commercial end user.

(2) Major security-based swap participants.

(i) Calculation required. A major security-based swap participant must calculate as of the close of each business day the amount of equity in the account of each counterparty.

(ii) Account equity requirements. Except as provided in paragraph (c)(2)(iii) of this section, a major security-based swap participant must by noon of each business day:

(A) Collect from a counterparty cash, securities and/or money market instruments in an amount equal to the negative equity in the account calculated on the previous business day pursuant to paragraph (c)(2)(i) of this section; and

(B) Deliver to a counterparty cash, securities and/or money market instruments in an amount equal to the positive equity in the account calculated on the previous business day pursuant to paragraph (c)(2)(i) of this section.

(iii) Exceptions. (A) Transactions with commercial end users. The requirements of paragraph (c)(2)(ii)(A) of this section do not apply to a counterparty that is a commercial end user.

(B) Transactions with security-based swap dealers. The requirements of paragraph (c)(2)(ii)(A) of this section do not apply to a counterparty that is a security-based swap dealer.

Note: A security-based swap dealer must collect from a counterparty that is a major security-based swap participant cash, securities, and/or money market instruments as required by paragraph (c)(1)(ii) of this section.

(C) Security-based swap legacy accounts. The requirements of paragraph (c)(2)(ii) of this section do not apply to a legacy security-based swap account of a counterparty that is not a commercial end user.

(3) Deductions for securities held as collateral. The fair market value of securities and money market instruments held in the account of a counterparty must be reduced by the amount of the deductions the security-based swap dealer would apply to the securities and money market instruments pursuant to § 240.15c3-1 or § 240.18a-1, as applicable, for the purpose of determining whether the level of equity in the account meets the requirement of paragraph (c)(1)(ii) of this section.

(4) Collateral requirements. A security-based swap dealer and a major security-based swap participant when calculating the amount of equity in the account of a counterparty may take into account cash and the fair market value of securities and money market instruments pledged and held as collateral in the account provided:

(i) The collateral is subject to the physical possession or control of the security-based swap dealer or the major security-based swap participant;

(ii) The collateral is liquid and transferable;

(iii) The collateral may be liquidated promptly by the security-based swap dealer or the major security-based swap participant without intervention by any other party;

(iv) The collateral agreement between the security-based swap dealer or the major security-based swap participant and the counterparty is legally enforceable by the security-based swap dealer or the major security-based swap participant against the counterparty and any other parties to the agreement;

(v) The collateral does not consist of securities issued by the counterparty or a party related to the security-based swap dealer, the major security-based swap participant, or to the counterparty; and

(vi) If the Commission has approved the security-based swap dealer's use of a VaR model to compute net capital, the approval allows the security-based swap dealer to calculate deductions for market risk for the type of collateral.

(5) Qualified netting agreements. A security-based swap dealer or major security-based swap participant may include the effect of a netting agreement that allows the security-based swap dealer or major security-based swap participant to net gross receivables from and gross payables to a counterparty upon the default of the counterparty, for the purposes of the calculations required pursuant to paragraph (c)(1)(i)(A) and paragraph (c)(2)(i) of this section, if:

(i) The netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings;

(ii) The gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and

(iii) For internal risk management purposes, the security-based swap dealer or major security-based swap participant monitors and controls its exposure to the counterparty on a net basis.

(6) Minimum transfer amount. Notwithstanding any other provision of this rule, a security-based swap dealer or major security-based swap participant is not required to collect or deliver cash, securities or money market instruments pursuant to this section with respect to a

particular counterparty unless and until the total amount of cash, securities or money market instruments that is required to be collected or delivered, and has not yet been collected or delivered, with respect to the counterparty is greater than $100,000.

(7) Frequency of calculations increased. The calculations required pursuant to paragraph (c)(1)(i) and paragraph (c)(2)(i) of this section must be made more frequently than the close of each business day during periods of extreme volatility and for accounts with concentrated positions.

(8) Liquidation. A security-based swap dealer and major security-based swap participant must take prompt steps to liquidate securities and money market instruments in an account that does not meet the account equity requirements of this section to the extent necessary to eliminate the account equity deficiency.

(d) Calculating margin amount. A security-based swap dealer must calculate the margin amount required by paragraph (c)(1)(i)(B) of this section for non-cleared security-based swaps as follows:

(1) Standardized approach. (i) Credit default swaps. For credit default swaps, the security-based swap dealer must use the method specified in § 240.18a-1(c)(1)(vi)(A) or, if the security-based swap dealer is registered with the Commission as a broker or dealer, the method specified in § 240.15c3-1(c)(2)(vi)(O)(1).

(ii) All other security-based swaps. For security-based swaps other than credit default swaps, the security-based swap dealer must use the method specified in § 240.18a-1(c)(1)(vi)(B) or, if the security-based swap dealer is registered with the Commission as a broker or dealer, the method specified in § 240.15c3-1(c)(2)(vi)(O)(2).

(2) Model approach. For security-based swaps other than equity security-based swaps, a security-based swap dealer authorized by the Commission to compute net capital pursuant to § 240.18a-1(d) or § 240.15c3-1e may use its internal market risk model subject to the requirements in § 240.18a-1(d) or § 240.15c3-1e in lieu of using the methods required in paragraphs (d)(1)(i) and (ii) of this section.

(e) Risk monitoring and procedures. A security-based swap dealer must monitor the risk of each account and establish, maintain, and document procedures and guidelines for monitoring the risk of accounts as part of the risk management control system required by § 240.15c3-4. The security-based swap dealer must review, in accordance with written procedures, at reasonable periodic intervals, its non-cleared security-based swap activities for consistency with the risk monitoring procedures and guidelines required by this section. The security-based swap dealer also must determine whether information and data necessary to apply the risk monitoring procedures and guidelines required by this section are accessible on a timely basis and whether information systems are available to adequately capture, monitor, analyze, and report relevant data and information. The risk monitoring procedures and guidelines must include, at a minimum, procedures and guidelines for:

(1) Obtaining and reviewing account documentation and financial information necessary for assessing the amount of current and potential future exposure to a given counterparty permitted by the security-based swap dealer;

(2) Determining, approving, and periodically reviewing credit limits for each counterparty, and across all counterparties;

(3) Monitoring credit risk exposure to the security-based swap dealer from non-cleared security-based swaps, including the type, scope, and frequency of reporting to senior management;

(4) Using stress tests to monitor potential future exposure to a single counterparty and across all counterparties over a specified range of possible market movements over a specified time period;

(5) Managing the impact of credit exposure related to non-cleared security-based swaps on the security-based swap dealer's overall risk exposure;

(6) Determining the need to collect collateral from a particular counterparty, including whether that determination was based upon the creditworthiness of the counterparty and/or the risk of the specific non-cleared security-based swap contracts with the counterparty;

(7) Monitoring the credit exposure resulting from concentrated positions with a single counterparty and across all counterparties, and during periods of extreme volatility; and

(8) Maintaining sufficient equity in the account of each counterparty to protect against the largest individual potential future exposure of a non-cleared security-based swap carried in the account of the counterparty as measured by computing the largest maximum possible loss that could result from the exposure.

15. Section 240.18a-4 is added to read as follows:

§ 240.18a-4 Segregation requirements for security-based swap dealers and major security-based swap participants.

(a) Definitions. For the purposes of this section:

(1) The term cleared security-based swap means any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered with the Commission pursuant to section 17A of the Act (15 U.S.C. 78q-1);

(2) The term excess securities collateral means securities and money market instruments carried for the account of a security-based swap customer that have a market value in excess of the current exposure of the security-based swap dealer to the customer, excluding:

(i) Securities and money market instruments held in a qualified clearing agency account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the clearing agency resulting from a security-based swap transaction of the customer; and

(ii) Securities and money market instruments held in a qualified registered security-based swap dealer account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the other security-based swap dealer resulting from the security-based swap dealer entering into a non-cleared security-based swap transaction with the other security-based swap dealer to offset the risk of a non-cleared security-based swap transaction between the security-based swap dealer and the customer.

(3) The term qualified clearing agency account means an account of a security-based swap dealer at a clearing agency established to hold funds and other property in order to purchase, margin, guarantee, secure, adjust, or settle cleared security-based swap transactions for the security-based swap customers of the security-based swap dealer that meets the following conditions:

(i) The account is designated "Special Clearing Account for the Exclusive Benefit of the Cleared Security-Based Swap Customers of [name of security-based swap dealer]";

(ii) The clearing agency has acknowledged in a written notice provided to and retained by the security-based swap dealer that the funds and other property in the account are being held by the clearing agency for the exclusive benefit of the security-based swap customers of the security-based swap dealer in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the security-based swap dealer with the clearing agency; and

(iii) The account is subject to a written contract between the security-based swap dealer and the clearing agency which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the clearing agency or any person claiming through the clearing agency, except a right, charge, security interest, lien, or claim resulting from a cleared security-based swap transaction effected in the account.

(4) The term qualified registered security-based swap dealer account means an account at another security-based swap dealer registered with the Commission pursuant to section 15F of the Act that is not an affiliate of the security-based swap dealer and that meets the following conditions:

(i) The account is designated "Special Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of security-based swap dealer]";

(ii) The account is subject to a written acknowledgement by the other security-based dealer provided to and retained by the security-based swap dealer that the funds and other property held in the account are being held by the other security-based swap dealer for the exclusive benefit of the security-based swap customers of the security-based swap dealer in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the security-based swap dealer with the other security-based swap dealer;

(iii) The account is subject to a written contract between the security-based swap dealer and the other security-based swap dealer which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the other security-based swap dealer or any person claiming through the other security-based swap dealer, except a right, charge, security interest, lien, or claim resulting from a non-cleared security-based swap transaction effected in the account; and

(iv) The account and the assets in the account are not subject to any type of subordination agreement between the security-based swap dealer and the other security-based swap dealer.

(5) The term qualified security means:

(i) Obligations of the United States;

(ii) Obligations fully guaranteed as to principal and interest by the United States; and

(iii) General obligations of any State or subdivision of a State that:

(A) Are not traded flat and are not in default;

(B) Were part of an initial offering of $500 million or greater; and

(C) Were issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year-end.

(6) The term security-based swap customer means any person from whom or on whose behalf the security-based swap dealer has received or acquired or holds funds or other property for the account of the person with respect to a cleared or non-cleared security-based swap transaction. The term does not include a person to the extent that person has a claim for funds or other property which by contract, agreement or understanding, or by operation of law, is part of

the capital of the security-based swap dealer or is subordinated to all claims of security-based swap customers of the security-based swap dealer.

(7) The term special account for the exclusive benefit of security-based swap customers means an account at a bank that is not the security-based swap dealer or an affiliate of the security-based swap dealer and that meets the following conditions:

(i) The account is designated "Special Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of security-based swap dealer]";

(ii) The account is subject to a written acknowledgement by the bank provided to and retained by the security-based swap dealer that the funds and other property held in the account are being held by the bank for the exclusive benefit of the security-based swap customers of the security-based swap dealer in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the security-based swap dealer with the bank; and

(iii) The account is subject to a written contract between the security-based swap dealer and the bank which provides that the funds and other property in the account shall at no time be used directly or indirectly as security for a loan or other extension of credit to the security-based swap dealer by the bank and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

(b) Physical possession or control of excess securities collateral. (1) A security-based swap dealer must promptly obtain and thereafter maintain physical possession or control of all excess securities collateral carried for the accounts of security-based swap customers.

(2) A security-based swap dealer has control of excess securities collateral only if the securities and money market instruments:

(i) Are represented by one or more certificates in the custody or control of a clearing corporation or other subsidiary organization of either national securities exchanges, or of a custodian bank in accordance with a system for the central handling of securities complying with the provisions of § 240.8c-1(g) and § 240.15c2-1(g) the delivery of which certificates to the security-based swap dealer does not require the payment of money or value, and if the books or records of the security-based swap dealer identify the security-based swap customers entitled to receive specified quantities or units of the securities so held for such security-based swap customers collectively;

(ii) Are the subject of bona fide items of transfer; provided that securities and money market instruments shall be deemed not to be the subject of bona fide items of transfer if, within 40 calendar days after they have been transmitted for transfer by the security-based swap dealer to the issuer or its transfer agent, new certificates conforming to the instructions of the security-based swap dealer have not been received by the security-based swap dealer, the security-based swap dealer has not received a written statement by the issuer or its transfer agent acknowledging the transfer instructions and the possession of the securities or money market instruments, or the security-based swap dealer has not obtained a revalidation of a window ticket from a transfer agent with respect to the certificate delivered for transfer;

(iii) Are in the custody or control of a bank as defined in section 3(a)(6) of the Act, the delivery of which securities or money market instruments to the security-based swap dealer does not require the payment of money or value and the bank having acknowledged in writing that the securities and money market instruments in its custody or control are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank;

(iv)(A) Are held in or are in transit between offices of the security-based swap dealer; or

(B) Are held by a corporate subsidiary if the security-based swap dealer owns and exercises a majority of the voting rights of all of the voting securities of such subsidiary, assumes or guarantees all of the subsidiary's obligations and liabilities, operates the subsidiary as a branch office of the security-based swap dealer, and assumes full responsibility for compliance by the subsidiary and all of its associated persons with the provisions of the Federal securities laws as well as for all of the other acts of the subsidiary and such associated persons; or

(v) Are held in such other locations as the Commission shall upon application from a security-based swap dealer find and designate to be adequate for the protection of customer securities.

(3) Each business day the security-based swap dealer must determine from its books and records the quantity of excess securities collateral in its possession and control as of the close of the previous business day and the quantity of excess securities collateral not in its possession and control as of the previous business day. If the security-based swap dealer did not obtain possession or control of all excess securities collateral on the previous business day as required by this section and there are securities or money market instruments of the same issue and class in any of the following non-control locations:

(i) Securities or money market instruments subject to a lien securing an obligation of the security-based swap dealer, then the security-based swap dealer, not later than the next business day on which the determination is made, must issue instructions for the release of the securities or money market instruments from the lien and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;

(ii) Securities or money market instruments held in a qualified clearing agency account, then the security-based swap dealer, not later than the next business day on which the determination is made, must issue instructions for the release of the securities or money market instruments by the clearing agency and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;

(iii) Securities or money market instruments held in a qualified registered security-based swap dealer account maintained by another security-based swap dealer, then the security-based swap dealer, not later than the next business day on which the determination is made, must issue instructions for the release of the securities or money market instruments by the other security-based swap dealer and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;

(iv) Securities or money market instruments loaned by the security-based swap dealer, then the security-based swap dealer, not later than the next business day on which the determination is made, must issue instructions for the return of the loaned securities or money market instruments and must obtain physical possession or control of the securities or money market instruments within five business days following the date of the instructions;

(v) Securities or money market instruments failed to receive more than 30 calendar days, then the security-based swap dealer, not later than the next business day on which the determination is made, must take prompt steps to obtain physical possession or control of the securities or money market instruments through a buy-in procedure or otherwise;

(vi) Securities or money market instruments receivable by the security-based swap dealer as a security dividend, stock split or similar distribution for more than 45 calendar days, then the security-based swap dealer, not later than the next business day on which the determination is made, must take prompt steps to obtain physical possession or control of the securities or money market instruments through a buy-in procedure or otherwise; or

(vii) Securities or money market instruments included on the books or records of the security-based swap dealer as a proprietary short position or as a short position for another person more than 10 business days (or more than 30 calendar days if the security-based swap dealer is a market maker in the securities), then the security-based swap dealer must, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities or money market instruments.

(c) Deposit requirement for special account for the exclusive benefit of security-based swap customers. (1) A security-based swap dealer must maintain a special account for the exclusive benefit of security-based swap customers that is separate from any other bank account of the security-based swap dealer. The security-based swap dealer must at all times maintain in the special account for the exclusive benefit of security-based swap customers, through deposits into the account, cash and/or qualified securities in amounts computed in accordance with the formula set forth in § 240.18a-4a. In determining the amount maintained in a special account for the exclusive benefit of security-based swap customers, the security-based swap dealer must deduct:

(i) The percentage of the value of a general obligation of a State or subdivision of a State specified in § 240.15c3-1(c)(2)(vi);

(ii) The aggregate value of general obligations of a State or subdivision of a State to the extent the amount of the obligations of a single issuer exceeds 2% of the amount required to be maintained in the special account for the exclusive benefit of security-based swap customers;

(iii) The aggregate value of all general obligations of a State or subdivision of a State to the extent the amount of the obligations exceeds 10% of the amount required to be maintained in the special account for the exclusive benefit of security-based swap customers; and

(iv) The amount of funds held at a single bank to the extent the amount exceeds 10% of the equity capital of the bank as reported by the bank in its most recent Consolidated Reports of Condition and Income.

(2) It is unlawful for a security-based swap dealer to accept or use credits identified in the items of the formula set forth in § 240.18a-4a except to establish debits for the specified purposes in the items of the formula.

(3) The computations necessary to determine the amount required to be maintained in the special account for the exclusive benefit of security-based swap customers must be made daily as of the close of the previous business day and any deposit required to be made into the account must be made on the next business day following the computation no later than 1 hour after the opening of the bank that maintains the account. The security-based swap dealer may make a withdrawal from the special account for the exclusive benefit of security-based swap customers only if the amount remaining in the account after the withdrawal is equal to or exceeds the amount required to be maintained in the account pursuant to paragraph (c)(1) of this section.

(4) A security-based swap dealer must promptly deposit into a special account for the exclusive benefit of security-based swap customers funds or qualified securities of the security-based swap dealer if the amount of funds and/or qualified securities in one or more special accounts for the exclusive benefit of security-based swap customers falls below the amount required to be maintained pursuant to this section.

(d) Requirements for non-cleared security-based swaps. (1) Notice. A security-based dealer and a major security-based swap participant must provide the notice required pursuant to section 3E(f)(1)(A) of the Act (15 U.S.C. 78c-5(f)) to a counterparty in writing prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the effective date of this section.

(2) Subordination. (i) Counterparty that elects to have individual segregation at an independent third-party custodian. A security-based swap dealer must obtain an agreement from a counterparty that chooses to require segregation of funds or other property pursuant to section 3E(f) of the Act (15 U.S.C. 78c-5(f)) in which the counterparty agrees to subordinate all of its claims against the security-based swap dealer to the claims of security-based swap customers of the security-based swap dealer but only to the extent that funds or other property provided by the counterparty to the independent third-party custodian are not treated as customer property as that term is defined in 11 U.S.C. 741 in a liquidation of the security-based swap dealer.

(ii) Counterparty that elects to have no segregation. A security-based swap dealer must obtain an agreement from a counterparty that does not choose to require segregation of funds or other property pursuant to section 3E(f) of the Act (15 U.S.C. 78c-5(f)) or paragraph (c)(3) of this section in which the counterparty agrees to subordinate all of its claims against the security-based swap dealer to the claims of security-based swap customers of the security-based swap dealer.

16. Section 240.18a-4a is added to read as follows:

Rule 18a-4a Formula for determining the amount to be maintained in the special account for the exclusive benefit of security-based swap customers.

	Credits	Debits
1. Free credit balances and other credit balances in the accounts carried for security-based swap customers	$______	

2. Monies borrowed collateralized by securities in accounts carried for security-based swap customers	$______	
3. Monies payable against security-based swap customers' securities loaned	$______	
4. Security-based swap customers' securities failed to receive	$______	
5. Credit balances in firm accounts which are attributable to principal sales to security-based swap customers	$______	
6. Market value of stock dividends, stock splits and similar distributions receivable outstanding over 30 calendar days	$______	
7. Market value of short security count differences over 30 calendar days old	$______	
8. Market value of short securities and credits (not to be offset by longs or by debits) in all suspense accounts over 30 calendar days	$______	
9. Market value of securities which are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the 40 days	$______	
10. Debit balances in accounts carried for security-based swap customers, excluding unsecured accounts and accounts doubtful of collection		$______
11. Securities borrowed to effectuate short sales by security-based swap customers and securities borrowed to make delivery on security-based swap customers' securities failed to deliver		$______
12. Failed to deliver of security-based swap customers' securities not older than 30 calendar days		$______
13. Margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in accounts carried for security-based swap customers		$______
14. Margin related to security future products written, purchased or sold in accounts carried for security-based swap customers required and on deposit in a qualified clearing agency account at a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q-1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1)		$______
15. Margin related to cleared security-based swap transactions in accounts carried for security-based swap customers required and on deposit in a qualified clearing agency account at a clearing agency registered with the Commission pursuant to section 17A of the Act (15 U.S.C. 78q-1)		$______
16. Margin related to non-cleared security-based swap transactions in accounts carried for security-based swap customers required and held in a qualified registered security-based swap dealer account at another security-based swap dealer		$______
Total Credits	$______	
Total Debits		$______

Excess of Credits over Debits	$_____	

Note A. Item 1 shall include all outstanding drafts payable to security-based swap customers which have been applied against free credit balances or other credit balances and shall also include checks drawn in excess of bank balances per the records of the security-based swap dealer.
Note B. Item 2 shall include the amount of options-related or security futures product-related Letters of Credit obtained by a member of a registered clearing agency or a derivatives clearing organization which are collateralized by security-based swap customers' securities, to the extent of the member's margin requirement at the registered clearing agency or derivatives clearing organization.
Note C. Item 3 shall include in addition to monies payable against security-based swap customer's securities loaned the amount by which the market value of securities loaned exceeds the collateral value received from the lending of such securities.
Note D. Item 4 shall include in addition to security-based swap customers' securities failed to receive the amount by which the market value of securities failed to receive and outstanding more than thirty (30) calendar days exceeds their contract value.
Note E. (1) Debit balances in accounts shall be reduced by the amount by which a specific security (other than an exempted security) which is collateral for margin requirements exceeds in aggregate value 15 percent of the aggregate value of all securities which collateralize all accounts receivable; provided, however, the required reduction shall not be in excess of the amount of the debit balance required to be excluded because of this concentration rule. A specified security is deemed to be collateral for an account only to the extent it is not an excess margin security.
(2) Debit balances in special omnibus accounts, maintained in compliance with the requirements of section 4(b) of Regulation T under the Act (12 CFR 220.4(b)) or similar accounts carried on behalf of another security-based swap dealer, shall be reduced by any deficits in such accounts (or if a credit, such credit shall be increased) less any calls for margin, marks to the market, or other required deposits which are outstanding 5 business days or less.
(3) Debit balances in security-based swap customers' accounts included in the formula under item 10 shall be reduced by an amount equal to 1 percent of their aggregate value.
(4) Debit balances in accounts of household members and other persons related to principals of a security-based swap dealer and debit balances in cash and margin accounts of affiliated persons of a security-based swap dealer shall be excluded from the Reserve Formula, unless the security-based swap dealer can demonstrate that such debit balances are directly related to credit items in the formula.
(5) Debit balances in accounts (other than omnibus accounts) shall be reduced by the amount by which any single security-based swap customer's debit balance exceeds 25% (to the extent such amount is greater than $50,000) of the broker-dealer's tentative net capital (i.e., net capital prior to securities haircuts) unless the security-based swap dealer can demonstrate that the debit balance is directly related to credit items in the Reserve Formula. Related accounts (e.g., the separate accounts of an individual, accounts under common control or subject to cross guarantees) shall be deemed to be a single security-based swap customer's accounts for purposes of this provision. If the Commission is satisfied, after taking into account the circumstances of the concentrated account including the quality, diversity, and marketability of the collateral securing the debit balances in accounts subject to this provision, that the concentration of debit balances is appropriate, then the Commission may, by order, grant a partial or plenary exception from this provision.
The debit balance may be included in the reserve formula computation for five business days from the day the request is made.
(6) Debit balances of joint accounts, custodian accounts, participations in hedge funds or limited partnerships or similar type accounts or arrangements of a person who would be excluded from the definition of security-based swap customer ("non-security-based swap customer") which persons includible in the definition of security-based swap customer shall be included in the Reserve Formula in the following manner: if the percentage ownership of the non-security-based swap customer is less than 5 percent then the entire debit balance shall be included in the formula; if such percentage ownership is between 5 percent and 50 percent then the portion of the debit balance attributable to the non-security-based swap customer shall be excluded from the formula unless the security-based swap dealer can demonstrate that the debit balance is directly related to credit items in the formula; if such percentage ownership is greater than 50 percent, then the entire debit balance shall be excluded from the formula unless the security-based swap dealer can demonstrate that the debit balance is directly related to credit items in the formula.

Note F. Item 13 shall include the amount of margin required and on deposit with Options Clearing Corporation to the extent such margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by security-based swap customers' securities.

Note G. (a) Item 14 shall include the amount of margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q-1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) for security-based swap customer accounts to the extent that the margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by security-based swap customers' securities.

(b) Item 14 shall apply only if the security-based swap dealer has the margin related to security futures products on deposit with:

(1) A registered clearing agency or derivatives clearing organization that:

(i) Maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits. For purposes of this Note G, the term "security deposits" refers to a general fund, other than margin deposits or their equivalent, that consists of cash or securities held by a registered clearing agency or derivative clearing organization;

(ii) Maintains at least \$3 billion in margin deposits; or

(iii) Does not meet the requirements of paragraphs (b)(1)(i) through (b)(1)(ii) of this Note G, if the Commission has determined, upon a written request for exemption by or for the benefit of the security-based swap dealer, that the security-based swap dealer may utilize such a registered clearing agency or derivatives clearing organization. The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances, if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors; and

(2) A registered clearing agency or derivatives clearing organization that, if it holds funds or securities deposited as margin for security futures products in a bank, as defined in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)), obtains and preserves written notification from the bank at which it holds such funds and securities or at which such funds and securities are held on its behalf. The written notification shall state that all funds and/or securities deposited with the bank as margin (including security-based swap customer security futures products margin), or held by the bank and pledged to such registered clearing agency or derivatives clearing agency as margin, are being held by the bank for the exclusive benefit of clearing members of the registered clearing agency or derivatives clearing organization (subject to the interest of such registered clearing agency or derivatives clearing organization therein), and are being kept separate from any other accounts maintained by the registered clearing agency or derivatives clearing organization with the bank. The written notification also shall provide that such funds and/or securities shall at no time be used directly or indirectly as security for a loan to the registered clearing agency or derivatives clearing organization by the bank, and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank. This provision, however, shall not prohibit a registered clearing agency or derivatives clearing organization from pledging security-based swap customer funds or securities as collateral to a bank for any purpose that the rules of the Commission or the registered clearing agency or derivatives clearing organization otherwise permit; and

(3) A registered clearing agency or derivatives clearing organization that establishes, documents, and maintains:

(i) Safeguards in the handling, transfer, and delivery of cash and securities;

(ii) Fidelity bond coverage for its employees and agents who handle security-based swap customer funds or securities. In the case of agents of a registered clearing agency or derivatives clearing organization, the agent may provide the fidelity bond coverage; and

(iii) Provisions for periodic examination by independent public accountants; and

(4) A derivatives clearing organization that, if it is not otherwise registered with the Commission, has provided the Commission with a written undertaking, in a form acceptable to the Commission, executed by a duly authorized person at the derivatives clearing organization, to the effect that, with respect to the clearance and settlement of the security-based swap customer security futures products of the broker-dealer, the derivatives clearing organization will permit the Commission to examine the books and records of the derivatives clearing organization for compliance with the requirements set forth in § 240.15c3–3a, Note G. (b)(1) through (3).

(c) Item 14 shall apply only if a security-based swap dealer determines, at least annually, that the registered clearing agency or derivatives clearing organization with which the security-based swap dealer has on deposit margin related to security futures products meets the conditions of this Note G.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: October 18, 2012

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. IA-3490; October 19, 2012

NOTICE OF INTENTION TO CANCEL REGISTRATIONS OF CERTAIN INVESTMENT ADVISERS PURSUANT TO SECTION 203(h) OF THE INVESTMENT ADVISERS ACT OF 1940

Notice is given that the Securities and Exchange Commission (the "Commission") intends to issue an order or orders, pursuant to Section 203(h) of the Investment Advisers Act of 1940 (the "Act"), cancelling the registrations of the investment advisers whose names appear in the attached Appendix, hereinafter referred to as the registrants.

BACKGROUND:

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") which, among other things, amended certain provisions of the Act.[1] These amendments included provisions that delegate generally to the states regulatory responsibility over certain mid-sized advisers – i.e., those that have between $25 million and $100 million of assets under management.[2] These provisions and related rule amendments required a significant number of advisers registered with the Commission to withdraw their registrations with the Commission and to switch to registration with one or more state securities authorities.[3]

To implement the division of regulatory responsibility mandated by the Dodd-Frank Act, the Commission adopted rule 203A-5 under the Act.[4] Rule 203A-5 required each investment adviser registered with the Commission to file an amended Form ADV in the first quarter of 2012 indicating whether it remained eligible for registration by the Commission. The rule also extended until June 28, 2012 the deadline for advisers no longer eligible for Commission

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1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 *See* section 410 of the Dodd-Frank Act; 15 U.S.C. 80b-3a.

3 For example, section 410 of the Dodd-Frank Act required mid-sized advisers to register with the states: (i) if the adviser is required to be registered as an investment adviser with the securities commissioner of the state in which it maintains its principal office and place of business; and (ii) if registered with that state, the adviser would be subject to examination as an investment adviser by that securities commissioner. 15 U.S.C. 80b-3a(a)(2). The Commission also amended certain exemptions from the prohibition on Commission registration that were previously adopted under section 203A of the Act. *See* 17 CFR 275.203a-2.

4 17 CFR 275.203a-5.

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registration to register with the states and withdraw registration with the Commission.[5] In conjunction with adopting rule 203A-5 and other rules to implement the Dodd-Frank Act, the Commission stated that it expected to cancel the registration of advisers no longer eligible to register with the Commission that failed to file an amendment or withdraw their registrations in accordance with rule 203A-5.[6]

DISCUSSION:

Section 203(h) of the Act provides, in pertinent part, that if the Commission finds that any person registered under Section 203, or who has pending an application for registration filed under that section, is no longer in existence, is not engaged in business as an investment adviser, or is prohibited from registering as an investment adviser under section 203A, the Commission shall by order, cancel the registration of such person.[7]

Commission staff, in coordination with state securities regulators, contacted SEC-registered investment advisers before and after the filing deadlines to remind them of their filing obligations under rule 203A-5 and to withdraw from Commission registration by filing Form ADV-W if no longer eligible. The registrants listed in the Appendix either have not filed a Form ADV amendment with the Commission in 2012, or have indicated on Form ADV that they are no longer eligible to remain registered with the Commission as investment advisers but have not filed Form ADV-W to withdraw their registration. Accordingly, the Commission believes that reasonable grounds exist for a finding that these registrants are no longer in existence, are not engaged in business as investment advisers, or are prohibited from registering as investment advisers under section 203A, and that their registrations should be cancelled pursuant to section 203(h) of the Act.

Any registrant listed in the Appendix that wishes to file a Form ADV amendment indicating that it is eligible for registration or a Form ADV-W to withdraw its registration with the Commission may do so by December 17, 2012. The registrations of registrants whose amended Form ADVs are received by the Commission by December 17, 2012 will not be cancelled, and the registrations of registrants that file Form ADV-W will be withdrawn and will not be cancelled by a Commission order or orders. For more information or for questions about the inclusion of a registrant on this list, contact: Jennifer Porter, Senior Counsel at (202) 551-6787, or Melissa Roverts, Branch Chief at (202) 551-6722 (Division of Investment Management, Office of Investment Adviser Regulation).

Notice is also given that any interested person may, by December 17, 2012, at 5:30 P.M., submit to the Commission in writing a request for a hearing on the cancellation of a registrant, accompanied by a statement as to the nature of his interest, the reason for such request, and the

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5 *See* 17 CFR 275.203a-5(b), (c).

6 *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Rel. No. 3221, at 15 (Jun. 22, 2012) [76 FR 42950, 42953-42954 (Jul. 19, 2011)].

7 15 U.S.C. 80b-3(h).

issues, if any, of fact or law proposed to be controverted, and he may request that he be notified if the Commission should order a hearing thereon. Any such communication should be addressed: Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, D.C. 20549.

At any time after December 17, 2012, the Commission may issue an order or orders cancelling the registrations of any or all of the registrants listed in the Appendix, upon the basis of the information stated above, unless an order or orders for a hearing on the cancellation shall be issued upon request or upon the Commission's own motion. Persons who requested a hearing, or to be advised as to whether a hearing is ordered, will receive any notices and orders issued in this matter, including the date of the hearing (if ordered) and any postponements thereof.

By the Commission. Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

APPENDIX:

801-68570	12 METER MANAGEMENT, LP
801-72955	3SISTERS SUSTAINABLE MANAGEMENT, LLC
801-71854	ACCESS GLOBAL ADVISORS
801-70973	ADVANCED FINANCIAL SOLUTIONS, INC.
801-71094	AFC ASSET MANAGEMENT SERVICES, INC.
801-67660	ALDUS CAPITAL, LLC
801-71247	ALDWYCH CAPITAL PARTNERS, LLC
801-71312	ALLIANCE CONSULTING, LLC
801-39288	ALPHA CAPITAL MANAGEMENT INC
801-69679	ALPHA VISTA ADVISORS LLC
801-63858	ALPINE CAPITAL MANAGEMENT, LLC
801-63029	AM INVESTMENT PARTNERS LLC
801-67985	AMERICAN PEGASUS LDG, LLC
801-66956	AMOEBA CAPITAL PARTNERS PTE. LTD.
801-58279	AMUSSEN, HUNSAKER & ASSOCIATES INCORPORATED
801-72517	ANCHOR INVESTMENT PARTNERS LLC
801-74690	ANVIL CAPITAL ADVISORS, LLC
801-69544	APELLES INVESTMENT MANAGEMENT, LP
801-72622	ARCHETYPE ADVISORS, LLC
801-70395	ARTIENCE CAPITAL MANAGEMENT, LLC
801-70301	ASSET MANAGEMENT STRATEGIES, LLC
801-69874	ASSOCIATED PROFESSIONAL INVESTMENTS, LLC
801-69463	ATHENA ASSET MANAGEMENT & RESEARCH, LLC
801-72293	BAG SECURITIES, LLC

801-72112	BAOCHUAN CAPITAL MANAGEMENT, LLC
801-62938	BARRINGTON ASSET MANAGEMENT, INC.
801-60288	BEACON CAPITAL MANAGEMENT LIMITED
801-61433	BERKSHIRE ADVISORS, INC.
801-72146	BETA CAPITAL MANAGEMENT LLC
801-71757	BEYOND CAPITAL FINANCIAL MANAGEMENT GROUP, INC.
801-69391	BILTMORE INVESTMENT MANAGEMENT, LLC
801-56997	BISCAYNE ADVISORS, INC.
801-67617	BLACK KNIGHT ASSET MANAGEMENT
801-71729	BOLI FUND MANAGEMENT, LLC
801-14429	BOWMAN FINANCIAL MANAGEMENT CO INC
801-72221	BOYD INVESTMENT MANAGEMENT, LLC
801-68519	BRADLEY WEALTH MANAGEMENT, LLC
801-63049	BRICOLEUR CAPITAL MANAGEMENT, LLC
801-69628	BRIGHTON WEALTH MANAGEMENT, INC.
801-65969	BROADSTREET CAPITAL PARTNERS, LP
801-63011	BROADWATER CAPITAL MANAGEMENT LLC
801-70514	BRYN MAWR FINANCIAL, LLC
801-67201	BURR & COMPANY, LLC
801-68809	C.S. ANDERSON FINANCIAL SERVICES, INC
801-65805	C2 ASSET MANAGEMENT L.L.C.
801-70179	CABAL CAPITAL MANAGEMENT, LLC
801-70320	CACHE EQUITY LLC
801-30978	CAMBRIDGE FINANCIAL SERVICES, LTD
801-55780	CAMERON, MURPHY & SPANGLER, INC.
801-51319	CANNON TINGEY INVESTMENT ADVISORS INC
801-69502	CAPITAL CITY INVESTMENT MANAGEMENT COMPANY, INC.
801-37116	CAPITAL MANAGEMENT CORP OF THE NORTHEAST
801-69804	CAPITAL STRATEGIES FINANCIAL CORPORATION
801-68390	CAPSTONE CAPITAL GROUP
801-69331	CARLTON WEALTH MANAGEMENT LLC
801-66142	CARMICHAEL STRATEGIES LLC
801-71599	CARRINGTON STRATEGIC ADVISORS, LLC
801-65962	CASTLESTONE MANAGEMENT LLC
801-67329	CENTURION INVESTMENT PARTNERS, LLC
801-72550	CENTURY CITY CAPITAL MANAGEMENT, LLC
801-69779	CHELSEA MORGAN ADVISORS LLC
801-68372	CHESTER CAPITAL MANAGEMENT, LLC
801-57162	CHEVY CHASE ASSET MANAGEMENT LLC
801-64167	CHRONIM INVESTMENTS INC.
801-68715	CLEARPATH WEALTH MANAGEMENT, LLC
801-70840	CLOSED-END FUND ADVISORS INC.
801-68833	COAST WEALTH MANAGEMENT, INC.
801-68548	CONCORD ATLANTIC, INC.

801-34934	CONSTITUTION RESEARCH & MANAGEMENT INC
801-61705	COPLEY SQUARE CAPITAL MANAGEMENT, LLC
801-41021	CORDILLERA ASSET MANAGEMENT
801-63182	CORNERSTONE CAPITAL MANAGEMENT
801-55989	CREDICORP SECURITIES INC
801-69969	CREMAC ASSET MANAGEMENT, LLC
801-63124	CURTIS WEALTH MANAGEMENT GROUP, LLC
801-70413	D LITTLE, L.L.C.
801-56278	DANIEL FRISHBERG FINANCIAL SERVICES, INC.
801-72077	DB2 INVESTMENT ADVISORY SERVICES INC.
801-42306	DILMUN INVESTMENTS, INC
801-67499	DISCOVERY FINANCIAL GROUP, LLC
801-56038	DIVELEY LIND & ASSOCIATES LLC
801-70505	DJM WEALTH STRATEGIES, LLC
801-60809	DKR CAPITAL PARTNERS L.P.
801-66443	DKR FUSION MANAGEMENT L.P.
801-72443	DODD, ANDREW JAMES
801-70325	DOUBLE ALPHA GROUP LLC
801-72304	DOWNEY CAPITAL MANAGEMENT, INC.
801-68820	DUNCAN-WILLIAMS, INC.
801-65704	DURHAM ASSET MANAGEMENT L.L.C.
801-57802	DYNAMIC WEALTH MANAGEMENT
801-68994	EAGLEEYE ASSET MANAGEMENT, LLC
801-62482	EFFICIENT PORTFOLIO CONSULTANTS, LLC
801-68115	EMPIRE INVESTING GROUP, LLC
801-57005	EMPIRE INVESTMENT ADVISORS INC
801-65038	ERISEY WEALTH MANAGEMENT LLC
801-63668	EVOLUTION CAPITAL STRATEGIES LLC
801-61152	EXECUTIVE ASSET MANAGEMENT, INC.
801-60991	FAIRSON MANAGEMENT LIMITED
801-64720	FIDUCIARY MANAGEMENT GROUP, LLC
801-71217	FILIPINOFUNDS INVESTMENT MANAGEMENT, LLC
801-68836	FINANCIAL LEGACY ASSOCIATES, LLC
801-24481	FIRST INVESTMENT CORPORATION
801-36095	FLAGSHIP CAPITAL MANAGEMENT INC
801-69662	FLATFEEADVISORS.COM, INC.
801-66649	FORESIGHT ASSET MANAGEMENT, LLC
801-69724	FORT CAPITAL MANAGEMENT, LLC
801-63002	FOSTER INVESTMENT CONSULTING LLC
801-56788	FOUNDING PARTNERS CAPITAL MANAGEMENT COMPANY
801-61582	FPC SERVICES, INCORPORATED
801-69648	FUTURE VALUE CONSULTANTS LIMITED
801-45317	GANUCHEAU CAPITAL MANAGEMENT, INC.
801-19290	GARLIKOV ADVISORS INC

801-65627	GDG ASSET MANAGEMENT LIMITED
801-66112	GELLER & LEHMANN, LLC
801-72754	GILDED ADVISORS LLC
801-69546	GLANZ, DANIEL
801-74448	GLOBAL EVOLUTION USA, LLC
801-69333	GLOBAL PLUS+ INVESTMENT MANAGEMENT, LLC
801-72227	GLOBAL PORTFOLIO MANAGEMENT, LTD.
801-60090	GOLD COAST SECURITIES, INC.
801-74628	GOLDENGROVE LLC
801-62648	GOODSTEIN & ASSOCIATES, LLC
801-72960	GOSLIN III, ALBERT ERNEST
801-71624	GRANT PARK CAPITAL PARTNERS, LLC
801-71579	GRAVITY CAPITAL PARTNERS, LLC
801-67236	GRAYBEARD CAPITAL, LLC
801-69383	GREENWICH CREEK CAPITAL MANAGEMENT, LLC
801-66346	GUALARIO & CO., LLC
801-66823	GUNDERSON CAPITAL MANAGEMENT INC.
801-47199	HANSEN, BRIAN BENNETT
801-69429	HATTINGH, DIEDERIK JOHANNES
801-53254	HAVELL CAPITAL MANAGEMENT LLC
801-69963	HELIOS INVESTMENTS INC
801-68598	HEPWORTH EQUITY PARTNERS, LLC
801-66435	HIGHVIEW POINT PARTNERS, LLC
801-72056	HILL CAPITAL MANAGEMENT LLC
801-69123	HILL-TOWNSEND CAPITAL, LLC
801-68714	HOLMAN INVESTMENTS AND PLANNING, LLC
801-67355	HOLTER, WILLIAM LATIMER
801-70767	HORIZON FUNDS MANAGEMENT, LLC
801-71677	HORIZONS WEST CAPITAL PARTNERS, LLC
801-67009	HRJ CAPITAL, L.L.C.
801-71614	INNOVATUM CAPITAL PARTNERS, LLC
801-70807	INSTITUTIONAL BULLION INVESTMENT ADVISORS, LLC
801-67273	INVESTMENT SECURITY GROUP, LLC
801-69098	IRVINGTON CAPITAL LLC
801-51879	J A GIBBONS LLC
801-64391	JADIS INVESTMENTS LLC
801-68063	JDM FINANCIAL GROUP LLC
801-66648	JENNINGS INVESTMENT ADVISORS, LLC
801-66895	JERMYN CAPITAL (SINGAPORE) PTE. LTD.
801-71822	JIM POE AND ASSOCIATES INC.
801-71814	JOBES SOLO INVESTMENT GROUP, LLC
801-66643	JOHN R. FIESTA, LLC
801-57979	JOHN SHAW NOTMAN
801-45453	JUMPER GROUP INC

801-66884	K.K. JERMYN CAPITAL
801-72005	KAJO INVESTMENTS, LLC
801-67024	KENNEDY WEALTH MANAGEMENT GROUP LTD.
801-69948	KLARAOS, LLC
801-42331	KOCH ASSET MANAGEMENT LLC
801-69365	KURTIN FINANCIAL ADVISERS, LLC
801-69343	L&P FINANCIAL TRUSTEES LTD
801-73035	LANCELOT CAPITAL LIMITED
801-63887	LANPHIER CAPITAL MANAGEMENT, INC.
801-68524	LEXINGTON INVESTMENT COUNSEL, LLC
801-70312	LIGHTHOUSE CAPITAL PARTNERS, LLC
801-56394	LITCHFIELD & NELSON, INC
801-56364	LITTLEFIELD ASSET MGMT. INC.
801-49599	LONGWOOD INVESTMENT ADVISORS INC
801-37592	M. D. FALK & COMPANY, INC.
801-66388	MACARTHURCOOK INVESTMENT MANAGERS LIMITED
801-74815	MADISONLEE PARTNERS, LLC
801-71939	MANAIA CAPITAL MANAGEMENT, INC.
801-45332	MAPLE LEAF INVESTMENT MANAGEMENT INC
801-71070	MARKS THERIOT WALSTON & COMPANY, INC.
801-55125	MARSDEN CAPITAL MANAGEMENT, LLC.
801-67908	MARTINELLI DISCENZA INVESTMENT COUNSEL, INC.
801-60658	MCW ADVISORS
801-63100	MEREDITH PORTFOLIO MANAGEMENT INC.
801-63422	MERIDIAN ASSET MANAGEMENT LLC
801-70666	MG SULLIVAN, LLC
801-69605	MICOUD INVESTMENTS LIMITED
801-66328	MIRAMAR ASSET MANAGEMENT, LLC
801-57042	MOHAWK ASSET MANAGEMENT INC
801-71711	MONTGOMERY ASSET MANAGEMENT, LLC
801-42907	NANCY ABRAMS & ASSOCIATES, INC.
801-69301	NEF ADVISORS, LLC
801-72732	NEMAN FINANCIAL, INC.
801-64824	NEXCORE FINANCIAL SERVICES, INCORPORATED
801-72628	NEXTGEN FAMILY OFFICE, LLC
801-65128	NIGHTWATCH CAPITAL ADVISORS, LLC
801-68540	NJR INVESTMENT ADVISORY, INC.
801-69484	NORTH POINT ADVISORS
801-50288	NORTHSTAR CAPITAL INC
801-65702	OLYMPIUS CAPITAL, L.P.
801-23421	OMICRON GROUP LTD
801-71953	ONYX INVESTMENT ADVISORS
801-67259	ORACLE FINANCIAL SERVICES, LLC
801-68545	OSAGE ENERGY PARTNERS, L.P.

801-71098	OUTSTANDING VALUE FINANCIAL MANAGEMENT, LLC
801-65021	PACIFIC FINANCIAL ADVISORS, INC.
801-65166	PARK PLACE CAPITAL LIMITED
801-60542	PATRICK LLOYD BECKER
801-34567	PCA REAL ESTATE ADVISORS, INC.
801-66276	PELION INVESTMENT ADVISORS, INC.
801-65099	PEMIGEWASSET CAPITAL LLC
801-66759	PENSION PERFORMANCE ADVISORS, INC.
801-63878	PERMANENT VALUE INC.
801-72260	PINACULO LLC
801-70132	PLACE, BRYAN, MCNEILL
801-68161	PRESIDIUM PARTNERS, LLC
801-14186	PROFESSIONAL INVESTMENT COUNSEL, INC
801-71591	PROSAPIA CAPITAL MANAGEMENT, LLC
801-62787	QUANTEL ASSOCIATES, INC.
801-63842	QUANTUM FAMILY OFFICE GROUP, LLC
801-68872	QUANTUM WEALTH MANAGEMENT LLC
801-70459	RANDY MEYER INVESTMENT MANAGEMENT, LLC
801-72606	RFG ADVISORY GROUP, LLC
801-44866	RICH INVESTMENTS INC
801-57081	RINCON PACIFIC MANAGEMENT INC
801-64933	RIOUX & COMPANY, LLC
801-68439	RIVERSEDGE CONVERTIBLE PORTFOLIO ADVISORS, LLC
801-70387	ROSE & SKY INVESTMENTS (CAYMAN) LTD
801-62387	RUBY CORPORATION
801-44751	RULAPAUGH STANLEY EUGENE
801-72770	RUTHERFORD, GARY LEE
801-60566	RYAN CAPITAL ADVISORS, LLC
801-72680	S BROWN AND ASSOCIATES, LLC
801-70230	SACHS INVESTMENT GROUP, LLC
801-69730	SANCTUARY WEALTH MANAGEMENT, LLC
801-26861	SANDER CAPITAL ADVISORS, INC.
801-51254	SCEPTRE INVESTMENT COUNSEL LIMITED
801-58027	SCHELLER FINANCIAL SERVICES INC.
801-70944	SEDGEFIELD CAPITAL MANAGEMENT, LLC
801-71779	SELECT ASSET MANAGEMENT, LLC
801-64724	SENTINEL WEALTH ADVISORS, LLC
801-63183	SFM, LLC
801-16175	SHEA JOHN A INVESTMENT ADVISOR
801-39915	SK GROUP, INC
801-33087	SMITH WILLIAM BRUCE
801-64817	SMITH, THURMAN LEONARD
801-70455	SOUTHPORT ASSET MANAGEMENT
801-61272	SOVEREIGN INTERNATIONAL ASSET MANAGEMENT, INC.

801-70589	SOVEREIGN PRIVATE WEALTH, INC.
801-67746	STATE CAPITAL WEALTH MANAGEMENT INC
801-25597	STEINE & GOOCH CO INC
801-66434	STEPHEN M. GROSS, INC.
801-47378	STEPHEN P. MOULTON & ASSOCIATES, LTD.
801-24483	STERLING JOHNSTON CAPITAL MANAGEMENT, L.P.
801-69491	STRANBERG CAPITAL LLC
801-36025	STRATEGIS FINANCIAL GROUP, INC
801-74213	TANDRAGEE GLOBAL ADVISORS, LLC
801-53568	TBIG FINANCIAL SERVICES INC
801-28191	THE CARMACK GROUP, INC.
801-68698	THE COLOMA GROUP, L.LC.
801-54184	THE DELANCEY CAPITAL GROUP, LP
801-64694	THE OXFORD PRIVATE CLIENT GROUP, LLC
801-36203	THE SPANGLER GROUP, INC.
801-71205	THE UNIVERSITY FUNDS, LLC
801-66115	THOMSON FINANCIAL ADVISORS LLC.
801-62975	THUNDERSTORM CAPITAL LLC
801-47405	TONG ROBERT WAI
801-65028	TRIBUTARY CAPITAL MANAGEMENT., LLC
801-72696	TRILLION CAPITAL, LLC
801-69905	TRIVELLONI ASSET MANAGEMENT, LLC
801-67142	TWEDDELL GOLDBERG LLC
801-61159	UNIVEST INVESTMENTS, INC.
801-64165	USF SERVICES, LLC
801-71511	VANTAGE POINT ADVISORS, LLC
801-42685	VARN INVESTMENT COUNSEL INC
801-39326	VIRGINIA CAPITAL MANAGEMENT GROUP INC
801-60397	W.WALL AND COMPANY, INC.
801-63137	WALRUS PARTNERS, LLC
801-67403	WASHINGTON CORNER CAPITAL MANAGEMENT, LP
801-62780	WATERS CAPITAL ADVISERS, LLC
801-63026	WATERVILLE INVESTMENTS, INC.
801-74505	WEALTH FOCUS RESOURCES, LLC
801-69539	WEALTH LTD
801-54769	WEALTH MANAGEMENT LLC
801-62294	WELLS, CANNING & ASSOCIATES INC.
801-48199	WENDEL ANDREW MARTIN
801-40981	WEST ELLIS INVESTMENT MANAGEMENT INC
801-71961	WEST RIDGE REALTY ADVISORS LLC
801-19899	WESTRIDGE CAPITAL MANAGEMENT INC
801-64673	WFP SECURITIES CORPORATION
801-37177	WHB WOLVERINE ASSET MANAGEMENT INC
801-72403	WICKER PARK ADVISORS, LLC

801-16393	WILLIAMSON & SNEED INCORPORATED
801-67795	WILSHIRE-PENNINGTON GROUP, INC.
801-12695	WITTER WILLIAM D INC
801-69064	WORLDWIDE ASSET MANAGEMENT GROUP, LLC
801-70899	WYNNCORR CAPITAL MANAGEMENT, LLC

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-68080; File No. S7-08-11

RIN 3235 AL13

Clearing Agency Standards

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is adopting new Rule 17Ad-22 in accordance with Section 17A of the Securities Exchange Act of 1934 ("Exchange Act"), Section 763 of Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), and Section 805 of Title VIII ("Title VIII") of the Dodd-Frank Act. Rule 17Ad-22 establishes minimum requirements regarding how registered clearing agencies must maintain effective risk management procedures and controls as well as meet the statutory requirements under the Exchange Act on an ongoing basis.

EFFECTIVE DATE: [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: Jeffrey Mooney, Assistant Director; Katherine Martin, Senior Special Counsel; Doyle Horn, Special Counsel; Stephanie Park, Special Counsel; or Justin Byrne, Attorney-Advisor; Office of Clearance and Settlement, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010 at (202) 551-5710.

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SUPPLEMENTARY INFORMATION: The Commission is adopting rules for the operation of a registered clearing agency that identify minimum standards designed to enhance the regulatory framework for clearing agency supervision.

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I. Background

A. Statutory Framework for the Regulation of Clearing Agencies

1. Introduction

Congress directed the Commission to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions when it added Section 17A to the Exchange Act as part of the Securities Acts Amendments of 1975.[1] The Commission's ability to achieve this goal and its supervision of securities clearance and settlement systems is based upon the regulation of registered clearing agencies. Over the years, clearing agencies registered with the Commission have become an essential part of the infrastructure of the U.S. securities markets. Clearing agencies help reduce the costs of securities trading and are required to be carefully structured to manage and reduce counterparty risk.

The Commission used this experience with regulating clearing agencies to help address developments recently in the over-the-counter ("OTC") derivatives markets. In December 2008, the Commission acted to facilitate the central clearing of credit default swaps (hereinafter referred to as "credit default swaps" or "CDS"), the largest category of OTC security-based swaps, by permitting certain entities that performed central counterparty ("CCP") services to clear and settle credit default swaps on a temporary, conditional basis.[2] Consequently, some

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1 See 15 U.S.C. 78q-1 and S. Rep. No. 94-75, at 4 (1975) (the Senate Committee on Banking, Housing and Urban Affairs urging that "[t]he Committee believes the banking and security industries must move quickly toward the establishment of a fully integrated national system for the prompt and accurate processing and settlement of securities transactions").

2 The Commission authorized five entities to clear credit default swaps. See Exchange Act Release Nos. 60372 (July 23, 2009), 74 FR 37748 (July 29, 2009), 61973 (Apr. 23, 2010), 75 FR 22656 (Apr. 29, 2010) and 63389 (Nov. 29, 2010), 75 FR 75520 (Dec. 3,

credit default swaps transactions were centrally cleared prior to the enactment of the Dodd-Frank Act.

2. Section 17A of the Exchange Act

Section 17A of the Exchange Act[3] and Rule 17Ab2-1[4] require entities to register with the Commission prior to performing the functions of a clearing agency. Under the statute, the Commission is not permitted to grant registration unless it determines that the rules and operations of the clearing agency meet the standards set forth in Section 17A.[5] If the Commission registers a clearing agency, the Commission oversees the clearing agency to facilitate compliance with the Exchange Act using various tools that include, among other things, the rule filing process for self-regulatory organizations ("SROs") and on-site examinations by Commission staff. Section 17A(d) also gives the Commission authority to adopt rules for clearing agencies as necessary or appropriate in the public interest, for the protection of

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2010) (CDS clearing by ICE Clear Europe Limited); 60373 (July 23, 2009), 74 FR 37740 (July 29, 2009), 61975 (Apr. 23, 2010), 75 FR 22641 (Apr. 29, 2010) and 63390 (Nov. 29, 2010), 75 FR 75518 (Dec. 3, 2010) (CDS clearing by Eurex Clearing AG); 59578 (Mar. 13, 2009), 74 FR 11781 (Mar. 19, 2009), 61164 (Dec. 14, 2009), 74 FR 67258 (Dec. 18, 2009), 61803 (Mar. 30, 2010), 75 FR 17181 (Apr. 5, 2010) and 63388 (Nov. 29, 2010), 75 FR 75522 (Dec. 3, 2010) (CDS clearing by Chicago Mercantile Exchange, Inc.); 59527 (Mar. 6, 2009), 74 FR 10791 (Mar. 12, 2009), 61119 (Dec. 4, 2009), 74 FR 65554 (Dec. 10, 2009), 61662 (Mar. 5, 2010), 75 FR 11589 (Mar. 11, 2010) and 63387 (Nov. 29, 2010), 75 FR 75502 (Dec. 3, 2010) (CDS clearing by ICE Trust US LLC); 59164 (Dec. 24, 2008), 74 FR 139 (Jan. 2, 2009) (temporary CDS clearing by LIFFE A&M and LCH.Clearnet Ltd.) (collectively, "CDS Clearing Exemption Orders"). LIFFE A&M and LCH.Clearnet Ltd. allowed their order to lapse without seeking renewal.

3 See 15 U.S.C. 78q-1(b). See also Pub. L. No 111-203 § 763(b) (adding subparagraph (g) to Section 17 of the Exchange Act).

4 See 17 CFR 240.17Ab2-1.

5 Specifically, Sections 17A(b)(3)(A)–(I) identify determinations that the Commission must make about the rules and structure of a clearing agency prior to granting registration. See 15 U.S.C. 78q-1(b)(3)(A)–(I). The staff of the Commission provided guidance on meeting the requirements of Section 17A in its Announcement of Standards for the Registration of Clearing Agencies. See Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980).

investors, or otherwise in furtherance of the purposes of the Exchange Act and prohibits a registered clearing agency from engaging in any activity in contravention of these rules and regulations.[6] Pursuant to Section 21(a) of the Exchange Act, the Commission can invoke its enforcement powers to initiate and conduct investigations to determine violations of the federal securities laws, including those specifically applicable to clearing agencies.[7] In so doing, the Commission may institute civil actions seeking injunctive and other equitable remedies and/or administrative proceedings to, among other things, suspend or revoke registration, impose limitations upon a clearing agency's activities, functions, or operations, or impose other sanctions.[8]

3. The Dodd-Frank Act

On July 21, 2010, President Barack Obama signed the Dodd-Frank Act into law.[9] The Dodd-Frank Act was enacted to, among other things, promote the financial stability of the United States by improving accountability and transparency in the financial system.[10]

a. Title VII of the Dodd-Frank Act

Title VII of the Dodd-Frank Act ("Title VII") provides the Commission and the Commodity Futures Trading Commission ("CFTC") with enhanced authority to regulate certain OTC derivatives in response to the recent financial crisis.[11] The Dodd-Frank Act is intended to bolster the existing regulatory structure and provide regulatory tools to oversee the OTC

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6 See 15 U.S.C. 78q-1(d).

7 See 15 U.S.C. 78u.

8 See id.; see also 15 U.S.C. 78s(h).

9 The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

10 See id.

11 See id. §§701-774.

derivatives market, which has grown exponentially in recent years and is capable of affecting significant sectors of the U.S. economy. Title VII provides that the CFTC will regulate "swaps," the Commission will regulate "security-based swaps," and the CFTC and the Commission will jointly regulate "mixed swaps."[12]

Title VII was designed to provide greater certainty that, wherever possible and appropriate, swap and security-based swap contracts formerly traded exclusively in the OTC market are centrally cleared.[13] The swap and security-based swap markets traditionally have been characterized by privately negotiated transactions entered into by two counterparties, in which each assumes the credit risk of the other counterparty.[14] Clearing of swaps and security-based swaps was at the heart of Congressional reform of the derivatives markets in Title VII.[15] Clearing agencies are broadly defined under the Exchange Act and undertake a variety of

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12 Section 712(d) of the Dodd-Frank Act provides that the Commission and the CFTC, in consultation with the Board of Governors of the Federal Reserve System, shall further define the terms "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," "eligible contract participant" and "security-based swap agreement." The Commission and the CFTC jointly adopted rules to further define the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and eligible contract participant." Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", Securities Exchange Act Release No. 34-66868 (Apr. 27, 2012).

13 See, e.g., Report of the Senate Committee, supra note 11, at 34 (stating that "[s]ome parts of the OTC market may not be suitable for clearing and exchange trading due to individual business needs of certain users. Those users should retain the ability to engage in customized, uncleared contracts while bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible.").

14 See, e.g., Financial Stability Board, Implementing OTC Derivatives Market Reforms (Oct. 25, 2010), available at http://www.financialstabilityboard.org/publications/r_101025.pdf.

15 As previously noted, the Dodd-Frank Act seeks to ensure that, wherever possible and appropriate, derivatives contracts formerly traded exclusively in the OTC market be cleared. See supra note 11.

functions.[16] One such function is to act as a CCP, which is an entity that interposes itself between the counterparties to a trade.[17] For example, when a security-based swap contract between two counterparties that are members of a CCP is executed and submitted for clearing, it is typically replaced by two new contracts – separate contracts between the CCP and each of the two original counterparties. At that point, the original parties to the transaction are no longer counterparties to each other. Instead, each acquires the CCP as its counterparty, and the CCP assumes the counterparty credit risk of each of the original counterparties that are members of the CCP.[18] Structured and operated appropriately, CCPs may improve the management of counterparty risk and may provide additional benefits such as multilateral netting of trades.[19] The Dodd-Frank Act amended the Exchange Act to require, among other things, that transactions in security-based swaps must be cleared through a clearing agency if they are of a type that the

16 Section 3(a)(23)(A) of the Exchange Act defines the term "clearing agency" to mean any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for the comparison of data regarding the terms of settlement of securities transactions to reduce the number of settlements of securities transactions or the allocation of securities settlement responsibilities. Such term also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates. 15 U.S.C. 78c(a)(23)(A).

17 See id. An entity that acts as a CCP for securities transactions is a clearing agency as defined in the Exchange Act and is required to register with the Commission.

18 See Cecchetti, Gyntelberg and Hollanders, Central Counterparties for Over-the-Counter Derivatives, Bank for International Settlement Quarterly Review (Sept. 2009), available at http://www.bis.org/publ/qtrpdf/r_qt0909f.pdf.

19 See id. at 46; see also Bank for International Settlements' Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, Guidance on the Application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC Derivatives CCPs: Consultative Report (May 2010), available at http://www.bis.org/publ/cpss89.pdf.

Commission determines must be cleared, unless an exemption from mandatory clearing applies.[20] Title VII of the Dodd-Frank Act also added new provisions to the Exchange Act that require entities that act as a clearing agency with respect to security-based swaps ("security-based swap clearing agencies") to register with the Commission[21] and require the Commission to adopt rules with respect to security-based swap clearing agencies.[22] Compliance with any such rules is a prerequisite to the registration of a clearing agency with the Commission and is also a condition to the maintenance of its continued registration.[23] Finally, Title VII provided that some of the entities that the Commission permitted to clear and settle credit default swaps on a temporary, conditional basis prior to the July 21, 2010, enactment of the Dodd-Frank Act were deemed to be registered clearing agencies (the "Deemed Registered Provision").[24]

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20 See 15 U.S.C. 78c-3; Exchange Act Release No. 34-63557 (Dec. 15, 2010), 75 FR 82490 (Dec. 30, 2010); Exchange Act Release No. 34-67286 (June 28, 2012); 34-63556 (Dec. 15, 2010), 75 FR 79992 (Dec. 21, 2010).

21 15 U.S.C. 78q-1(g) (adding subparagraph (g) to Section 17A of the Exchange Act). Pursuant to Section 774 of the Dodd-Frank Act, the requirement in Section 17A(g) of the Exchange Act for security-based swap clearing agencies to be registered with the Commission took effect on July 16, 2011.

22 15 U.S.C. 78q-1(i) and (j). Pub. L. No. 111-203 § 763(b) (adding subparagraphs (i) and (j) to Section 17A of the Exchange Act).

23 Under the Exchange Act, a clearing agency can be registered with the Commission only if the Commission makes a determination that the clearing agency satisfies the requirements set forth in paragraphs (A) through (I) of Section 17A(b)(3) of the Exchange Act. 15 U.S.C. 78q-1(b)(3).

24 See 15 U.S.C. 78q-1(l). The Deemed Registered Provision applies to certain depository institutions that cleared swaps as multilateral clearing organizations and certain derivatives clearing organizations ("DCOs") that cleared swaps pursuant to an exemption from registration as a clearing agency. As a result, ICE Clear Credit LLC, ICE Clear Europe Limited and the Chicago Mercantile Exchange, Inc. were deemed registered clearing agencies with the Commission on July 16, 2011, solely for the purpose of clearing security-based swaps. Under this Deemed Registered Provision, an eligible clearing agency is deemed registered for the purpose of clearing security-based swaps and is therefore required to comply with all requirements of the Exchange Act, and the rules thereunder, applicable to registered clearing agencies, including, for example, the obligation to file proposed rule changes under Section 19(b) of the Exchange Act.

b. **Title VIII of the Dodd-Frank Act**

In addition to the provisions from Title VII that expand the Commission's authority under the Exchange Act to include activities related to security-based swaps, Title VIII of the Dodd-Frank Act, entitled the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act"), establishes an enhanced supervisory and risk control system for systemically important clearing agencies and other financial market utilities ("FMUs").[25] In part, the Clearing Supervision Act provides that the Commission, considering relevant international standards and existing prudential requirements, may prescribe regulations that contain risk management standards for the operations related to payment, clearing, and settlement activities ("PCS

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25 See infra note 29. Under Section 803 of the Clearing Supervision Act, clearing agencies may be FMUs. Therefore, the Commission may be the Supervisory Agency of a clearing agency that is designated as systemically important ("Designated Clearing Entity") by the Financial Stability Oversight Council ("Council"). See 12 U.S.C. 5463. The definition of "FMU," which is contained in Section 803(6) of the Clearing Supervision Act, contains a number of exclusions including, but not limited to, designated contract markets, registered futures associations, swap data repositories, swap execution facilities, national securities exchanges, national securities associations, alternative trading systems, security-based swap data repositories, security-based swap execution facilities, brokers, dealers, transfer agents, investment companies and futures commission merchants. 12 U.S.C. 5462(6)(B). The designation of systemic importance hinges on a determination by the Council that the failure of, or a disruption to, the functioning of the FMU could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States. See 12 U.S.C. 5463(a)(2)(A)–(E). The designation of an FMU is significant, in part, because it will subject such designated entity to heightened oversight consistent with the terms of the Clearing Supervision Act. For example, the Clearing Supervision Act requires the Supervisory Agency to examine at least once annually any FMU that the Council has designated as systemically important. The Commission intends to conduct such annual statutory cycle examinations on the Commission's fiscal year basis. The Commission staff anticipates conducting the first annual statutory cycle examination of any designated FMU for which it is the Supervisory Agency in the annual cycle following such designation.

Activities")[26] of a Designated Clearing Entity or the conduct of designated activities by a Financial Institution.[27] In prescribing such standards, the Commission must consult the Board of Governors of the Federal Reserve System ("Federal Reserve" or "the Board") and the Financial Stability Oversight Council ("Council"). On July 11, 2011, the Council published a final rule concerning its authority to designate FMUs as systemically important,[28] and on July 18, 2012, the Council designated The Depository Trust Company ("DTC"), Fixed Income Clearing Corporation ("FICC"), National Securities Clearing Corporation ("NSCC") and The Options Clearing Corporation ("OCC") as systemically important.[29]

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26 Certain post-trade processing activities that are not captured by the Clearing Supervision Act may nevertheless be subject to regulation by the Commission under the Exchange Act. See infra note 100 and accompanying text.

27 See Section 805(a)(2) of the Clearing Supervision Act. Those regulations may govern "(A) the operations related to payment, clearing, and settlement activities of such designated clearing entities; and (B) the conduct of designated activities by such financial institutions." 12 U.S.C. 5464(a)(2). PCS Activities are defined in Section 803(7) of the Clearing Supervision Act. 12 U.S.C 5462(7).

The definition of "financial institution," which is contained in Section 803(5) of the Clearing Supervision Act, outlines numerous exclusions but defines financial institution as a branch or agency of a foreign bank, an organization operating under Section 25 or 25A of the Federal Reserve Act, a credit union, a broker or dealer, an investment company, an insurance company, an investment adviser, a futures commission merchant, commodity trading advisor or commodity pool operator and any company engaged in activities that are financial in nature or incidental to a financial activity. 12 U.S.C. 5462(5)(A).

28 See 76 FR 44763 (July 27, 2011) (the Council also expects to address the designation of payment, clearing, or settlement activities as systemically important in a separate rulemaking).

29 See 12 U.S.C. 5321 (establishing the Council and designating its voting and nonvoting members); see also 12 U.S.C. 5463 (designation of systemic importance). In accordance with Section 804 of the Clearing Supervision Act, the Council has the authority, on a non-delegable basis and by a vote of not fewer than two-thirds of the members then serving, including the affirmative vote of its chairperson, to designate those FMUs that the Council determines are, or are likely to become, systemically important. The Council may, using the same procedures, rescind such designation if it determines that the FMU no longer meets the standards for systemic importance. Before making either determination, the Council is required to consult with the Board and the relevant

B. International Considerations

Section 17A(i) of the Exchange Act provides that the Commission, in establishing clearing agency standards and in its oversight of clearing agencies, may conform such standards and such oversight to reflect evolving international standards.[30] Section 805(a) of the Clearing Supervision Act directs the Commission to take into consideration relevant international standards and existing prudential requirements for clearing agencies that are designated as FMUs.[31] The current international standards most relevant to risk management of clearing agencies are the standards developed by the International Organization of Securities Commissions ("IOSCO") and the Committee on Payment and Settlement Systems ("CPSS") that are contained in the report entitled Principles for Financial Market Infrastructures ("FMI Report").[32] The final FMI Report was published on April 16, 2012, and replaces CPSS and IOSCO's previous standards applicable to clearing agencies that were contained in the following reports: Recommendations for Securities Settlement Systems (2001) ("RSSS") and Recommendations for Central Counterparties (2004) ("RCCP") (collectively, "CPSS-IOSCO Recommendations").[33] These international standards were formulated by securities regulators

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Supervisory Agency as determined in accordance with Section 803(8) of the Clearing Supervision Act. Section 804 also sets forth procedures that give entities 30 days advance notice and an opportunity for a hearing prior to being designated as systemically important.

30 15 U.S.C. 78q-1(i).

31 12 U.S.C. 5464(a)(1).

32 CPSS-IOSCO, Principles for Financial Market Infrastructures (Apr. 2012), available at http://www. iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf.

33 The complete RSSS and RCCP Reports are available on the website of the Bank for International Settlements at http://www. iosco.org/library/pubdocs/pdf/IOSCOPD123.pdf and http://www.iosco.org/library/pubdocs/pdf/IOSCPD176.pdf respectively.

The Board applies these standards in its supervisory process and expects systemically important systems, as determined by the Board and subject to its authority, to complete a and central banks to promote sound risk-management practices and encourage the safe design and operation of entities that provide clearance and settlement services. The FMI Report harmonizes and, where appropriate, strengthens the previous international standards; it also incorporates additional guidance for OTC derivatives CCPs.[34]

II. Overview of Proposal and General Comments Received on the Proposing Release and Commission Response

A. Summary of the Clearing Agency Standards Proposing Release

On March 3, 2011, the Commission proposed for comment a series of rules related to standards for the operation and governance of clearing agencies ("Proposing Release").[35] The Proposing Release contained the following proposals:

(1) Proposed Rule 17Ad-22, which would require certain minimum standards for all clearing agencies registered with the Commission;

(2) Proposed Rule 17Aj-1, which would require dissemination of pricing and valuation information by security-based swap CCPs;

(3) Proposed Rule 17Ad-23, which would require all clearing agencies to have adequate safeguards and procedures to protect the confidentiality of trading information of clearing agency participants;

(4) Proposed Rule 17Ad-24, which would exempt certain security-based swap dealers and security-based swap execution facilities from the definition of clearing agency;

(5) Proposed Rule 17Ab2-1, which would amend an existing Commission rule concerning registration of clearing agencies to account for security-based swap clearing agencies and to make other technical changes;

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self-assessment against the standards set forth in the policy. See Policy on Payment System Risk, 72 FR 2518 (Jan. 12, 2007).

34 See FMI Report, supra note 32.

35 See Exchange Act Release No. 34-64017 (Mar. 3, 2011), 76 FR 14472 (Mar. 16, 2011) ("Proposing Release"), available at http://www.sec.gov/rules/proposed/2011/34-64017fr.pdf.

(6) Proposed Rule 17Ad-25, which would require all clearing agencies to have procedures that identify and address conflicts of interest;

(7) Proposed Rule 17Ad-26, which would require clearing agencies to set standards for all members of their boards of directors or committees; and

(8) Proposed Rule 3Cj-1, which is modeled on Section 3C(j) of the Exchange Act and would require all clearing agencies to designate a chief compliance officer.

The Commission also noted in the Proposing Release that the definition of clearing agency under Section 3(a)(23)(A) of Exchange Act includes any person who:

- acts as an intermediary in making payments or deliveries or both in connection with transactions in securities;
- provides facilities for the comparison of data regarding the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities;
- acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry, without physical delivery of securities certificates (such as a securities depository); or
- otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates (such as a securities depository).[36]

Based on the Exchange Act definition, the Commission stated its preliminary view that certain post-trade processing services may fall within the clearing agency definition and asked for comments regarding the Commission's preliminary interpretation.

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36 15 U.S.C. 78c(a)(23)(A).

Since the publication of the Proposing Release, the Commission has received 25 comment letters on the Proposing Release from a broad range of market participants, and the Commission and staff also had discussions with representatives of clearing agencies, trade associations, public interest groups and other interested parties.[37] The Commission has taken into consideration international initiatives and consulted with other U.S. financial regulators as

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37 The comment file is published on the Commission's website, available at http://www.sec.gov/comments/s7-08-11/s70811.shtml. See Letter from American Benefits Council, dated May 6, 2011 ("ABC Letter"); letter from Chris Barnard, dated March 21, 2011 ("Barnard Letter"); letter from Dennis M. Kelleher, President & CEO and Steven W. Hall, Securities Specialist, Better Markets, Inc., dated April 29, 2011 ("Better Markets Letter"); letter from Joanne Medero, Richard Prager and Supurna VedBrat, BlackRock, dated April 29, 2011 ("BlackRock Letter"); letter from Craig S. Donohue, CME Group, dated April 29, 2011 ("CME Letter"); letter from Glenn Davis, Senior Research Associate, Council of Institutional Investors, dated April 14, 2011 ("CII Letter"); letter from Ernst & Young, dated April 29, 2011 ("ENY Letter"); letter from Mark Beeston, Chief Executive Officer of Portfolio Risk Services, ICAP®, dated July 7, 2011 ("ICAP Letter"); letter from R. Trabue Bland, Intercontinental Exchange, Inc., dated April 29, 2011 ("ICE Letter"); letter from Robert Pickel, Executive Vice Chairman, International Swaps and Derivatives Association, dated April 29, 2011 ("ISDA Letter"); letter from Ian Axe, CEO, LCH.Clearnet Group Limited, dated April 28, 2010 ("LCH Letter"); letter from Stuart J. Kaswell and Carlotta King, Managed Funds Association, dated March 24, 2011 ("MFA (Kaswell/King) Letter"); letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, dated April 29, 2011 ("MFA (Kaswell) Letter"); letter from Kevin Gould, President, Markit™, dated April 29, 2011 ("Markit™ (April) Letter"); letter from Kevin Gould, President, Markit™, dated July 26, 2011 ("Markit™ (July) Letter"); letter from Jeff Gooch, CEO, MarkitSERV™, dated April 29, 2011 ("MarkitSERV™ (April) Letter"); letter from Jeff Gooch, CEO, MarkitSERV™, dated July 18, 2011 ("MarkitSERV™ (July) Letter"); letter from Norman Reed, General Counsel, Omgeo, dated May 5, 2011 ("Omgeo Letter"); letter from Larry E. Thompson, General Counsel, The Depository Trust & Clearing Corporation, dated April 29, 2011 ("The DTCC (April) Letter"); letter from Larry E. Thompson, General Counsel, The Depository Trust & Clearing Corporation, dated July 21, 2011 ("The DTCC (July) Letter"); letter from William H. Navin, Executive Vice President, General Counsel and Secretary, The Options Clearing Corporation, dated April 29, 2011 ("The OCC Letter"); letter from James Cawley, Co-Founder, Swaps and Derivatives Market Association, dated June 3, 2011 ("SDMA (June) Letter"); letter from Christoffer Mohammar, General Counsel, TriOptima Group, dated April 29, 2011 ("TriOptima Letter"); letter from Richard H. Baker, President & Chief Executive Officer, Managed Funds Association, dated March 24, 2011 ("MFA (Baker) Letter"); letter from James Cawley, Co-Founder, Swaps and Derivatives Market Association, dated April 19, 2011 ("SDMA (April) Letter").

appropriate, including the CFTC and the Federal Reserve, to inform the Commission's final actions. Commenters generally supported the goals of the proposal. As further discussed below, however, several commenters recommended that the proposal be amended or clarified in certain respects.

After careful review and consideration of the comments, the Commission is today adopting Rule 17Ad-22, with certain modifications discussed below, to address comments received. As adopted, Rule 17Ad-22 is meant to establish minimum requirements for registered clearing agency risk management practices and operations with due consideration given to equivalent standards of other regulators in the United States[38] and to international standards, as discussed above in Section I.B. We expect to address separately the other proposed rules and matters contained in the Proposing Release as explained in more detail in Section II.B below.

B. General Comments Received on the Proposing Release and the Commission Response

The Proposing Release was published in the Federal Register on March 16, 2011, and the comment period closed on April 29, 2011.[39] The Proposing Release contained proposed rules that cover various aspects of a clearing agency's operations and risk management that are listed in full in Section II.A. In addition to specific comments regarding the substance of the rules in the Proposing Release, a number of the comments the Commission received concern the larger framework for our rulemaking efforts involving clearing agencies and the manner in which the

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38 See Derivatives Clearing Organization General Provisions and Core Principles 76 FR 69334 (Nov. 8, 2011) (CFTC adopting final regulations to implement certain provisions of Title VII and Title VIII of the Dodd-Frank Act governing DCO activities) ("DCO Release"); Financial Market Utilities 76 FR 18445 (Apr. 4, 2011) (notice of proposed rulemaking to promulgate risk-management standards governing the operations related to the payment, clearance and settlement activities of certain financial market utilities that are designated systemically important by the Council).

39 See supra note 35.

rules may be implemented. These comments focus on issues such as ensuring that: (1) sufficient time be given to clearing agencies to implement all new standards appropriately; (2) the Commission's regulations relating to risk management standards in particular be given careful consideration and recognize the complexity of the issues involved; (3) the Commission's regulations are consistent with those of other U.S. regulatory agencies and CPSS and IOSCO initiatives; and (4) appropriate distinctions between clearing agencies that provide CCP and central securities depository ("CSD") services from those that provide post-trade processing services are recognized in the Commission's regulations.

Set forth below is a description of the comments received by the Commission that express concerns about the general approach to clearing agency reform reflected in the Proposing Release. The Commission has carefully considered these general comments that were provided concerning the larger framework for our rule making efforts involving clearing agencies.[40] To address the concerns they raise, we have determined to take the actions described below.

1. Timing of Implementation

a. Comments Received

Three commenters asked for the implementation of the proposed rules to be subject to appropriate phase-in periods.[41] One commenter suggested that the appropriate phases should be determined by the Commission in consultation with the affected clearing agencies.[42] Another commenter requested that if the rules are adopted as proposed then they should not become

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40 See supra note 9, at Preamble.

41 See The DTCC (April) Letter at 5; The OCC Letter at 17; MFA (Kaswell/King) Letter at 2.

42 See The DTCC (April) Letter at 5.

effective for at least two years.[43] Two commenters stated that they believe that implementing all of the proposed rules in the Proposing Release at the same time would require extensive new policies and procedures, drafting, proposing and approval of rules and rule changes, raising additional financial resources, hiring and training of personnel, operational changes and many other tasks that would require clearing agencies to simultaneously respond to separate requirements promulgated under the Dodd-Frank Act.[44] Accordingly, these commenters requested that the Commission provide adequate time to implement necessary changes and expressed that phase-in periods would be appropriate.

One commenter asked the Commission to publish any modifications it may make to the proposed rules for an additional comment period.[45] Others stressed that if the Commission makes significant changes to its proposed rules, then the rules should be republished for further comment.[46]

One commenter stated that clearing agency rules such as those related to governance, conflicts of interest, registration, and financial resources should be adopted early in the implementation of rules for the security-based swap market.[47] The commenter also stated that

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43 See The OCC Letter at 17 (adding that if the Commission adopts a financial resources standard in Rule 17Ad-22(b)(3) to require a security-based swaps clearing agency that performs CCP services to have enough financial resources to be able to withstand the default of its two largest participants in extreme but plausible market conditions then that requirement should be subject to delayed implementation of at least two years).

44 See id.; The DTCC (April) Letter at 6.

45 See The DTCC (April) Letter at 2.

46 See The OCC Letter at 17.

47 See MFA (Kaswell/King) Letter at Annex A.

barriers to effective "buy-side" participation in CCPs must be eliminated early in the phase-in process to enable "buy-side" participants to clear voluntarily at the same time as dealers.[48]

b. Commission Response

In light of the request by commenters for a phased approach to implementation of the clearing agency standards set forth in the Proposing Release,[49] the Commission has decided to address the standards in stages.

- In the first stage, the Commission is adopting only Rule 17Ad-22. The compliance date for Rule 17Ad-22 will be sixty days from publication in the Federal Register.
- The second planned stage in the implementation of standards for clearing agencies is the consideration by the Commission of rules that correspond to proposed Rules 17Aj-1; 17Ad-23; 17Ad-24; 17Ab2-1 and 3Cj-1 as well as the clearing agency governance and conflict of interest concerns that its previous proposal addressed through its proposal of Rule 17Ad-25, Rule 17Ad-26 and Regulation MC.[50]
- The third planned stage is for the Commission to consider rules tailored to clearing agencies that perform certain post-trade processing services. The Commission sought comment concerning these types of clearing agencies in the Proposing Release and preliminarily intends to propose rules addressed to them as described in more detail in Sections II.B.4 and III.A below. As appropriate, the Commission may also propose rules that will incorporate principles set forth in the FMI Report.

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48 See id.

49 See supra notes 41-44 and accompanying text.

50 Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC, Exchange Act Release No. 344-63107 (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010) ("Regulation MC").

The Commission believes the phased approach to implementation provides clearing agencies with the benefit of additional time with respect to some of the requirements contemplated in the Proposing Release, while putting into place minimum standards for operational and risk management practices of registered clearing agencies. This approach will allow the Commission to consider further the comments received on the Proposing Release and evolution of clearance and settlement activity in light of the requirements of Title VII and Title VIII of the Dodd-Frank Act, including the implementation of the mandatory clearing requirements with respect to security-based swaps mandated by the Dodd-Frank Act. Because the Commission is adopting 17Ad-22 largely as proposed, the Commission is not republishing Rule 17Ad-22 for additional comments.

We believe that the implementation of these standards is an important first step in crafting regulatory changes contemplated by Title VII and Title VIII of the Dodd-Frank Act as intended by Congress. The adoption of Rule 17Ad-22 will also allow the Commission to coordinate its activities as the supervisory agency for clearing agencies designated as systemically important financial market utilities under Title VIII of the Dodd-Frank Act with the complementary responsibilities of the Federal Reserve.[51] In addition, the Commission believes that the adoption of standards for registered clearing agencies at this time will help facilitate the development of the security-based swap market. Rule 17Ad-22 establishes minimum standards for a wide range of issues, including governance, financial resources and membership. For example, Rules 17Ad-22(b)(5), (6) and (7) are designed to prohibit membership practices that

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51 Section 805 of the Clearing Supervision Act provides that (i) the Commission may prescribe standards for designated clearing entities in consultation with the Council and the Board and (ii) the Board may determine that the Commission's existing prudential requirements with respect to designated clearing entities are insufficient to prevent or mitigate significant credit, liquidity, operational or other risks to the financial markets or the financial stability of the United States.

may limit competition among market participants. In particular, Rule 17Ad-22(b)(6) is designed to facilitate correspondent clearing, which will allow buy-side participants to obtain access to CCP services without having to become direct members of a clearing agency.

2. <u>Special Attention to Risk Management Standards</u>

a. Comments Received

Generally, commenters supported the requirements of proposed Rules 17Ad-22(b)(1)–(4) that would govern the risk management standards and practices of registered clearing agencies that perform CCP services or CCPs.[52] However, in several respects, commenters asked the Commission to pay special attention to the technical nature of CCP risk management practices that are addressed by these rules. The comments received by the Commission span a range of views on these matters. But thematically, many of them coalesce around a question of whether the Commission should prescribe detailed specifications within these rules to define compliance standards more clearly or take a less prescriptive approach that affords clearing agencies greater discretion to establish, implement, maintain and enforce policies and procedures based on the facts and circumstances of the individual clearing agency.

For instance, proposed Rule 17Ad-22(b)(1) would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to measure credit exposures to participants at least once a day and limit exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control. Of those commenters who asked the Commission to consider modifications to the proposed rule, two suggested that public disclosure requirements should

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52 <u>See</u> discussion <u>infra</u> Section III.C.

accompany any choice made by a CCP to reduce margin requirements on the basis of an inverse or offsetting correlation between participants' positions.[53] Several others focused on what role the Commission should take in defining "normal market conditions" for purposes of the rule[54] as well as how frequently a CCP should be required to measure its credit exposures[55] and whether such measurements should be required to include the customers of participants.[56]

Proposed Rule 17Ad-22(b)(2) would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models[57] to set margin requirements and review them at least monthly. One commenter argued that CCPs should be required to make their margin-setting methodology available to customers to help them understand the responsibilities that are commensurate with CCP participation.[58] Another commenter suggested clearing agencies should have discretion when complying with the rule to decide which aspects of a margin methodology are appropriate for monthly review.[59] Still other commenters concentrated on the extent to which the Commission should prescribe the parameters of a CCP's margin model, such as the confidence level, amount of data used to

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53 See ISDA Letter at 7; Better Markets Letter at 3-4.

54 See The OCC Letter at 7; Better Markets Letter at 3-4.

55 See LCH Letter at 2; Better Markets Letter at 5.

56 See LCH Letter at 2.

57 The term "risk-based models" is meant to encompass any models, systems and associated parameters used by clearing agencies to mitigate risks.

58 See MFA (Kaswell) Letter at 2.

59 See The OCC Letter at 7.

inform the standard of "normal market conditions," and the use of factors such as liquidity and concentration.[60]

With respect to proposed Rule 17Ad-22(b)(3), commenters asked the Commission to give further consideration to whether it is appropriate to create different financial resources standards for a security-based swap CCP. As proposed, the rule would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions, provided that a security-based swap clearing agency would be required to maintain sufficient financial resources to withstand, at a minimum, a default by the two participants to which it has the largest exposures in extreme but plausible market conditions. One commenter argued that characteristics of the instruments traded in the security-based swap market support differentiating the requirements of the rule[61] while other commenters advanced reasons for why it may be appropriate for the rule to employ only a single standard.[62] Commenters also highlighted that it is important for the Commission to account for the international standards in this area[63] and they expressed contrasting views about how standardized and prescriptive the Commission should be in specifying the meaning of "extreme but plausible market conditions."[64]

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60 See, e.g., ISDA Letter at 7; Better Markets Letter at 3-4; The OCC Letter at 7.

61 See Better Markets Letter at 5.

62 See LCH Letter at 2; The OCC Letter at 8; The DTCC (April) Letter at 12.

63 See The OCC Letter at 9; LCH Letter at 2-3.

64 See Better Markets Letter at 5-6; The DTCC (April) Letter at 10; The OCC Letter at 10.

Similarly, some commenters asked the Commission to reconsider how prescriptive it should be in its approach to the requirements of Rule 17Ad-22(b)(4).[65] The proposed rule would require a CCP to establish, implement, maintain and enforce policies and procedures reasonably designed to provide for an annual model validation consisting of the evaluation of the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs those functions. In this area, commenters expressed contrasting views about the appropriate level of detail that should be embedded within the rule to guide clearing agency practices. The comments addressed matters including how frequently a model validation should be performed[66] and, when a model validation is performed, how a CCP should be required to ensure that the process represents a candid, independent and objective assessment.[67]

A more complete discussion of these comments and others that pertain to Rules 17Ad-22(b)(1)–(4) is contained in Section III.C below.

b. Commission Response

The Commission acknowledges the many thoughtful comments we received regarding the risk management standards and practices reflected in the Proposing Release and agrees that

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65 See, e.g., The DTCC (April) Letter at 13; The OCC Letter at 11; Better Markets Letter at 6.

66 See The DTCC (April) Letter at 13; Better Markets Letter at 6.

67 See The DTCC (April) Letter at 13-15; The OCC Letter at 11; Better Markets Letter at 6.

the topic deserves particular care and attention.[68] We also agree with the commenters who pointed out that:

- Many of the risk management standards and practices underlying proposed Rule 17Ad-22 require relatively significant judgments to be made and at times there are no established or definitive sources of guidance to aid decision-making. Therefore, for a CCP's risk management practices to be most effective, the CCP must have some degree of flexibility to tailor the practices appropriately to meet the demands of the specific financial markets it serves, and the Commission's interpretation of Rule 17Ad-22 should not be rigidly applied as uniform standards without variation.[69]
- The specific risk management practices most appropriate for any individual CCP and for registered clearing agencies generally are unlikely to remain static.[70] Rather, risk management practices can be expected to evolve to keep pace with changes in technology, market practices and financial professionals' understanding of the characteristics of the markets.[71]

For example, the Commission recognizes that a less prescriptive approach can help promote efficient practices and encourage regulated entities to consider how to manage their regulatory obligations and risk management practices in a way that complies with Commission

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68 See discussion supra Section II.B.

69 See infra notes 82-84 and accompanying text.

70 See infra note 79 and accompanying text.

71 See The DTCC (April) Letter at 6 ("As markets continue to globalize and standards continue to evolve, the Commission should consider additional modifications to its rules, as necessary and appropriate, to meet the important objective that the Commission's rules remain in alignment with global standards.").

rules while accounting for the particular characteristics of their business and believes the approach reflected in proposed Rule 17Ad-22 is consistent with this perspective.

The Commission believes that one outgrowth of this less prescriptive approach is that there may be additional questions from the clearing agencies regarding how various regulatory requirements apply with regard to clearance and settlement services for particular instruments or products having different market characteristics. Commenters were particularly concerned with the application of Rules 17Ad-22(b)(1)–(4) and with particular risk management standards, including, but not limited to, the proper amount of financial resources, measurement and management of credit exposures, back testing, model validation, use of concentration, liquidity and other factors to determine margin requirements, and the appropriate meaning of "extreme but plausible market conditions."

We note that the Commission or its staff may from time to time issue additional guidance to the extent necessary to address questions arising from the dynamic nature of clearing agency risk management practices, changing market practices, and technological advances.

To date, the Exchange Act and the related regulations promulgated by the Commission have not established particularized requirements regarding clearing agencies' risk management practices.[72] Nevertheless, CCPs registered as clearing agencies generally adopt margin requirements designed to cover potential losses under normal market conditions to help ensure the financial safety of the enterprise, protect the interests of clearing members, and meet or exceed standards of risk management best practices recognized in the financial services industry

72 See generally Section 17A of the Exchange Act (15 U.S.C. 78q-1) and Standards for Clearing Agency Regulation (Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980)).

generally.[73] Additional charges, including, but not limited to, those contained in separately constituted default or guaranty funds are also used to cover losses beyond that (i.e., tail events associated with extreme but plausible market conditions).[74]

To meet this standard, the current practice of registered CCPs is to calculate daily margin requirements using risk-based models to ensure coverage at a 99% confidence interval over a designated time horizon.[75] Given the history of usage of this standard in CCP practices and international standards,[76] the Commission believes it is appropriate to codify this commonly accepted practice as the minimum benchmark for measuring credit exposures and setting margin requirements. However, the Commission also recognizes that this minimum standard may not be sufficient for all CCPs and believes the rules allow flexibility for CCPs to adopt more conservative approaches when appropriate given the nature of the financial product being cleared, the preferences of their members, or other factors consistent with the general responsibilities of clearing agencies under the Exchange Act to perfect the national clearance and settlement system.

Furthermore, the Commission notes that a CCP can develop rules and procedures that are tailored to its practices and operations in order to meet the demands of the specific financial markets it serves. When a CCP proposes to make rule changes, rule changes are required to be submitted to the Commission under Section 19(b) of the Exchange Act and are subject to review,

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73 See, e.g., NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf.

74 See CME Group letter to CPSS-IOSCO regarding the Consultation Report: Principles for Financial Market Infrastructures (July 28, 2011), available at http://www.bis.org/publ/cpss94/cacomments/cmegroup.pdf.

75 See infra Section V.B.2 (discussion on current industry baselines).

76 See infra note 571 and accompanying text.

public comment and approval, as applicable. In addition to the SRO rule filing process, the Commission works closely with each clearing agency it oversees from the point of its application for registration with the Commission and thereafter through examinations and periodic monitoring of the clearing agency's risk management framework and operations.[77]

3. Coordinated U.S. Domestic and International Standards

a. Comments Received

Three commenters strongly encouraged the Commission and the CFTC to coordinate and cooperate in the development of their parallel regulation of clearing agencies and derivatives clearing organizations ("DCOs") to build a harmonized U.S. framework for OTC derivatives and to bring appropriate consistency to the two agencies' regulation of similar products, practices and markets.[78]

One commenter stressed that rules applicable to clearance and settlement of single name credit default swaps should be comparable to the final requirements applicable to clearance and settlement of index-based credit default swaps because clearinghouses will undoubtedly service both and therefore different sets of compliance standards could lead to unnecessary operational inefficiencies and may have the unintended consequence of tilting the market in favor of one class of instruments.[79]

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77 See Risk Management Supervision of Designated Clearing Entities (July 2011), Report by the Commission, Board and CFTC to the Senate Committees on Banking, Housing, and Urban Affairs and Agriculture in fulfillment of Section 813 of Title VIII of the Dodd-Frank Act, at 25.

78 See ICE Letter at 2; MFA (Kaswell) Letter at 8-9; CME Letter at 4.

79 See CME Letter at 4.

Three commenters urged the Commission to incorporate specific requirements for processing, clearing and transfer of customer positions.[80] Two of the commenters urged the Commission to adopt specific rules in these areas that are similar to what the CFTC has proposed for DCOs—specifically with respect to proposed Rule 39.12(b)(7).[81]

Three commenters expressed a preference for principles-based rather than prescriptive rules.[82] One commenter expressed its belief that the CFTC's proposals for DCOs are overly prescriptive and should be eschewed in favor of case-by-case review of a clearing organizations' proposed rule changes.[83] The commenter added that less prescriptive rules will be easier to reconcile between the two regulatory agencies.[84]

One commenter strongly encouraged the Commission to avoid final action on its proposed rules before it has clarity on what clearinghouse regulations are ultimately adopted by European and United Kingdom regulators and what approaches to regulation are embraced by the final FMI Report.[85] The commenter argued that this approach would allow the Commission

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80 See MFA (Kaswell) Letter at 8-9; SDMA (June) Letter at 19; Barnard Letter at 2.

81 See MFA (Kaswell) Letter at 8-9; SDMA (June) Letter at 19 (citing proposed rule 39.12(b)(7) from the CFTC's Requirements for Processing, Clearing and Transfer of Customer Positions, 76 FR 13101 (Mar. 10, 2011) which would require "each derivatives clearing organization to coordinate with each swap execution facility and designated contract market that lists for trading a product that is cleared by the derivatives clearing organization, in developing rules and procedures to facilitate prompt and efficient processing of all contracts, agreements, and transactions submitted to the derivatives clearing organization for clearing."). The CFTC reserved this rule section in its DCO Release but has not yet adopted the proposed rule as a final requirement.

82 See CME Letter at 3; The DTCC (April) Letter at 6; The OCC Letter at 2.

83 See The OCC Letter at 2.

84 See id.

85 See The OCC Letter at 3.

to adopt rules that would not unknowingly force market activity into other jurisdictions by virtue of associated regulatory costs.[86]

b. Commission Response

We recognize that both domestic and foreign regulators may be undertaking similar regulatory initiatives with respect to risk management and operation of clearing agencies. We believe that adopting Rule 17Ad-22 now, largely in the form proposed, and the phased implementation schedule set forth above[87] will ensure that the Commission's rulemaking for clearing agencies will be coordinated with equivalent processes being undertaken by the CFTC and the Federal Reserve in the United States and foreign regulators. As discussed above, the CPSS-IOSCO Recommendations served as the benchmark for the operations of the CCPs and CSDs around the world since the publication of the RSSS in 2001 and the RCCP in 2004, respectively. In addition, the CFTC and Federal Reserve have also considered the CPSS-IOSCO Recommendations in their rulemaking efforts with respect to the clearance and settlement process. Consequently, the final rules that the CFTC recently adopted to govern the activities of a DCO[88] and the rules proposed by the Federal Reserve for certain CCPs and CSDs[89] each borrow from the principles in the CPSS-IOSCO Recommendations and reflect requirements that we believe are consistent with the minimum requirements for registered clearing agencies that the Commission is adopting in Rule 17Ad-22. Because Rule 17Ad-22 will generally codify existing practices that similarly reflect the CPSS-IOSCO Recommendations, the Commission does not believe it will conflict with regulatory requirements that are being implemented by other

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86 See id.

87 See supra Section II.B.

88 See Derivatives Clearing Organization General Provisions and Core Principles, supra note38.

89 See Financial Market Utilities, supra note 25.

regulators or in other jurisdictions.

4. Appropriate Distinctions between Clearing Agencies

a. Comments Received

In the Proposing Release, the Commission identified certain services in the area of post-trade securities processing that may be captured by the definition of a clearing agency in the Exchange Act. Two commenters generally supported the distinctions the Commission proposed for rules that should apply to all types of clearing agencies versus those that should apply only to CCPs.[90] Several commenters argued that entities that perform certain post-trade processing services (i.e., comparison of trade data, collateral management and tear-up/compression) are not performing services that fall within the definition of a clearing agency under the Exchange Act and consequently entities that perform these services should not be required to register as a clearing agency or comply with Rule 17Ad-22.[91]

b. Commission Response

We are not persuaded by commenters who suggested that post-trade processing services should be automatically excluded from the definition of a clearing agency in the Exchange Act.[92] We believe that view is inconsistent with the plain meaning of the clearing agency definition because the definition of clearing agency in Section 3(a)(23)(A) of the Exchange Act covers any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities and provides facilities for the comparison of data regarding the terms of settlement of securities transactions, to reduce the number of settlements of securities

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90 See TriOptima Letter at 5; ICE Letter at 2.

91 See generally TriOptima Letter; Markit (April) Letter; Markit (July) Letter; MarkitSERV (April) Letter; MarkitSERV (July) Letter; Omgeo Letter.

92 See supra note 91 and accompanying text.

transactions, or for the allocation of securities settlement responsibilities.[93] That view also is inconsistent with prior interpretive guidance from the Commission addressing the broader spectrum of activities that are associated with that term.[94] The determination of whether particular activities meet the definition of a clearing agency depends on the totality of the facts and circumstances involved.[95]

On July 1, 2011, the Commission published a conditional, temporary exemption from clearing agency registration for entities that perform certain post-trade processing services for security-based swap transactions.[96] The order facilitated the Commission's identification of entities that operate in that area and that accordingly may fall within the clearing agency definition. Several entities complied with the conditions of that order and remain exempt from

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93 See supra note 36.

94 See Confirmation and Affirmation of Securities Trades; Matching, Exchange Act Release No. 34-39829 (Apr. 6, 1998), 63 FR 17943 (Apr. 13, 1998) (noting that "[t]he Commission is of the view that matching constitutes a clearing agency function within the meaning of the clearing agency definition under Section 3(a)(23) of the Exchange Act. Specifically, matching constitutes 'comparison of data respecting the terms of settlement of securities transactions.'").

95 See, e.g., supra note 1, at 91 (the Senate Committee on Banking, Housing and Urban affairs acknowledging that through the intended breadth of the clearing agency definition the Commission even retains authority "to negate, by rule, exclusions in this category in order to assure the prompt and accurate clearance and settlement of securities transactions or to prevent evasions of the Exchange Act").

96 See, e.g., Exchange Act Release No. 34-64796 (July 1, 2011), 76 FR 39963 (July 7, 2011) (providing an exemption from registration under Section 17A(b) of the Exchange Act, and stating that "[t]he Commission is using its authority under section 36 of the Exchange Act to provide a conditional temporary exemption [from clearing agency registration], until the compliance date for the final rules relating to registration of clearing agencies that clear security-based swaps pursuant to sections 71A(i) and (j) of the Exchange Act, from the registration requirement in Section 17A(b)(1) of the Exchange Act to any clearing agency that may be required to register with the Commission solely as a result of providing Collateral Management Services, Trade Matching Services, Tear Up and Compression Services, and/or substantially similar services for security-based swaps").

clearing agency registration under its terms.[97] By allowing potential clearing agency registrants to elect temporary, conditional exemption from registration, the order has given the Commission more time to consider whether these entities meet the clearing agency definition and, if registration is required, to consider what form of regulation may be most appropriate for those services.

The Commission preliminarily agrees with commenters that it is appropriate to consider a tailored framework of regulation for clearing agencies that perform certain post-trade processing services because such activities do not involve the same credit, market and operational risk concerns that are presented by clearing agencies that perform CCP or CSD services.[98] Accordingly, the Commission intends to separately address clearing agencies that perform only post-trade processing services. The Commission has previously distinguished entities that provide certain post-trade services and fall within the definition of clearing agency from those

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97 The Commission notes further that its adoption of Rule 17Ad-22 does not have any effect on the Commission's order granting a conditional temporary exemption from clearing agency registration for entities that perform certain post-trade processing services for security-based swap transactions. See supra note 96 and accompanying text. The temporary exemption is conditioned on these entities providing the Commission with identifying information and a detailed description of the types of services they provide. Section 17A(g) of the Exchange Act contains a registration requirement for security-based swaps clearing agencies. Section 17A(j) of the Exchange Act requires the Commission to adopt rules governing persons that are registered as clearing agencies for security-based swaps under the Exchange Act, and Section 17A(i) requires security-based swaps clearing agencies to comply with such standards as the Commission may establish by rule as a condition to being registered or maintaining registration. As the Commission previously indicated with respect to the effective date for Section 17A(g), if a Title VII provision requires a rulemaking, such provision will not go into effect "not less than" 60 days after publication of the final related rule. 76 FR 36287, 36302 (June 22, 2011). The Commission has not adopted any rules applicable to clearing agencies that perform services; therefore, the registration requirement of Section 17A(g) will not be applicable to such clearing agencies until the date when rules with respect to such clearing agencies are adopted pursuant to Section 17A(i).

98 See supra notes 90-91 and accompanying text.

entities that provide services more commonly associated with the functions of a clearing agency (e.g., CCP and CSD services).[99] As part of its future rulemaking regarding these types of clearing agencies, the Commission may consider whether to apply the future rules to clearing agencies engaged in activities that were separately identified by Congress as PCS Activities in the Clearing Supervision Act. In particular, the Clearing Supervision Act identifies the following as PCS Activities:

(1) calculation and communication of unsettled financial transactions between counterparties;

(2) netting of transactions;

(3) provision and maintenance of trade, contract, or instrument information;

(4) management of risks and activities associated with continuing financial transactions;

(5) transmittal and storage of payment instructions;

(6) movement of funds;

(7) final settlement of financial transactions; and

(8) other similar functions that the Council may determine.[100]

Accordingly, at this time, the Commission does not intend for Rule 17Ad-22 to apply to clearing agencies that perform post-trade processing services. The scope of Rule 17Ad-22 will be limited to clearing agencies that are registered with the Commission and the rule will not apply to any clearing agencies operating pursuant to an exemption from registration as a clearing agency granted by the Commission, unless the terms of future exemptions specifically

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99 See, e.g., Exchange Act Order No. 34-44188 (Apr. 17, 2001) (providing an exemption from registration as a clearing agency to a subsidiary of Omgeo conducting electronic trade confirmation and matching services).

100 12 U.S.C. 5462(7).

contemplate its application, in whole or in part. The Commission has clarified this as part of the final Rule 17Ad-22 adopted today by adding the word "registered" before the term "clearing agency" appearing in the first instance in paragraphs (b), (c)(1), (c)(2), and (d). For this reason, references to the term "clearing agency" in this release are generally intended to capture only registered clearing agencies, unless the context suggests otherwise. The Commission may consider at a later time whether rules tailored to clearing agencies that provide post-trade processing services would be appropriate.

III. Description of Rule 17Ad-22

A. Overview and Scope

The Commission is adopting Rule 17Ad-22 with minor modifications from the proposal to implement the statutory provisions for clearing agencies under the Exchange Act. Rule 17Ad-22 requires registered clearing agencies to establish, implement, maintain and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis. These minimum requirements will work in tandem with the requirements in Section 17A that the Commission must make certain determinations regarding a clearing agency's rules.

The Commission anticipates that the clearing agency's rules and procedures will likely continue to evolve so that the clearing agency can adequately respond to changes in technology, legal requirements, trading volume, trading practices, linkages between financial markets and the financial instruments traded in the markets that a clearing agency serves. Accordingly, registered clearing agencies must evaluate continually and make appropriate updates and improvements to their operations and risk management practices to facilitate the prompt and accurate clearance and settlement of securities transactions and to safeguard securities and funds in their custody or control.

Rule 17Ad-22 consists of the following parts: (1) Rule 17Ad-22(a) provides definitions for certain terms; (2) Rule 17Ad-22(b) contains risk management and participation requirements for registered CCPs; (3) Rule 17Ad-22(c) establishes a reporting requirement for registered clearing agencies with respect to certain matters including financial resources and methodologies used to calculate financial requirements; and (4) Rule 17Ad-22(d) requires registered clearing agencies, as applicable, to meet certain minimum standards.

As noted above, at this time, the Commission intends for Rule 17Ad-22 to apply only to registered clearing agencies. The Commission may consider at a later time whether any additional rules tailored to clearing agencies that perform post-trade processing services would be appropriate. In addition, Rule 17Ad-22 will not apply to any clearing agencies operating pursuant to an exemption from registration as a clearing agency granted by the Commission unless the terms of future exemptions specifically contemplate its application, in whole or in part.

B. Definitions – Rule 17Ad-22(a)

1. Proposed Rule

Proposed Rule 17Ad-22(a) contains five definitions. Proposed Rule 17Ad-22(a)(1) would define "central counterparty" as a clearing agency that interposes itself between counterparties to securities transactions to act functionally as the buyer to every seller and as the seller to every buyer. Proposed Rule 17Ad-22(a)(2) would define "central securities depository services" to mean services of a clearing agency that is a securities depository as described in

Section 3(a)(23) of the Exchange Act.[101] Proposed Rule 17Ad-22(a)(3) would define "participant," for the limited purposes of Rules 17Ad-22(b)(3) and 17Ad-22(d)(14), to mean that if a participant controls another participant, or is under common control with another participant, then the affiliated participants shall be collectively deemed to be a single participant. Proposed Rule 17Ad-22(a)(4) would define "normal market conditions," for the limited purposes of Rules 17Ad-22(b)(1) and (2), to mean conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.[102] Proposed Rule 17Ad-22(a)(5) would define "net capital," for the limited purpose of Rule 17Ad-22(b)(7), to have the same meaning as set forth in Rule 15c3-1 under the Exchange Act for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.[103]

2. Comments Received

Commenters generally supported proposed Rule 17Ad-22(a)(3) because it would require a clearing agency to take account of an entire group of affiliated entities when complying with the financial resources requirements of proposed Rule 17Ad-22(b)(3), as well as the requirements in proposed Rule 17Ad-22(d)(14) for risk controls to address participants' failures to settle.[104] However, one commenter recommended that the rule employ the phrase "participant family" because "participant" on its own may be easily confused with other uses of that term in

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101 See supra note 36 and accompanying text.

102 The definition of normal market conditions in Rule 17Ad-22(a)(4) is consistent with the corresponding explanation established in the CPSS-IOSCO Recommendations. See RCCP, supra note 33, at 21 (explanatory note number 1).

103 As appropriate, the clearing agency may develop risk-adjusted capital calculations for prospective clearing members that are not broker-dealers.

104 See The DTCC (April) Letter at 9-10.

the Exchange Act and in the rules and regulations thereunder.[105] Accordingly, the commenter suggested that "participant family" should be defined to mean each participant that controls, is controlled by or is under common control with another participant.[106] The commenter recommended that the standard of control for this purpose should be defined as the disclosed ownership of 50% or more of the voting securities or other interests in a participant and that it should be based on information available to the clearing agency.[107]

One commenter expressed concern about the definition of "normal market conditions" as conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.[108] The commenter argued that it would be unusual to define normal market conditions this way (i.e., using margin requirements as a standard of measure) because margin models are designed to adjust during periods of market turbulence.[109]

The Commission received no comments on proposed Rules 17Ad-22(a)(1), (2) and (5).

3. Final Rule

As described more fully below, the Commission is adopting Rules 17Ad-22(a)(1), (2), (4) and (5) as proposed. We are also adopting Rule 17Ad-22(a)(3) with certain modifications to address concerns of commenters.

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105 See id.

106 See The DTCC (April) Letter at 10.

107 See id.

108 See The OCC Letter at 7.

109 See id.

We agree with commenters who suggested that in the interest of clarity and to avoid confusion with use of the term "participant" elsewhere in Exchange Act regulations, Rule 17Ad-22(a)(3) should be modified so that the term defined by the rule is "participant family" instead of "participant." We are also modifying Rule 17Ad-22(a)(3) with respect to the language that describes the test for determining when a sufficient relationship of control exists between participants to qualify them as a "participant family." The definition has been expanded to include entities controlled by a participant and to cover direct and indirect relationships. Accordingly, Rule 17Ad-22(a)(3) now provides that participants will be deemed to be a "participant family" for purposes of Rules 17Ad-22(b)(3) and 17Ad-22(d)(14) when "a participant directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, another participant." This modification is intended to respond to the recommendation of commenters and more closely conform the text of Rule 17Ad-22(a)(3) to the language in which this standard appears in other contexts within the U.S. federal securities laws.[110] At the same time, we are not narrowing the definition of control in this context to mean ownership of 50% or more of the voting securities or other interests in a participant.[111] We believe the more appropriate evaluation of control is based on the relationship between the entities and the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. In conducting this evaluation, clearing agencies should also be guided by the definition of "control" set forth in Rule 405 under the Securities Act of 1933, using the information available to them.

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110 See, e.g., 17 CFR 230.405 (using "controls or is controlled by, or is under common control with" in the definition of affiliate found in Rule 405 under the Securities Act of 1933).

111 See supra note 107 and accompanying text.

The Commission agrees with the commenter that well-designed margin models include factors that adjust to periods of market turbulence. The Commission, however, is not persuaded by the argument that the definition of normal market conditions in Rule 17Ad-22(a)(4) is at odds with the concept of certain periods of market turbulence.[112] The rule defines "normal market conditions" as those that prevail 99 trading days out of 100. Margin models and other risk control mechanisms designed to adjust during periods of market turbulence are consistent with the definitional standard to the extent they help to reduce the number of trading days during which a clearing agency's exposure to participants are not fully covered by such measures.

The definition of "normal market conditions" in Rule 17Ad-22(a)(4) is also modeled on relevant and analogous international standards. The RCCP stipulates that a CCP should limit its exposures to potential losses from defaults by its participants in normal market conditions and defines "normal market conditions" as price movements that produce changes in exposures that are expected to breach margin requirements or other risk controls only 1% of the time.[113] The standard also comports with the international standard for bank capital requirements established by the Bank for International Settlements, which requires banks to measure market risks at a 99% confidence interval when determining regulatory capital requirements.[114]

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112 The Commission notes that the definition of normal market conditions found in Rule 17Ad-22(a) is modeled on the current international standard for determining normal market conditions in the CPSS-IOSCO Recommendations.

113 See Bank for International Settlements' Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, Recommendations for Central Counterparties (Nov. 2004), at 18-21, available at http://www.bis.org/publ/cpss64.pdf.

114 See infra Section V.B.2 (discussion on current industry practices).

C. Risk Management Requirements for Central Counterparties: Rules 17Ad-22(b)(1)–(4)

Rules 17Ad-22(b)(1)–(4) contain several requirements that address risk management practices by registered CCPs. Specifically, the proposed rules would create standards with respect to: (1) measurement and management of credit exposures; (2) margin requirements; (3) financial resources; and (4) annual evaluations of the performance of the clearing agency's margin models.

During the comment period, commenters pointed out that to properly frame these requirements requires a great deal of technical expertise and that a failure to properly allow that expertise to influence final rules adopted by the Commission could result in inefficient requirements that lack the proper degree of flexibility to achieve prudent risk management practices without being overly burdensome. In some cases, commenters argued that personnel at the clearing agencies possess the requisite levels of experience and expertise to help the Commission shape CCP risk management standards.[115]

As an initial matter, the Commission believes that Rules 17Ad-22(b)(1)–(4) are appropriate minimum standards for registered CCPs and that they are consistent with existing international standards of practice. However, we agree that the process of evaluating, testing and refining CCP risk management standards will be ongoing and necessarily include an open dialogue among the CCPs, investors, the Commission and various other interested parties. In particular, the Commission will carefully consider further input from interested parties obtained through outreach to various constituencies and in response to any rules or rule amendments that may be proposed by the Commission upon considering the international standards developed by CPSS-IOSCO in the FMI Report.

115 See The DTCC (April) Letter at 18–20; The OCC Letter at 12; LCH Letter at 3–4.

Further, Rules 17Ad-22(b)(1), (2), and (3) establish targets for clearing agencies to meet without prescribing a particular method. Accordingly, the rules provide clearing agencies with the flexibility to establish risk management procedures (e.g., back testing, stress testing, model validation procedures and the composition of financial resources) that are appropriately tailored to current market conditions and can be revised over time to address changes in market conditions. Given the existing use and general understanding by U.S. CCPs and CCPs and regulatory authorities around the world of the RCCP and the principles that form the basis of Rules 17Ad-22(b)(1), (2) and (3), the Commission is adopting these rules largely as proposed.

1. Rule 17Ad-22(b)(1): Measurement and Management of Credit Exposures

a. Proposed Rule

Proposed Rule 17Ad-22(b)(1), as proposed, would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to measure its credit exposures to its participants at least once each day, and limit its exposures to potential losses from defaults by its participants under normal market conditions[116] so that the operations of the CCP will not be disrupted and non-defaulting participants will not be exposed to losses that they cannot anticipate or control.

b. Comments Received

Three commenters urged the Commission to consider adopting a more prescriptive version of the rule.[117] Of this group, one suggested that the rule should permit a CCP to use correlated positions to reduce initial margin requirements only if the CCP can demonstrate a robust correlation between those positions under stressed market conditions and the CCP

116 See supra note 102 and accompanying text.

117 See ISDA Letter at 7; LCH Letter at 2; Better Markets Letter at 5.

publicly discloses its methodology periodically for determining the correlation and the CCP's resulting margin requirements.[118] Another commenter suggested that a CCP should be required to measure credit exposures several times each business day and to recalculate initial and variation margin for each clearing member and the clearing member's clients more than once each day.[119] The third commenter stated that Rule 17Ad-22(b)(1) should also require the CCP to perform intraday calculations of credit risk exposure when circumstances warrant, including situations where the security-based swap is illiquid, difficult to price, or highly volatile.[120]

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(b)(1) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We agree with commenters that the risks CCPs face are subject to change over time due to the potential for significant changes in the risk profiles of participants and if those risks are not appropriately measured and managed by the CCP, they can result in the accrual of significant liabilities.[121] The Commission believes that measuring credit exposures once each day is the minimum frequency of measurement that will permit a clearing agency to consider effectively the credit exposures it faces.

The Commission agrees with commenters that clearing agencies may need to measure credit exposures more frequently than once each day in order to ensure that the CCP can facilitate the prompt and accurate clearance and settlement of securities transactions and ensure that they operate safely and efficiently. That point of view is reflected in the rule requirement

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118 See ISDA Letter at 7.

119 See LCH Letter at 2.

120 See Better Markets Letter at 5.

121 See supra notes 119-120 (citing the Better Markets Letter and LCH Letter).

that the measurement must be performed at least once each day. However, the Commission believes that a less prescriptive and more flexible rule sets a more appropriate baseline standard. Each CCP is exposed to participants in different markets characterized by different trading patterns, volumes, liquidity, transparency and other unique market characteristics. Rather than prescribing a specific frequency for risk exposure measurements (other than the once daily minimum), the Commission believes that CCPs should monitor exposure and margin coverage on an intraday basis depending on the individual risk characteristics of their members and businesses, and adjust their risk management processes as needed. This stance is also consistent with our understanding that the practice at many CCPs is to measure credit exposures more than once daily.[122]

While the Commission also agrees with commenters who expressed the view that a CCP should provide reductions in initial margin requirements based on offsetting or inversely correlated positions only if the CCP can demonstrate a robust correlation between those positions—including under stressed market conditions,[123] the rule is being adopted as proposed. The Commission believes that the determination of whether positions are sufficiently correlated to warrant offsets or whether reductions should be provided at all, is a matter that should be determined by the CCP as it implements its risk management procedures, and submitted to the Commission for review and public comment, as part of the Section 19b-4 rule filing process. The Commission believes that the rule should allow each CCP the flexibility to set margin requirements based on the unique products and markets that it serves. Margin requirements will vary based on a number of factors, including, but not limited to, the type, volume, and volatility of the instruments cleared. It is difficult to make determinations at the rule level regarding the

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122 See id.

123 See supra note 118 and accompanying text.

suitability of margin reductions based on adequate position correlations; therefore, the Commission believes it is more appropriate to conduct such methodological evaluations during the supervisory process.

As adopted, Rule 17Ad-22(b)(1) does not require that a registered CCP publicly disclose its correlation methodology and related margin requirements.[124] Correlation methodology is generally considered confidential by clearing agencies because it is a critical element in determining their margin requirements. While CCPs generally provide this type of information to their participants, it typically is not made public. In this connection, we are adopting Rule 17Ad-22(d)(9), discussed below, which requires each registered CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide market participants with sufficient information to enable them to identify and evaluate the risks and costs associated with using its services. Rule 17Ad-22(d)(9) is intended in part to promote appropriate levels of transparency concerning a CCP's margin practices while allowing registered clearing agencies to tailor disclosure in a way that preserves incentives for business model innovations and responsible competition among clearing agencies.

We are also adopting Rule 17Ad-22(b)(1), as it was proposed, to require registered CCPs to establish, implement, maintain, and enforce written policies and procedures reasonably designed to limit their exposures to potential losses from participant defaults. By collecting sufficient margin and having other liquid resources at its disposal, the Commission expects that a clearing agency will be able to limit its exposures to potential losses from defaults by clearing members in normal market conditions.[125]

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124 See The OCC Letter at 17; The DTCC (April) Letter at 7.

125 See supra note 102 and accompanying text.

2. Rule 17Ad-22(b)(2): Margin Requirements

a. Proposed Rule

Proposed Rule 17Ad-22(b)(2) would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to: (i) use margin requirements to limit its credit exposures to participants under normal market conditions;[126] (ii) use risk-based models to set margin requirements; and (iii) review the models at least monthly.

b. Comments Received

One commenter recommended that the rule be amended to require that the CCP's margin requirements must be sufficient to limit credit exposures to both the CCP's participants and the clients of the CCP's participants.[127] Another commenter supported standardization of the way CCPs set margin requirements and stated that the final rule should require those clearing agencies to make their margin-setting methodology available to customers.[128] The commenter argued that this disclosure would enable market participants to reasonably anticipate when additional margin may be required and would consequently promote stable liquidity in the marketplace.[129]

In response to a question asked by the Commission in the Proposing Release, one commenter stated that adopting Rule 17Ad-22(b)(2) as proposed is unlikely to create the risk that

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126 See id.

127 See LCH Letter at 2.

128 See MFA (Kaswell) Letter at 2.

129 See id. (noting that if the Commission requires the creation of these transparent conditions with respect to margin in its final rules, then the commenter would fully support the ability of clearing agencies to have flexibility to modify margin requirements as necessary, including by imposing special margin requirements or requiring intraday posting of margin).

CCPs will lower margin standards to compete for business.[130] The commenter asserted that integrity in risk management is the primary focus of CCPs, and that a CCP would suffer severe reputational harm if it risked using guaranty fund resources to cover margin deficiencies of clearing members.[131] In addition, according to the commenter, CCPs do not alter margin requirements based on the identity of the individual counterparty.[132]

One commenter contended that certain aspects of a CCP's margin methodology, such as choice of confidence levels (used to estimate expected shortfall), the number of days' data relied on, and the various weights used to determine stress test charges do not need to be reviewed on a monthly basis.[133] If the final rule does require a monthly review, the commenter suggested that the Commission should make clear that CCPs have substantial discretion to determine which aspects of the model are appropriate for the monthly review.[134] In contrast, another commenter asked the Commission to consider a more prescriptive approach to the rule. It suggested that Rule 17Ad-22(b)(2) should be modified to require a clearing agency to use two to three years of historical price data when establishing normal market conditions, consider liquidity and the amount of time necessary to replace a position once a default occurs, and make a showing of significant and reliable correlation of price risks before it is allowed to net initial margin using long and short positions.[135]

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130 See id.

131 See id.

132 See MFA (Kaswell) Letter at 2-3.

133 See The OCC Letter at 7.

134 See id.

135 See Better Markets Letter at 3–4.

One commenter focused more narrowly on the appropriate confidence level that should be applied to initial margin collected by a clearing agency.[136] The commenter argued that setting the appropriate confidence level is directly tied to the degree of mutualization performed by a clearing agency (i.e., the lesser the degree of mutualization the higher the appropriate confidence level because the amount of funds available to manage a default will be reduced).[137]

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(2) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. This requirement recognizes that the collection of assets (e.g., cash or securities) from participants provides the clearing agency with assets to limit its exposure to a participant in the event of a participant default. By limiting its credit exposure in this manner, a CCP is less likely to be subject to disruptions in its operations as a result of a participant default, thereby facilitating the prompt and accurate clearance and settlement of securities transactions.

The Commission does not believe it is necessary to amend the rule to state that a registered CCP's margin requirements must limit credit exposures to customers of participants as well as participants.[138] Margin requirements applicable to a customer's securities positions are established in accordance with regulations specifically governing customer margin practices[139] and in some cases through additional margin requirements imposed by the participant to address

136 See ISDA Letter at 7.

137 See id. (stating, for example, that if the clearing agency performs mutualization in its default fund and for clients in omnibus client accounts then a 99% confidence level is completely appropriate. By contrast, if the clearing agency imposes a requirement for individualized client accounts instead of an omnibus account, then the commenter believes that a confidence level greater than 99% is likely appropriate).

138 See supra note 127 and accompanying text.

139 See, e.g., 17 CFR 240.15c3-3 (Customer protection—reserves and custody of securities and Regulation T, 12 CFR 220).

its credit risk to the customer. As a result, even when a participant is transacting on the behalf of a customer, the CCP enters into a transaction only with the participant, and therefore it is the participant's creditworthiness that the clearing agency's margin requirements must adequately address.

The Commission is aware that some CCPs may already have the ability to measure credit exposures to customers of participants as well as to participants. To the extent that such margin practices are already in place or develop over time to help ensure prompt and accurate clearance and settlement in the market the clearing agency serves, we believe those practices can be effective in limiting aggregate credit exposures of clearing agencies. We agree that the ability to limit credit exposures to customers of participants using margin may help inform and shape appropriate credit risk management practices in certain cases – for example, where (i) direct access to a clearing agency by some participants may be relatively more constrained by the operational or financial demands commensurate with participation; (ii) open interest periods associated with the instruments cleared by the clearing agency are relatively significant; or (iii) customer margin requirements are established independently from the CCP (e.g., pursuant to regulation or by agreement with a participant). However, we believe that, at this time, individual CCPs should develop rules and procedures to address these specific circumstances consistent with their general responsibilities as clearing agencies under the Exchange Act and that rules of this kind would be subject to the rule filing procedures of Section 19b-4.

The Commission is not amending Rule 17Ad-22(b)(2) to specify which aspects or components of the CCP's risk-based models must be reviewed in the context of the CCP's monthly review.[140] The Commission recognizes that some assumptions that underlie model

140 See supra note 134 and accompanying text.

parameters may be widely accepted by current convention, and those components therefore may be less likely to become outdated from month to month. On the other hand, the Commission notes that market conditions and risks are constantly changing and CCPs will need to exercise discretion in how they administer their review of those components.

The Commission notes that, to the extent a CCP believes that an assumption in a model or parameter does not lend itself to empirical testing, a review of that assumption can in some cases be accomplished by the CCP performing a theoretical assessment of that assumption compared to alternative assumptions. For example, a CCP may evaluate the appropriateness of the number of days of market data used in its margin model or the expected amount of time needed to liquidate a security in an event of default by comparing the performance of the margin model when a range of representative values is input.

Also consistent with the intent of preserving appropriate flexibility for clearing agencies to tailor their methods of achieving compliance, the Commission is not prescribing a particular confidence level for initial margin in Rule 17Ad-22(b)(2).[141] Rather, subject to Commission oversight, Rule 17Ad-22(b)(2) allows a confidence level determination to be made by the clearing agency as part of the development of its margin parameters and risk-based models. In arriving at an appropriate confidence level, we agree with commenters that the extent of mutualization of financial resources performed by a CCP in its risk management practices and the particular use of individualized client accounts or an omnibus account structure are appropriate factors to consider.[142] The Commission also chose not to stipulate specific requirements pertaining to the scope of historical price data, liquidity and replacement considerations, and the correlation of price risks used in calculating margin requirements, again

141 See supra note 136 and accompanying text.

142 See supra note 137 and accompanying text.

opting for a more flexible standard. While a clearing agency may take such factors into consideration when determining margin requirements, each registered CCP should be free to develop the best margin methodology to accommodate its unique products and markets. Accordingly, the Commission believes that it should not attempt to prescribe the appropriate margin methodologies for each CCP or financial instrument.[143]

We agree with commenters who asserted that a CCP's disclosure of its margin-setting methodology to customers facilitates prompt and accurate clearance and settlement by enabling market participants to better plan for margin costs associated with the use of the clearing agency.[144] As noted above, registered CCPs must submit their risk management procedures, including margin methodology, to the Commission for review and public comment as a proposed rule change under Rule 19b-4. The Rule 19b-4 process provides for public disclosure, as well as an opportunity for interested parties to comment on the proposed rule change. In addition, the Commission believes that any reasonable process for implementing risk management practices will involve further, more detailed communication with clearing members and their customers regarding the particular expected results of the practices in identified circumstances. Such communication may involve both direct contacts with members and their customers or indirect contacts through general information published by the CCP on its website or in other generally available resources.

3. Rule 17Ad-22(b)(3): Financial Resources

a. Proposed Rule

Proposed Rule 17Ad-22(b)(3) would require a CCP to establish, implement, maintain and

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143 See Section 17A discussion supra Section I.A.2 and accompanying text.

144 See supra note 59.

enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions, provided that a security-based swap clearing agency would be required to maintain sufficient financial resources to withstand, at a minimum, a default by the two participants (also referred to as the "cover two" standard) to which it has the largest exposures in extreme but plausible market conditions.[145]

b. Comments Received

Commenters expressed a wide range of views concerning proposed Rule 17Ad-22(b)(3). Some commenters generally supported the proposed rule.[146] Others expressed concern that the introduction of two different financial resources standards may discourage CCPs from extending their services to security-based swaps or may discourage prospective participants from seeking membership in CCPs for security-based swaps, which would disrupt the goal of the Dodd-Frank Act to promote central clearing.[147] One commenter stated its opinion that no historical or empirical case has been made for changing the way that CCPs currently measure the sufficiency

145 See proposed Rule 17Ad-22(a)(3), supra Section III.B.1 (defining "participant" for purposes of proposed Rule 17Ad-22(b)(3)).

146 See Better Markets Letter at 5 (supporting the rule and stating that it appropriately differentiates between security-based swap and non security-based swap clearing agencies due to unique features of the security-based swap markets, such as jump-to-default risk); see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); BlackRock Letter at 2 (supporting Rules 17Ad-22(b)(1)–(7) because these rules will benefit the markets by reducing concentration risk, increasing the diversity of market participants involved in governance, enhancing competition and lowering costs for customers of clearing members); MFA (Kaswell) Letter at 2 (generally supporting the rules proposed under 17Ad-22(b) because they would establish reasonable, objective, risk-based criteria for fair and open access).

147 See LCH Letter at 2; The OCC Letter at 9.

of their financial resources and that no cost-benefit analysis has been done on the impact of any such change on the operations and economics of CCPs.[148]

A commenter also suggested that CCPs should consider the simultaneous default of multiple clearing members when sizing their financial resources but that a simultaneous default of the two largest clearing members is an extremely implausible occurrence, and accordingly it is not a scenario that should be embedded as a fixed requirement in the Commission's rules.[149] That commenter stated that it is reasonable to assume a default by the two largest participants would take place in conditions of heightened market volatility, which would cause a CCP to collect more financial resources because of the risk-based nature of margin requirements.[150]

One commenter disagreed with assertions in the Proposing Release that the performance of CCP services for security-based swaps entails risks that are unique to those products and that those unique risks support the proposed "cover two" requirement.[151] The commenter also stated that accounting for the jump-to-default risk of certain security-based swap instruments (i.e., credit-default swaps) should be addressed through calculation of financial resource requirements using more extreme market scenarios instead of adjusting the number of participant defaults.[152] The commenter urged the Commission to consider how changes taking place to the infrastructure

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148 See The DTCC (April) Letter at 12.

149 See The OCC Letter at 8.

150 See The OCC Letter at 9.

151 See The OCC Letter at 8 (expressing by way of example that a total return security-based swap on a single underlying security of a company that has a large market capitalization is a lower risk management challenge for a clearing agency that performs CCP services than a put or a call option on the same underlying security. It expressed a belief that the risk is much the same as a security future on the same underlying).

152 See id.

and risk management practices in the securities markets due to the Dodd-Frank Act may render irrelevant certain risks that are associated with security-based swaps today.[153]

Commenters supported the position that the Commission's regulatory standards for CCPs should be modified where appropriate to account for the relevant work of international standard setters such as the CPSS and IOSCO.[154] However, commenters pointed out that a "cover two" standard would be inconsistent with the existing CPSS-IOSCO Recommendations for financial resources.[155] They also urged the Commission not to require any CCP to increase its liquidity resources or otherwise re-engineer its risk management controls unless and until there is industry and regulatory consensus on the changes that should be made.[156] These commenters encouraged the Commission to ensure that its final rulemakings are aligned with the existing CPSS-IOSCO Recommendations to the closest extent possible.[157]

Commenters disagreed over what role the Commission should play in defining the term "extreme but plausible market conditions" as that term appears in proposed Rule 17Ad-22(b)(3).[158] One commenter favored a significant role for the Commission.[159] Other

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153 See id.

154 See The OCC Letter at 9 (citing CPSS-IOSCO Recommendation for Central Counterparties, Recommendation 3).

155 See id.

156 See The DTCC (April) Letter at 12.

157 See LCH Letter at 2–3; The OCC Letter at 9.

158 See Better Markets Letter at 5–6; The DTCC (April) Letter at 10.

159 See Better Markets Letter at 5–6 (stressing that the Commission should provide concrete guidance on the meaning of "extreme but plausible market conditions" to prevent lax or self-serving interpretation of that standard and to promote consistent practices among clearing agencies that will prevent the adoption of lower standards designed to reduce costs and attract business volume at the expense of stability and risk mitigation. The commenter also expressed that the Commission's definition of the standard should focus on unprecedented periods of illiquidity, volatility and interconnectedness that lead to multiple defaults).

commenters agreed that CCPs should be primarily responsible for determining the parameters of the standard because of their unique access to market data and understanding of the range of applicable market conditions.[160] Those commenters stated that Rule 17Ad-22(b)(3) should clarify that a CCP is responsible for determining what constitutes "extreme but plausible market conditions."

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(b)(3) with certain modifications to address concerns raised by commenters, including but not limited to the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies and clarifications relating to the term "participant family" as discussed above.[161] The Commission believes that requiring a registered CCP, other than a security-based swap CCP, to maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions, reduces the likelihood that a default would create losses that disrupt the operations of the CCP and adversely affect the clearing agency's non-defaulting participants.

While the Commission is sensitive to the consequences of establishing a different standard for CCPs that clear security-based swaps, the Commission believes that the financial resources of the entity must be robust enough to accommodate the risks that are particular to each market served – irrespective of whether such analysis results in different standards. The Commission believes that requiring a security-based swap CCP to cover its two largest potential exposures is the appropriate standard due to the nature of these products. Security-based swaps

160 See The DTCC (April) Letter at 10; The OCC Letter at 10.

161 See supra note 146 (supporting the rule as proposed); see also supra section III.B.3 (discussing the term "participant family").

pose unique risk management issues. In particular, credit default swaps, a subset of security-based swaps, are non-linear financial instruments subject to additional risk factors such as jump-to-default risk[162] and asymmetrical risk allocation between short and long counterparties. Unlike other products that also exhibit these characteristics (e.g., Long-Term Equity Anticipation Securities (LEAPS)), credit default swaps are unique in their size relative to their underlying markets. Recent research shows that notional outstandings in credit default swaps are often close to or greater than the outstanding value of the underlying instruments.[163] The traditional procedures for a clearing agency to handle a default may not be effective and may entail

162 Jump-to-default risk refers to the expected change in the value of a CDS contract if a credit event were to occur with respect to a reference entity under the terms of the CDS contract, triggering an obligation for the seller of protection under the contract to make a lump sum payment to the protection buyer. Jump-to-default only refers to the incremental information in the determination that a credit event has occurred because the market already prices the probability of a credit event. In practice, credit events are largely anticipated such that jump-to-default results in small changes in value as opposed to a first order pricing effect. Jump-to-default risk exists for all CDS, not merely those on reference entities perceived as risk credits. While the decline in contract value from a credit event is usually bigger for creditworthy reference entities (because the initial contract value is higher and thus has farther to fall), jump-to-default risk can also be measured for distressed reference entities that are expected to suffer a credit event in the near future. As a hypothetical example, market participants might have measured the jump-to-default risk in "Hypothetical Risky Corporation" five-year CDS when the CDS was trading at 70% upfront (that is, a seller would need to receive an up-front payment of 70% of notional value to write the contract) and the expected value in default was 80% upfront (implying a 20% recovery rate) as being equal to 10% of notional value; equally, they might have measured the jump-to-default risk of "Hypothetical Safe Corporation" five-year CDS when it was trading at 0.30% per annum and no up-front payment (roughly equivalent to an up-front payment of 1.5%) with an expected value in default of 60% upfront (implying a 40% recovery rate) as being equal to approximately 58.5% of notional value. See generally Darrell Duffie and Haoxiang Zhu, Does a Central Clearing Counterparty Reduce Counterparty Risk? (Stanford Univ. 2010), available at http://www.stanford.edu/~duffie/DuffieZhu.pdf.

163 See, e.g., Stavros Peristiani, Vanessa Savino, "Are Credit Default Swaps Associated with Higher Corporate Defaults?", Federal Reserve Bank of New York Staff Report No. 494 (May 2011); Alessandro Fontana and Martin Scheicher, "An analysis of euro area sovereign CDS and their relation with government bonds," European Central Bank Working Paper Series, No. 1271 (Dec. 2010).

significant risk to a CCP clearing security-based swaps.[164] To address this concern, CCPs have implemented procedures that provide for the management and oversight of the liquidation or transfer of the defaulting member's positions by a default management committee comprising senior CCP staff and representatives from member institutions.[165]

The Commission does not believe that changes in the security-based swap market resulting from the Dodd-Frank Act (e.g., mandatory clearing requirements, the establishment of the Council, etc.) have eliminated or will eliminate the additional risk management challenges of security-based swaps noted above. Therefore, the Commission believes that it should codify the existing standard for maintenance of financial resources established by CCPs currently clearing security-based swaps.

The Commission notes that current industry participants recognize the need for more stringent financial resource requirements for CCPs that clear credit default swaps.[166] This point is evidenced by the fact that the "cover two" standard has been employed since before the enactment of the Dodd-Frank Act and prior to the adoption of the European Market

164 For example, when a participant defaults, the CCP terminates all of its contracts with the defaulting participant. The traditional procedures for handling a default, which are used by CCPs for most exchange-traded derivatives, call for the CCP to promptly enter the market and replace the contracts, so as to hedge against further losses on the open positions created by termination of the defaulter's contracts. However, if the markets for the contracts cleared by the CCP are illiquid, entering the market may induce adverse price movements, especially if the defaulting participant's positions are large relative to the overall market for the contracts. See Bank for International Settlement's Committee on Payment and Settlement Systems, New Developments in Clearing and Settlement Arrangements for OTC Derivatives (Mar. 2007).

165 See id.

166 See, e.g., ISDA Letter at 1; see also Letter to William C. Dudley from the OTC Derivatives Supervisors Group, dated March 31, 2011, available at http://www.newyorkfed.org/newsevents/news/markets/2011/SCL0331/pdf (generally supporting enhancing the framework for OTC derivatives risk management).

Infrastructure Regulation ("EMIR")[167] by the major CCPs clearing credit default swaps, both in the United States and internationally. For example, both of the registered CCPs providing clearing services for credit default swap transactions to customers in the United States, ICE Clear Credit and ICE Clear Europe, already meet a "cover two" standard as does CME Group ("CME") with respect to its clearing service for index credit default swaps, which is registered with the Commission but does not yet provide CCP services for security-based swaps.[168] LCH.Clearnet, a leading CCP for OTC derivatives in Europe, maintains a "cover two" standard for its credit default swap CCP activities.[169] These practices are consistent with the "cover two" financial resources requirement for European CCPs contained in EMIR.[170]

Given that both of the registered CCPs providing clearing services for security-based swap transactions already meet the proposed standard, and that CME, which proposes to provide such services, is currently following a "cover two" standard in index credit default swap clearing, the Commission believes that Rule 17Ad-22(b)(3) does not represent a change in existing market

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167 Regulation No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, 2012 O.J. (L 201).

168 See CFTC-SEC Staff Roundtable on Clearing of Credit Default Swaps (Oct. 2010), at 123, available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7_102210-transcrip.pdf (Stan Ivanov, ICE Clear Credit stating "at ICE we look at two simultaneous defaults of the two biggest losers upon extreme conditions…."). See also CDS Clearing Solution ICE Clear Europe (June 2012), at 6, available at https://www.theice.com/publicdocs/clear_europe/ICE_Clear_Europe_CDS_Clearing_Overview.pdf ("Guaranty Fund covers simultaneous default of 2 largest Clearing Members"); CME Rulebook, Chapter 8H, Rule 8H07, available at http://www.cmegroup.com/rulebook/CME/I/8H/07.html.

169 See LCH.Clearnet CDS Clearing Rulebook, Chapter 4, Article 4.4.1.2 (May 5, 2012), available at http://www.lchclearnet.com/Images/CDSClear%20Rulebook_tcm6-61343.pdf.

170 See supra note 167, at 43.

practices and would not hinder the growth of existing security-based swap CCPs.[171] Furthermore, the Commission does not believe the rule poses an overly burdensome barrier to entry for future CCPs wishing to clear security-based swaps, as we do not intend the rule to require a registered CCP clearing security-based swaps to cover its two largest participant exposures in the event of default for all of its products. A CCP can choose to maintain a separate default fund for security-based swaps, limiting the overall financial burden.[172]

We are adopting Rule 17Ad-22(b)(3) with modifications intended to recognize different types of structures currently employed by CCPs clearing security-based swaps and similar structures that may be developed in the future. The final rule allows that the policies and procedures may provide that the additional financial resources required to be held under the "cover two" standard may be maintained for the entire CCP or in separately maintained funds. This modification from the proposal recognizes that clearing agencies' practices may be structured as (i) conducting security-based swap clearing activities in a separate legal entity or (ii) maintaining within one legal entity separate rules, membership requirements, risk management practices, and financial resources specifically designed to cover the CCP's exposures to a separate pool of instruments that includes security-based swaps. The Commission also believes that as security-based swap CCPs introduce new products for clearing on an incremental basis in the future, the adopted rule will provide them with appropriate flexibility to

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171 See supra note 168.

172 See CME Rulebook, Chapter 8, Rule 802, available at http://www.cmegroup.com/rulebook/CME/I/8/02.html ("The Clearing House shall establish a guaranty fund (the "Base Guaranty Fund") for products other than CDS Products…"); see also CME Rulebook, Chapter 8H, Rule 8H07, available at http://www.cmegroup.com/rulebook/CME/I/8H/07.html ("The Clearing House shall establish a financial safeguards package to support CDS clearing, and each CDS Clearing Member shall make a CDS Guaranty Fund deposit with the Clearing House."); see generally discussion infra Section V.B.1.iii.c.

organize their operations to obtain additional financial resources to cover exposures for each new security-based swap product in the manner most appropriate for their organization.[173]

Some commenters argued that the Commission should not adopt a standard for the level of financial resources that may be inconsistent with the FMI Report and that there should be industry and regulatory consensus on the level of financial resources that must be maintained.[174] The FMI Report states that CCPs should maintain financial resources to cover the default of the largest two participants when the CCP is involved in activities with a more-complex risk profile.[175] The FMI Report describes a more-complex risk profile as "clearing financial instruments that are characterized by discreet jump-to-default price changes or that are highly correlated with potential participant defaults."[176] The vast majority of security-based swaps by

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173 The Commission is also aware that clearing agencies that provide CCP services for security-based swap transactions generally do not separate their operations and risk management practices between swap and security-based swap instruments. For example, we understand that some registered clearing agencies may wish to accept customer assets used to margin customer positions consisting of swaps and security-based swaps in commingled customer omnibus accounts and are already offering clearing services for swaps and security-based swaps in commingled proprietary accounts. Accordingly, where a clearing agency's operations and risk management practices are commingled, the clearing agency will be subject to the "cover two" requirement applicable to security-based swap CCPs under Rule 17Ad-22(b)(3). See Letter from Winston & Strawn LLP, dated Nov. 7, 2011 (requesting exemptive relief for ICE Clear Credit LLC in connection with a program to commingle customer funds and implement portfolio CDS).

174 See supra note 156.

175 See FMI Report, supra note 32, at 36 (Principle 4: Credit risk "In addition, a CCP that is involved in activities with a more-complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions. All other CCPs should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions.").

176 See id.

notional value and other measures are credit default swaps products with such characteristics, and, accordingly, the Commission believes that the standard being adopted today with regard to security-based swaps is substantially similar to that in the FMI Report.[177] As security-based swap products with different characteristics are proposed for clearing over time, the Commission would evaluate risk profiles of such products to consider how they would be treated under the "cover two" standard.

The Commission also is not persuaded that the "cover two" standard reflects an implausible occurrence that therefore should not be embedded into the Commission's rules. The financial crisis of 2008 demonstrated the plausibility of the default of two large participants in a clearing agency over a brief period. One large investment bank was saved from the brink of default in March 2008.[178] In September 2008, two large financial institutions failed and another large financial institution was rescued from insolvency by the Federal Reserve.[179] Throughout the course of these events, the U.S. and world financial markets were affected by a systemic crisis of confidence that stifled the ability of market participants to obtain financing and avoid

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177 The Commission has previously estimated that single-name CDS will constitute roughly 95% of the market, as measured on a notional basis, for instruments that fall within the definition of security-based swap. See Securities Exchange Act Release No. 34-66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012), at 30636, n.476.

178 See Board of Governors of the Federal Reserve System, Bear Stearns, JPMorgan Chase, and Maiden Lane LLC, http://www.federalreserve.gov/newsevents/reform_bearstearns.htm (last visited June 25, 2012).

179 LaBonte and Norden Berg, Dodd-Frank Act, Congressional Research Services, Title VIII: Supervision of Payment, Clearing and Settlement Activities (Dec. 10, 2010), at 1, available at http://www.llsdc.org/attachments/files/279/CRS-R41529.pdf (noting the failures of Lehman Brothers Holdings, Inc. and Washington Mutual, Inc. in 2008 and the subsequent rescue of American International Group, Inc.).

default.[180] The Commission believes therefore that it is plausible to assume that a systemic market disruption like that which was experienced in 2008 could affect the two largest participants of a security-based swap CCP.

One clearing agency commented that since its modeling assumptions for simultaneous default of two participants assume significant market volatility but its modeling assumptions for the default of the largest participant assume low volatility, it is possible that a requirement for financial resources to cover the default of the largest two participants may result in only a slightly higher or even a lower requirement than one for financial resources to cover the default of the largest participant.[181] However, the Commission is not persuaded by this comment and the assumption regarding low volatility. All registered clearing agencies are expected to ensure that the assumptions underlying their models are reasonably designed to meet the requirements of the Exchange Act and related regulations at all times, and the Commission staff reviews the practices of clearing agencies in this area through its established supervisory process. To the extent Commission staff identifies shortcomings in an individual registered clearing agency's practices relevant to its maintenance of the "cover one" or "cover two" requirements, further action may be taken to address such concerns, as may be necessary or appropriate. For example, in connection with an examination, the Commission can request corrective action as part of its examination findings. Where there are shortcomings that violate the clearing agency's rules or Rule 17Ad-22(b)(3), the Commission may take enforcement action.[182]

Finally, the Commission does not believe that Rule 17Ad-22(b)(3) will require major

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180 See, e.g., Trustee's Preliminary Investigation Report and Recommendations of the Attorneys for James W. Giddens for the SIPA Liquidation of Lehman Brothers, Inc. (Aug. 25, 2010), available at http://dm.epiq11.com/LBI/Project/default.aspx.

181 See supra note 150.

182 See Section 17A discussion supra Section I.A.2 and accompanying text.

changes to the practices that have been developed to measure the sufficiency of financial resources at registered CCPs. The Commission understands that all CCPs currently registered with the Commission maintain enough financial resources to withstand the default of their largest participant under extreme but plausible market conditions.[183] All of the security-based swap transactions that are centrally cleared in the United States are handled by a security-based swap CCP that maintains enough financial resources to be able to withstand the default of its two largest participants.[184]

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183 See, e.g., International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the National Securities Clearing Corporation's Observance of the CPSS-IOSCO Recommendations for Central Counterparties (2010), at 10, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10129.pdf (assessing NSCC's observance of Recommendation 5 from the RCCP that a CCP should maintain sufficient financial resources to withstand, at a minimum, the default of a participant to which it has the largest exposure in extreme but plausible market conditions and noting that NSCC began evaluating itself against this standard in 2009 and has back-testing results to support that during the period from January through April 2009 there was sufficient liquidity to cover the needs of the failure of the largest affiliated family 99.98% of the time); International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the Fixed Income Clearing Corporation – Government Securities Division's Observance of the CPSS-IOSCO Recommendations for Central Counterparties (2010), at 9-10, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10130.pdf (finding that Fixed Income Clearing Corporation's Government Securities Division "observed" the requirement to maintain enough financial resources to meet the default of its largest participant in extreme but plausible market conditions).

184 See supra note 168 (reflecting that ICE Clear Credit "looks at two simultaneous defaults of the two biggest losers upon extreme conditions…."). Most centrally cleared CDS transactions have cleared at ICE Clear Credit or ICE Clear Europe Limited. As of April 19, 2012, ICE Clear Credit had cleared approximately $15.6 trillion notional amount of CDS contracts based on indices of securities and approximately $1.5 trillion notional amount of CDS contracts based on individual reference entities or securities. As of April 19, 2012, ICE Clear Europe had cleared approximately €7.2 trillion notional amount of CDS contracts based on indices of securities and approximately €1.2 trillion notional amount of CDS contracts based on individual reference entities or securities. See https://www.theice.com/marketdata/reports/ReportCenter.shtml. As of April 19, 2012, CME had cleared approximately $522 billion notional amount of CDS contracts based on indices of securities.

The Commission agrees with the commenter who suggested that it is important for the Commission to provide concrete guidance regarding the meaning of "extreme but plausible market conditions" to assure consistent treatment of that term across clearing CCPs. In general, "extreme but plausible market conditions" are tail event conditions in which the price movement of a cleared security results in losses exceeding expectations at a 99% confidence interval, causing a clearing agency's exposures to its participants to breach margin requirements or other risk controls (i.e., a one out of 100 days scenario). For example, "extreme but plausible market conditions" may include or exceed the worst historical price movement for a particular financial instrument over a specified time horizon. However, the Commission also agrees with commenters that argued that industry professionals, including but not limited to personnel at the clearing agencies themselves, are likely to be equipped with the relevant expertise that can contribute to developing a well-informed standard of "extreme but plausible market conditions." To ensure that the standard is consistently applied across CCPs and that it accurately captures the market understanding of the terminology, the Commission expects to review and publish for public comment rule proposals from clearing agencies adopting a definition for "extreme but plausible market conditions" that is appropriate for the market they serve.

4. Rule 17Ad-22(b)(4): Model Validation

a. Proposed Rule

Rule 17Ad-22(b)(4), as proposed, would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for an annual model validation process consisting of evaluating the performance of the CCP's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions.[185] The Commission is adopting Rule 17Ad-22(b)(4) to ensure that a registered CCP's models are validated by qualified persons free from influence from the persons responsible for development or operation of the systems and models being validated, with sufficient frequency to assure that the models perform in a manner that facilitates prompt and accurate clearance and settlement of transactions.

b. Comments Received

Commenters generally supported proposed Rule 17Ad-22(b)(4)[186] but they also provided several suggested modifications regarding the required frequency of the model validation and how best to achieve the proper level of scrutiny and testing of the model's adequacy. One commenter stated that the rule should not require the model to be validated on an annual basis. Instead, the commenter suggested that the frequency should be left to the discretion of the clearing agency because it is in the best position to determine the appropriate timing,[187] and in

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185 Any person responsible for supervising the operation of the clearing agency's margin model would be viewed as performing the functions associated with the clearing agency's margin model and could not therefore have supervisory authority over the person conducting the model validation.

186 See The DTCC (April) Letter at 13 (supporting Rule 17Ad-22(b)(4) and recommending certain clarifications); see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); BlackRock Letter at 2 (supporting Rules 17Ad-22(b)(1)–(7) because these rules will benefit the markets by reducing concentration risk, increasing the diversity of market participants involved in governance, enhancing competition and lowering costs for customers of clearing members); LCH Letter at 3 (generally supporting the Commission's proposed rules under 17Ad-22(b)); MFA (Kaswell) Letter at 2 (generally supporting the Commission's proposed rules under 17Ad-22(b)).

187 See The DTCC (April) Letter at 13.

the absence of a material change (either to the model itself or in the market environment that affects the model), requiring an annual validation may be unnecessary and overly burdensome.[188]

Commenters also argued that the CCP is in the best position to determine how to conduct a candid assessment free from outside influence concerning its margin models and that qualified internal personnel at the CCP are capable of validating the models if reasonable steps are taken to ensure objectivity (i.e., the reviewers are not the same individuals who are or who were involved in designing the models or who are otherwise biased due to their involvement in implementation of the models).[189] Commenters argued that Rule 17Ad-22(b)(4) should not prescribe a particular method for a clearing agency to achieve that outcome.[190]

One commenter recommended that the Commission should replace the text in proposed Rule 17Ad-22(b)(4) that addresses independence with language from the Proposing Release that "the person validating the clearing agency's model should be sufficiently free from outside influences so that he or she can be completely candid in their [sic] assessment of the model."[191] The commenter stated that this construction is more consistent with RCCP 4: Financial Resources[192] and with Principle 6: Margin from the Consultative version of the FMI Report[193] because it does not prescribe a model validation frequency or a specific way to achieve integrity

188 See id.

189 See The DTCC (April) Letter at 13; The OCC Letter at 11.

190 See The DTCC (April) Letter at 13.

191 See The DTCC (April) Letter at 14.

192 See RCCP, supra note 33, at 19.

193 See Principles for Financial Market Infrastructures Consultative Report (Mar. 2011), at 40, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD350.pdf; but see supra note 32, at 56 (stating in the finalized FMI Report that a CCP should have its margin model validated at least annually).

in the validation process.[194] Another commenter stated that proposed Rule 17Ad-22(b)(4) should be strengthened to require the model validation to be performed by an outside, independent expert and that the CCP must adjust and revalidate the model at any time it has reason to believe the model is no longer adequate.[195]

Another commenter stated that requiring a CCP to bring independence to the model review process by detaching it from the model development process would effectively require maintenance of two quantitative teams.[196] According to this commenter, that result would impose costs on the CCP to staff both teams as well as create potential staffing problems because talented personnel with the requisite quantitative skills often view the review process as non-creative.[197] That structure, the commenter argued, may create adversarial relationships within the CCP and could require senior management to resolve highly-technical disputes between the model development team and model review team.[198]

The same commenter suggested that proposed Rule 17Ad-22(b)(4) should be revised to require a CCP to do the following: (1) maintain a culture of commitment to quality where correcting and improving models is career-enhancing; (2) adopt sound policies and procedures that create a transparent and auditable model review process; and (3) require that reporting lines must come together at a person who is well-versed in technical quantitative matters.[199] Commenters also cited to the recently released Supervisory Guidance on Model Risk Management, in which the Federal Reserve and the Office of the Comptroller of the Currency

194 See The DTCC (April) Letter at 15.

195 See Better Markets Letter at 6.

196 See The OCC Letter at 11.

197 See id.

198 See id.

199 See id.

stated that "corporate culture plays a role [in providing appropriate incentives for proper model review] if it establishes support for objective thinking and encourages questioning and challenging of decisions" and that "independence may be supported by separation of reporting lines, [but] it should be judged by actions and outcomes because there may be additional ways to ensure objectivity and prevent bias."[200]

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(4) with certain modifications to address concerns raised by commenters, including the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. In light of comments asking the Commission to clarify the standard of independence of the qualified person who performs the model validation, the Commission is revising the text of Rule 17Ad-22(b)(4) so that the annual model validation must be performed by a qualified person who is free from influence from the persons responsible for development or operation of the systems and models being validated. Generally, the Commission would consider that a person was free from influence when that person does not, including but not limited to, perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions. The Commission believes that the change from the proposal addresses the concerns raised by commenters.[201] Specifically, the Commission

200 See id.; see also The DTCC (April) Letter at 14 (citing Supervisory Guidance on Model Risk Management (Apr. 4, 2011)), available at http://www.occ.treas.gov/news-issuances/bulletins/2011/bulletin-2011-12a.pdf.

201 See, e.g., The OCC Letter at 11-12 (stating that "[w]e think that a clearing agency is capable of validating its own models through the use of qualified internal personnel, provided that appropriate steps are taken to ensure objectivity, such as ensuring that the reviewers are not the same individuals as those who are or were involved in *designing* such models or are *otherwise biased* due to their involvement in implementation of the models. Many employees who perform functions associated with margin models may

agrees that who will be the reviewer of the model is best left to the discretion of the CCP, so long as the goals of the model validation process are achieved.[202]

As proposed, Rule 17Ad-22(b)(4) would not have permitted the model validation to be performed by a person performing functions associated with the CCP's margin models (except as part of the annual model validation), or who reports to a person who performs those functions.[203] The Commission reasoned in the Proposing Release that a person involved with the functions related to the model's operation, or someone who reports to such a person, may be less likely to evaluate critically the margin models.[204] After considering the comments, the Commission agrees that instead of requiring a particular method or reporting structure, the less-prescriptive language from the Proposing Release, namely, that a person may perform the model validation as long as that person is free from influence from the persons responsible for development or operation of the systems and models being validated so that he or she can be candid in his or her assessment of the model, would be appropriate to achieve the intended purpose.

The Commission also notes that the "sufficiently free from influence" standard is consistent with the FMI Report, which does not prescribe a specific method to assure the effectiveness of the validation process,[205] and is consistent with the recent guidance from the Federal Reserve and the Office of the Comptroller of the Currency in Supervisory Guidance on

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have no particular conflict or bias that would prevent them from conducting objective model validations and, in fact, many such employees may have a strong interest in ensuring that margin models are as well-designed as possible.").

202 See The DTCC (April) Letter at 14 ("The DTCC model risk policy provides that all models must be certified as valid by a qualified independent reviewer, defined as 'a qualified reviewer that did not develop and does not currently own the model.' The reviewer may be an individual or unit within the organization or an outside consultant.").

203 See supra note 185 and accompanying text.

204 See supra note 35.

205 See FMI Report, supra note 32.

Model Risk Management.[206] The revised standard adopted by the Commission herein would not require the clearing agency to detach model review from model development or to maintain two separate quantitative teams and thus would not lead to potential increased costs.

The Commission is not persuaded that the model validation must be performed by an outside independent expert.[207] As noted above, the Commission believes that objectivity can be preserved where the person performing the model validation is an employee of the CCP as long as the clearing agency strictly adheres to the standard the Commission is adopting herein. Because the Commission has not previously required CCPs to perform an annual model validation, we understand that the implementation of this requirement may require the exercise of substantial judgment by such clearing agencies in the adoption and implementation of written policies and procedures. The Commission intends to review the development of compliance practices and to issue interpretive guidance as appropriate.

The Commission is not persuaded that the frequency of the model validation should be left to the discretion of the CCP. Current model validation practices vary among CCPs. Some CCPs conduct annual validations, while other conduct them on an ad hoc basis. Because of the role margin plays in a default, a CCP needs assurance of its value in the event of liquidation, as well as the capacity to draw upon its margin promptly. The Commission believes, especially considering its statutory responsibilities and the importance of model validation in limiting systemic risk, that it is important to create a consistent and uniformly applied minimum standard

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206 Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, Supervisory Guidance on Model Risk Management (Apr. 4, 2011), at 9, available at http://occ.gov/news-issuances/bulletins/2011/bulletin-2011-12a.pdf (stating that independence for model review "should be judged by actions and outcomes, since there may be [many] ways to ensure objectivity and prevent bias").

207 See supra note 195.

across all clearing CCPs. The Commission believes that requiring model validation at least annually is appropriate because model performance is not ordinarily expected to vary significantly over short periods but should be reevaluated as market conditions change. Furthermore, the Commission does not think the standard of an annual model validation is too burdensome, particularly given the fact that the Commission is not prescribing any specific qualifications or credentials of the person performing the model validation and is not requiring the person performing the model validation to be independent of the clearing agency and given how important understanding of the margin methodology is to the risk management framework.

The requirement for an annual model validation does not preclude the CCP from adjusting its model any time it has reason to believe that the model is no longer adequate. In fact, as noted above, Rule 17Ad-22(b)(2) requires a CCP to review its risk-based models to set margin requirements at least monthly.

The Commission continues to believe that clearing agencies that provide CCP services must have a qualified person conduct a review of models that are used to set margin levels, along with related parameters and assumptions, to assure that the models perform in a manner that facilitates prompt and accurate clearance and settlement of transactions. In determining whether a person is qualified to conduct the model validation, registered CCPs may consider several factors, including the person's experience in validating margin models, expertise in risk management generally, and understanding of the clearing agency's particular operations and procedures.

While the Commission agrees with the commenter who suggested that CCPs should strive to create a culture of commitment to quality where improving models is career-enhancing and to adopt sound policies and procedures to create a transparent and auditable model review process,[208] the Commission believes that this result can be achieved by requiring that a model validation review occur annually and that the reviewer be qualified and free from influence from the persons responsible for development or operation of the systems and models being validated.

D. Participant Access Standards for Central Counterparties: Rules 17Ad-22(b)(5)–(7)

Section 17A of the Exchange Act requires that a clearing agency shall not be registered unless the Commission determines, among other things, that the clearing agency's rules do not impose burdens on competition that are unnecessary or inappropriate to promote the purposes of the Exchange Act[209] and that the rules are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the CCP.[210] Therefore, when evaluating the participation standards at a CCP, the Commission must strike an appropriate balance between affording CCPs the necessary discretion to select clearing members that do not jeopardize the CCP's ability to facilitate prompt and accurate clearance and settlement while also not impeding access to central clearing among a range of market participants.

Rules 17Ad-22(b)(5), (6) and (7) introduce certain requirements regarding access to registered CCPs. Respectively, the rules would require a registered CCP to do the following: (1) provide the opportunity for a person who does not perform any dealer or security-based swap dealer services to obtain membership; (2) refrain from using minimum portfolio size and minimum volume transaction thresholds as conditions to membership; and (3) provide the ability to obtain membership to persons who maintain net capital equal to or greater than $50 million.

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208 See supra note 199 and accompanying text.

209 15 U.S.C. 78q-1(b)(3)(F).

210 15 U.S.C. 78q-1(b)(3)(G).

Rules 17Ad-22(b)(5), (6) and (7) each address the common topic of access to and participation in CCPs. Several commenters provided general comments on that shared focus. Those comments represent a wide range of views and are reflected immediately below.

Some commenters expressed their general support for the ways that Rules 17Ad-22(b)(5), (6), and (7) would promote fair and open access to CCP services through CCP participation requirements that are risk appropriate without being unnecessarily restrictive.[211] One of these commenters expressed support for the design of the rules but also made a request for the rules to offer more flexibility and latitude for CCPs to establish participation requirements that ensure integrity of operation and risk management."[212]

Two commenters urged the Commission not to adopt proposed Rules 17Ad-22(b)(5), (6) and (7).[213] The first commenter concluded that the proposed rules, while well-intentioned, "are unnecessary and counterproductive to the goal of fair and open access within a framework of the safe and sound operation of clearing agencies."[214] In particular, this commenter stated its belief that proposed Rules 17Ad-22(b)(5), (6) and (7) are overly prescriptive and that the Commission already has ample and alternative authority under which to monitor membership practices.[215] Specifically, the commenter pointed to the existing requirement in Section 17A(b)(3)(F) of the Exchange Act that a clearing agency shall not be registered unless the Commission determines

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211 See LCH Letter at 3 (upholding the Commission's intent of "ensuring broad participation in and open access to clearing agencies"); MFA (Kaswell) Letter at 2, 3 (generally supporting the Commission's proposed rules under 17Ad-22(b)); CME Letter at 3 (generally supporting "the regulatory objective of participation requirements that are risk appropriate without being unnecessarily restrictive, in order to promote fair and open access to clearing services.").

212 See LCH Letter at 3.

213 See The DTCC (April) Letter at 9; The OCC Letter at 12.

214 See The DTCC (April) Letter at 18.

215 See id.

that the clearing agency's rules are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency. The commenter also stated that if proposed Rule 17Ad-22(d)(2) is adopted, that rule would already require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to have participation requirements that are objective, publicly disclosed, and that permit fair and open access.[216] Finally, this commenter argued that proposed Rules 17Ad-22(b)(5), (6) and (7) do not conform to current or proposed global standards related to participation in CCPs. In contrast, the commenter stated its belief that Section 17A(b)(3) of the Exchange Act and proposed Rule 17Ad-22(d)(2) are consistent with RCCP Recommendation 2: Participation requirements[217] as well as FMI Principle 18: Access and participation requirements.[218]

The second commenter, while not opposed to the substance of proposed Rules 17Ad-22(b)(5), (6) and (7), generally questioned the need to hard wire these requirements into the Commission's rules.[219] Specifically, this commenter argued that the Commission already has authority under Section 17A(b)(3)(F) of the Securities Exchange Act to deny registration to a clearing agency if the clearing agency's rules are designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency.[220] In addition, this commenter stated that under proposed Rule 17Ad-22(d)(2) the Commission would gain less

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216 See id.

217 RCCP Recommendation 2 provides that "[a] CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access."

218 Principle 18 from the FMI Report provides that "[a]n FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access."

219 See The OCC Letter at 12.

220 See id.

prescriptive but broader and coextensive rule-based authority without imposing "one size fits all" access requirements.[221]

In the "Final Rule and Guidance" sections for Rules 17Ad-22(b)(5), (6) and (7) below, we address these more general comments in the context of a discussion of the more specific comments the Commission received on the proposed rules.

1. Rule 17Ad-22(b)(5): Non-Dealer Member Access

a. Proposed Rule

Rule 17Ad-22(b)(5), as proposed, would require a registered CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide the opportunity for a person that does not perform any dealer[222] or security-based swap dealer[223] services to obtain membership on fair and reasonable terms at the CCP in order to clear securities for itself or on behalf of other persons.

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221 See id.

222 The term "dealer" is defined in Section 3(a)(5) of the Exchange Act and means any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. The definition contains an exception for a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business. There is also an exception for banks engaging in certain specified activities. See 15 U.S.C. 78c(a)(5) for the complete definition.

223 Pursuant to Section 761 of the Dodd-Frank Act, the term "security-based swap dealer" is added as Section 3(a)(71) of the Exchange Act, 15 U.S.C 78c(a), and generally means any person who (A) holds itself out as a dealer in security-based swaps; (B) makes a market in security-based swaps; (C) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or (D) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps. The Commission and the CFTC jointly adopted rules to further define the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and eligible contract participant." See supra note 12 (Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", Securities Exchange Act Release No. 34-66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012)).

b. Comments Received

Some commenters generally supported the goals of Rule 17Ad-22(b)(5),[224] while other commenters expressed several concerns.[225] Specifically, one commenter stated that "any regulatory mandate to admit specific entities as members of a CCP could undermine the impartial development and application of risk-based standards for membership."[226] This commenter acknowledged the discussion in the Proposing Release explaining that proposed Rule 17Ad-22(b)(5) would not prohibit a clearing agency from using factors aside from a potential clearing member's dealer or security-based swap dealer status to make an admissions decision, but nevertheless urged the Commission to forgo adoption of the rule altogether because it believes clearing agencies should be permitted, under Commission oversight, to determine how best to promote correspondent clearing[227] and to design membership standards.[228] The commenter suggested that if the rule is adopted, it should be modified to reflect the more permissive process for evaluation described in the body of the Proposing Release, namely by

224 See supra note 211 (citing LCH Letter, MFA (Kaswell) Letter, and CME Letter); see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); BlackRock Letter at 2 (supporting Rules 17Ad-22(b)(1)–(7) because these rules will benefit the markets by reducing concentration risk, increasing the diversity of market participants involved in governance, enhancing competition and lowering costs for customers of clearing members).

225 See The DTCC (April) Letter at 18–19; The OCC Letter at 12.

226 See The DTCC (April) Letter at 18.

227 Correspondent clearing is an arrangement between a current participant of a clearing agency and a non-participant that desires to use the clearing agency for clearance and settlement services.

228 See The DTCC (April) Letter at 18–19. The commenter also stated its belief that "financial resources" and "creditworthiness" should be expressly added to the factors that may be considered. Moreover, the commenter suggested that the term "otherwise qualified" be clarified as it was not precise enough standard to meaningfully inform clearing agencies of what criteria may be considered when evaluating potential members.

clarifying that the clearing agency may take other factors into account in making membership decisions.[229]

c. Final Rule

The Commission is adopting Rule 17Ad-22(b)(5) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies.

While the Commission understands concerns raised by commenters, the Commission ultimately believes that the benefits of Rule 17Ad-22(b)(5) are critical to maintaining fairness and open access to central clearing for all market participants, including security-based swaps participants. The Commission believes that no registered CCP should deny membership solely because a person does not perform any dealer or security-based swap dealer services and that such a requirement unfairly discriminates against certain market participants and should be prohibited. The Commission does not believe that performing dealer or security-based swap dealer services is, by itself, a sufficient indicator of whether an applicant should be admitted to a clearing agency.

Dealer and security-based swap dealer services generally involve services designed to facilitate securities transactions by buying and selling securities for a person's own account.[230] The Commission continues to believe that requiring registered CCPs to allow persons who are not dealers or security-based swap dealers to become members of the clearing agency will promote more competition by allowing more firms to clear, thereby increasing competition among clearing members on both price and service which should, in turn, reduce costs to market participants. The enhanced access to central clearing should engender more correspondent

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229 See The DTCC (April) Letter at 19.

230 See supra note 222.

clearing in the security-based swap market. Because of the relationship between security-based swaps and traditional securities (e.g., market participants using security-based swaps to hedge positions in traditional securities), the Commission believes that applying these rules to all CCPs will help ensure that market participants have access to central clearing in all instruments that are centrally cleared.

In situations where direct access to clearing agencies is limited by reasonable participation standards, firms that do not meet these standards may still be able to access clearing agencies through correspondent clearing arrangements with direct participants.[231] Such a process involves the non-participant entering a correspondent clearing arrangement with a participant so that the transaction may be submitted by the participant to the clearing agency. Thus, the success of correspondent clearing arrangements depends on the willingness of participants to enter such arrangements with non-participant firms that may act as direct competitors to the participants in the participants' capacity as dealers or security-based swap dealers in the market for the relevant securities. Given that the existing CCP participants that are dealers or security-based swap dealers may therefore have incentives to restrict competitors in the securities execution markets from accessing a CCP, correspondent clearing arrangements may be inhibited unless participants that do not provide dealer or security-based swap dealer services are provided with the ability to become direct members of a clearing agency.

Also, the Commission is not persuaded by the comment that Rule 17Ad-22(b)(5) is likely to undermine the impartial development and application of risk-based standards for

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231 See Exchange Act Release Nos. 63107 (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010) and 64018 (Mar. 3, 2011), 76 FR 12645 (Mar. 8, 2011) (Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC).

membership.[232] Simply stated, Rule 17Ad-22(b)(5) is designed to prohibit registered CCPs from denying membership on fair and reasonable terms to otherwise qualified persons solely by virtue of the fact that they do not perform any dealer or security-based swap dealer services.[233] The Commission fully recognizes that persons who are not dealers or security-based swap dealers may fail to meet other standards for membership at a clearing agency, such as the operational capabilities required for direct participation. While non-dealer status cannot serve as the sole reason for denying membership, Rule 17Ad-22(b)(5) does not prohibit a registered CCP from taking other standards of membership into account when establishing membership criteria for non-dealers.

Because the factors that each CCP considers when establishing membership criteria differ based on the particular characteristics of the relevant clearing agency and the markets it serves, the Commission believes that it would be counterproductive to modify Rule 17Ad-22(b)(5) to make it more specific and therefore more constraining. One commenter, however, requested that the Commission provide additional clarity in terms of what is required to be considered "otherwise qualified" for membership at a CCP.[234] In response to this comment, the Commission notes that, for purposes of Rule 17Ad-22(b)(5), the term "otherwise qualified" means that the clearing agency's sole reason for denying membership to a prospective participant would be the prospective participant's status as a non-dealer or non security-based swap dealer and that it otherwise maintains the financial resources, creditworthiness, operational capacity, and any other additional characteristics necessary to meet the obligations of participation. As CCPs shape practices to come into compliance with Rule 17Ad-22(b)(3), the Commission will

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232 See supra note 228.

233 See Proposing Release, supra note 35, at Section II.A.

234 See supra note 229.

consider whether further guidance is appropriate.

The Commission believes that the incentives of persons who do not perform dealer or security-based swap dealer services to promote access at a CCP in general would tend to be consistent with increased competition in the market for the relevant securities. These persons do not execute securities trades for their own account. Instead, they provide correspondent clearing services for market participants.[235] As a result, their ability to provide correspondent clearing services would tend to increase as competition and transaction volumes increased. Accordingly, the Commission believes that Rule 17Ad-22(b)(5) will foster the development of correspondent clearing arrangements that will allow market participants who are not dealers or security-based swap dealers to obtain access to a registered CCP and that such access will have the beneficial result of greater competition in and access to central clearing. Moreover, because entities must meet all of the standards for membership, the Commission does not believe that it will undermine the development or application of risk management standards.

2. Rule 17Ad-22(b)(6): Portfolio Size and Transaction Volume Thresholds Restrictions

a. Proposed Rule

Rule 17Ad-22(b)(6), as proposed, would prohibit a CCP from having membership standards that require participants to maintain a portfolio of any minimum size or to maintain a minimum transaction volume.

235 For a description of correspondent clearing activity, see generally The Role and Regulation of Clearing Brokers, 48 Bus. Law 841 (May 1993).

b. Comments Received

Some commenters expressed general support for the goals of proposed Rule 17Ad-22(b)(6).[236] At the same time, one commenter opposed adoption of the rule because of concern that "any regulatory mandate on portfolio size and transaction volume thresholds could undermine the impartial development and application of risk-based standards for membership" in a CCP.[237] This commenter also questioned why certain language in the discussion section of the Proposing Release (explaining that the proposed rule "would not prohibit a central counterparty from considering portfolio size and transaction volume as one of several factors when reviewing a potential participant's operations") was not included in the text of the proposed rule.[238] In addition, the commenter stated that even if a CCP has the discretion to consider portfolio size and transaction volume when making a membership decision, it is unclear how much weight the clearing agency actually may give to this factor without running afoul of Rule 17Ad-22(b)(6).[239] Finally, this commenter noted that it ultimately would prefer to see the Commission not adopt Rule 17Ad-22(b)(6) and instead continue to oversee determinations made by clearing agencies concerning membership standards and the weight, if any, to be given to portfolio size and transaction volume.[240]

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236 See supra note 211 (citing LCH Letter, MFA (Kaswell) Letter, and CME Letter); see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); BlackRock Letter at 2 (supporting Rules 17Ad-22(b)(1)–(7) because these rules will benefit the markets by reducing concentration risk, increasing the diversity of market participants involved in governance, enhancing competition and lowering costs for customers of clearing members).

237 See The DTCC (April) Letter at 19.

238 See id.

239 See The DTCC (April) Letter at 19–20.

240 See The DTCC (April) Letter at 20.

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(b)(6) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies.

We believe that imposing minimum thresholds on the size or transaction volume of a participant's portfolio would not function as a good indicator of whether the participant is able to meet its obligations to a CCP.[241] The Commission believes that trading volume and portfolio size alone are poor grounds for limiting participant access to central clearing, and that sole use of these criteria could indicate unfair discrimination against certain market participants and thus should be prohibited as the sole basis for determining membership.

New participants to a CCP that do not, at least initially, intend to transact in substantial size or volume may nevertheless have the operational and financial capacity to perform the activities that other participants are able to perform. Therefore, the Commission believes that Rule 17Ad-22(b)(6) will help facilitate compliance with the requirement in Section 17A of the Exchange Act that the rules of a CCP must permit fair and open access.[242]

For the same reasons discussed in connection with Rule 17Ad-22(b)(5), the Commission is not persuaded by the comment that Rule 17Ad-22(b)(6) is likely to undermine the impartial development and application of risk-based standards for membership.[243] Specifically, the rule does not prohibit a CCP from considering portfolio size and transaction volume as one of several factors when reviewing a potential participant's operations. Rather, the rule prohibits the

241 Rule 17Ad-22(b)(6) would not prohibit a clearing agency from imposing maximum portfolio sizes or transaction volume amounts.

242 See supra note 210.

243 See supra note 237.

establishment of minimum portfolio sizes or transaction volumes that by themselves would act as barriers to participation by new participants in clearing. Rule 17Ad-22(b)(6) is an absolute bar to the sole use of these criteria for determining membership. The Commission also does not believe that it would be prudent to modify the rule text to make it more specific and potentially more constraining because the factors that each CCP considers when establishing appropriate membership criteria differ to some degree based on the particular characteristics of the relevant clearing agency and the markets it serves. As noted more generally in Section II.B above, the Commission will consider whether to issue further guidance to facilitate compliance as clearing agencies establish, implement, maintain and enforce policies and procedures responsive to Rule 17Ad-22(b)(6).

3. Rule 17Ad-22(b)(7): Net Capital Restrictions

a. Proposed Rule

Proposed Rule 17Ad-22(b)(7) would require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide a person that maintains net capital[244] equal to or greater than $50 million with the opportunity to obtain membership at the CCP, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the CCP.

b. Comments Received

Some commenters supported proposed Rule 17Ad-22(b)(7).[245] Several commenters expressed support for the rule because it would require access to a CCP to be scaled in a risk-

244 Proposed Rule 17Ad-22(a)(5) would define "net capital" for the limited purposes of proposed Rule 17Ad-22(b)(7) to have the same meaning as set forth in Rule 15c3-1 under the Exchange Act for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.

245 See MFA (Kaswell) Letter at 3; ISDA Letter at 4; BlackRock Letter at 1.

based way.[246] One of these commenters expressed the hope that the CFTC would adopt a similar requirement and urged the Commission to work together with the CFTC to harmonize their respective rules in this area.[247]

Another commenter supportive of Rule 17Ad-22(b)(7) urged the Commission to modify the rule to eliminate the ability of a CCP to raise its minimum net capital threshold above $50 million.[248] This commenter stressed that if the Commission declined to take such action when adopting a final rule, then the Commission should (i) require the clearing agency's rationale to meet a higher burden of proof than currently proposed; (ii) require the clearing agency to demonstrate not only that it could not effectively manage the risk using other measures but also that raising the minimum capital requirement is the least restrictive means by which to address the risk posed to the clearing agency; and (iii) review the clearing agency's showing and make an express determination that no other, less- competitively-restrictive measures are available to the clearing agency to manage the risk effectively.[249]

One commenter stated that net capital, without regard to other risk factors, does not conclusively establish creditworthiness or any of the other generally accepted qualifications for becoming a member of a CCP.[250] Another commenter agreed with this assertion, but cited it as support for Rule 17Ad-22(b)(7) on the basis that clearing members with net capital closer to $50

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246 See ISDA Letter at 4; MFA (Kaswell) Letter at 3; BlackRock Letter at 1.

247 See ISDA Letter at 4. See also Derivatives Clearing Organization General Provisions and Core Principles, supra note 38 (in which the CFTC adopted Rule 39.12(a)(2)(iii) to require that a DCO shall not set a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member in order to clear swaps).

248 See MFA (Kaswell) Letter at 4–5 (noting that the CFTC in the DCO Release adopted rule 39.12(a)(2)(iii) in a form that does not permit adjustment of the $50 million net capital requirement for membership).

249 See MFA (Kaswell) Letter at 4–5.

250 See The DTCC (April) Letter at 20.

million may have other characteristics that make their risk profile less risky than clearing members with greater amounts of net capital.[251]

Several commenters expressed concern over proposed Rule 17Ad-22(b)(7).[252] One commenter stated that the proposed $50 million net capital standard could create conditions where a clearing member at that net capital level might use its $50 million of net capital to access multiple clearing agencies.[253] Commenters suggested that this standard would increase the likelihood that the clearing member would not be able to meet capital calls close in time from multiple clearing agencies.[254] To address this concern about margin call risk, the commenter suggested that the rule should be modified to require: (i) daily reporting from each clearing member of its capital cover for the potentially numerous assessments that it could be subject to from each clearing agency where it is a member; (ii) the clearing member to conduct regular stress tests at an "extreme but plausible" market level in relation to the potentially numerous clearing agency assessments that it could be subject to, and to provide the results to each clearing agency where it is a member; and (iii) each clearing agency to monitor and assess, on a daily basis, the ability of a clearing member and its related affiliates to meet these potential assessment exposures and share this daily analysis with other CCPs and any relevant prudential regulator.[255] The commenter stated that unless regulators and clearing agencies are able and willing to commit

251 See MFA (Kaswell) Letter at 3.

252 See The OCC Letter at 12; The DTCC (April) Letter at 9.

253 See ISDA Letter at 3.

254 See id.

255 See id.

to these actions, then it believes that a far larger minimum net capital requirement, such as $1 billion, is appropriate.[256]

Another commenter expressed concern that because not all market participants use a net capital computation, the proposed rule could give unfair advantages to some market participants over others in terms of gaining and retaining membership at a CCP.[257] The commenter concluded that proposed Rule 17Ad-22(b)(7) should not be adopted, and instead CCPs should continue to determine membership standards subject to Commission oversight (including capital requirements and other measures of creditworthiness) as well as how best to ensure that access to the clearing agency is fair and open.[258]

One commenter noted the Commission's reference in the Proposing Release to the tiered membership standards of the FICC as an example of capital-related requirements that differentiate between types of participants.[259] The commenter stated its opposition to "tiers" in the membership structure of CCPs on the basis that they can have discriminatory or anti-competitive effects.[260] Finally, another commenter stated it generally does not see the need for the approach proposed in Rule 17Ad-22(b)(7) because it believes the Commission has other tools at its disposal to review membership standards on a case-by-case basis that account for the nature of a particular clearing agency's activities and the risks associated with those activities.[261]

256 See id.

257 See The DTCC (April) Letter at 20.

258 See id.

259 See MFA (Kaswell) Letter at 4.

260 See id.

261 See The OCC Letter at 12.

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(b)(7) with certain modifications, including the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. As noted by the commenters expressing support for the rule,[262] we believe that persons that maintain a net capital level of equal to or greater than $50 million, as well as an appropriate level of financial expertise, should not be denied participation in a CCP based solely on their net capital levels, provided that such persons are able to comply with other reasonable membership standards. In the Proposing Release, we cited recent broker-dealer reporting data available to the Commission reflecting that the $50 million threshold for net capital is a standard that provides the potential for approximately 4% of the total number of broker-dealers or approximately 201 firms could be eligible to gain clearing membership at one of the registered clearing agencies.[263] According to this data, raising the net capital requirement to $100 million would have reduced the community of eligible broker-dealers by 73 firms or 35% to 128 eligible firms, while reducing the net capital threshold to as low as $25 million would increase the number of broker-dealer potentially eligible for membership by 86 firms or 43% to 287 firms (approximately 6% of broker-dealers). The Commission believes that firms that maintain a net capital level of equal to or greater than $50 million have sufficient financial resources to participate at some level in a CCP provided that they are able to comply with other reasonable membership standards and is concerned that some firms with less than $50 million of net capital may not have sufficient financial resources to fulfill membership obligations. The rule also ensures that each

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262 See supra note 245.

263 Even if proposed Rule 17Ad-22(b)(7) is successful in encouraging the broadening of membership in CCPs that clear CDS, the Commission believes the number of broker-dealers newly eligible for clearing membership that become clearing members as a result of this change is likely to be substantially less than 201.

clearing agency will have the flexibility to develop scalable policies and procedures to limit the activities of participants based on their level of net capital.[264] For example, a CCP can place limits on its potential exposure to participants operating at certain net capital thresholds by restricting the maximum size of the portfolio such participants are permitted to maintain at the clearing agency. Accordingly, the Commission believes the $50 million minimum standard strikes the proper balance between promoting open access to central clearing among participants that have the capacity to participate without posing undue risk to CCPs. The Commission also believes that Rule 17Ad-22(b)(7) would facilitate sound risk management practices by the clearing agencies. The CCPs that seek Commission permission to employ a higher net capital requirement as a condition for membership at the clearing agency must demonstrate to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures. The CCPs seeking to implement such requirements should examine and articulate the benefits of higher net capital requirements and link the nature and degree of participation with the potential risks posed by the participant.

The Commission also does not believe that $50 million net capital standard contained in Rule 17Ad-22(b)(7) would give an advantage to some prospective members at a CCP over others. Further, the rule explicitly is not intended in any way to create an "entitlement" to membership for firms with more than $50 million in capital. Upon adoption of Rule 17Ad-22, a registered CCP cannot restrict access because a participant does not have a net capital level of

264 The Commission notes that some clearing agencies currently utilize capital-related requirements that differentiate among types of participants. For instance, the FICC has maintained a $50 million net worth requirement and $10 million excess net capital requirement for its Category 1 Dealer Netting Members and a $25 million net worth requirement and $10 million excess net capital requirement for its Category 2 Dealer Netting Members. This type of arrangement would continue to be acceptable under Rule 17Ad-22(b)(7).

$50 million or more; however, the CCP's policies and procedures can prescribe other reasonable membership standards and can be reasonably designed to limit the activities of the participant in comparison to the activities of other participants that maintain a higher net capital level. For example, as a way to help make its requirements scalable, a registered CCP may elect to place limits on its potential exposure to participants operating at certain net capital thresholds by restricting the maximum size of the portfolio such participants are permitted to maintain at the CCP.

Rule 17Ad-22(b)(7) also permits a registered CCP to provide for a higher net capital requirement (i.e., higher than $50 million) as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures, such as scalable limitations on the transactions that the participants may clear through the CCP, and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application. While the Commission is sympathetic to commenters who asked the Commission to eliminate the ability in Rule 17Ad-22(b)(7) of a clearing agency to impose a higher net capital requirement and argued for a heightened burden of proof in such cases,[265] the Commission has decided not to modify this part of the rule. Specifically, the Commission recognizes the benefit of maintaining flexibility to allow a CCP to impose higher net capital requirements in circumstances where that is necessary to mitigate risks that could not otherwise be effectively managed by other measures. For the same reason, the Commission is declining to modify the rule to prohibit a CCP from having tiered membership standards. The Commission is not persuaded by commenters who stated that use of tiered membership standards by clearing

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265 See supra notes 248–249 and accompanying text.

agencies is by itself anti-competitive because the Commission believes the approach taken by the rule permits well capitalized mid-tier firms to compete directly with large dealers and notes that Section 17A of the Exchange Act expressly requires that the rules of a clearing agency not be designed in a way that the rules discriminate among participants in their use of clearing agency services.[266] It is the Commission's view that tailoring participant membership standards based on participant risk profile is neither discriminatory nor anti-competitive. In addition, the use of scalable limitations on the transactions that the participants may clear and settle through the clearing agency is likely to be a key tool for allowing a clearing agency to comply with Rule 17Ad-22(b)(7) without encountering the delay and operational difficulties of having to request Commission approval to impose a net capital requirement that exceeds $50 million and without compromising the clearing agency's risk management standards.[267]

Finally, the Commission did not make any changes to Rule 17Ad-22(b)(7) in response to suggestions that the rule could create margin call risk because a participant with the minimum net capital level might access multiple clearing agencies.[268] The Commission does not believe that the rule will increase margin call risk. While the Commission understands the concerns raised by this commenter, the Commission believes that the clearing agencies themselves are best positioned to address this issue due to their expertise in this area, as well as their other regulatory obligations related to their risk management and financial well-being. Rule 17Ad-22(d)(2) requires clearing agencies to establish, implement, maintain and enforce written policies

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266 See id.

267 Compare with note 258 and accompanying text (the Commission is not persuaded by the position that Rule 17Ad-22(b)(7) should not be adopted, but agrees with the commenters premise that clearing agencies should retain some discretion to allow their expertise to inform participation standards within the requirements of the rule).

268 See supra notes 253–256 and accompanying text.

and procedures reasonably designed to require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP and have procedures in place to monitor that participation requirements are met on an ongoing basis. Accordingly, a small clearing member should not be able to expose a clearing agency to significant risk even if it is able to clear at multiple CCPs.[269] The Commission also will be able to monitor the financial strength of clearing members that are registrants pursuant to other financial reporting requirements. Accordingly, we believe that it is important to allow CCPs enough flexibility to determine the most effective approach for mitigating any potential call risk. In addition, the Commission will continue to monitor this issue and will consider whether any regulatory changes are necessary based on experience with the $50 million capital standard. The Commission will also consider any further action responsive to this issue after receiving input from interested parties through the outreach described in Section II.B.

E. Record of Financial Resources and Annual Audited Financial Statements: Rules 17Ad-22(c)(1)–(2)

1. <u>Rule 17Ad-22(c)(1): Record of Financial Resources for Central Counterparties</u>

a. Proposed Rule

Proposed Rule 17Ad-22(c)(1) would provide that each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any

269 For example, CCPs that participate in the Shared Market Information System (SHAMIS) will be able to see a clearing member's risk and financial information across participating CCPs, and a CCP also could on its own initiative require clearing members to directly report their clearing activity at other clearing agencies. Other similar systems may develop in the future.

time upon Commission request, a CCP shall calculate and maintain a record[270] of the financial resources necessary to meet its requirement in proposed Rule 17Ad-22(b)(3) and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

b. Comments Received

Commenters generally supported proposed rule 17Ad-22(c)(1).[271]

c. Final Rule

We are adopting Rule 17Ad-22(c)(1) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. The Commission believes that it is appropriate to require registered clearing agencies to make these calculations quarterly or at any time based on the request of the Commission because it provides a periodic update of the financial resources that are needed by the clearing agencies as market conditions change. The structure of Rule 17Ad-22(c)(1) also provides flexibility for the Commission to request such calculations on a real-time basis, which we believe to be useful during periods of market stress or other circumstances where more timely information is desired. The Commission believes that these calculations and related documentation will also help our oversight of compliance by clearing agencies with Rule 17Ad-

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270 See Exchange Act Rule 17a-1 (17 CFR 240.17a-1). Clearing agencies may destroy or otherwise dispose of records at the end of five years consistent with Exchange Act Rule 17a-6 (17 CFR 240.17a-6).

271 See The DTCC (April) Letter at 7; see also Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed rule 17Ad-22 concerning standards for clearing agencies); LCH Letter at 1 (stating its general belief that the rules in the Proposing Release "will help establish a comprehensive regulatory framework to reduce risk, increase transparency and promote market integrity within the financial system.").

22(b)(3) by providing a clear record of the method used by the clearing agency to maintain sufficient financial resources.

2. Rule 17Ad-22(c)(2): Clearing Agency Annual Audited Financial Statements

a. Proposed Rule

Rule 17Ad-22(c)(2), as proposed, would require a clearing agency to post on its website an annual audited financial report. Each financial report would be required to: (i) be a complete set of financial statements of the clearing agency for the most recent two fiscal years of the clearing agency and be prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country, the financial statements may be prepared according to U.S. GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS"); (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iii) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02).

b. Comments Received

Commenters generally supported proposed Rule 17Ad-22(c)(2).[272] In response to a question asked by the Commission in the Proposing Release, one commenter stated that it does not believe the Commission should require a reconciliation to U.S. GAAP for reports prepared using IFRS because it believes that IFRS is a high-quality set of accounting standards that is

[272] See The DTCC (April) Letter at 7; ENY Letter at 2.

widely recognized, understood and used by investors when evaluating investment opportunities.[273] The commenter also asked the Commission to consider allowing non-U.S. based clearing agencies to prepare their financial statements in accordance with accounting standards generally accepted in the clearing agency's particular jurisdiction so long as the financial statements are accompanied by a reconciliation to U.S. GAAP.[274] The commenter suggested that not allowing this flexibility could force non-U.S. based clearing agencies to post financial statements on their website that do not conform to the clearing agency's local accounting and financial reporting requirements.[275]

c. Final Rule

We are adopting Rule 17Ad-22(c)(2) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We have also changed references to "annual audited financial report" to "annual audited financial statements" to be consistent with the term used in Regulation S-X. Furthermore, we have clarified that a registered clearing agency will be required to post its financial statements of income, changes in stockholders' equity and other comprehensive income and cash flows[276] within 60 days after the end of its fiscal year, which is consistent with the staff guidance on meeting the requirements of Section 17A in its Announcement of Standards for the

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273 See ENY Letter at 1.

274 See id. at 2.

275 See id.

276 The added language, "changes in stockholders' equity and other comprehensive income," does not change the substance of the rule as provided in the Proposing Release. This language has been added in the final rule to clarify the scope of what is meant by a complete set of financial statements consistent with customary industry accounting practices.

Registration of Clearing Agencies.[277] The Commission believes that requiring the disclosure of the clearing agency's annual audited financial statements to be an additional layer of information about the activities and financial strength of the clearing agency that market participants may find useful in assessing their use of the clearing agency's services.[278]

Consistent with recommendations from commenters, we are adopting Rule 17Ad-22(c)(2) in a form that does not require a reconciliation to U.S. GAAP for clearing agency reports that are prepared using IFRS.[279] We appreciate the request made by commenters for the Commission to consider allowing non-U.S. based clearing agencies to prepare their financial statements in accordance with accounting standards generally accepted in their home jurisdiction so long as the financial statements are accompanied by a reconciliation to U.S. GAAP.[280] However, we also recognize the advantages of financial statement disclosure that are limited to more widely applied bases of accounting and may offer more utility to market participants, regulators and other stakeholders of clearing agencies. Therefore, we have limited the different bases of accounting upon which the annual audited financial statements may be prepared to IFRS and U.S. GAAP.

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277 See Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980) ("Accordingly, a clearing agency should undertake in its rules to furnish to participants, within 60 days following the close of the clearing agency's fiscal year, unconsolidated audited comparative financial statements which are prepared in accordance with generally accepted accounting principles and are covered by a report prepared by its independent public accountant.").

278 The requirements of proposed Rule 17Ad-22(c)(2) concerning the audited annual financial statements would apply individually to each respective clearing agency.

279 See supra note 273.

280 See supra notes 274-275 and accompanying text.

F. Minimum Standards for Registered Clearing Agencies: Rules 17Ad-22(d)(1)–(15)

Rule 17Ad-22(d) sets forth certain minimum standards regarding the operations of registered clearing agencies providing CCP or CSD services. The standards established in Rule 17Ad-22 address areas including: (1) transparent and enforceable rules and procedures; (2) participation requirements; (3) custody of assets and investment risk; (4) operational risk; (5) money settlement risk; (6) cost-effectiveness; (7) links; (8) governance; (9) information on services; (10) immobilization and dematerialization of securities certificates; (11) default procedures; (12) timing of settlement finality; (13) delivery versus payment; (14) risk controls to address participants' failures to settle; and (15) physical delivery risks.

Like Rules 17Ad-22(b) and (c), Rule 17Ad-22(d) is designed to work in tandem with the Commission's existing mandate under Section 17A of the Exchange Act by establishing minimum standards for clearing agency operations. In particular, Congress directed the Commission to facilitate the establishment of (1) a national system for the prompt and accurate clearance and settlement of transactions in securities (other than exempt securities) and (2) linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options.[281] In using its authority, the Commission must consider the public interest, the protection of investors, the safeguarding of securities and funds, and the maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents.[282] When Congress established this system for the regulation of clearing agencies in 1975, Congress found that:

281 See 15 U.S.C. 78q-1(a)(2)(A).

282 See 15 U.S.C. 78q-1(b)(3)(A)–(I).

- The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.
- Inefficient procedures for clearance and settlement impose unnecessary costs on investors and persons facilitating transactions by and acting on behalf of investors.
- New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.
- The linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.[283]

These findings serve as objectives in the Commission's ongoing efforts to enhance efficiency and reduce risk in the operation of the U.S. clearance and settlement system. Over the years, the Commission's view of the actions by a clearing agency that are necessary to meet these objectives as well as the other requirements in Section 17A has changed with prevailing market conditions and as new technologies are developed. For example, in the years after the October 1987 market break, the Commission worked to implement a number of changes in the securities markets, including the reduction of the standard settlement time frame for a securities transaction to the third day after the securities trade date (i.e., T+3) and the conversion to a same-day funds settlement system.[284] In 2004, in a concept release titled Securities Transaction

283 See 15 U.S.C. 78q-1(a)(1).

284 See 17 CFR 240.15c6-1; Exchange Act Release No. 34-26051 (Aug. 31, 1988), 53 FR 34852 (Sept. 8, 1988).

Settlement, the Commission noted at that time that (1) size and growth of the securities markets; (2) tighter linkages among markets and market participants; and (3) a possible wide-scale regional disruption prompted the Commission to consider shortening the standard T+3 securities settlement cycle even further to mitigate the possibility of systemic disruptions and to facilitate a more efficient clearance and settlement system.[285]

Over time, changes to the U.S. legal framework have also led to enhancements in the operation of the U.S. clearance and settlement system. For example, the adoption of Revised Article 8 of the Uniform Commercial Code in 1995 strengthened the laws governing the holding and transfer of securities.[286] In response, clearing agencies changed their rules to provide greater legal certainty to their direct investors and provide greater protection to investors.[287] Amendments to the U.S. bankruptcy code in 2005 similarly provided an opportunity for enhanced legal protections for clearing agencies and clearing agency participants.[288]

Consistent with these examples of how the Commission's approach to administrative oversight and practices by clearing agencies have changed over time to meet the objectives of Section 17A, the Commission believes that Rule 17Ad-22(d) creates standards for various aspects of the payment, clearance and settlement process and that to meet these standards clearing agencies will likely need to update their rules and procedures as market conditions evolve (e.g., through new products and trading strategies), to keep pace with relevant changes in

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285 See Concept Release: Securities Transaction Settlement, Release No. 34-49405 (Mar. 11, 2004).

286 See generally James S. Rogers, Policy Perspectives on Revised U.C.C. Article 8 (1996), Boston College Law School Faculty Papers, Paper 343, available at http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1346&context=lsfp.

287 Securities and Exchange Act Release Nos. 39924 (Apr. 27, 1998), 63 FR 24584 (May 4, 1998) and 36781 (Jan. 26, 1996), 61 FR 3958 (Feb. 2, 1996).

288 Bankruptcy Abuse Prevention and Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23.

technology, and appropriately respond to other conditions.[289] The discussion below provides greater detail regarding each respective standard covered in Rules 17Ad-22(d)(1)–(15). As indicated in Section II.B the Commission intends to observe clearing agency practices as they are developed to establish, implement, maintain and enforce policies and procedures that are intended to achieve compliance with Rules 17Ad-22(d)(1)–(15). Monitoring those practices and through cognizance of changes in other relevant areas that affect a clearing agency's operation and governance, such as market conditions, technology, or international standards, the Commission may modify Rules 17Ad-22(d)(1)–(15) over time or adopt additional rules as appropriate. The Commission may also choose to issue further guidance concerning its rules for clearing agencies.

1. Rule 17Ad-22(d)(1): Transparent and Enforceable Rules and Procedures

a. Proposed Rule

Rule 17Ad-22(d)(1), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for a well-founded, transparent and enforceable structure for each aspect of their activities in all relevant jurisdictions.[290]

b. Comments Received

Commenters generally supported Rule 17Ad-22(d)(1).[291]

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289 See supra note 71.

290 A relevant jurisdiction would include, among others, activities (1) in the United States, (2) involving any means of interstate commerce, or (3) in respect to providing clearing services to any U.S. person. For clearing agencies that operate in multiple jurisdictions, this also could include resolving possible conflicts of laws issues that the clearing agency may encounter.

291 See The DTCC (April) Letter at 7 (noting its support for proposed Rule 17Ad-22(d)(1) as drafted); see also Better Markets Letter at 2 (stating generally that"[i]n fashioning the

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(d)(1) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We believe that well-founded, transparent and enforceable policies and procedures established to underpin a clearing agency's operational and business activities are essential to reduce legal risks and enhance a clearing agency's ability to facilitate the prompt and accurate clearance and settlement of securities transactions and safeguard securities and funds as required for the protection of investors by Section 17A of the Exchange Act.[292]

To achieve compliance with Rule 17Ad-22(d)(1), a clearing agency must have written policies and procedures[293] in place that, at a minimum, address the significant aspects of a clearing agency's operations and risk management to provide a well-founded legal framework and must be clear, internally consistent, and readily accessible by the public in order to provide a transparent legal framework. In addition, the clearing agency must be able to enforce its policies and procedures that contemplate enforcement by the clearing agency. Moreover, policies and

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rules, and in accordance with the Dodd-Frank Act, the Commission has appropriately taken into account international standards governing clearance and settlement"); Barnard Letter at 1 (supporting generally the thrust of the Commission's proposals in the Proposing Release, particularly proposed Rule 17Ad-22 concerning standards for clearing agencies); The OCC Letter at 7 (applauding the Commission generally for choosing to incorporate many aspects of the current CPSS-IOSCO Recommendations in the Proposing Release); LCH Letter at 1 (stating its general belief that the rules in the Proposing Release "will help establish a comprehensive regulatory framework to reduce risk, increase transparency and promote market integrity within the financial system").

292 15 U.S.C. 78q-1(a)(1)(A).

293 Clearing agencies are SROs as defined in Section 3(a)(26) of the Exchange Act. A stated policy, practice, or interpretation of an SRO, such as a clearing agency's written policies and procedures, would generally be deemed to be a proposed rule change, unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization and is not a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of a SRO's existing rule. See 17 CFR 240.19b-4.

procedures that govern or create remedial measures that a party other than the clearing agency (such as a clearing member) can undertake to seek redress or to promote compliance with applicable rules must be enforceable.[294] Examples of legal risk in the operation of a clearing agency include, among other things, the likelihood that the policies and procedures of a clearing agency are incomplete, opaque, or not enforceable and will therefore adversely affect the functioning of the clearing agency.[295] The Commission believes that it is helpful for a clearing agency to bear these risk factors in mind and that it should also consider the extent to which changes in the legal framework affecting the clearing agency may require changes to its organization and practices to ensure that the establishment, implementation, maintenance and enforcement of its policies and procedures continues to provide for a well-founded, transparent and enforceable structure that protects the interests of the clearing agency and its participants.

2. Rule 17Ad-22(d)(2): Participation Requirements

a. Proposed Rule

Rule 17Ad-22(d)(2), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency; have procedures in place to monitor that participation requirements are met on an ongoing basis; and have participation requirements that are objective, publicly disclosed, and permit fair and open access.

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294 The Commission believes that Rule 17Ad-22(d)(1) would augment the Exchange Act requirement that the rules of the clearing agency must provide that its participants shall be appropriately disciplined for any violation of any provision of the rules of the clearing agency. See 15 U.S.C. 78q-1(b)(3)(G).

295 See generally RSSS Recommendation 1, Legal Framework and RCCP Recommendation 1, Legal Risk, supra note 33.

b. Comments Received

Some commenters supported proposed Rule 17Ad-22(d)(2).[296]

One commenter stated its specific preference for proposed Rule 17Ad-22(d)(2) to facilitate the Commission's regulation of access at clearing agencies compared to Rules 17Ad-22(b)(5), (6) and (7) for CCPs.[297] The commenter suggested that adoption of Rule 17Ad-22(d)(2), though not a prescriptive rule, would give the Commission a broad level of plenary authority over participant access to clearing agencies.[298]

One commenter recommended that the Commission should take an expansive, prescriptive approach to its rule requirements for clearing agency participation and participant monitoring.[299] The commenter asked that the Commission to be more detailed in the requirements of its proposed rules that address participation standards, like Rule 17Ad-22(d)(2).[300] The commenter suggested that the Commission should apply this approach within several categories of clearing agency operation that it believes comprise risk management.[301]

One commenter supported the requirement in Rule 17Ad-22(d)(2) for clearing members to have written policies and procedures for risk management but also emphasized the importance

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296 See The DTCC (April) Letter at 7; see also Better Markets Letter at 2; Barnard Letter at 1; The OCC Letter at 7; LCH Letter at 1.

297 See The OCC Letter at 12.

298 See id.

299 See Barnard Letter at 1; ISDA Letter at 3–4.

300 See ISDA Letter at 3–4.

301 See id. (citing the following areas as components of a clearing agency's risk management framework: (1) board and senior management oversight; (2) an organizational structure that conforms to the overall strategy and risk policy set by the board; (3) that individuals permitted to take risk on behalf of the clearing member have a strong understanding of the organization's risk profile, the products it trades, and approved trading limits; (4) risk management that is independent and reports directly to senior management or the board; and (5) strong systems and procedures for controlling, monitoring, and reporting risk (including for transactions with affiliates)) (emphasis added).

of placing emphasis on practical experience in risk management.[302] The commenter urged the Commission to require that participants in a clearing agency must be able to participate in its default management process, which includes the ability to bid for the portfolios of other clearing members.[303] The commenter also stated that if a clearing agency admitted a clearing member that was unable to participate in default management, it would reduce available resources and liquidity, place heightened burdens on other clearing members, and reduce the likelihood that the clearing agency's risk management process would operate effectively.[304]

One commenter encouraged the Commission to prohibit clearing agencies from imposing rules or engaging in conduct that is prejudicial to indirect clearing participants compared to direct clearing participants (e.g., with respect to eligibility or the timing of clearing or processing of trades), and stated that if a transaction satisfies a clearing agency's rules then the clearing process for that trade should be the same regardless of whether it involves direct or indirect clearing participants.[305]

Some commenters expressed concern that clearing agency participants may rely on the resources and services of a third party to meet the requirements developed by clearing agencies pursuant to Rule 17Ad-22(d)(2).[306] One commenter expressed that it does not believe that a

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302 See ISDA Letter at 4.

303 See ISDA Letter at 5.

304 See id.

305 See MFA (Kaswell) Letter at 7 (further stating that this includes "barriers to competitive price provision by a liquidity provider that is an indirect clearing participant versus a direct clearing participant" because "when an indirect clearing participant trades with another indirect clearing participant, the clearing process should be identical and as prompt as when one of the parties is a direct clearing participant so long as the transaction satisfies the relevant clearing agency's rules, requirements and standards otherwise applicable to such trades."); MFA (Baker) Letter Attachment 1, at 1.

306 See ISDA Letter at 4–5.

clearing member should be able to use a credit facility funding arrangement from an unaffiliated entity to satisfy financial resource requirements developed by a clearing agency pursuant to Rule 17Ad-22(d)(2).[307] The commenter noted that in this case the clearing member receives only a contractual right to funds, may need to attempt to enforce that right at a time of stressed liquidity, and does not have rights to monitor the financial resources of the liquidity facility.[308] The same commenter stated that participants should not be permitted to outsource default management.[309] It argued that preventing the outsourcing of default management arrangements is critical to mitigate risks associated with outsourcing.[310]

Several commenters argued that Rule 17Ad-22(d)(2) is only appropriate for CCPs.[311] As noted below, Rule 17Ad-22(d)(2) only applies to these entities.

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(d)(2) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies.

Rule 17Ad-22(d)(2) is intended to reduce the likelihood of defaults by participants, while also providing flexibility for clearing agencies to tailor standards that are linked to the obligations of the participant. The Commission believes the rule fosters compliance with the

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307 See ISDA Letter at 4.

308 See id.

309 See ISDA Letter at 5.

310 See id. (noting (1) the fact that the third-party does not "have skin in the game" and (2) the third party service provider could inappropriately bind a clearing member to accept positions from a defaulting clearing member that it is not equipped to handle. The commenter also pointed out that conflicts of interest could exacerbate these risks if the third party service provider is operated by a competing clearing member).

311 See Omgeo Letter at 10; TriOptima Letter at 6–7.

requirement under Section 17A of the Exchange Act that the rules of a clearing agency must not be designed to permit unfair discrimination in the admission of participants by requiring standards that are designed to be measurable, open and fair.[312]

We agree with those commenters who supported Rule 17Ad-22(d)(2) as a mechanism to help ensure that clearing agencies meet the Exchange Act requirements in their participation standard practices.[313] However, we are not persuaded by the position that Rule 17Ad-22(d)(2) is so coextensive with the requirements of Rules 17Ad-22(b)(5), (6) and (7) that it renders the adoption of those rules unnecessary.[314] As discussed above, Rules 17Ad-22(b)(5), (6) and (7) are responsive to specific concerns about access to CCPs that have been brought to the attention of the Commission in connection with efforts to promote central clearing of security-based swaps by the financial services industry, government regulators and legislators in response to the recent financial crisis.[315] We believe that Rule 17Ad-22 promotes the compliance of all clearing agencies with the requirement in Section 17A of the Exchange Act that a clearing agency's rules may not be designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency. We also believe this complements the design of Rules 17Ad-22(b)(5), (6) and (7) to specifically promote compliance with the fair access requirement by CCPs.

We agree with commenters that comprehensive and explicit requirements are an appropriate part of a clearing agency's risk management framework, including participation

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312 15 U.S.C. 78q-1(b)(3)(F).

313 See supra note 296.

314 See supra note 297.

315 See discussion supra Section II.B.

standards.[316] We also agree with commenters who stated that it is important for the Commission to promote clearing agencies' use of practical experience in establishing, implementing, maintaining and enforcing their policies and procedures concerning participation standards and that the inability of a clearing member to participate in the default management process during a default would be problematic.[317] Accordingly, we believe that it is important to allow clearing agencies enough flexibility to use their market experience to shape the rules, policies and procedures addressing participation standards and for the Commission to oversee the suitability of those standards through its oversight, including the SRO rule filing process, periodic inspections and examinations, and day-to-day monitoring of the activities of clearing agencies. Because of the importance of clearing agency flexibility and the existing oversight mechanisms, the Commission declines to adopt more prescriptive requirements under Rule 17Ad-22(d)(2) at this time.

We agree with commenters that credit facility arrangements represent a contractual right to funds and that enforcement of that contractual right may become more difficult during stressed market conditions.[318] However, we do not believe that the rule should completely prohibit participants from using credit facility arrangements with an unaffiliated entity to satisfy financial resource requirements to a clearing agency because such credit facility arrangements can be an important tool that allows clearing agencies to access liquidity quickly in times of stress avoiding an immediate need to liquidate assets. Instead, we expect clearing agencies to use their expertise to establish rules, policies and procedures that properly reflect the extent to which credit facility arrangements are appropriate for participants at the particular clearing agency

316 See supra notes 299-300.

317 See supra note 302 and accompanying text.

318 See supra notes 306–308 and accompanying text.

based on the particular clearance and settlement services it provides.

We agree with commenters who stated that clearing agencies should not process trades differently on the sole basis of whether the trade is between direct clearing members or involves participants that access the clearing agency through those clearing members, and so the Commission does not find it necessary to create disparate standards for the treatment of direct and indirect participants.[319]

3. Rule 17Ad-22(d)(3): Custody of Assets and Investment Risk

a. Proposed Rule

Proposed Rule 17Ad-22(d)(3) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to hold assets in a manner whereby risk of loss or of delay in access to them is minimized, and invest in instruments with minimal credit, market and liquidity risks. Compliance with the requirement is intended to improve the ability of the clearing agency to meet its settlement obligations by reducing the likelihood that assets securing participant obligations to the clearing agency would be unavailable or insufficient when the clearing agency needs to draw on them.

b. Comments Received

Some commenters expressed concerns about the application and scope of proposed Rule 17Ad-22(d)(3). One commenter stated that proposed Rule 17Ad-22(d)(3) is not sufficiently clear in its scope.[320] The commenter urged the Commission to make clear that Rule 17Ad-22(d)(3) applies only to the assets of the clearing agency that are available to facilitate

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319 See supra note 305 and accompanying text.

320 See The DTCC (April) Letter at 21.

settlement in the event of a participant default and not those assets that are held in custody by the clearing agency.[321]

However, another commenter asked the Commission to clarify that proposed Rule 17Ad-22(d)(3) applies to customer assets only and not to the assets of the clearing agency (or its sponsor).[322] The commenter noted that by defining the scope of Rule 17Ad-22(d)(3) that way the rule would not apply to clearing agencies that perform post-trade processing services (e.g., compression or collateral management) and do not take in or retain any assets of their users.[323] An additional commenter agreed that Rule 17Ad-22(d)(3) should not apply to clearing agencies that do not hold assets on behalf of participants.[324]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(3) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. The Commission believes that Rule 17Ad-22(d)(3) strengthens the requirement in Section 17A(b)(3)(F) of the Exchange Act that the rules of a clearing agency must be designed to ensure the safeguarding of securities and funds in the custody or control of

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321 See The DTCC (April) Letter at 21–22 (remarking that it believes this ambiguity is also contained in RCCP 7: Custody and investment risks on which Rule 17Ad-22(d)(3) is modeled but noting that proposed language for FMI Principle 16: Custody and investment risk would resolve that ambiguity and asking the Commission to revise Rule 17Ad-22(d)(3) as follows to make clear that the requirements of the rule do not apply to assets of participants held in custody: "(d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable: (3) Hold its assets in a manner whereby risk of loss or of delay in its access to them is minimized; and invest such assets in instruments with minimal credit, market and liquidity risks").

322 See TriOptima Letter at 7.

323 See id.

324 See Omgeo Letter at 10.

the clearing agency or for which the clearing agency is responsible.[325] Because the purpose of Rule 17Ad-22(d)(3) is to help ensure assets are available in the event of a participant default, Rule 17Ad-22(d)(3) would apply to all assets held by a clearing agency that may be used for that purpose. However, the Commission notes that Rule 17Ad-22(d)(3) may not apply to the assets of a participant's customer depending on how a clearing agency's operations are structured. The Commission does not expect that registered clearing agencies would need to rely on their physical assets, such as computers, furniture and buildings, to cover a participant default under the rule.

We appreciate the concerns expressed by commenters who asked the Commission to clarify how Rule 17Ad-22(d)(3) applies in the context of the different services that a clearing agency may perform, and note that Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities that are exempt from registration as a clearing agency.

4. Rule 17Ad-22(d)(4): Identification and Mitigation of Operational Risk

a. Proposed Rule

Rule 17Ad-22(d)(4), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify sources of operational risk and minimize these risks through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient and secure and have adequate scalable capacity; and have business continuity plans that allow for timely recovery of operations and ensure the fulfillment of a clearing agency's obligations.

Rule 17Ad-22(d)(4) should help to ensure that clearing agencies are able to operate with minimal disruptions, even during times of market stress when there may be greater demands on

325 15 U.S.C. 78q-1(b)(3)(F).

their systems due to higher volume. In addition, the rule would require that clearing agencies have business continuity plans that allow for timely recovery of operations and ensure the fulfillment of a clearing agency's obligations. This requirement would be relevant in the event of, among other things, deficiencies in information systems or internal controls, human errors, management failures, unauthorized intrusions into corporate or production systems, or disruptions from external events such as natural disasters.

b. Comments Received

Several commenters recommended that the rule should not apply to the activities of clearing agencies that perform post trade processing services. For example, one commenter reasoned that the application of proposed Rule 17Ad-22(d)(4) to a clearing agency that performs post-trade comparison services is unnecessary if that clearing agency is operating pursuant to a conditional exemptive order from the Commission.[326] The commenter stated that the conditions of an exemptive order can be tailored to provide the Commission with sufficient regulatory oversight of a clearing agency's operational risks.[327]

Another commenter expressed its view that operational risk management and disaster recovery systems are critical to any well-founded compression service or collateral management service.[328] However, the commenter argued that a clearing agency that performs those services

326 See Omgeo Letter at 10.

327 See id. (identifying such measures as making the clearing agency subject to: (1) the Commission's Automation Review Program, (2) regular audits by Commission staff, (3) annual reports to the Commission, (4) a duty to report systems outages to the Commission, and (4) on-site inspections by Commission staff of the clearing agency's facilities).

328 See TriOptima Letter at 7–8.

should be free to implement and amend such procedures as it considers necessary to operate its business without undue regulatory delay or oversight.[329]

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(d)(4) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We believe that Rule 17Ad-22(d)(4) complements the existing guidance provided by the Commission in its Automation Review Policy Statements[330] and the Interagency White Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.[331] We also believe that Rule 17Ad-22(d)(4) helps to address risks posed by potential operational

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329 See id. (supporting its position through assertions that: (1) the robustness of a compression service's systems will be a competitive issue that will be determinant of the commercial viability of the compression service; (2) compression services do not represent a systemic risk to the viability of the market because collateral management providers merely run a set of calculations for collateral management purposes; (3) systems integrity is a central feature of the provider's contractual framework and system design and, ultimately, its ability to attract users; and (4) the risk of data loss is, in practice, very small).

330 See Automated Systems of Self-Regulatory Organizations, Exchange Act Release No. 34-27445 (Nov. 16, 1989), 54 FR 48703 (Nov. 24, 1989); Automated Systems of Self-Regulatory Organizations (II), Release No. 34-29815 (May 9, 1991), 56 FR 22489 (May 15, 1991) ("Automation Review Policy Statements"). Generally, the guidance in the Automation Review Policy Statements provides for the following activities by clearing agencies: (1) performing periodic risk assessments of its automated data processing ("ADP") systems and facilities; (2) providing for the selection of the clearing agency's independent auditors by non-management directors and authorizing such non-management directors to review the nature, scope, and results of all audit work performed; (3) having an adequately staffed and competent internal audit department; (4) furnishing annually to participants audited financial statements and an opinion from an independent public accountant as to the clearing agency's system of internal control – including unaudited quarterly financial statements also should be provided to participants upon request; and (5) developing and maintaining plans to assure the safeguarding of securities and funds, the integrity of the ADP system, and recovery of securities, funds, or data under a variety of loss or destruction scenarios.

331 See Exchange Act Release No. 47638 (Apr. 7, 2003), 68 FR 17809 (Apr. 11, 2003), available at http://www.sec.gov/news/studies/34-47638.htm.

deficiencies to a clearing agency and its participants and therefore supports the requirement in Section 17A of the Exchange Act that a clearing agency must be so organized and have the capacity to be able to facilitate prompt and accurate clearance and settlement. Finally, Rule 17Ad-22(d)(4) does not require clearing agencies to eliminate all operational risks. Instead, the rule provides registered clearing agencies with the ability to consider the relevant trade-offs between cost and risk reduction. The rule provides this ability by allowing registered clearing agencies, subject to Commission oversight, to develop systems, controls, and procedures that are "appropriate" in response to the identified risks.[332]

As discussed above, Rule 17Ad-22 applies only to registered clearing agencies. It does not apply to entities that perform post-trade processing services or that are exempt from registration as a clearing agency. As discussed above, entities that perform certain post trade processing services, and that fall within the definition of clearing agency, may be subject to different rulemaking by the Commission at a later time.[333]

5. Rule 17Ad-22(d)(5): Money Settlement Risks

a. Proposed Rule

Proposed Rule 17Ad-22(d)(5) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants, and require funds transfers to the clearing agency to be final when effected. Money settlement arrangements, among other things, are meant to reduce the risk that financial obligations related to the activities of the clearing agency are not timely settled or discharged

332 See discussion supra Section I.A.2.
333 See discussion supra Section II.B.4 and Section III.A.

with finality. Generally, money settlement by a clearing agency and its participants involves the use of a settlement bank[334] as an intermediary. Failure by the settlement bank to effectuate timely and final settlement adversely affects the clearing agency by exposing it to credit and liquidity pressures that in turn can destabilize the clearing agency's ability to facilitate prompt and accurate clearance and settlement.

The Commission is providing clearing agencies with flexibility to implement arrangements in a manner fit for them to meet the requirement of the rule. The Commission notes that there are a number of arrangements that clearing agencies could establish to comply with the rule, including criteria for use of settlement banks that address the banks' creditworthiness, access to liquidity, and operational reliability, and legal agreements with settlement banks to ensure that funds transfers to the clearing agency are final when affected.

b. Comments Received

One commenter stressed that if the Commission adopts Rule 17Ad-22(d)(5) as proposed then the Commission should clarify that a clearing agency cannot eliminate all exposure to settlement bank risk.[335] The commenter pointed out that even if a clearing agency uses an account at a U.S. Federal Reserve bank to make settlement with participants, the clearing agency is still exposed to the settlement risk of the commercial banks that are used by clearing agency participants.[336]

The same commenter stressed that the Commission should not mandate a minimum number of settlement banks and that the requirements of Rule 17Ad-22(d)(5) should focus on

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334 A settlement bank is a bank that is used to effect money settlements between a central counterparty and its participants.

335 See The OCC Letter at 14.

336 See id.

providing clearing agencies with discretion to select settlement banks with care, diversifying risk among those settlement banks to the extent practicable, and monitoring their financial status.[337]

Two commenters argued that proposed Rule 17Ad-22(d)(5) should be applicable only to clearing agencies that take in or process securities or funds from users.[338]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(5) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We believe Rule 17Ad-22(d)(5) limits the potential that a clearing agency's money settlement arrangements will cause the clearing agency to face higher levels of credit and liquidity risks. In addition, the Commission believes that the rule is consistent with the requirement of Section 17A(b)(3)(F) of the Exchange Act, which requires the rules of a clearing agency to be designed to assure the safeguarding of securities and funds that are in the custody or control of the clearing agency or for which it is responsible.[339]

As noted, some commenters pointed out that a clearing agency may not be positioned to eliminate all exposure to credit and liquidity risks from the use of banks to effect money settlements.[340] For example, we agree that even if a clearing agency elects to use an account at a U.S. Federal Reserve bank to make settlement with participants, the clearing agency is still exposed to the settlement risk of the banks chosen by clearing agency participants. The Commission notes however that Rule 17Ad-22(d)(5) does not require a clearing agency to

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337 See id.

338 See Omgeo Letter at 11; TriOptima Letter at 8 (stating that the proposed rule should not apply to compression services and collateral management providers that do not hold or process any of their users' assets).

339 15 U.S.C. 78q-1(b)(3)(F).

340 See supra notes 335–336 and accompanying text.

completely eliminate settlement bank risks. Instead, the clearing agency must establish, implement, maintain and enforce written policies and procedures reasonably designed to employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks. We believe clearing agencies have the authority through their rules to shape the settlement bank practices in order to achieve that outcome. We also agree with commenters that clearing agencies should retain discretion, subject to Commission oversight, to establish rules governing settlement bank practices with participants that are tailored to the operations of the clearing agency.[341]

As discussed above, Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities that are exempt from registration as a clearing agency except to the extent specifically contemplated by the terms of a future exemption.

6. Rule 17Ad-22(d)(6): Cost-Effectiveness

a. Proposed Rule

Rule 17Ad-22(d)(6), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to be cost-effective in meeting the requirements of participants while maintaining safe and secure operations.

Having clearing agencies be mindful of the costs that are incurred by their participants, while maintaining such compliance, should help to reduce inefficiencies in the provision of clearing agency services. This point is particularly important in circumstances where clearing agencies may not be subject to strong competitive forces (such as when there is only one clearing agency for an asset class) for the provision of their services and therefore may have less of an

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341 See supra note 337 and accompanying text.

incentive to be cost-effective in meeting the requirements of participants. Accordingly, the Commission believes the rule should potentially help reduce the costs incurred for clearing agency services while also maintaining appropriate standards for a clearing agency's operations.

b. Comments Received

Two commenters expressed reservations about the rule.[342] One commenter stated that it is unnecessary to apply proposed Rule 17Ad-22(d)(6) to a clearing agency if the Commission already regulates the cost-effectiveness of that clearing agency through conditions in an exemptive order.[343]

Another commenter stressed that unless a provider of compression or collateral management services is systemically important, or market participants are obliged to purchase its services, then it should be free to set fees in a fair and commercial manner that encourages broad participation while permitting sufficient flexibility to offer favorable rates to high-volume users, early adopters, magnet clients and other key participants.[344] The commenter added that portfolio compression and collateral management are service areas in which cost effectiveness is a dominant part of commercial viability and that those services today do not represent a systemic risk to the viability of the markets.[345]

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342 See Omgeo Letter at 11; TriOptima Letter at 8.

343 See Omgeo Letter at 11 ("[P]ursuant to Omgeo's Exemptive Order, Omgeo may not charge its customers more for use of its central matching services than Omgeo charges its customers when all counterparties are customers of Omgeo. Moreover, because DTCC, which is industry-owned, is the majority owner of Omgeo's Class A Interests, which controls the U.S. regulated aspects of Omgeo's business, DTCC can influence the prices Omgeo charges for its U.S. regulated services. This system has worked well, and therefore application of Proposed Rule 17Ad-22(d)(6) to Omgeo is unnecessary").

344 See TriOptima Letter at 8.

345 See id.

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(d)(6) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. As discussed above, the Commission believes Rule 17Ad-22(d)(6) is appropriate and serves to advance the statutory goals of prompt and accurate clearance and settlement.[346] Specifically, the rule should help reduce the costs incurred for clearing agency services by requiring registered clearing agencies to be mindful of costs incurred by their participants, which may include keeping fees lower for participants, while also requiring that registered clearing agencies maintain safe and secure operations.

With regard to suggestions that Rule 17Ad-22(d)(6) should not apply to entities that perform certain post-trade services (i.e., comparison of trade data, collateral management and compression/tear-up services),[347] or a clearing agency through the conditions of an exemptive order rather than the requirements of Rule 17Ad-22(d)(6),[348] we note that Rule 17Ad-22 only applies to CCPs and CSDs and does not apply to entities exempt from registration as clearing agency except to the extent specifically contemplated by the terms of a future exemption.

7. **Rule 17Ad-22(d)(7): Links**

a. **Proposed Rule**

Rule 17Ad-22(d)(7), as proposed, would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear or settle trades, and to ensure that these risks are managed

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346 See supra note 1.

347 See supra notes 344–345 and accompanying text.

348 See supra note 343 and accompanying text.

prudently on an ongoing basis. Tying the operations of different clearing agencies together by link arrangements potentially exposes a clearing agency and its members to the risk that the other entity may experience a financial loss or is otherwise unable to meet its settlement obligations that causes the clearing agency or its members to fail to meet their obligations.[349] Although the design and operation of each link will present a unique risk profile, clearing agencies potentially face legal, operational, credit and liquidity risks from link arrangements. In addition, because links can create interdependencies, clearing agencies may be affected by systemic risk if there are deficiencies in these arrangements. The Commission believes that requiring clearing agencies to evaluate and monitor any link arrangements they maintain is essential to protect the marketplaces that clearing agencies serve because the requirement would reduce the likelihood that such arrangements perpetuate risks that could create disruptions in the operations of clearing agencies.

b. Comments Received

Three commenters expressed concerns about the rule.[350] One commenter expressed concern that proposed Rule 17Ad-22(d)(7) is not sufficiently clear in scope.[351] Specifically, the commenter stated that it is not entirely clear whether the rule applies only to links between clearing agencies or may also apply to other "links" and any other entities that may be involved in the process of clearing and settling trades.[352] Accordingly, the commenter asked the

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349 A clearing agency may be required to enter into a participant agreement with the other clearing organization as part of the link arrangement, which includes sharing in the loss allocations of that clearing organization. See RCCP 4.10.6, supra note 33.

350 See The DTCC (April) Letter at 22; TriOptima Letter at 9; Omgeo Letter at 12.

351 See The DTCC (April) Letter at 22.

352 See id. (providing examples of these other types of links such as those that a clearing agency may establish with a data processor, pricing service, custodian bank, transfer agent or liquidity provider).

Commission to revise the proposed rule text for 17Ad-22(d)(7).[353] An additional commenter suggested that proposed Rule 17Ad-22(d)(7) should be modified to encourage prudent portfolio compression and collateral management services globally.[354] One commenter argued that it should not be subject to Rule 17Ad-22(d)(7) because it is already subject to the conditions of an exemptive order from clearing agency registration by the Commission.[355]

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(d)(7) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. We believe the rule is consistent with and furthers the purposes of the Exchange Act. Section 17A(a)(1)(D) of the Exchange Act states that the linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance

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353 See The DTCC (April) Letter at 23 (requesting that Rule 17Ad-22(d)(7) be revised as follows: "Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable, evaluate the potential sources of risks that can arise when the clearing agency establishes links with other central counterparties or central securities depositories either cross-border or domestically to clear trades, and ensure that the risks are managed prudently on an ongoing basis.").

354 See TriOptima Letter at 9 (noting its belief that regulations that restrict the global availability of compression services and collateral management services will necessarily reduce the effectiveness of the risk-management service, by reducing the geographic scope of counterparties to which domestic users can connect). The commenter expressed its views on modifying Rule 17Ad-22(d)(7) in the larger context of its belief "that the registration requirement with respect to [portfolio compression services and] . . . collateral management services is inappropriate and would place unnecessary burdens on entities providing swap market participants useful back-office tools that are intended to improve the efficiency of collateral management systems in a manner that reduces systemic risk." See TriOptima Letter at 1.

355 See Omgeo Letter at 12 (suggesting that its exemptive order is the oversight mechanism that strikes the appropriate balance to govern its link arrangements because its link arrangements (1) do not involve the handling of securities or funds; (2) provide for standardization and processing of information in a uniform and efficient manner; and (3) disruptions to its link arrangements are of a different type and are far less significant than disruptions in the linkages of registered clearing agencies).

and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.[356] Further, Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions.[357]

The Commission agrees with the suggestion from some commenters that the specific type of link arrangements contemplated by Rule 17Ad-22(d)(7) is link arrangements between clearing agencies.[358] The Commission notes however that under Section 17A(b)(3)(F) of the Exchange Act, a clearing agency is charged with responsibility to coordinate with persons engaged in the clearance and settlement of securities transactions, not just other clearing agencies.[359] Accordingly, we have not amended the text of Rule 17Ad-22(d)(7) from the proposal. Further, the Commission notes that during the clearance and settlement process, a registered clearing agency is confronted with a variety of risks that must be identified and understood if they are to be effectively controlled.[360] To the extent that these risks arise as a result of a registered clearing agency's links with another entity involved in the clearance and settlement process, Rule 17Ad-22(d)(7) should help ensure that clearing agencies have policies and procedures designed to identify those risks.

Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities that are exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

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356 15 U.S.C. 78q-1(a)(1)(D).

357 15 U.S.C. 78q-1(b)(3)(F).

358 See supra note 352.

359 15 U.S.C. 78q-1(b)(3)(F).

360 See RCCP, supra note 33, at 39.

8. Rule 17Ad-22(d)(8): Governance

a. Proposed Rule

Proposed Rule 17Ad-22(d)(8) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to have governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of the Exchange Act applicable to clearing agencies,[361] to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures.[362]

b. Comments Received

Two commenters registered their preference for what they regard as the principles-based approach in proposed Rule 17Ad-22(d)(8) to regulation of clearing agency governance rather than the prescriptive rules set forth in the Commission's proposed Regulation MC applicable to the security-based swap clearing agencies.[363] One commenter urged the Commission not to adopt hard and fast standards that will be costly to implement and maintain and yield little or no apparent corresponding regulatory benefits.[364]

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361 Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency be designed to protect investors and the public interest. 15 U.S.C. 78q-1(b)(3)(F).

362 Rule 17Ad-22(d)(8) would complement other applicable requirements concerning governance at clearing agencies that may also separately apply. These other requirements include the existing regulatory framework of Section 17A of the Exchange Act and the related requirements contemplated by proposed Rule 17Ad-25, as well as Section 765 of the Dodd-Frank Act with respect to security-based swap clearing agencies. See supra Section III.F (stating that clearing agencies be required to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest). See also Exchange Act Release No. 63107 (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010), supra note 231.

363 See CME Letter at 3; The OCC Letter at 14 (referencing the Commission's proposed requirements for clearing agencies in Regulation MC).

364 See CME Letter at 4.

One commenter urged the Commission to ensure that Rule 17Ad-22(d)(8) as well as any requirements adopted from the Commission's proposed Regulation MC pertaining to the mitigation of conflicts of interest are designed to ensure that buy-side market participants have a meaningful voice in the operating committees of clearing agencies because that representation is critical to promoting robust governance arrangements at clearing agencies and serving the best interests of the U.S. financial system.[365] Another commenter stated that proposed Rules 17Ad-22(d)(8), 17Ad-25, and 17Ad-26 reflect a better approach to governance, conflicts of interest, and board and committee composition than the Commission's proposed requirements for clearing agencies under Regulation MC.[366]

One commenter urged the Commission to consider complementing proposed Rule 17Ad-22(d)(8) with a minimum board independence requirement so that at least two-thirds of all board directors would be required to be independent.[367]

Several commenters made recommendations to the Commission concerning the application of Rule 17Ad-22(d)(8) to clearing agencies that perform post-trade processing services.[368] One commenter stated that if the Commission interprets proposed Rule 17Ad-22(d)(8) to be applicable to clearing agencies that perform post-trade processing services for security-based swaps (e.g., comparison of data, portfolio compression and collateral management) then the governance requirements should be commensurate with the low risk presented by those service providers because requirements that are unduly onerous would impose

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365 See BlackRock Letter at 2.

366 See The DTCC (April) Letter at 8.

367 See CII Letter at 1.

368 See TriOptima Letter at 9; Omgeo Letter at 12.

unnecessary burdens and costs.[369] Another commenter argued that application of proposed Rule 17Ad-22(b)(8) to a clearing agency is unnecessary in cases when an industry utility has such a significant influence over a clearing agency's management and operation that the clearing agency's governance is already appropriately transparent to fulfill the public interest.[370]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(8) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. Rule 17Ad-22(d)(8) is designed to promote these types of arrangements and the ability of a clearing agency to serve the interests of its various constituents and the interests of the general public while maintaining prudent risk management processes to promote prompt and accurate clearance and settlement.

Governance arrangements have the potential to play an important role in making sure that clearing agencies fulfill the Exchange Act requirements that the rules of a clearing agency be designed to protect investors and the public interest and to support the objectives of owners and participants. Similarly, governance arrangements may promote the effectiveness of a clearing agency's risk management procedures by creating an oversight framework that fosters a focus on the critical role that risk management plays in promoting prompt and accurate clearance and settlement.[371]

We appreciate the perspective of commenters who prefer the more general policies and

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369 See TriOptima Letter at 9.

370 See Omgeo Letter at 12.

371 The role of governance arrangements in promoting effective risk management has also been a focus of rules recently proposed by the Commission to mitigate conflicts of interest at security-based swap clearing agencies. See Exchange Act Release No. 63107 (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010).

procedures design of Rule 17Ad-22(d)(8) to any more prescriptive rulemaking by the Commission in the area of clearing agency governance.[372] We agree that Rule 17Ad-22(d)(8) provides an important element of discretion to a clearing agency to be able to use its experience and expertise to hone policies and procedures for governance arrangements that support the clearing agency's particular operations. Even so, we are not persuaded by the assertions that more prescriptive Commission rules to address clearing agency governance practices would necessarily be disproportionately costly to implement and maintain when compared to potential countervailing benefits.[373] We continue to perform a careful review and evaluation of the comments that the Commission received on proposed Rules 17Ad-25, 17Ad-26 and Regulation MC, which commenters rightly observed represent separate, and in some cases more prescriptive, proposed requirements related to clearing agency governance and mitigation of conflicts of interest.

At this time, the Commission also is not acting on the recommendation of some commenters to structure Rule 17Ad-22(d)(8) so that it would require at least two-thirds of a clearing agency's board of directors to be independent.[374] Proposed Rule 17Ad-26 and Regulation MC address whether and how to require some degree of independent representation on the board of a clearing agency. We believe it is more appropriate to consider those issues in connection with the Commission's ongoing consideration of those rules.

With regard to suggestions that Rule 17Ad-22(d)(8) should not apply to entities that perform certain post-trade services (i.e., comparison of trade data, collateral management and

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372 See supra note 364.

373 See id.

374 See supra note 367.

compression/tear-up services),[375] we note that Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

We are not persuaded by the argument that the operation of a clearing agency through a utility model negates the need for Rule 17Ad-22(d)(8) because regardless of the business model adopted, the board should reflect the interests of the full range of stakeholders in order to effective.[376] In response to comments that the rule should apply to a clearing agency in a way that is commensurate with the risk of its services,[377] the Commission expects that not all policies and procedures established by clearing agencies to satisfy Rule 17Ad-22(d)(8) will be the same. Instead, to be useful to a clearing agency and its interested parties, the policies and procedures should necessarily reflect the unique relationships at that clearing agency between the scope of its operations and its governance and risk management needs.

9. Rule 17Ad-22(d)(9): Information on Services

a. Proposed Rule

Proposed Rule 17Ad-22(d)(9) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using the clearing agency's services.

The Commission believes that requiring a clearing agency to disclose information sufficient for participants to identify risks and costs associated with using the clearing agency will allow participants to make informed decisions about the use of the clearing agency and take

375 See supra notes 368–370.

376 See supra note 370 and accompanying text.

377 See supra note 369 and accompanying text.

appropriate actions to mitigate their risks and costs associated with the use of the clearing agency.

b. Comments Received

One commenter stated that it does not believe that the proposed rule is necessary because among other things a clearing agency's fees, collateral deposits, and operational requirements are already included in the clearing agency's rules and its published procedures and are already required to be sufficiently available to market participants and the public at large.[378]

Two commenters expressed that application of proposed Rule 17Ad-22(d)(9) to clearing agencies that do not handle securities or funds is unnecessary.[379]

c. Final Rule

We are adopting Rule 17Ad-22(d)(9) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies We believe that requiring a clearing agency to have policies and procedures that require a clearing agency to disclose sufficient information so that participants can identify risks and costs associated with using the clearing agency will allow participants to make informed decisions about the use of the clearing agency and take appropriate actions to mitigate their risks and costs associated with the use of the clearing agency. While the rule provides clearing agencies flexibility to determine how to adequately disclose information so participants can identify and evaluate risks and costs associated with participation, the Commission believes that disclosure of the clearing agency rulebook, the costs of its services, a description of netting and

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378 See The OCC Letter at 15.

379 See Omgeo Letter at 12; see also TriOptima Letter at 9 (noting that compression services and collateral management services operate on the basis of clear, standardized documentation and present few risks to users. If a compression cycle or collateral management service fails, the users' pre-existing transactions remain in effect and the risks can be disclosed in user documentation).

settlement activities it provides, participants' rights and obligations, information regarding its margin methodology, and information regarding the extreme but plausible scenarios that the clearing agency uses to stress test its margin requirements are among the categories of information that participants could use to identify and evaluate risks and costs associated with use of the clearing agency. The Commission also believes that it is reasonable to expect that the type of information and level of detail that market participants will consider to be sufficient will evolve over time and therefore clearing agencies should seek to establish regular channels of communication with market participants and processes for continuously improving their disclosure practices as the marketplace changes over time.

Because clearing agencies are SROs, their rules are published by Commission and are generally available on each clearing agency's website. Nevertheless, discrete rule proposals do not necessarily provide a complete picture of a clearing agency's operations and the risk mitigation procedures. Accordingly, the rule is intended to promote a better understanding among market participants of a clearing agency's operations. A better understanding should foster confidence in the clearing agency's ability to manage those risks and costs, including, but not limited to, any margin requirements, restrictions or limitations of the clearing agency's obligations, and conditions used by the clearing agency to test the adequacy of its financial resources.

We acknowledge that existing requirements address the need for clearing agencies to incorporate matters such as the clearing agency's fees, collateral deposits, and operational requirements in its rules and procedures, which are already made available to market participants and the public.[380] The Commission is also aware that under Rule 17Ad-22(d)(9), the nature of

[380] See supra note 378.

the information that clearing agencies must provide, how frequently it must be provided, and who is entitled to receive it are all aspects of compliance with Rule 17Ad-22(d)(9) that implicate concerns by clearing agencies about protection of their proprietary information.[381] We believe that the nature and extent of information that is required to be provided under Rule 17Ad-22(d)(9) should be tailored to the needs of market participants based on the risks and costs to which they are exposed. Clearing agencies are expected to establish such tailored approaches in their policies and procedures designed to achieve compliance with Rule 17Ad-22(d)(9).

We agree with commenters who recommended that Rule 17Ad-22(d)(9) should only apply categorically to clearing agencies that take in or process securities or funds. Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency except to the extent specifically contemplated by a future exemption.

10. Rule 17Ad-22(d)(10): Immobilization and Dematerialization of Securities Certificates

a. Proposed Rule

Proposed Rule 17Ad-22(d)(10) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to immobilize[382] or

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381 See id.

382 Immobilization refers to any circumstance where an investor does not receive a physical certificate upon the purchase of securities or is required to physically deliver a certificate upon the sale of securities.

dematerialize[383] securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides CSD services.[384]

The Commission believes that the immobilization and dematerialization of securities and their transfer by book entry results in reduced costs and risks associated with securities settlements and custody by removing the need to hold and transfer many, if not most, physical certificates.[385] The Commission also believes that the proposed rule strengthens the requirement in Section 17A(b)(3)(F) of the Exchange Act for the rules of a clearing agency to assure the safeguarding of securities and funds that are in the custody or control of the clearing agency or for which it is responsible.[386]

b. Comments Received

One commenter expressed concern that proposed Rule 17Ad-22(d)(10) places responsibilities on clearing agencies that perform CSD services to immobilize or dematerialize securities that are beyond the clearing agency's control. Therefore, the commenter requested

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383 Dematerialization is the process of eliminating physical certificates as a record of security ownership.

384 See proposed Rule 17Ad-22(a)(2) for definition of "central securities depository services." DTC is currently the only registered clearing agency that provides central securities depository services.

385 By concentrating the location of physical securities in a single central securities depository, clearing agencies are able to centralize the operations associated with custody and transfer and reduce costs through economies of scale. Virtually all mutual fund securities, government securities, options, and municipal bonds in the United States are dematerialized and most of the equity and corporate bonds in the U.S. market are either immobilized or dematerialized. While the U.S. markets have made great strides in achieving immobilization and dematerialization for institutional and broker-to-broker transactions, many industry representatives believe that the small percentage of securities held in certificated form impose unnecessary risk and expense to the industry and to investors. See Exchange Act Release No. 8398 (Mar. 11, 2004), 69 FR 12921 (Mar. 18, 2004).

386 15 U.S.C. 78q-1(b)(3)(F).

that the rule be revised to reflect the need for cooperation from market participants and regulators.[387]

Another commenter stated its belief that the proposed Rule 17Ad-22(d)(10) should not apply to portfolio compression and collateral management services for security-based swaps.[388]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(10) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. Rule 17Ad-22(d)(10) does not require a clearing agency to take any actions that are beyond the scope of its rules, procedures and operations. We agree that collaboration between regulators, market participants, and clearing agencies is necessary to achieve total immobilization or dematerialization of securities certificates; but this result is not required by Rule 17Ad-22(d)(10). The Commission also understands that some clearing agencies already have taken steps in furtherance of full dematerialization in the U.S. financial markets and that such efforts are ongoing.[389]

In response to comments about the application of the rule to portfolio compression and collateral management services, the Commission notes that Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing

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387 See The DTCC (April) Letter at 23–24 (asking the Commission to reformulate Rule 17Ad-22(d)(10) as follows: "Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable, promote the immobilization or dematerialization of securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides central securities depository services.").

388 See TriOptima Letter at 11.

389 See DTCC White Paper, Strengthening the U.S. Financial Markets: A Proposal to Fully Dematerialize Physical Securities, Eliminating the Costs and Risks They Incur (July 2012).

agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

11. Rule 17Ad-22(d)(11): Default Procedures

a. Proposed Rule

Proposed Rule 17Ad-22(d)(11) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to make key aspects of their default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default.

The Commission believes that the rule would provide certainty and predictability to market participants about the measures a clearing agency will take in the event of a participant default because default procedures, among other things, are meant to reduce the likelihood that a default by a participant, or multiple participants, will disrupt the clearing agency's operations. By creating a framework of default procedures that are designed to permit a clearing agency to take actions to contain losses and liquidity pressures it faces while continuing to meet its obligations, the clearing agency should be in a better position to continue providing its services in a manner that promotes accurate clearance and settlement during times of market stress.

The Commission also believes that the requirements in Rule 17Ad-22(d)(11) would increase the possibility that defaults by participants, should they occur, would proceed in an orderly and transparent manner. In particular, the rule would help to ensure that all participants are aware of the default process and are able to plan accordingly and that clearing agencies would have sufficient time to take corrective actions to mitigate potential losses.

b. Comments Received

One commenter urged the Commission to place additional requirements on clearing agencies to conduct and document a test of their default management plans.[390] The commenter stated its belief that default management tests should be undertaken at least on a semi-annual basis.[391]

One commenter responded to a question asked by the Commission in the Proposing Release about how much flexibility clearing agencies should have in the amount of time they are permitted to manage a default and perform a liquidation of positions. The commenter recommended that in the context of security-based swaps the time permitted should be the time necessary for the clearing agency to actually liquidate a security-based swap portfolio rather than establishing a predetermined period by rule.[392] The commenter noted that the time necessary depends on facts and circumstances and is likely to be tied to the characteristics of the security-based swaps involved and the particular markets it in which they trade--as well as the liquidation times derived from the default management plan and practice testing by the clearing agency.[393] The commenter stated that the Commission should have a view of and sign-off authority over the clearing agency's default management plan.[394] The commenter also noted that clearing agencies should continually monitor the risk associated with concentration in participants' positions, and if that concentration could not be liquidated within the time required by the default

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390 See ISDA Letter at 5.

391 See id.

392 See ISDA Letter at 6.

393 See id.

394 See id.

management plan, the clearing agency should have discretion to include extra charges in initial margin to reflect that risk.[395]

Two commenters argued that proposed Rule 17Ad-22(d)(11) should not apply to entities that perform post-trade processing services such as comparison of data,[396] collateral management and portfolio compression.[397]

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(d)(11) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. The Commission believes that the requirements in Rule 17Ad-22(d)(11) increase the possibility that defaults by participants, should they occur, will proceed in an orderly and transparent manner because Rule 17Ad-22(d)(11) helps to ensure that all participants are able to plan for the default process and that clearing agencies will have sufficient time to take corrective action to mitigate potential losses.

As an initial matter, we believe that how frequently a clearing agency conducts default management tests should be determined by each individual clearing agency, in consultation with, and subject to oversight by, the Commission.[398] We agree that it is important for clearing agencies to conduct default management tests, but clearing agencies overseen by the Commission already largely perform these types of exercises as part of their compliance with the requirements of Section 17A of the Exchange Act. Unless additional circumstances clarify that a prescriptive course of action by the Commission is appropriate to bring more standardized scope

395 See id.

396 See Omgeo Letter at 13.

397 See TriOptima Letter at 10.

398 See supra notes 390–391 and accompanying text.

and frequency to these exercises, we believe that it is appropriate, subject to Commission oversight, to continue to allow clearing agencies discretion to design and perform default management tests that are suited to their particular clearance and settlement activities.

With respect to the commenter who advised the Commission not to establish a particular period in Rule 17Ad-22(d)(11) during which a clearing agency would be required to manage and complete a default liquidation process for security-based swaps, we are not adopting specifically bounded timing requirements in Rule 17Ad-22(d)(11) for a clearing agency to achieve compliance with the rule. Instead, our current belief is that the more general approach we are adopting in Rule 17Ad-22(d)(11) allows clearing agencies to establish, implement, maintain and enforce policies and procedures that comply with Rule 17Ad-22(d)(11) and take into account the particular characteristics of the financial instruments and market dynamics involved in a default at a particular clearing agency. We believe this is the best approach to allow clearing agencies to contain losses and the liquidity pressures that they face while continuing to meet their obligations

We also agree with commenters who suggested that it is appropriate for clearing agencies to consider concentration risk in margin practices and that if certain concentrations indicate that liquidation of the concentrated positions could not be performed within the parameters of the clearing agency's default management plan, then the clearing agency should consider extra initial margin charges to account for that occurrence.[399] We believe that these issues are appropriately addressed by individual clearing agencies through the submission of proposed rule changes to the Commission for review and public comment.

With regard to suggestions that Rule 17Ad-22(d)(11) categorically should not apply to entities that perform certain post-trade services (i.e., comparison of trade data, collateral

399 See supra note 395 and accompanying text.

management and compression/tear-up services),[400] we note that Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

12. Rule 17Ad-22(d)(12): Timing of Settlement Finality

a. Proposed Rule

Proposed Rule 17Ad-22(d)(12) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure that final settlement occurs no later than the end of the settlement day and that intraday or real-time finality is provided where necessary to reduce risks. The Commission believes that settlement finality should occur not later than the end of the settlement day because it will help to limit the volume of outstanding obligations that are subject to settlement at any one time and thereby reduce the settlement risk exposure of participants and the clearing agency.

b. Comments Received

One commenter that operates several clearing agencies expressed concern that the second clause of proposed Rule 17Ad-22(d)(12), which reads "and require that intraday or real-time finality be provided where necessary to reduce risks" could be interpreted to require intraday or real-time settlement finality beyond what its clearing agencies currently provide and are capable of providing without significant systems and process changes.[401] The commenter asked the Commission to clarify that the rule is not intended to impose an obligation on the clearing agencies it operates to provide intraday or real-time finality beyond their current practices or any obligation to build additional capability unless and until there is industry and

400 See supra notes 396–397 and accompanying text.

401 See The DTCC (April) Letter at 25.

regulatory consensus on whether and what additional capability to build and how to allocate the cost.[402]

One commenter expressed general support for proposed Rule 17Ad-22(d)(12) but requested that the Commission provide clarification regarding how the rule is compatible with correction of errors and also clarify that "title transfer" of initial margin may not occur when it is posted to a clearing agency.[403] Another commenter stated that although it generally supports the proposed requirement to ensure that final settlement occurs no later than the end of the settlement day, it also believes that this requirement must be interpreted reasonably.[404] The commenter asked the Commission to expressly state in the adopting release that circumstances may arise that make same-date settlement impossible, such as natural disasters, terrorist acts, and major communications breakdowns.[405] The commenter added that it currently has the ability to make margin calls on an intraday basis as necessary and its agreements with settlement banks expressly provide when payments in satisfaction of such calls become irrevocable.[406] The commenter asked the Commission to specifically state whether this structure satisfies the requirements of proposed Rule 17Ad-22(d)(12).[407]

One commenter expressed concern that proposed Rule 17Ad-22(d)(12) fails to provide clear standards for real-time trade processing and therefore does not provide a workable framework for trade processing and clearing of security-based swaps.[408] To address its concern,

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402 See id.

403 See ISDA Letter at 7.

404 See The OCC Letter at 15.

405 See id.

406 See id.

407 See id.

408 See SDMA Letter at 6.

the commenter requested that the Commission adopt rules equivalent to CFTC Rules 37.6(b) and 39.12(B)(7) to require swaps to be immediately confirmed and accepted for clearing upon execution.[409]

Two commenters argued that proposed Rule 17Ad-22(d)(11) should not apply to entities that perform post-trade processing services such as comparison of data,[410] collateral management and portfolio compression,[411] because those services do not involve settlement of transactions.

c. **Final Rule**

The Commission is adopting Rule 17Ad-22(d)(12) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. Rule 17Ad-22(d)(12) does not require a clearing agency that has policies and procedures in place to facilitate final settlement by the end of the settlement day to alter its rules and procedures. As stated in the Proposing Release, "intraday or real-time finality may be necessary to reduce risk in circumstances where the lack of intraday or real-time finality may impede the clearing agency's ability to facilitate prompt and accurate clearance and settlement, cause the clearing agency's participants to fail to meet their obligations, or cause significant disruptions in the securities markets."[412] The Commission agrees with the commenter that a decision to revise the settlement process to implement intraday settlement should involve

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409 See id.

410 See Omgeo Letter at 13.

411 See TriOptima Letter at 10.

412 See Proposing Release, supra note 35, at 14490.

consultation with all stakeholders.[413] The Commission is not proposing a rule at this time, but plans to study the issue further. Furthermore, the need to correct errors would not be a violation of Rule 17Ad-22(d)(12). We agree that Rule 17Ad-22(d)(12) must be reasonably construed to provide that in extreme circumstances same-date settlement may be impossible to achieve (i.e., due to natural disasters, terrorist acts, and major communications breakdowns).[414] The Commission however notes that the duty of a clearing agency to address these situations is governed by Rule 17Ad-22(d) (4), which requires a clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify sources of operational risk and minimize these risks through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient and secure and have adequate scalable capacity; and have business continuity plans that allow for timely recovery of operations and ensure the fulfillment of a clearing agency's obligations.

We agree with commenters that the timing of the effective transfer of initial margin is an important consideration related to achieving settlement finality in an event of default.[415] In general, the validity of the clearing agency's liens and interest in collateral, including initial margin posted by participants, likely could be ascertained by referring to the clearing agency membership agreements, its rules and procedures and Articles 8 and 9 of the Uniform Commercial Code.

With respect to the commenter who said that that the rules in 17Ad-22(d)(12): "fail to provide clear standards for real time trade processing," the Commission does not intend for the

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413 We note that one clearing agency has made efforts to create a dialogue with the industry on the issue of shortening the settlement cycle. See DTCC White Paper, Proposal to Launch a New Cost-Benefit Analysis on Shortening the Settlement Cycle (Dec. 2011).

414 See supra note 404 and accompanying text.

415 See supra note 403 and accompanying text.

rule to provide standards for security-based swaps that are centrally cleared to be confirmed, accepted for clearing and guaranteed by a clearing agency at the point of trade execution.[416] Instead, Rule 17Ad-22(d)(12) focuses on achieving settlement on the particular settlement date associated with the securities transaction or on an intraday or real-time basis (i.e., delivery versus payment) where those additional steps are necessary to reduce risks. The Commission continues to consider the appropriateness of proposing more specific rules that would require transactions to be immediately confirmed and accepted for clearing upon execution.

We agree with commenters that Rule 17Ad-22(d)(12) should not apply if a clearing agency's services do not involve the handling of securities or funds to facilitate settlement of obligations. As discussed above, Rule 17Ad-22 applies only to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

13. Rule 17Ad-22(d)(13): Delivery versus Payment

a. Proposed Rule

Proposed Rule 17Ad-22(d)(13) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to eliminate principal risk by linking securities transfers to funds transfers to achieve delivery versus payment ("DVP").

DVP eliminates the risk that a party would lose some or its entire principal because payment is made only if securities are delivered. The Commission believes that clearing agencies should be required to use this payment method to reduce the potential that delivery of

[416] See supra notes 408–409 and accompanying text.

the security is not appropriately matched with payment for a security, thereby impeding the clearing agency's ability to facilitate prompt and accurate clearance and settlement.

b. Comments Received

One commenter pointed out that the Commission previously approved an SRO rule change which eliminated the commenter's right to reject matched trades that are reported to it by an exchange even if the purchasing clearing member eventually fails to pay the purchase price of the option.[417] This approach was adopted because of a preference by the clearing agency and its participants to mutualize the risk of such defaults rather than bear the risk that a completed trade would be rejected on the following day because of the default of the counterparty.[418] The commenter asked the Commission to confirm that it would not consider this policy to violate Rule 17Ad-22(d)(13).[419]

Two commenters argued that proposed Rule 17Ad-22(d)(13) should not apply to entities that perform post-trade processing services such as comparison of data,[420] collateral management and tear-up/compression,[421] because those services do not involve settlement of transactions.

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(13) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. As described in the Proposing Release, DVP is achieved in the settlement process when the mechanisms facilitating settlement ensure that delivery occurs if and

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417 See The OCC Letter at 15.

418 See id.

419 See id.

420 See Omgeo Letter at 13.

421 See TriOptima Letter at 10.

only if payment occurs.[422] The Commission believes that clearing agencies should be required to link securities transfers to funds transfers in a way that achieves DVP to reduce the potential that delivery of the security is not appropriately matched with payment for a security, thereby impeding the clearing agency's ability to facilitate prompt and accurate clearance and settlement.

The elimination by a clearing agency of its right to reject matched trades and subsequently relying on mutualization of resources to make settlement if necessary does not violate Rule 17Ad-22(d)(13), as mutualization of risk by participants is an acceptable means of eliminating principal risk that would otherwise exist for a clearing agency. The rule requires a clearing agency to establish policies and procedures to link the transfer of securities and funds in a manner that mitigates principal risk in the event of a participant default. The rule does not govern when a clearing agency guarantees a transaction or the clearing agency's loss allocation procedures in the event of a default.

We agree with commenters who suggested that Rule 17Ad-22(d)(13) is not applicable to clearing agencies that do not handle securities or funds to perform settlement. As discussed above, Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

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[422] See Bank for International Settlements, Delivery Versus Payment in Securities Settlement Systems (1992), available at http://www.bis.org/publ/cpss06.pdf. Three different DVP models can be differentiated according to whether the securities and/or funds transfers are settled on a gross (trade-by-trade) basis or on a net basis.

14. Rule 17Ad-22(d)(14): Risk Controls to Address Participants' Failure to Settle

a. Proposed Rule

Proposed Rule 17Ad-22(d)(14) requires clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides CSD services[423] and extends intraday credit to participants.

The Commission believes it is important for clearing agencies that provide CSD services to institute risk controls, including collateral requirements and limits, to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in these circumstances to address the risk that the participant may fail to settle after credit has been extended. The Commission also believes that requiring the controls to be designed to withstand the inability of the participant with the largest payment obligation to settle, in such circumstances, would reduce the likelihood of disruptions at the clearing agency by having controls in place to account for the largest possible loss from any individual participant and thereby help the clearing agency to provide prompt and accurate clearance and settlement during times of market stress.

b. Comments Received

One commenter asked the Commission to revise Rule 17Ad-22(d)(14) to expressly state that the rule applies to a clearing agency that provides CSD services and extends intraday credit

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423 See proposed Rule 17Ad-22(a)(2) for definition of "central securities depository services."

through the operation of a net settlement system.[424] The commenter emphasized that it is important to acknowledge a distinction in the rule between central securities depositories that operate gross settlement systems and those that operate net settlement systems because gross settlement systems amount to a direct intraday extension of credit while a net settlement system places the clearing agency in the position of being a legal agent that extends intraday credits on behalf of other participants that are then settled only at one or more discrete, prescribed times during the process day.[425]

Responding to a question posed by the Commission in the Proposing Release, the same commenter stated its belief that clearing agencies that provide CSD services should not be required to maintain enough financial resources to be able to withstand a settlement failure by the two participant families with the largest settlement obligations to the clearing agency that performs central depository services.[426] The commenter argued that no empirical or historical case has been made to support such a change in how clearing agencies that perform CSD services currently operate their risk management controls.[427]

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424 See The DTCC (April) Letter at 25–26 (noting that the standard in RSSS 9, on which Rule 17Ad-22(d)(14) is modeled, specifically identifies central securities depositories that operate net settlement systems).

425 See The DTCC (April) Letter at 26 (suggesting the following language to revise the proposed rule: "each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable, institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant family fully, that ensure timely settlement in the event that the participant family with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and operates a net settlement system or extends intraday credit to participants").

426 See The DTCC (April) Letter at 26–27.

427 See id.

One commenter stated that the requirements of proposed Rule 17Ad-22(d)(14) should not apply to portfolio compression or collateral management service providers for security-based swaps.[428]

c. Final Rule

We are adopting Rule 17Ad-22(d)(14) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to registered clearing agencies. The Commission believes it is important for clearing agencies that provide CSD services to institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in these circumstances to address the risk that the participant may fail to settle after credit has been extended. The Commission also believes that requiring the controls that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle, in such circumstances, reduces the likelihood of disruptions at the clearing agency.

The Commission considered the concerns of commenters who asked the Commission to abstain from any action that would modify Rule 17Ad-22(d)(14) to require a clearing agency that performs CSD services and extends intraday credit to participants to maintain enough financial resources to be able to withstand a settlement failure by the two participant families with the largest settlement obligations to the clearing agency.[429] Rule 17Ad-22(d)(14) does not apply to clearing agencies that provide CCP services.

We understand the request for clarification from some commenters who asked the Commission to revise Rule 17Ad-22(d)(14) to apply solely to a clearing agency that performs

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428 See TriOptima Letter at 10.

429 See supra notes 426-427 and accompanying text.

CSD services and extends intraday credit to participants through a net settlement system.[430] We agree that the requirements of Rule 17Ad-22(d)(14) apply in full in the context of the operation of a net settlement system. Nevertheless, a clearing agency providing CSD services may choose to organize its operations so that it settles transactions on a trade-for-trade or gross basis and may extend credit in the form of intraday loans or repurchase agreements to facilitate settlement. Accordingly, we are not changing the text of Rule 17Ad-22(d)(14), as suggested, in order to continue to address that situation if it occurs.

We agree with commenters who argued that Rule 17Ad-22(d)(14) does not apply to clearing agencies that do not perform CSD services and do not extend intraday credit to participants.[431] As discussed above, Rule 17Ad-22 only applies to entities that perform CCP or CSD services and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

15. Rule 17Ad-22(d)(15): Physical Delivery Risks

a. Proposed Rule

Proposed Rule 17Ad-22(d)(15) would require clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to disclose to their participants the clearing agency's obligations with respect to physical deliveries.[432]

The Commission believes that such policies and procedures will help to ensure that participants have information that is likely to enhance the participants' understanding of their

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430 See supra notes 424–425 and accompanying text.

431 See supra note 428 and accompanying text.

432 The proposed rule would provide clearing agencies with the flexibility to determine the method by which the clearing agency will state this information to its participants. However, the clearing agencies should take care to develop an approach that provides sufficient notice to its participants regarding the clearing agency's obligations.

rights and responsibilities with respect to using the clearance and settlement services of the clearing agency. The Commission also believes that providing such information to participants would promote a shared understanding regarding physical delivery practices between the clearing agency and its participants that could help reduce the potential for fails and thereby facilitate prompt and accurate clearance and settlement.

The rule also would require clearing agencies to reasonably design their operations to identify and manage the risks that arise in connection with their obligations for physical deliveries. The risks associated with physical deliveries could stem from, among other factors, operational limitations with respect to assuring receipt of physical deliveries and processing of physical deliveries. The Commission believes that requiring clearing agencies to identify and manage these risks would reduce the potential that issues will arise as a result of physical deliveries because the clearing agency will have acted preemptively to deal with potential issues that may disrupt the clearance and settlement process. Accordingly, the Commission believes this requirement would help a clearing agency to facilitate prompt and accurate clearance and settlement consistent with Section 17A of the Exchange Act.[433]

b. Comments Received

One commenter stated that the requirements of proposed Rule 17Ad-22(d)(15) should not apply to portfolio compression or collateral management service providers for security-based swaps.[434]

c. Final Rule

The Commission is adopting Rule 17Ad-22(d)(15) as proposed, except for the clarification discussed in Sections II.B.4 and III.A regarding the application of the rule only to

433 15 U.S.C. 78q-1(b)(3)(F).

434 See TriOptima Letter at 11.

registered clearing agencies. The Commission believes that Rule 17Ad-22(d)(15) helps ensure that participants will have information that enhances their understanding of their rights and responsibilities with respect to using the physical delivery services of a clearing agency which will help reduce the potential for fails. Accordingly, the Commission believes this requirement should help facilitate prompt and accurate clearance and settlement consistent with Section 17A of the Exchange Act.[435]

As discussed above, Rule 17Ad-22 only applies to registered clearing agencies and does not apply to entities exempt from registration as a clearing agency, unless the terms of future exemptions specifically contemplate its application, in whole or in part.

IV. Paperwork Reduction Act

A. Overview and Burden Estimate Comparison to Proposing Release

Certain provisions of the final rules contain new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[436] In accordance with 44 U.S.C. 3507 and 5 CFR 1320.11, the Commission has submitted the information to the Office of Management and Budget ("OMB") for review. The title of the new collection of information is "Clearing Agency Standards." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The control number for Rule 17Ad-22 is OMB Control No. 3235-0695.

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435 15 U.S.C. 78q-1(b)(3)(F).

436 44 U.S.C. 3501 et seq.

1. Changes in Estimates

As an initial matter, we note that the PRA burden estimates in this adopting release are significantly lower than the PRA burden estimates in the Proposing Release.[437] Several reasons account for the change. The Proposing Release contained five proposed rules with PRA collection of information requirements in addition to Rule 17Ad-22 – proposed Rules 17Aj-1, 17Ad-23, 17Ad-25, 17Ad-26 and 3Cj-1. As described above, these other proposed rules are not being adopted at this time.

Additionally, the Proposing Release estimated that the proposed rules would have applied to seventeen entities. A number of these entities -- in particular those providing post-trade processing services for security-based swap transactions -- would have been completely unfamiliar with the Commission's registration process for clearing agencies. Further, these entities typically do not have written rule books to govern their relationship with their users. As a result, they would have experienced significant initial burdens associated with the proposed rules.

In contrast, the final rules being adopted today apply only to the seven clearing agencies currently registered with the Commission that provide CCP or CSD services, as discussed above in Section II.B.4.[438] These registered clearing agencies already have written rules, policies and

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437 See Proposing Release, supra note 35, at 14521 ("The Commission preliminarily believes that for all respondent clearing agencies the aggregate paperwork burdens contained in proposed Rules 17Ad-22(d)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14), (15), (b)(1), (2), (3), (4), (5), (6), (7), (c)(1) and (2) would impose a one-time burden of 83,343 hours and an ongoing annual burden of 39,658 hours."). In the adopting release, the Commission estimates the total initial burden for Rule 17Ad-22 to be 11,880 hours, with the total ongoing annual burden for Rule 17Ad-22 to be 4,888 hours. See infra Section IV.C.7.

438 The Commission also notes that the Boston Stock Exchange Clearing Corporation ("BSECC") and Stock Clearing Corporation of Philadelphia ("SCCP") are currently registered with the Commission as clearing agencies but conduct no clearance or

procedures addressing significant aspects of Rule 17Ad-22. For purposes of the PRA analysis, the Commission also estimates that three entities may potentially register with the Commission as clearing agencies acting as CCPs, bringing the total number of respondents to ten – nine of which are CCPs and one of which is a CSD.[439] The Commission believes that some of the entities seeking to register with the Commission as clearing agencies may already be providing similar services in other jurisdictions and therefore may already have written rules and procedures similar to those contemplated by Rule 17Ad-22. Accordingly, the Commission believes that the potential PRA burden on this smaller and more established group of respondents will be significantly lower than the estimates provided in the Proposing Release. Further, the Proposing Release treated each subsection of the rule -- and therefore each required policy and procedure -- as a separate PRA burden. However, the Commission believes that registered clearing agencies are more likely to be able to address the changes required by Rule 17Ad-22 in an integrated, not piecemeal, review and drafting process. That is, respondents are likely to group aspects of Rule 17Ad-22 together as they implement policies and procedures responsive to Rule 17Ad-22. Therefore, the revised PRA burden estimates no longer account for each requirement as a separate burden.

Finally, the Commission has revised the PRA burden estimates in recognition that many parts of Rule 17Ad-22 – specifically Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) -- reflect usual and customary practices of registered clearing agencies. Since registered clearing agencies already comply with significant aspects of Rule 17Ad-22 in the normal course of their

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settlement operations. See Securities Exchange Act Release Nos. 63629 (Jan. 3, 2011), 76 FR 1473 (Jan. 10, 2011), and 63268 (Nov. 8, 2010), 75 FR 69730 (Nov. 15, 2010), respectively.

439 The burden estimates include the possibility that either BSECC or SCCP, or both, resume operations in the future.

activities, many aspects of Rule 17Ad-22 impose minimal PRA burdens on registered clearing agencies limited to the review of the rule and their existing policies and procedures. As discussed below, because certain rules would involve adjustments to a registered clearing agency's rule book and its policies and procedures rather than the creation of entirely separate policies and procedures to support entirely new operations and practices, the Commission recognizes that some aspects of Rule 17Ad-22 will impose incremental new PRA burdens on registered clearing agencies.

Accordingly, the estimated PRA burdens discussed below reflect these updated assessments of the likely PRA burdens.

2. Organization of PRA Review

The discussion of the PRA burdens and costs associated with Rule 17Ad-22 is organized in the following manner:

1. Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15)
2. Rule 17Ad-22(b)(4)
3. Rules 17Ad-22(b)(5)–(7)
4. Rule 17Ad-22(c)
5. Rule 17Ad-22(c)(1)
6. Rule 17Ad-22(c)(2)

Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) are discussed together because these rules represent usual and customary practices already being implemented by registered clearing agencies. Because Rules 17Ad-22(b)(4), (b)(5)–(7) and (c), respectively establish new minimum practices for registered clearing agencies with regard to model validation, membership practices and certain financial information, the adopting release discusses these rules separately. The burden discussion for Rules 17Ad-22(c)(1) and (2) has been split into sections to account for the different information collection requirements for varying numbers of respondents.

B. Summary of Collection of Information, Use of Information and Comments Received

As noted earlier, the Commission received 25 comment letters concerning the proposed rules.[440] While the Commission received general comments in support of its approach that is both consistent with current global standards[441] and principles-based[442], thereby making compliance less burdensome for registered clearing agencies, a few commenters discussed the paperwork and compliance burden concerns for some of the rules associated with this adopting release. Some commenters expressed general concerns about the burden of regulation, but such comments focused on rules in the Proposing Release not being adopted today and on areas that go beyond the scope of the adopting release.[443] Commenters expressed concerns about the

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440 See supra note 37.

441 See The DTCC (April) Letter at 4 (stating that "[t]he application of global standards to clearing agencies will also prevent clearing agencies and their participants from incurring unnecessary expense associated with complying with different, and potentially conflicting regulatory standards."); see also The OCC Letter at 3 (encouraging the Commission "to avoid taking final action on the Proposed Rules prior to receiving greater clarity on what clearinghouse regulations are ultimately adopted by European and U.K. legislators and regulators and what approaches to regulation are ultimately embraced by CPSS/IOSCO. Many potential market participants will be able to choose the jurisdiction in which they conduct their clearing activity, and imposing more prescriptive and costly regulatory burdens on U.S. clearing agencies will have a predictably adverse competitive impact on those clearing agencies.").

442 See The DTCC (April) Letter at 6 (stating that "[i]f the Proposed Rules are overly prescriptive, organizations such as DTCC may be subject to conflicting requirements and may be forced to fragment certain enterprise-wide programs in order to comply with such conflicting requirements, which could substantially increase costs and compliance risks within such organizations."); The OCC Letter at 2 (stating that it "support[s] the Commission's approach. . . ."); CME Letter at 3 (stating that "CME Group favors a principles-based approach in these areas, and we urge the Commission not to adopt hard and fast standards that will be costly to implement and maintain and that yield little or no apparent corresponding regulatory benefits.").

443 See, e.g., ICE Letter at 1-2 (stating that "[p]ost-trade processing service providers would be unable to distribute end-of-day settlement prices, as required by the Proposal, and the

burdens associated with parts of Rule 17Ad-22(b), and those comments are addressed below. Commenters did not specifically comment on the burdens associated with Rule 17Ad-22(c)–(d).

1. Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15)

The rules in the adopting release contain requirements subject to the PRA. Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) contain "collection of information requirements" within the meaning of the PRA. These rules would require a registered clearing agency to have policies and procedures to adequately document all material aspects of its liquidity risk management processes and its compliance with their requirements. The information collected by virtue of written policies and procedures requirements contained in Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) generally codify usual and customary practices at CCPs and registered clearing agencies, and thus the PRA burden would be expected to be minimal. Rules 17Ad-22(b)(1)–(3) require written policies and procedures that address risk management practices by CCPs. Specifically, the rules would create standards with respect to: (1) measurement and management of credit exposures; (2) margin requirements; and (3) financial resources. The Commission did not receive comments on the burdens associated with Rule 17Ad-22(b)(1)–(3).

Rule 17Ad-22(d) sets forth certain minimum standards regarding the operations of registered clearing agencies. The standards established in 17Ad-22(d) address areas including: (1) transparent and enforceable rules and procedures; (2) participation requirements; (3) custody of assets and investment risk; (4) operational risk; (5) money settlement risk; (6) cost-effectiveness; (7) links; (8) governance; (9) information on services; (10) immobilization and dematerialization of securities certificates; (11) default procedures; (12) timing of settlement

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record keeping requirements of the Proposal would prove so burdensome to such providers that the efficiency and alacrity that they provide to the CDS industry would be adversely affected.").

finality; (13) delivery versus payment; (14) risk controls to address participants' failures to settle; and (15) physical delivery risks. Commenters did not comment on the burdens associated with Rule 17Ad-22(d).

2. Rule 17Ad-22(b)(4)

Rule 17Ad-22(b)(4) contains "collection of information requirements" within the meaning of the PRA. Rule 17Ad-22(b)(4) will require a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who is free from influence so that he can be candid in his assessment of the model.

One commenter stated that "a regulatory requirement of model validation on an annual basis is unnecessary (and may be overly burdensome) . . . . [and] can be achieved in a less directive manner."[444] The commenter did not provide an estimate of the proposed burdens. The commenter suggested that model validation should be conducted on a "periodic" basis by a qualified person who "is sufficiently free from outside influences to perform a candid evaluation."[445] The commenter did not explain how the suggested alternative requirements would achieve the purposes of the rule with a lesser burden.

The Commission is not persuaded by the position that the frequency of the model validation should be left to the discretion of the CCP.[446] The rule requiring that CCPs have policies and procedures in place for model validation at least annually is appropriate because model performance is not ordinarily expected to vary significantly over short periods but should

444 See The DTCC (April) Letter at 13.

445 See The DTCC (April) Letter at 15.

446 See id.

be reevaluated as market conditions change. Overall, the Commission believes the collection of information related to Rule 17Ad-22(b)(4) is necessary to achieve its purpose, particularly in light of the Congressional mandate under the Dodd-Frank Act.

3. Rules 17Ad-22(b)(5)–(7)

Rules 17Ad-22(b)(5)–(7) contain "collection of information requirements" within the meaning of the PRA. The information collection under the written policies and procedures requirements contained in Rules 17Ad-22(b)(5)–(7) would establish requirements regarding access to CCPs.

One commenter expressed that proposed Rules 17Ad-22(b)(5)–(7) providing for mandatory access to CCPs in certain circumstances goes "beyond anything in current or proposed global standards. . . . [and is, therefore,] unnecessary and counterproductive to the goal of fair and open access within a framework of safe and sound operation."[447] But the commenter did not provide an estimate of these burdens. Nor did the commenter suggest alternative requirements that would achieve the purposes of the rule with a lesser burden.

While the Commission understands the concerns raised, the Commission ultimately believes that the benefits of Rules 17Ad-22(b)(5)–(7) are critical to maintaining fairness and open access to central clearing for all market participants, including security-based swaps participants.[448] In this regard, the Commission believes the collection of information related to

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[447] See The DTCC (April) Letter at 5; see also The DTCC (April) Letter at 4 (stating that "[t]he application of global standards to clearing agencies will also prevent clearing agencies and their participants from incurring unnecessary expense associated with complying with different, and potentially conflicting regulatory standards.").

[448] See supra Section III.D.1.

the rule is necessary to achieve its purpose, particularly in light of the Congressional mandate under the Dodd-Frank Act.

4. Rules 17Ad-22(c)(1)—(2)

Rule 17Ad-22(c)(1)—(2) contains "collection of information requirements" within the meaning of the PRA. The information collection under the written policies and procedures requirements contained in Rule 17Ad-22(c) establishes a recordkeeping requirement for CCPs regarding their responsibilities under Rule 17Ad-22(b)(3) and for registered clearing agencies with respect to posting on their respective websites annual audited financial statements.

Commenters did not specifically comment on the burdens associated with Rule 17Ad-22(c)(1)—(2).

C. Total Initial and Annual Reporting and Recordkeeping Burdens

1. Standards in Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) that Impose a PRA Burden

The requirements to develop written policies and procedures in Rules 17Ad-22(b)(1)–(3) and Rules 17Ad-22(d)(1)–(15) impose a PRA burden. The requirements in Rules 17Ad-22(b)(1)–(3) will apply to CCPs that are registered clearing agencies. The Commission estimates that a total of nine CCPs[449] will be subject to the burdens under Rules 17Ad-22(b)(1)–(3). Currently, six clearing agencies are registered to provide CCP services, and the Commission estimates that three more entities could register as clearing agencies to provide CCP services. The requirements in Rules 17Ad-22(d)(1)–(15) (with the exception of Rules 17Ad-22(d)(10) and (13)–(15), which are applicable only to CSDs), on the other hand, apply to all registered clearing

449 The Commission believes that there is a potential for new security-based swap clearing agencies to form but does not expect there to be a large number based on the significant level of capital and other financial resources needed for the formation of a clearing agency.

agencies, of which there could potentially be a total of ten entities, including the one registered clearing agency that is a CSD.

As noted above, registered clearing agencies already have written policies and procedures that meet the standards set forth in Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) as part of their usual and customary business practice. Accordingly, the Commission believes that the registered clearing agencies would not need to build new infrastructure or modify operations to continue to meet Rule 17Ad-22(b)(1)–(3) and (d)(1)–(15). The Commission believes that registered clearing agencies will incur the incremental burdens of reviewing existing policies and procedures for compliance and updating existing policies and procedures where appropriate. The requirements would impose an aggregate one-time burden of approximately 1,750 hours for all registered clearing agencies.[450] The standards contained in Rule 17Ad-22(d) would also impose ongoing burdens on registered clearing agencies. For example, Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) would require registered clearing agencies to perform certain ongoing monitoring and enforcement activities with respect to the written policies and procedures the registered clearing agency creates in response to the standard. Accordingly, the Commission believes that those ongoing activities would impose an aggregate annual burden of approximately 600 hours for all respondent clearing agencies.[451] Because recent assessments of the registered U.S. clearing

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450 This figure was calculated as follows: ((Assistant General Counsel at 60 hours) + (Compliance Attorney at 85 hours) + (Computer Operations Manager at 15 hours) + (Senior Business Analyst at 15 hours)) = 175 hours x 10 respondent clearing agencies = 1,750 hours.

451 This figure was calculated as follows: Compliance Attorney at 60 hours x 10 respondent clearing agencies = 600 hours.

For each respondent clearing agency, the estimated annualized burden for Rules 17Ad-22(b)(1)—(3) and (d)(1)—(15) is 98 hours (figure calculated as follows: 175 hours (Year 1 burden) + 60 hours (Year 2 burden) + 60 hours (Year 3 burden) = 295 hours (estimated total burden over 3 years) ÷ 3 years = 98 hours).

agencies support the conclusion that clearing agencies and their rule books generally meet or exceed analogous standards of operation and governance to those standards within Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15),[452] the Commission believes that the burden estimate for the aggregate one-time burden should be revised down from the burden estimated in the Proposing Release. The Commission estimates that because these initial compliance efforts will largely comprise a review of existing policies and procedures, the aggregate one-time burden on respondent clearing agencies will be incremental to their current compliance processes. The expected review of current policies and procedures will likely not involve much involvement by the information technology staff at the clearing agency or much involvement by the clearing agency's assistant general counsel because the requirements of these rules have already been written into and have been implemented as part of the policies and procedures of registered clearing agencies. Accordingly, those burden estimates have been reduced and the burden estimate for the compliance attorney, who will most likely perform most of the review of current policies and procedures, has been increased. In order to estimate the one-time burden and annual burden for ongoing activities, we looked to the burdens imposed by similar policies and procedures requirements in Regulation NMS as a guide and adapted those figures for the purposes of this release.[453]

2. Standards in Rule 17Ad-22(b)(4) that Impose a PRA Burden

The requirement to develop written policies and procedures in Rule 17Ad-22(b)(4) imposes a PRA burden. The requirement in Rule 17Ad-22(b)(4) will apply to all CCPs. As

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452 See Proposing Release, supra note 35, at 14509.

453 See Exchange Act Release Nos. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (discussing in Section VIII.A.4 the time needed from legal, compliance, information technology and business operations personnel to create policies and procedures for preventing and monitoring trade-throughs).

discussed above, the Commission estimates that nine CCPs will be subject to the burdens under Rule 17Ad-22(b)(4).

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission has preserved the burden estimates from the Proposing Release. The Commission estimates that Rule 17Ad-22(b)(4) would impose a one-time burden on each respondent CCP of 210 hours, corresponding to an aggregate one-time burden on all respondent CCPs of 1,890 hours.[454]

Rule 17Ad-22(b)(4) would require one-time systems adjustments related to the capability to perform an annual model validation. These adjustments would amount to an aggregate one-time burden of approximately 900 hours.[455]

CCPs would be required to collect information relating to their model validation standards required by Rule 17Ad-22(b)(4) on an ongoing basis. The Commission expects that the exact burden of administering the procedures for model validation standards would vary depending on how frequently each CCP may need to update its procedures. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission estimates that the ongoing requirements of this rule would impose an annual burden of 60 hours on each respondent CCP, corresponding to an aggregate annual burden for all respondent CCPs of 540 hours.[456]

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454 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent CCPs = 1,890 hours.

455 This figure was calculated as follows: ((Chief Compliance Officer for 40 hours) + (Computer Department Operations Manager for 40 hours) + (Senior Programmer for 20 hours)) = 100 hours x 9 respondent CCPs = 900 hours.

456 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent CCPs = 540 hours for all respondent CCPs.

Based on its oversight of clearing agencies, the Commission estimates that Rule 17Ad-22(b)(4) would impose an annual cost on all respondent CCPs for work on model validation. The Commission believes clearing agencies would hire a consulting firm that dedicates two consultants to the project. Consistent with the Proposing Release,[457] the Commission estimates that should respondent CCPs decide to hire external consultants to develop and implement Rule 17Ad-22(b)(4) through written policies and procedures, the ongoing cost associated with hiring such consultants would be approximately $3.9 million per year.[458]

3. Standards in Rules 17Ad-22(b)(5)–(7) that Impose a PRA Burden

The requirements to develop written policies and procedures in Rules 17Ad-22(b)(5)–(7) impose a PRA burden. These PRA burdens will apply to all CCPs. As discussed above, the Commission estimates that nine CCPs will be subject to the burdens under Rules 17Ad-22(b)(5)–(7). The Commission believes that CCPs are more likely to be able to address the changes required by Rules 17Ad-22(b)(5)–(7) in an integrated, not piecemeal, review and drafting process to implement policies and procedures responsive to these rules. Therefore, the revised PRA burden estimates no longer account for each requirement as a separate burden.

For each respondent CCP, the estimated annualized burden for Rule 17Ad-22(b)(4) is 143 hours (figure calculated as follows: 210 hours + 100 hours (Year 1 burden) + 60 hours (Year 2 burden) + 60 hours (Year 3 burden) = 430 hours (estimated total burden over 3 years) ÷ 3 years = 143 hours).

457 See Proposing Release, supra note 35, at 14529.

458 This figure was calculated as follows: 2 Consultants for 30 hours per week at $600 per hour = $36,000 per week x 12 weeks = $432,000 per clearing agency x 9 respondent CCPs = $3,888,000. The $600 per hour figure for a consultant was calculated using www.payscale.com, modified by Commission staff to account for an 1800 hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission has preserved the burden estimates from the Proposing Release. The Commission estimates that Rules 17Ad-22(b)(5)–(7) would impose a one-time burden on each respondent CCP of 210 hours, corresponding to an aggregate one-time burden on all respondent CCPs of 1,890 hours.[459]

CCPs would be required to collect information relating to standards of Rules 17Ad-22(b)(5)–(7) on an ongoing basis. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission estimates that the ongoing requirements of this rule would impose an annual burden of 60 hours on each respondent CCP, corresponding to an aggregate annual burden for all respondent CCPs of 540 hours.[460]

4. Standards in Rule 17Ad-22(c) that Impose a PRA Burden

The standards in Rule 17Ad-22(c) impose a PRA burden.[461] The requirements of Rule 17Ad-22(c) will apply to all registered clearing agencies. Based on the analogous policies and

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459 This figure was calculated as follows: ((Assistant General Counsel at 87 hours) + (Compliance Attorney at 77 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 210 hours x 9 respondent CCPs = 1,890 hours.

460 This figure was calculated as follows: Compliance Attorney at 60 hours x 9 respondent CCPs = 540 hours for all respondent CCPs.

For each respondent CCP, the estimated annualized burden for Rules 17Ad-22(b)(5)—(7) is 110 hours (figure calculated as follows: 210 hours (Year 1 burden) + 60 hours (Year 2 burden) + 60 hours (Year 3 burden) = 330 hours (estimated total burden over 3 years) ÷ 3 years = 110 hours).

461 The burden discussion for the different information collection requirements of Rule 17Ad-22(c)(1)—(2) has been split into sections to account for the different requirements for varying numbers of respondents. Rule 17Ad-22(c) imposes an overall burden relating to policies and procedures and system adjustments on all registered clearing agencies, while Rule 17Ad-22(c)(1), as discussed below, imposes on CCPs an ongoing burden to generate the required reports concerning their financial resources and Rule 17Ad-22(c)(2), as discussed below, imposes initial and ongoing burdens related to annual

procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission has preserved the burden estimates from the Proposing Release. In contrast to the Proposing Release's burden estimates for proposed Rule 17Ad-22(c)(2), which accounted for 17 clearing agencies, the burden estimate in the adopting release for Rule 17Ad-22(c) reflects a smaller number of clearing agencies. The Commission estimates that Rule 17Ad-22(c) would impose a one-time burden on each respondent clearing agency of 191 hours, corresponding to an aggregate one-time burden on all respondent clearing agencies of 1,910 hours.[462]

The Commission believes the one-time burden imposed would involve adjustments needed to synthesize and format existing information in a manner sufficient to explain the methodology the clearing agency uses to meet the requirement of Rule 17Ad-22(c). The Commission believes these adjustments would impose a one-time burden of 100 hours on each clearing agency, corresponding to an aggregate one-time burden imposed on all clearing agencies of 1,000 hours.[463]

Clearing agencies would be required to collect information relating to standards of Rule 17Ad-22(c) on an ongoing basis. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission estimates that the ongoing requirements of this rule would impose an annual burden of 60 hours on each

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audited financial statements to all registered clearing agencies, some of which are already implementing this requirement as part of their usual and customary practices.

462 This figure was calculated as follows: ((Assistant General Counsel at 60 hours) + (Compliance Attorney at 85 hours) + (Computer Operations Manager at 23 hours) + (Senior Business Analyst at 23 hours)) = 191 hours x 10 respondent clearing agencies = 1,910 hours.

463 This figure was calculated as follows: ((Chief Compliance Officer at 40 hours) + (Computer Operations Department Manager at 40 hours) + (Senior Programmer at 20 hours)) = 100 hours x 10 respondent clearing agencies = 1,000 hours.

respondent clearing agency, corresponding to an aggregate annual burden for all respondent clearing agencies of 600 hours.[464]

5. Standards in Rule 17Ad-22(c)(1) that Impose a PRA Burden

The standards in Rule 17Ad-22(c)(1) impose a PRA burden. In contrast to the Proposing Release's burden estimates for proposed Rule 17Ad-22(c)(2), which accounted for 17 clearing agencies, the burden estimate in the adopting release for Rule 17Ad-22(c)(1) reflects a smaller number of clearing agencies. The requirements of Rule 17Ad-22(c)(1) will apply to nine CCPs.

On an ongoing basis, the Commission estimates that for a CCP to generate the required reports concerning its financial resources would impose a burden of three hours per respondent CCP per quarter. This amounts to an annual burden of 12 hours for each CCP and corresponds to an aggregate annual burden of 108 hours for all respondent CCP. [465]

6. Standards in Rule 17Ad-22(c)(2) that Impose a PRA Burden

The standards in Rule 17Ad-22(c)(2) impose a PRA burden. In contrast to the Proposing Release's burden estimates for proposed Rule 17Ad-22(c)(2), which accounted for 17 clearing

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464 This figure was calculated as follows: Compliance Attorney at 60 hours x 10 respondent clearing agencies = 600 hours for all respondent clearing agencies.

For each respondent clearing agency, the estimated annualized burden for Rule 17Ad-22(c) is 137 hours (figure calculated as follows: 191 hours + 100 hours (Year 1 burden) + 60 hours (Year 2 burden) + 60 hours (Year 3 burden) = 411 hours (estimated total burden over 3 years) ÷ 3 years = 137 hours).

465 This figure was calculated as follows: ((Compliance Attorney at 1 hour) + (Computer Operations Department Manager at 2 hours)) = 3 hours per quarter x 4 quarters per year = 12 hours per year x 9 respondent clearing CCPs = 108 hours.

For each respondent CCP, the estimated annualized burden for Rule 17Ad-22(c)(1) is 8 hours (figure calculated as follows: 0 hours (Year 1 burden) + 12 hours (Year 2 burden) + 12 hours (Year 3 burden) = 24 hours (estimated total burden over 3 years) ÷ 3 years = 8 hours).

agencies, the burden estimate in the adopting release for Rule 17Ad-22(c)(2) reflects a smaller number of clearing agencies. The requirements of Rule 17Ad-22(c)(2) will apply to all registered clearing agencies, a total of ten respondents.

The Commission expects that the exact burden of collecting information relating to the procedures for facilitating an annual audited financial statement of the clearing agency and posting that annual audited financial statement to the clearing agency's website would vary depending on how frequently each clearing agency may need to update its procedures. Also, the Commission estimates based on its experience with entities of similar size to the respondents to this collection, that the initial burden of generating annual audited financial statements would generally require on average 500 hours per respondent clearing agency.[466] However, as most registered clearing agencies are already implementing this requirement as part of their usual and customary practices, the rule, as an initial burden, would largely affect a total of four entities -- three potential new entrants and one clearing agency that currently does not have two years of annual audited financial statements prepared in accordance with U.S. GAAP or IFRS posted on its website and therefore, would be required to incur the costs of paying for an independent audit for two years of financial statements.[467] The Commission estimates that Rule 17Ad-22(c)(2) would impose a one-time burden on each of these four clearing agencies of 500 hours to prepare and review internal financial statements, corresponding to an aggregate one-time burden on the

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466 An example of the Commission's experience with entities of a similar size to the respondents is that the Commission required entities to post their annual financial statements on their respective websites as conditions to the Commission's authorizing them to provide CCP services for credit default swaps. See supra note 2.

467 BSECC and SCCP currently do not post audited financial statements on their websites and are considered new entrants.

four respondent clearing agencies of 2,000 hours.[468] This requirement would necessitate work hours of compliance personnel and finance personnel at the clearing agency to compile relevant data, organize and analyze that data, and then post it to the clearing agency's website consistent with the rule.

Clearing agencies also would be required to collect information relating to any procedures used to support compliance with Rule 17Ad-22(c)(2) on an ongoing basis. Based on the analogous policies and procedures requirements and the corresponding burden estimates in Regulation NMS, the Commission estimates that the ongoing requirements of this rule would impose an annual burden of 250 hours on each respondent clearing agency for collecting information relating to administering policies and procedures for facilitating an annual audited financial statement of the clearing agency and posting that annual audited financial statement to the clearing agency's website for an aggregate burden of 2,500 hours.[469]

The requirement also would require the services of a registered public accounting firm. The Commission estimates those services would on average cost approximately $500,000 annually.[470] Therefore, to meet the ongoing requirements of Rule 17Ad-22(c)(2) the

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468 This figure was calculated as follows: Senior Accountant at 500 hours x 4 respondent clearing agencies = 2,000 hours.

469 This figure was calculated as follows: Senior Accountant at 250 hours x 10 respondent clearing agencies = 2,500 hours.

Annualized, the estimated burden for Rule 17Ad-22(c)(2) is 333 hours (figure calculated as follows: 500 hours (Year 1 burden) + 250 hours (Year 2 burden) + 250 hours (Year 3 burden) = 1,000 hours (estimated total burden over 3 years) ÷ 3 years = 333 hours). This figure represents a weighted average for 10 respondent clearing agencies. The burden will be higher for clearing agencies that have not yet implemented Rule 17Ad-22(c)(2). The burden will be less for clearing agencies that have already implemented the requirement as part of their usual and customary practices.

470 A precise estimate of audit costs for clearing agencies cannot be made, and therefore, we examined a number of existing surveys, (see, e.g., surveys by CFO.com studying large

Commission estimates a total annual cost of approximately $5,000,000 in the aggregate for all respondent clearing agencies.[471]

7. Total Burden for Rule 17Ad-22

The total initial burden for Rule 17Ad-22 is 11,340 hours.[472] The total ongoing annual burden for Rule 17Ad-22 is 4,888 hours.[473] The ongoing external cost for Rule 17Ad-22 is $8.9 million.[474]

D. Collection of Information is Mandatory

The collection of information relating to Rule 17Ad-22(b) and Rule 17Ad-22(c)(1) will be mandatory for all CCPs. The collection of information relating to Rule 17Ad-22(c)(2) and Rule 17Ad-22(d) will be mandatory for all registered clearing agencies.

E. Confidentiality

The Commission expects that the written policies and procedures that will be generated pursuant to Rules 17Ad-22(b)(1)–(7), Rule 17Ad-22(c)(2), and Rules 17Ad-22(d)(1)–(15) will be communicated to the members, subscribers, and employees (as applicable) of all entities covered by the Rule. To the extent that this information is made available to the Commission, it

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and small public companies). While the costs may vary depending on the circumstances, we are using an estimate of $500,000, which is on the upper range for an average cost.

471 This figure was calculated as follows: $500,000 estimated cost of registered public accounting firm x 10 respondent clearing agencies = $5,000,000.

472 This figure was calculated as follows: 1,750 hours for initial burdens associated with 17Ad-22(b)(1)–(3) and (d)(1)–(15) + 2,790 hours for initial burdens associated with 17Ad- 22(b)(4) + 1,890 hours for initial burdens associated with 17Ad-22(b)(5)–(7) + 4,910 hours for initial burdens associated with 17Ad-22(c) = 11,340 hours.

473 This figure was calculated as follows: 600 hours for annual burdens associated with 17Ad-22(b)(1)–(3) and (d)(1)–(15) + 540 hours for annual burdens associated with 17Ad-22(b)(4) + 540 hours for initial burdens associated with 17Ad-22(b)(5)–(7) + 3,208 hours for annual burdens associated with 17Ad-22(c) = 4,888 hours.

474 This figure was calculated as follows: $3,888,000 (for Rule 17Ad-22(b)(4)) + $5,000,000 (for Rule 17Ad-22(c)(2)).

will not be kept confidential. Any records generated in connection with the requirement of Rules 17Ad-22(b)(1)–(3), Rules 17Ad-22(b)(5)–(7), Rule 17Ad-22(c)(2), and Rules 17Ad-22(d)(1)–(15) to establish written policies and procedures will be required to be preserved in accordance with, and for the periods specified in, Exchange Act Rules 17a-1[475] and 17a-4(e)(7).[476]

The information collected pursuant to Rule 17Ad-22(c)(1) relating to the calculation and maintenance of a record of the financial resources necessary to meet the requirements of Rule 17Ad-22(b)(3) will be retained by the registered clearing agencies that perform CCP services and will be available to the Commission. To the extent that the Commission receives confidential information pursuant to this collection of information, such information would be kept confidential, subject to the provisions of applicable law.[477]

V. Economic Analysis

A. Overview

The rules that we are adopting today are designed to enhance the substantive regulation of securities clearing agencies. The Commission is sensitive to the economic effects of the rules it is adopting today, including their costs and benefits. Some of these costs and benefits stem from statutory mandates, while others are affected by the discretion we exercise in implementing the mandates. We requested comment on all aspects of the costs and benefits of the proposal,

475 17 CFR 240.17a-1.

476 17 CFR 240.17a-4(e)(7).

477 See, e.g., 5 U.S.C. 552 (Exemption 4 of the Freedom of Information Act provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). Exemption 8 of the Freedom of Information Act provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8)).

including any effect our proposed rules may have on efficiency, competition, and capital formation.

As required by Title VII and Title VIII of the Dodd Frank Act, Rule 17Ad-22 will establish a regulatory framework for CCPs for security-based swap transactions and clearing agencies that are designated as systemically important by the Council. In so doing, Rule 17Ad-22 will help ensure that clearing agencies maintain effective operational and risk management procedures as well as meet the statutory requirements under the Exchange Act on an ongoing basis. Rule 17Ad-22 is consistent with the Dodd-Frank Act and the Congressional findings in the adoption of Section 17A. Specifically, Congress found that:

(A) The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.

(B) Inefficient procedures for clearance and settlement impose unnecessary costs on investors and persons facilitating transactions by and acting on behalf of investors.

(C) New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.

(D) The linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.[478]

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[478] See 15 U.S.C. 78q-1(a)(1).

Section 17A of the Exchange Act was adopted in direct response to the paperwork crisis of the late 1960's that nearly brought the securities industry to a standstill and directly or indirectly resulted in the failure of large numbers of broker-dealers[479] because the industry's clearance and settlement procedures were inefficient and lacked automation.

Economic characteristics of FMIs,[480] such as clearing agencies, including economies of scale, barriers to entry, and the particulars of their legal mandates may limit competition and confer market power on FMIs, which could lead to lower levels of service, higher prices, or under-investment in risk-management systems.[481] In addition, the institutional structure of entities that provide clearance and settlement services may not provide strong incentives or mechanisms for safe and efficient design and operation, fair and open access, or the protection of participant and customer assets in some circumstances.[482] Moreover, the participants in a clearing agency may not consider the full impact of their actions on other participants, such as the potential costs of delaying payments or settlements.[483] Overall, a clearing agency and its

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479 This crisis resulted from sharply increased trading volumes and historic industry inattention to securities processing, as demonstrated by inefficient, duplicative and highly manual clearance and settlement system, poor records, insufficient controls over funds and securities, and use of untrained personnel to perform processing functions. See, e.g., Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92d Cong., 1st Sess. 13 (1971).

480 A "financial market infrastructure" is a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions. See id. at 7.

481 See FMI Report, supra note 32, at 11.

482 See id.

483 See id.

participants may generate significant negative externalities for the entire securities market if they do not adequately manage their risks.[484]

While the Commission believes that the U.S. clearance and settlement system currently works well, it is important that the operations of clearing agencies evolve with the securities markets, especially as clearing agencies affect a wider array of market participants. A clearing agency's direct participants, such as broker–dealers, banks and other types of financial intermediaries, use clearing agencies to clear and settle proprietary trading activity. They also use clearing agencies as intermediaries for institutional investors, retail investors, and proprietary trading firms,[485] because clearing and settling a high volume of financial transactions multilaterally through a clearing agency may in many cases allow for greater efficiency and lower costs than settling bilaterally.[486] In addition, clearing agencies are often able to manage risks related to the clearing and settling of financial transactions more effectively for their participants, and, in some cases, reduce certain risks, such as the risk that a purchaser of a security will not receive the security or the risk that a seller of a security will not receive payment for the security.[487]

Because clearing agencies concentrate risk, a disruption in a clearing agency's operations or the failure of a clearing agency to meet its obligations could cause a systemic disruption that can be costly for more than just the clearing agency and its members. For example, a significant

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484 See id.

485 Some clearing agencies permit proprietary trading firms, including high-frequency traders, that meet the clearing agency's participation requirements, to clear trades without intermediation by a broker-dealer or futures commission merchant ("FCM").

486 See Risk Management Supervision of Designated Clearing Entities (July 2011), Report by the Commission, Board and CFTC to the Senate Committees on Banking, Housing, and Urban Affairs and Agriculture in fulfillment of Section 813 of Title VIII of the Dodd-Frank Act.

487 See id.

dollar value of financial transactions pending for clearance or to be cleared in the future through the clearing agency could fail to settle on time or at the original contract terms. If the clearing agency acting as a CCP does not have the funds to cover the fail, members of the clearing agency would suffer losses and liquidity constraints due to their inability to access their clearing fund contributions and the clearing agency's inability to honor its obligations.[488] In addition, the failure has the potential to harm the market as a whole in all financial instruments cleared by that clearing agency and its members, beyond the securities pending for clearance at the time of the original settlement failure.

The standards adopted today as part of Rule 17Ad-22 are intended to help mitigate these risks by requiring measures that would reinforce the safety of clearing agencies. Safe and reliable clearing agencies are essential not only to the stability of the securities markets they serve but often also to payment systems, which may be used by a clearing agency or may themselves use a clearing agency to transfer collateral. The safety of securities settlement arrangements and post-trade custody arrangements is also critical to the goal of protecting the assets of investors from claims by creditors of intermediaries and other entities that perform various functions in the operation of the clearing agency. Investors are more likely to participate in markets when they have confidence in the safety and reliability of clearing agencies; therefore the rule being adopted today should promote capital formation.

In addition, the rule seeks to promote the efficiency of clearing agencies. As described below, the structure of the clearing agency market and the structure of the clearing agencies

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488 See id. at 8. While no clearing agency has ever failed in the United States, such failure is not impossible. See, e.g., Donald MacKenzie, An Engine, Not A Camera: How Financial Models Shape Markets (2009); Ian Hay Davison, Securities Review Committee Report (1989) (discussing the events surrounding the failure of the Hong Kong Futures Exchange Clearing Corporation in 1987).

themselves may not provide the competitive incentives necessary to promote transparency, fair access, and efficient operations. Transparency helps to ensure that clearing members can make more informed decisions and that market participants in general have better information about the stability of the system. In turn, transparency promotes competition by facilitating comparisons across clearing agencies. Fair access ensures that a variety of market participants can gain access to clearing and settlement services and thus promotes competition by lowering barriers to entry for clearing agency participants.[489] Efficient operations can result in higher quality services or lower fees (or both) to clearing agency members and their customers.

The analysis below examines the projected economic effects of the adopted rules. The analysis starts with a baseline discussion of the current regulatory landscape and existing industry practices of clearing agencies relating to their operations and risk management procedures and membership policies. This discussion provides a point of comparison for the second half of the economic analysis, which is a discussion of the benefits and costs of the rules, as well as alternative approaches to the rules that were considered by the Commission.[490]

B. Baseline

Rule 17Ad-22 impacts the market for clearing agency services in securities, with an emphasis on CCP services. There are currently seven clearing agencies registered with the Commission that provide CCP or CSD services. Six of these clearing agencies offer CCP services, and one is a CSD. Together, they processed over $1 quadrillion in financial market

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489 See infra discussion of Rules 17Ad-22(b)(5), (6) and (7) in Section V.C.5.

490 In discussing the current practices of the registered clearing agencies below, we have omitted descriptions of the variations in the practices, policies, and procedures among registered clearing agencies that are, nevertheless, consistent with the requirements of the final rules. However, while these variations are not discussed, notable distinctions in practices, policies, and procedures that significantly impact the economic analysis are addressed, as applicable.

transactions in 2011.[491] Some of these clearing agencies also are regulated by the CFTC, the Federal Reserve, and the New York State Department of Banking.

Central clearing facilitates the management of counterparty credit risk among dealers and other institutions by shifting that risk from individual counterparties to CCPs, thereby helping protect counterparties from each other's potential failures and preventing the buildup of risk in such entities, which could be systemically important. Central clearing generally reduces the counterparty risk of market participants, including market makers and dealers. If market makers and dealers cannot diversify this counterparty risk, they generally pass the costs on to their clients in the form of higher transaction costs. In order for central clearing to reduce risk, mark-to-market pricing and margin requirements need to be applied in a consistent manner.[492] CCPs generally use liquid margin collateral to manage the risk of a CCP member's failure, and rely on the accuracy of their margin calculations and their access to liquid collateral to protect against sudden movements in market prices. A CCP can also reduce systemic risk through netting, by reducing the amount of funds or other assets that must be exchanged at settlement.[493]

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491 This figure was calculated from the following sources: DTCC 2011 Annual Report, available at http://dtcc.com/about/annuals/2011/report.php; OCC 2011 Annual Report, available at http://www.optionsclearing.com/components/docs/about/annual-reports/occ_2011_annual_report.pdf; CME Group 2011 Annual Report, available at http://cmegroup.com/investor-relations/annual-review/2011/downloads/CME_Group_2011_Annual_Report.pdf; InterContinental Exchange 2011 Annual Report, available at http://files.shareholder.com/downloads/ICE/1860307941x0x556734/44EA48C5-CBCB-4468-BF54-048BFEEC8264/ICE_2011AR.pdf.

492 See Christopher Culp, OTC-Cleared Derivatives: Benefits, Costs, and Implications of the "Dodd-Frank Wall Street Reform and Consumer Protection Act (Journal of Applied Finance, No. 2, 2010), available at http://www.rmcsinc.com/articles/OTCCleared.pdf.

493 See, e.g., Darrell Duffie and Haoxiang Zhu, Does a Central Clearing Counterparty Reduce Counterparty Risk?, (Stanford University, Working Paper, 2010), available at http://www.stanford.edu/~duffie/DuffieZhu.pdf; Nout Wellink, Mitigating System Risk in OTC Derivatives Markets, (Banque de France, Financial Stability Review, No. 14 – Derivatives – Financial innovation and stability, July 2010), available at

Nevertheless, a CCP also concentrates risks and responsibility for risk management in the CCP.[494] Consequently the effectiveness of a CCP's risk controls and the adequacy of its financial resources are critical aspects of the infrastructure of the market it serves.[495]

The market for CCP services in the United States tends to be segmented by financial instrument, with clearing agencies often specializing in particular instruments. As such, some market segments may have characteristics of natural monopolies capable of being sustained despite the presence of competitors with the potential to enter the market segment in question.[496] For example, in the United States, following a period of consolidation facilitated by the introduction of Section 17A of the Exchange Act, only one CCP currently processes transactions in U.S.-listed equities and only one CCP processes transactions in exchange-traded options. However, three clearing agencies currently serve as CCPs for swaps and security-based swaps. Although two of the CCPs for security-based swaps are affiliated entities, these affiliated CCPs do not compete with each other; one primarily serves the U.S. market for security-based swaps, and the other primarily serves the European market. Further, the affiliated CCP serving the U.S. market has a dominant market share in the United States, though the Commission believes this may be subject to change over time as a result of competition from the other registered CCPs offering security-based swap services, the entry of new competitors into the U.S. market or other factors.

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http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/etude15_rsf_1007.pdf; and Manmohan Singh, Collateral, Netting and System Risk in the OTC Derivatives Market," (International Monetary Fund, Working Paper, 2009), available at http://www.imf.org/external/pubs/ft/wp/2010/wp1099.pdf.

494 See RCCP, supra note 33, at 1.

495 See id.

496 A natural monopoly is one in which the economies of scale make having a single provider more efficient (lower average cost) than having multiple competitors.

The following sections set the baseline for comparison in our analysis of the economic effects. In particular, they describe the legal framework under which registered clearing agencies operate and the current practices of clearing agencies as they relate to the rules being adopted today.

1. Legal Framework

a. Overview of Statutory Framework and the Dodd-Frank Act

In recognition of the risks posed by the concentration of clearance and settlement activity at clearing agencies, the Exchange Act and Titles VII and VIII of the Dodd-Frank Act provide a framework for enhanced regulation and supervision of clearing agencies by the Commission.

i. Exchange Act

Section 17A of the Exchange Act[497] and Rule 17Ab2-1[498] require entities to register with the Commission prior to performing the functions of a clearing agency. Under the statute, the Commission is not permitted to grant registration unless it determines that the rules and operations of the clearing agency meet the standards set forth in Section 17A.[499] If the Commission registers a clearing agency, the Commission oversees the clearing agency to facilitate compliance with the Exchange Act using various tools that include, among other things, the rule filing process for SROs and on-site examinations by Commission staff. Section 17A(d) also gives the Commission authority to adopt rules for clearing agencies as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act and prohibits a registered clearing agency from engaging in

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497 See 15 U.S.C. 78q-1(b). See also Pub. L. No 111-203 § 763(b) (adding subparagraph (g) to Section 17 of the Exchange Act).

498 See 17 CFR 240.17Ab2-1.

499 See supra note 5.

any activity in contravention of these rules and regulations.[500] In 1980, the staff of the Commission provided guidance on meeting the requirements of Section 17A in its Standards for Clearing Agency Regulation.[501]

ii. Title VII of the Dodd-Frank Act

As described in Section I above, the Dodd-Frank Act was enacted to, among other things, mitigate systemic risk and promote the financial stability of the United States by improving accountability and transparency in the financial system and by providing for enhanced regulation and oversight of institutions designated as systemically important.[502] Specifically, Title VII of the Dodd-Frank Act amended the Exchange Act to require that security-based swap transactions must be cleared through a clearing agency that is registered with the Commission (or exempt from registration) if they are of a type that the Commission determines be cleared, unless an exemption from mandatory clearing applies.[503] New Section 17A(i) of the Exchange Act also gives the Commission authority to promulgate rules that establish standards for security-based swap clearing agencies.[504] Compliance with any such rules is a prerequisite to the registration of a clearing agency with the Commission[505] and is also a condition to the maintenance of its continued registration.[506]

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500 See 15 U.S.C. 78q-1(d).

501 See supra note 5.

502 See supra note 20.

503 See 15 U.S.C. 78c-3(a)(1) (as added by Section 763(a) of the Dodd-Frank Act).

504 15 U.S.C. 78q-1(i).

505 Under the Exchange Act, a clearing agency can be registered with the Commission only if the Commission makes a determination that the clearing agency satisfies the requirements set forth in paragraphs (A) through (I) of Section 17A(b)(3) of the Exchange Act. 15 U.S.C. 78q-1(b)(3).

506 See supra Section I.A.3.

iii. Title VIII of the Dodd-Frank Act

In addition to the provisions in Title VII that expand the Commission's authority under the Exchange Act to include security-based swap activities, Title VIII of the Dodd-Frank Act, entitled the Clearing Supervision Act, establishes an enhanced supervisory and risk control system for systemically important clearing agencies and other FMUs.[507] As previously noted, on July 18, 2012, the Council designated DTC, FICC, NSCC and OCC as systemically important, and Section 17A(i) of the Exchange Act provides that the Commission, in establishing clearing agency standards and in its oversight of clearing agencies, may conform such standards and such oversight to reflect evolving international standards.[508] Section 805(a) of the Clearing Supervision Act supplements the Exchange Act requirements by mandating the Commission to take into consideration relevant international standards and existing prudential requirements for clearing agencies that are designated as systemically important FMUs.[509]

In part, the Clearing Supervision Act provides that the Commission, considering relevant international standards and existing prudential requirements, may prescribe regulations that set risk management standards for the operations related to PCS Activities[510] of a Designated Clearing Entity or the conduct of designated activities by a Financial Institution.[511] Creation of any such risk management standards must be done in consultation with the Federal Reserve and the Council.

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507 See supra note 25.

508 15 U.S.C. 78q-1(i).

509 12 U.S.C. 5464(a)(1).

510 Certain post-trade processing activities that are not captured by the Clearing Supervision Act may nevertheless be subject to regulation by the Commission under the Exchange Act. See supra note 100 and accompanying text.

511 See supra note 27.

b. CPSS-IOSCO Standards

As noted above, the final FMI Report was published on April 16, 2012 to replace the earlier CPSS-IOSCO Recommendations and therefore represents a new reference point of international standards contemplated by the Exchange Act and the Clearing Supervision Act relevant for actions taken by the Commission.[512] The FMI Report recognizes that FMIs can differ significantly in design, organization and function and that certain principles are not applicable to certain types of FMIs. The principles are designed therefore to be applied holistically, and the Final Report expressly provides flexibility in terms of how FMIs will apply the principles. The clearing agencies registered with the Commission have generally implemented the CPSS-IOSCO Recommendations. The FMI Report states that financial market infrastructures (including CCPs and CSDs) are expected to observe the principles contained in the FMI Report through "appropriate and swift action" consistent with the national laws of their home jurisdictions.[513]

c. Complementary Regulation by Other Regulators

Rule 17Ad-22 and the rules for DCOs adopted by the CFTC[514] are generally consistent. The CFTC also incorporates some of the CPSS-IOSCO Recommendations by rule to supplement the DCO core principles of the Commodity Exchange Act ("CEA"). Nevertheless, there are some differences between the rules the Commission is adopting today and those of the CFTC.

First, Rule 17Ad-22(b)(1) requires a CCP to measure its credit exposures to its participants at least once a day while the CFTC's DCO rules require that DCOs perform that

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512 See supra note 32.

513 See RSSS and RCCP Reports, supra note 33.

514 See 76 FR 69334 (Nov. 8, 2011).

function periodically throughout the day. Second, consistent with the current practice at registered CCPs providing clearing of security-based swaps, Rule 17Ad-22(b)(3) requires CCPs for security-based swaps to maintain enough financial resources to withstand a default by the two largest participant families.[515] All other CCPs would be required to be able to withstand a default by the single largest participant family, for the reasons discussed in Section V.C below.

The CFTC applies the latter standard to all DCOs. In its October 2010 rule proposal, the CFTC proposed requiring that systemically important DCOs maintain sufficient financial resources to meet their financial obligations to their clearing members notwithstanding a default by the two clearing members creating the largest combined financial exposure for the systemically important DCO in extreme but plausible market conditions.[516] The CFTC did not adopt this proposal as part of its final rules for DCOs. The CFTC stated that it was premature to adopt this rule for the following reasons: (1) the Council had not designated any DCOs as systemically important; (2) the final FMI Report had not been published; and (3) EMIR was not final.[517] The CFTC stated that it would be closely monitoring developments and would be prepared to revisit the issue if the European Union or other foreign regulators move closer to implementation of their respective reforms.[518]

Third, Rule 17Ad-22(b)(4) requires model validations to be performed "annually" by a person who is free from influence from the persons responsible for development or operation of

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515 See supra Section III.C.3.

516 See Financial Resources Requirements for Derivatives Clearing Organizations, 75 FR 63113 (Oct. 14, 2010).

517 See id. at 69352.

518 We note that EMIR requires all CCPs to maintain sufficient financial resources to withstand the default of the two participants with the largest exposures. See supra note 167 at 43. EMIR was adopted in July 2012. See supra note 167.

the systems and models being validated so that he or she can be candid in his or her assessment of the model. The CFTC rule requires an "independent" validation on a "regular basis."

Fourth, Rule 17Ad-22(b)(7) provides for scalability of net capital requirements in proportion to the riskiness of the participants' activities and permits CCPs to seek Commission approval to impose a net capital requirement on participants that is higher than $50 million. In contrast, the CFTC's DCO rules do not provide for scalability and do not allow DCOs the option to seek approval for a higher net capital requirement.

Finally, a DCO is required to publicly disclose its margin-setting methodology and default procedures on its website. Rule 17Ad-22(d)(11) requires a clearing agency to make key aspects of its default procedures publicly available, but nothing in the rules the Commission is adopting today would require publication of the clearing agency's margin methodology.

2. Current Practices

An overview of the risk management practices, operations, policies and procedures of registered clearing agencies is set forth below. The discussions under the headings "Risk Management - Measurement of credit exposures," "--Margin" "--Financial Resources" and under the heading "Other Clearing Services" are based upon public representations[519] made by registered clearing agencies regarding their compliance with the CPSS-IOSCO Recommendations and upon the Commission's observations with regard to registered clearing agencies developed in carrying out its supervisory role. The discussion under the heading "Risk

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519 See, e.g., NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf; DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf; FICC/GSD's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 15, 2011), available at http://www.dtcc.com/legal/compliance/FICC_Self-Assessment.pdf.

Management -Model Validation" is based upon the Commission's observations with regard to registered clearing agencies in its supervisory role. The Commission notes that the practices observed at registered clearing agencies generally are performed pursuant to stated practices, policies and procedures as described below.[520]

a. Risk Management Practices

i. CCP practices as they relate to Rules 17Ad-22(b)(1)--(4)

CCPs have a range of tools that can be used to manage the financial risks to which they are exposed, and the tools that an individual CCP uses will depend upon the nature of its obligations. Nonetheless, there is a common set of procedures that are implemented by many CCPs to manage counterparty credit and liquidity risks. Broadly, these procedures enable CCPs to manage their risks by limiting the likelihood of defaults, by limiting the potential losses and liquidity pressures if a default should occur, and by ensuring that there are adequate resources to cover losses and meet payment obligations on schedule.

To manage its counterparty credit exposures to its participants effectively, a clearing agency must be able to measure those exposures. A clearing agency can ascertain its current credit exposure to each participant by marking each participant's outstanding contracts to current market prices and (to the extent permitted by a clearing agency's rules and supported by law) netting any gains against any losses. A clearing agency faces the risk that its exposure to a participant can change as a result of a change in prices, in positions, or both.

520 Registered clearing agencies are SROs as defined in Section 3(a)(26) of the Exchange Act. A stated policy, practice, or interpretation of an SRO, such as a clearing agency's written policies and procedures, would generally be deemed to be a proposed rule change. See 17 CFR 240.19b-4. See supra note 293.

The current practice of each CCP registered with the Commission includes these procedures: (1) measuring credit exposures at least once a day; (2) setting margin coverage at a 99% confidence level over some set period; (3) using risk-based models; (4) establishing a fund that mutualizes losses of defaults by one or more participants that exceed margin coverage; and (5) maintaining sufficient financial resources to withstand the default of at least the largest participant,[521] and in the case of security-based swap transactions, maintaining enough financial resources to be able to withstand the default of their two largest participants.[522]

1. Measurement of Credit Exposures

Currently, registered clearing agencies measure credit exposures at least once per day. Clearing agencies that guarantee trades on the trade date, such as the FICC/GSD and OCC, measure credit exposures multiple times per day. NSCC does not guarantee trades until midnight of T+1, and it only measures credit exposures daily, though it is considering an accelerated trade guarantee proposal that would potentially revise these practices.[523]

2. Margin

Clearing agencies use risk-based models to set initial and variation margin. Inputs to the margin calculation include, among other things, portfolio size, asset price volatility, current asset values, the likely liquidity of the asset should a particular market maker fail (market-maker domination charges), the likely time it would take to liquidate the assets, potential correlations between the value of assets posted as collateral and the assets being cleared, and the correlation of the prices in the portfolio of assets being cleared by the participant.

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521 See supra note 183.

522 See supra note 168.

523 See NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), at 24, available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf.

The current practice of many CCPs registered as clearing agencies is to calculate daily margin requirements using risk-based models to ensure coverage at a 99% confidence interval over a designated time horizon. Losses beyond this level are typically covered by the CCP's guaranty fund. This standard is consistent with the RCCP, which has been the internationally accepted minimum standard for CCPs.[524] The RCCP advises that CCPs use margin and other risk control mechanisms to limit exposures to potential losses from defaults by participants in normal market conditions. The generally recognized standard for normal market conditions, as defined in the RCCP, is price movements that produce changes in exposures that are expected to breach margin requirements or other risk controls only 1% of the time (i.e., at a 99% confidence interval).[525]

This standard comports with the international standard for bank capital requirements established by the Bank for International Settlements, which requires banks to measure market risks at a 99% confidence interval when determining regulatory capital requirements.[526] At the time the Basel Committee on Banking Supervision (the "Committee") contemplated this standard, banks measured value-at-risk using a range of confidence intervals from 90-99%.[527]

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524 See supra note 74.

525 See Bank for International Settlements' Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, Recommendations for Central Counterparties, (Nov. 2004), at 21, available at http://www.bis.org/publ/cpss64.pdf; see also infra Section V.B.2 (discussion on current industry baselines and the use of the 99% confidence level).

526 See Bank for International Settlements' Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2004), available at http://www.bis.org/publ/bcbs107.pdf; see also Darryll Hendricks and Beverly Hirtle, New Capital Rule Signals Supervisory Shift (Sept. 1998), available at http://www.bis.org/bcbs/ca/alrequse98.pdf.

527 See Bank for International Settlements' Basel Committee on Banking Supervision, An internal model-based approach to market risk capital requirements (Apr. 1995), at 12, available at http://www.bis.org/publ/bcbs17.pdf.

When determining the minimum quantitative standards for calculating risk measurements, the Committee noted the importance of specifying "a common and relatively conservative confidence level," choosing the 99% confidence interval over the other, less conservative measures.[528] Since adopted by the Committee in 1998, it has become a generally recognized practice of banks to quantify credit risk as the worst expected loss that a portfolio might incur over an appropriate time horizon at a 99% confidence interval.[529]

3. Financial Resources

All clearing agencies that act as CCPs in the United States collect contributions from their members to guaranty funds or clearing funds for the mutualization of losses under extreme but plausible market scenarios. The guaranty funds or clearing funds consist of liquid assets, the sizes of which vary depending on the products that the CCP clears. In particular, the guaranty funds for CCPs that clear security-based swaps are relatively larger (as measured by the size of the fund as a percentage of the total and largest exposures) than the guaranty funds or clearing funds for other financial instruments. The guaranty funds for security-based swaps are sized to achieve protection against a default by two participant families to whom the clearing agency has the largest exposures and are designed to protect the clearing agency from the extreme jump-to-default risk associated with large protection sellers. Security-based swap CCPs have organized their security-based swap clearing operations either in a separate legal entity or by establishing a separate fund and separate procedures (rules, membership requirements and risk management

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528 See id.

529 See Kenji Nishiguchi, Hiroshi Kawai, and Takanori Sazaki, Capital Allocation and Bank Management Based on the Quantification of Credit Risk, FRBNY Economic Policy Review (Oct. 1998), at 83, available at http://www.newyorkfed.org/research/epr/98v04n3/9810nish.pdf; see also Jeff Aziz and Narat Charupat, Calculating Credit Exposure and Credit Loss: A Case Study (Sept. 1998), at 34, available at http://www.bis.org/bcbs/ca/alrequse98.pdf.

practices) within a single legal entity. The registered clearing agencies clearing products other than security-based swaps maintain the financial resources to withstand the default of the single largest participant family.[530]

4. **Model Validation**

Clearing agencies registered with the Commission typically have a model validation process in place that evaluates the adequacy of margin models, parameters, and assumptions. Current model validation practices vary among clearing agencies. Some registered clearing agencies conduct annual validations, while others conduct them on an ad hoc basis or perform validations on new models or changes to existing models before implementing them. In addition to validating models, registered clearing agencies typically review models used to calculate margin on a regular basis and back-test them regularly to assess the reliability of the methodology in achieving the desired coverage. Based on our experience in supervising registered CCPs, we understand that registered CCPs' approaches to model validation include model validations conducted by a qualified person who is either an outside third party or is employed by the clearing agency but is free from influence from the persons responsible for the development or operation of the models.

ii. Other Clearing Services (practices as they relate to Rule 17Ad-22(d))

1. **Legal Risk**

Because registered clearing agencies are SROs, they have written policies and procedures in place that, at a minimum, address the significant aspects of their operations and risk

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530 See, e.g., DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf.

management practices.[531] A large portion of these policies and procedures are available to members and participants of clearing agencies, but it is also ordinarily the practice of clearing agencies to limit members' access to certain of their policies and procedures to ensure their integrity, particularly those policies and procedures associated with the oversight of clearing participants. Registered clearing agencies also make their rule books and certain key procedures available to the public to provide a transparent legal framework.[532]

Registered clearing agencies must be able to enforce those policies and procedures and such enforcement powers are specifically contemplated by operative provisions of the Exchange Act, subject to oversight by the Commission.[533] Clearing agency policies and procedures that purport to create remedial measures that a party other than the clearing agency (such as a clearing member) can use to seek redress or to promote compliance with applicable rules must also be enforceable in practice in order to be effective, and the Commission believes that Rule 17Ad-22(d)(1) would augment the Exchange Act requirement that the rules of the clearing agency must provide that its participants shall be appropriately disciplined for any violation of any provision of the rules of the clearing agency.[534]

2. Participation Requirements

Applicants for membership must provide a registered clearing agency with certain financial and operational information prior to being admitted as a member and on an ongoing basis as a condition of continuing membership. The registered clearing agency reviews this information to ensure that the applicant has the operational capability to meet the technical

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531 See supra note 520.

532 Generally, the rules and procedures of registered clearing agencies can be found on their respective websites.

533 See Sections 17A(b)(3)(A), (G), and (H) of the Exchange Act.

534 See 15 U.S.C. 78q-1(b)(3)(G).

demands of interfacing with the clearing agency. In particular, registered clearing agencies require that an applicant demonstrate that it has adequate personnel capable of handling transactions with the clearing agency and adequate physical facilities, books and records and procedures to fulfill its anticipated commitments to, and to meet the operational requirements of, the clearing agency and other participants with necessary promptness and accuracy and to conform to any condition or requirement that the clearing agency reasonably deems necessary for its protection.

Registered clearing agencies use the ongoing monitoring process to ensure they understand relevant changes in the financial condition of their participants and to mitigate credit risk exposure of the clearing agency to its participants. Financial statements filed with the regulatory agencies, information obtained from other SROs and information gathered from various financial publications are analyzed by risk management staff so that the clearing agency may evaluate whether the participant continues to be financially stable.

3. Custody of Assets and Investment Risk

Registered clearing agencies currently seek to minimize the risk of loss or delay in access by holding assets that are highly-liquid (e.g., cash, U.S. Treasury securities or securities issued by a U.S. government agency) and engaging banks to custody the assets and facilitate settlement. Clearing agencies that are designated systemically important by the Council may be provided account services at the appropriate Federal Reserve Bank to the extent such services are not already available as the result of other laws and regulations.[535] The use of account services at the

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[535] See Section 806(a) of the Clearing Supervision Act. "The Board of Governors may authorize a Federal Reserve Bank to establish and maintain an account for a designated financial market utility and provide the services listed in section 11A(b) of the Federal Reserve Act (12 U.S.C. 248a(b)) and deposit accounts under the first undesignated paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 342) to the designated

Federal Reserve Bank would reduce custody risk in clearing agencies that are designated systemically important by the Council.

4. Identification and Mitigation of Operational Risk

Registered clearing agencies develop and maintain plans to assure the safeguarding of securities and funds, the integrity of the Automated Data Processing systems, and recovery of securities, funds, or data under a variety of loss or destruction scenarios.[536] In addition, clearing agencies generally maintain an internal audit department to review the adequacy of the clearing agencies' internal controls, procedures, and records with respect to operational risks. Some clearing agencies also engage independent accountants to perform an annual study and evaluation of the internal controls relating to its operations.[537]

5. Money Settlement Risks

Registered clearing agencies use settlement banks to facilitate the cash portion of securities settlements. Because DTC is organized as a limited purpose trust company and is a member of the Federal Reserve System,[538] it has an account at the Federal Reserve Bank of New

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financial market utility that the Federal Reserve Bank is authorized under the Federal Reserve Act to provide to a depository institution, subject to any applicable rules, orders, standards, or guidelines prescribed by the Board of Governors." 12 U.S.C. 5465(a).

536 These practices, among others, have been developed pursuant to Commission guidelines. See Automation Review Policy Statements , supra note 330.

537 See NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf.

538 See Section 806(a) of the Dodd-Frank Act ("The Board of Governors may authorize a Federal Reserve Bank to establish and maintain an account for a designated financial market utility and provide the services listed in Section 11A(b) of the Federal Reserve Act (12 U.S.C. 248a(b)) and deposit accounts under the first undesignated paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 342) to the designated financial market utility that the Federal Reserve Bank is authorized under the Federal Reserve Act to

York, and uses that account to facilitate end-of-day settlement. NSCC, as an affiliate of DTC, also uses that account.

6. Cost-Effectiveness

Registered clearing agencies have procedures to control costs and to regularly review pricing levels against operating costs. These clearing agencies may use a formal budgeting process to control expenditures, and may review pricing levels against their costs of operation during the annual budget process. Clearing agencies also analyze workflows in order to make recommendations to improve the operating efficiency of the clearing agency.

7. Links

Each registered clearing agency is linked to other clearing organizations, trading platforms, and service providers. An example of such a link is DTC Canadian Link Service, which allows qualifying DTC participants to clear and settle valued securities transactions with participants of a Canadian securities depository. The link is designed to facilitate cross-border transactions by allowing participants to use a single depository interface for U.S. and Canadian dollar transactions and eliminate the need for split inventories.[539]

8. Governance

Each registered clearing agency has a board that governs the operations of the entity and supervises senior management. The key components of a clearing agency's governance arrangements include the clearing agency's ownership structure, the composition and role of its board, the structure and role of board committees, reporting lines between management and the

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provide to a depository institution, subject to any applicable rules, orders, standards, or guidelines prescribed by the Board of Governors.").

539 See infra note 617.

board, and the processes that ensure management is held accountable for the clearing agency's performance.

9. Information on Services

Because registered clearing agencies are SROs, their rules are published by the Commission and are available on each clearing agency's website. In addition, information regarding the operations and services of each clearing agency can be found either on the clearing agency's website or a website maintained by an affiliated entity of the clearing agency.

10. Immobilization and Dematerialization of Securities Certificates

Virtually all mutual fund securities, government securities, options, and municipal bonds in the United States are dematerialized, and most of the equity and corporate bonds in the U.S. market are either immobilized or dematerialized; some securities (e.g., mutual fund shares, U.S. Treasury bills) are issued on a completely dematerialized basis, while most securities issued to the public are issued in the form of one or more physical certificates. Through the end of 2010, over 99% of municipal and corporate debt by par value distributed through DTC was in book-entry-only form.[540] DTC estimates that in excess of 90% of the corporate and municipal securities issued to the public in the United States are distributed through DTC and are represented by one or more physical certificates that are immobilized at the depository.[541]

11. Default Procedures

Each registered clearing agency makes publicly available rules, policies or procedures that set forth the actions the clearing agency may take in the event of a participant default, with the exception of certain of their policies and procedures that are kept non-public to ensure their integrity, such as those associated with the oversight of clearing participants. For example,

540 See DTCC White Paper, supra note 389.

541 See id.

clearing agency rules typically state what constitutes a default, identify whether the board or a committee of the board may make that determination and describe what steps the clearing agency may take to protect itself and its participants. In this regard, clearing agencies typically attempt, among other things, to close-out, to hedge or to liquidate a defaulting participant's positions.

12. Timing of Settlement Finality

Each registered clearing agency has rules, policies or procedures that provide for the settlement of their respective securities transactions no later than the end of a pre-defined settlement day. For example, DTC provides for final settlement of securities transfers no later than the end of the day and the timing of finality is clearly defined. Final cash settlement occurs at the end of the processing day at DTC. Funds transfers through DTC's account at the Federal Reserve Bank of New York that occur between DTC and a settling bank that is acting on behalf of a DTC participant are final when made.

13. Delivery versus Payment

Rule 17Ad-22(d)(13) would apply to registered clearing agencies that provide CSD services. DTC currently is the only registered clearing agency that is a CSD. DTC operates a Model 2 DVP system that provides for gross settlements of securities transfers during the day followed by an end of day net funds settlement.[542] Under DTC's rules, in a DVP transaction, the delivering party is assured that it will be paid for the securities once they are credited to the receiving party's securities account.[543]

542 See DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf.

543 See id.

14. Risk Controls to Address Participant's Failure to Settle

The sole registered clearing agency providing CSD services, DTC, which also extends limited intraday credit to participants, has policies and procedures in place to ensure that timely settlement can be completed in the event of the default of the participant with the largest settlement obligation. DTC has policies and procedures to establish limits (called net debit caps) for each participant. The net debit cap ensures that the amount of cash that a participant owes the clearing agency at any one point in time does not exceed this pre-defined limit or cap. The net debit cap is set in relation to a participant's normal activity with the maximum net debit cap for an individual participant currently set at $1.8 billion. DTC also has implemented other risk management controls to help ensure settlement. For example, DTC monitors the value of the collateral supporting each participant's net debit in its settlement system based on the security's prior business day's closing market price, less a haircut, which is based primarily upon the availability of prices, ratings, and the price volatility of the particular security.

15. Physical Delivery Risks

Each registered clearing agency has rules and procedures that describe its obligations to its participants when it assumes deliveries of physical instruments. For example, under NSCC's rules governing its continuous net settlement ("CNS") system, NSCC becomes the contra-party for settlement purposes at the point NSCC's trade guarantee attaches, thereby assuming the obligation of its members that are receiving securities to receive and pay for those securities, and the obligation of members that are delivering securities to make the delivery. Unless NSCC has invoked its default rules, NSCC is not obligated to make those deliveries until it receives from members with delivery obligations deliveries of such securities; rather, deliveries that come into CNS ordinarily are promptly redelivered to parties that are entitled to receive them through an allocation algorithm. Members are obligated to take and pay for securities allocated to them in the CNS process. NSCC's rules also provide mechanisms allowing receiving members a right to receive high priority in the allocation of deliveries, and also permit a member to buy-in long positions that have not been delivered to it by the close of business on the scheduled settlement date.

b. Participant Access (practices as they relate to Rules 17Ad-22(b)(5)–(7))

To address credit risk management, clearing agencies establish requirements for participants' financial resources, creditworthiness, and operational capability, and maintain procedures to ensure ongoing compliance with their rules. In its regulatory capacity overseeing clearing agencies, Commission staff has observed that applicants for clearing agency membership must demonstrate standards of financial responsibility, operational capability and character. Specific criteria used by clearing agencies address the extent and nature of the business the applicant intends to conduct through the clearing agency and the applicant's capital resources and financial stability, including factors bearing on its financial capability to meet its projected clearing agency obligations.[544]

As of December 31, 2011, registered CCPs (including those clearing nontraditional securities such as credit default swaps) had the following numbers of members:

- FICC – 302 members

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544 See, e.g., International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the NSCC's Observance of the CPSS-IOSCO Recommendations for Central Counterparties (2010), at 6-8, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10129.pdf; IMF's Detailed Assessment of Observance of the Fixed Income Clearing Corporation – Government Securities Division's Observance with the CPSS-IOSCO Recommendations for Central Counterparties, performed in connection with the Financial Sector Assessment Program of the United States in 2010, at 6-8, available at www.imf.org/external/pubs/ft/scr/2010/cr10130.pdf.

- NSCC – 187 full members; 647 limited members
- OCC – 120 members
- CME – 64 members
- ICE Clear Credit – 27 members
- ICE Clear Europe – 60 members

CCPs for traditional securities already have rules regarding access and membership. All CCPs for traditional securities allow non-dealer members, and none of them have minimum portfolio size or trading volume thresholds.[545] In addition, the minimum capital requirements to access these CCPs range from $500,000 to $10,000,000.

Certain clearing agencies that provide CCP services for security-based swap transactions, however, have required members to have significant minimum portfolio sizes or trading volumes, meet significantly higher minimum capital requirements, and require members to operate a dealer business. Such requirements may present challenges to new liquidity providers in the relevant market. The CCPs argue that these requirements are necessary to mitigate the risk exposure of the CCP in the event of default by a clearing member.[546] For example, because markets for credit default swaps are generally less liquid than markets for exchange-traded derivatives, traditional procedures for a CCP to handle a member default may not be effective. The traditional procedures for handling a default, which are used by CCPs for most exchange-traded derivatives, call for the CCP to terminate all of its contracts with the defaulting participant and promptly enter the market and replace the contracts, so as to hedge against further losses on

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545 See infra discussion of Rules 17Ad-22(b)(5), (6) and (7) in Section V.C.5 (benefits and costs of broad access requirements and non-dealer membership).

546 See generally Bank for International Settlements, New Developments in Clearing and Settlement Arrangements for OTC Derivatives (Mar. 2007), at 27-29.

the open positions created by termination of the defaulter's contracts. But if the markets for the contracts cleared by the CCP are illiquid, prompt replacement of the contracts may induce adverse price movements, especially if the defaulting participant's positions are large. Consequently, the application of traditional default procedures to illiquid credit default swaps contracts may entail significant risk to the CCP.

To address this potential risk, these CCPs developed a default management process that requires traders from their clearing members to be seconded to the CCP to manage the defaulter's portfolio. They would be charged with neutralizing the market risk in the portfolio by entering into new OTC derivative contracts with non-defaulting clearing members. Once neutralized as much as possible, the portfolio would be divided and auctioned to non-defaulting members. The CCP would determine a reservation price for the auction, and if a non-defaulting clearing member's bid exceeds that reservation price, the auction would be deemed successful. If not, the auction would fail. In the event of a failed auction, the portfolio would be divided among the non-defaulting clearing members pro rata based on their volumes of business. Under this process, a non-defaulting CCP participant would bear the risk of entering the markets to hedge open positions created by a default only if it is a successful bidder or if one or more auctions fail and it is assigned positions because it has outstanding positions with the CCP.

This process creates a tension between the need for effective default management procedures and the maintenance of fair and open access to a CCP's services. Because of the stringent capital and other requirements imposed by the CCP's membership standards, membership in a CCP clearing security-based swaps generally has been limited to very large dealers, those meeting the outstanding swap portfolio amount and capital requirements. Current members may also have an incentive to exclude new members, either to manage counterparty risk or to block competitors. Being a member of a CCP may provide a competitive boost to a new member that is a smaller dealer by allowing the CCP's creditworthiness to be substituted for that of the new member. Requirements that prevent smaller dealers from entering as new members may, therefore, undermine competition and the entry of new liquidity providers in the relevant market. Indeed, one committee argues that access criteria in credit default swaps have had the effect of excluding market participants such as mid-tier financial institutions and buy-side firms from direct access to CCPs.[547] While such requirements have to date been adopted only by CCPs that engage in the clearance and settlement of credit default swaps, the Commission believes that preventing the introduction of such requirements also may be an important consideration for other types of instruments.

c. Disclosure of Financial Information (practices as they relate to Rule 17Ad-22(c))

Currently, there is no rule requirement under the Exchange Act or Commission rule that mandates clearing agencies to record and maintain information about their financial resources. Nevertheless, as part of their ordinary risk management procedures developed in consultation with their members, clearing agencies produce at least quarterly internal reports regarding the ability of the CCP to withstand a default by the participant (or two participants) to which the clearing agency has the largest exposure in extreme but plausible market conditions. In addition, as part of the Commission's supervision, oversight and monitoring of clearing agencies, the Commission staff can obtain such information on request. However, clearing agencies do not all currently record and maintain documentation that explains the methodology used to compute their financial resource requirements as required by Rule 17Ad-22(b)(3).

547 See Committee on the Global Financial System, The Macrofinancial Implications of Alternative Configurations for Access to Central Counterparties in OTC Derivatives Markets (Nov. 2011), at 9.

Commission staff guidance to clearing agencies provides that clearing agencies should provide, within 60 days following the close of the clearing agency's fiscal year, audited annual financial statements to those participants who have made clearing fund contributions and/or have money and/or securities in the clearing agency's systems.[548] With one exception, the clearing agencies report their accounting information in U.S. GAAP.[549] At present, clearing agencies publish annual audited financial statements on their respective websites and provide unaudited quarterly and annual audited financial statements to their members.[550] All the clearing agencies currently have their financial statements audited in accordance with the standards of the PCAOB by a registered public accounting firm, and when the financial statements are posted on their websites, the clearing agencies include the report of the auditor.

d. Comparison of Current Practices and Rule to CPSS-IOSCO Recommendations as Related to Rules 17Ad-22(b)(1)–(3) and (d)

In 2009, based upon an agreement reached with the U.S. Department of Treasury, the operations of several U.S. clearing agencies were assessed by independent assessors from the

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548 See Exchange Act Release No. 16900 (June 17, 1980). Because BSECC and SCCP do not conduct clearance and settlement operations they do not post audited financial statements. See supra note 438.

549 ICE Clear Europe posts financial statements in UK GAAP.

550 See DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf; NSCC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Nov. 14, 2011), available at http://www.dtcc.com/legal/compliance/NSCC_Self_Assessment.pdf; FICC/GSD's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 15, 2011), available at http://www.dtcc.com/legal/compliance/FICC_Self-Assessment.pdf.

IMF against the CPSS-IOSCO Recommendations.[551] The IMF's assessments supported a finding of full or broad observance of the CPSS-IOSCO Recommendations by each of the clearing agencies registered with the Commission at that time. Further, CME, ICE Clear Credit and ICE Clear Europe represented to the Commission that they met the standards set forth in the RCCP when they sought to obtain an exemption from the Commission to provide CCP services for credit default swaps transactions.[552] Only one CCP, OCC, has not either been subject to an assessment using the RCCP or publicly stated its view on whether it complies with the RCCP.[553] Rules 17Ad-22(b)(1), (2), (3) and (d) are largely modeled on the CPSS-IOSCO Recommendations and therefore are largely consistent with observed practices.

The table below maps the requirements of Rules 17Ad-22(b)(1)–(3) and (d) to the corresponding CPSS-IOSCO Recommendations.

551 See supra note 183.

552 See generally Securities Exchange Act Release No. 60372 (July 23, 2009), 74 FR 37748 (July 29, 2009) (temporary exemptions in connection with CDS clearing by ICE Clear Europe); Securities Exchange Act Release No. 60373 (July 23, 2009), 74 FR 37740 (July 29, 2009) (temporary exemptions in connection with CDS clearing by Eurex Clearing AG); Securities Exchange Act Release No. 59578 (Mar. 13, 2009), 74 FR 11781 (Mar. 19, 2009) ("March 2009 CME order") and Securities Exchange Act Release No. 61164 (Dec. 14, 2009), 74 FR 67258 (Dec. 18, 2009) ("December 2009 CME order") (temporary exemptions in connection with CDS clearing by CME); Securities Exchange Act Release No. 59527 (Mar. 6, 2009), 74 FR 10791 (Mar. 12, 2009), Securities Exchange Act Release No. 61119 (Dec. 4, 2009), 74 FR 65554 (Dec. 10, 2009), and Securities Exchange Act Release No. 61662 (Mar. 5, 2010), 75 FR 11589 (Mar. 11, 2010) (temporary exemptions in connection with CDS clearing by ICE Trust U.S. LLC).

553 Nevertheless, the Commission has approved a proposed rule change by OCC that revised its clearing fund formula so that it would be the larger of either of the following events: (1) the default of the largest single clearing member group; or (2) an event involving the near-simultaneous default of two randomly-selected clearing member groups. For a more complete description of the proposed rule change, see discussion of the costs of Rule 17Ad-22(b)(3).

Comparison of Rule 17Ad-22 to CPSS-IOSCO RCCP and RSSS Standards		
Rule 17Ad-22	**CPSS-IOSCO RCCP and RSSS**	
17Ad-22 (b)(1): Measurement and management of credit exposures	**RCCP Recommendation 3**	
17Ad-22 (b)(2): Margin requirements	**RCCP Recommendation 4**	
17Ad-22 (b)(3): Financial resources	**RCCP Recommendation 5**[554]	
17Ad-22 (d)(1): Transparent and enforceable rules	**RCCP Recommendation 1 and RSSS Recommendation 1**	
17Ad-22 (d)(2): Participation requirements	**RCCP Recommendation 2 and RSSS Recommendation 2**	
17Ad-22 (d)(3): Custody of assets and investment risk	**RCCP Recommendation 7and RSSS Recommendation 7**	
17Ad-22 (d)(4): Identification and mitigation of operational risk	**RCCP Recommendation 8 and RSSS Recommendation 11**	
17Ad-22 (d)(5): Money settlement risks	**RCCP Recommendation 9 and RSSS Recommendation 10**	
17Ad-22 (d)(6): Cost-effectiveness	**RCCP Recommendation 12 and RSSS Recommendation 15**	
17Ad-22 (d)(7): Links	**RCCP Recommendation 10 and RSSS Recommendation 19**	
17Ad-22 (d)(8): Governance	**RCCP Recommendation 13 and RSSS Recommendation 13**	
17Ad-22 (d)(9): Information on services	**RCCP Recommendation 14 and RSSS Recommendation 17**	
17Ad-22 (d)(10): Immobilization and dematerialization of securities certificates	**RSSS Recommendation 6**	
17Ad-22 (d)(11): Default procedures	**RCCP Recommendation 6**	
17Ad-22 (d)(12): Timing of settlement finality	**RSSS Recommendation 8**	

554 RCCP Recommendation 5: Financial Resources states that "[a] CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions." The explanatory note states that this should be viewed as a minimum standard and that planning by a CCP should consider the potential for two or more participants to default in a short time frame. Rule 17Ad-22(b)(3) requires that a clearing agency that provides CCP services maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions; provided that a security-based swap clearing agency shall maintain sufficient financial resources to withstand, at a minimum, a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions.

17Ad-22 (d)(13): Delivery versus payment	**RSSS Recommendation 7**	
17Ad-22 (d)(14): Controls to address participants' failure to settle	**RSSS Recommendation 9**	
17Ad-22 (d)(15): Physical delivery risks	**RCCP Recommendation 10**	

C. Consideration of Costs, Benefits, and the Effect on Efficiency, Competition and Capital Formation

1. Overview

The purpose of each rule being adopted today is to enhance the regulatory framework for registered clearing agencies. This regulatory framework will facilitate ongoing compliance with the statutory requirements that clearing agencies have rules that facilitate the prompt and accurate clearance and settlement of securities transactions and derivative agreements, contracts and transactions for which they are responsible, and safeguard funds and securities. The rules do so by requiring certain minimum standards. The Commission believes that these requirements will help ensure resilient and cost-effective clearing agency operations as well as promote transparency that would consequently support confidence among market participants in clearing agencies' ability to serve as efficient and financially stable mechanisms for clearance and settlement and to facilitate capital formation.

In addition, the rules relating to membership requirements will help facilitate broad participation and open access to clearing agencies. If the rules enhance market participation by investors, the rules may thereby increase price competition, discovery, and price efficiency in the securities cleared by the clearing agency.

Taken together, the rules are largely consistent with existing industry practices. In particular, Rules 17Ad-22(b)(1)–(3) and (d) are modeled on the CPSS-IOSCO Recommendations, which have been in place since 2004 and are generally observed by all clearing agencies. Rule 17Ad-22(c)(2) would codify the existing practice of most registered clearing agencies of maintaining certain financial information on their websites. Registered CCPs already disclose their annual audited financial statements on their websites, and all except for one registered CCP prepare such financial statements using U.S. GAAP or IFRS.[555] By codifying existing practices, the rules ensure that these benefits are being achieved with minimal need for change or for disruption to the affected industry, while also providing new entrants with legal certainty and transparency in meeting regulatory standards. At the same time, the rules have been written to accommodate changes in technology and market developments. Lastly, Rules 17Ad-22(b)(4) and (b)(5)–(7) establish new minimum practices for clearing agencies with regard to model validation and membership practices respectively.

In the Proposing Release, the Commission identified potential costs and benefits resulting from Rule 17Ad-22, as proposed, and requested comment on all aspects of the cost-benefit analysis, including the identification and assessment of any costs and benefits that were discussed in the analysis.

The Commission carefully considered all comments received on the Proposing Release. The comments are discussed above in Section III in relation to each part of Rule 17Ad-22. In particular, the Commission carefully considered comments setting forth alternatives to the requirements contained in Rule 17Ad-22. The discussion immediately below takes into account the alternatives proposed by commenters. Several commenters argued that Rule 17Ad-22(d) should not apply to entities that perform certain post-trade processing services (i.e., comparison of trade data, collateral management and tear-up/compression).[556] In response to those

555 ICE Clear Europe posts financial statements prepared in accordance with UK GAAP.

556 See generally TriOptima Letter; Markit (April) Letter; Markit (July) Letter; MarkitSERV (April) Letter; MarkitSERV (July) Letter; Omgeo Letter.

comments, the Commission has limited the scope of Rule 17Ad-22 to clearing agencies that are registered with the Commission.

As discussed above, many of the provisions in Rule 17Ad-22 are modeled on the CPSS-IOSCO Recommendations. As a general alternative to prescribing its own requirements under Rule 17Ad-22, the Commission considered requiring registered clearing agencies to perform self-assessments using the CPSS-IOSCO Recommendations. This approach would have been similar to the Board's amendment to its Payment System Risk Policy Statement that directed certain systemically important entities to conduct self-assessment using the CPSS-IOSCO Recommendations.[557] The Commission decided against this alternative because the Commission believes that it would be more appropriate for the Commission to require registered clearing agencies to conduct assessments against Commission rules because the Commission's regulatory approach relies on examining and inspecting for compliance with, and, if necessary, enforcing, a clear set of rules. Lastly, the Commission also considered alternatives to each of the individual provisions of Rule 17Ad-22, which are discussed in more detail below.

The Commission believes the resulting revised regulatory framework should enhance confidence in the market and better serve market participants. With the adoption of these rules, clearing agencies will be well-positioned to withstand market volatility and evolve with market developments and technological advancements. Establishing rules that are consistent with current practice minimizes up-front costs and provides a good starting point for promoting appropriate risk management practices. As clearing agency practices evolve over time in response changes in technology, legal requirements and other factors, clearing agencies may need to make appropriate updates and improvements to their operations and risk management

[557] See supra note 33.

practices, and as a result, actual costs of ongoing compliance with Rule 17Ad-22 may differ from the estimates discussed below.

The following addresses the entire rule and each rule provision being adopted today, its purpose, benefits and costs, and the impact of the rule on efficiency, competition and capital formation.[558]

2. Purpose of Rule 17Ad-22

The adoption by the Commission of Rule 17Ad-22 should benefit the U.S. financial markets in several ways. Because market participants and regulatory authorities are familiar with the CPSS-IOSCO Recommendations upon which Rule 17Ad-22 is based, the provisions being adopted today will increase the consistency among regulatory frameworks worldwide and thus diminish the opportunities for regulatory arbitrage. Since their publication in 2001, and 2004, respectively, the RSSS and RCCP have been used by the World Bank and IMF in numerous technical assistance and FSAP missions.[559] Regulators from multiple jurisdictions also have assessed the operations of clearing organizations using the RSSS and RCCP and

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558 Section 3(f) of the Exchange Act requires the SEC, whenever it engages in rulemaking pursuant to the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the SEC from adopting any such rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

559 Between 2000 and 2009, 35 securities settlement systems were assessed against the RSSS in 22 countries during FSAP and FSAP update missions. See Presentation by Massimo Cirasino, World Bank, and Christine Sampic, IMF, Financial Infrastructure Week, Rio de Janeiro, Brazil (Mar. 15, 2011).

incorporated them into their regulatory frameworks.[560] The CPSS-IOSCO Recommendations have been used as a recognized standard for market participants and regulators to compare the operations of CCPs and CSDs.

The establishment of consistent standards for CCP and CSD operations is an important goal that underpinned the enactment of Section 17A of the Exchange Act. When Congress adopted Section 17A, as part of the 1975 Amendments to the Securities Act ("1975 Amendments"), it determined that the implementation of linked systems for clearance and settlement and uniform standards would reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors. The legislative history noted that when broker-dealers must deal with a dozen or more different clearing and depository systems in their daily securities operations, the result is excessive cost and poorer service to investors.[561] Rule 17Ad-22 establishes minimum standards for the operations and risk management practices for clearing agencies that are consistent with the standards for CCPs and CSDs operating domestically and in other jurisdictions.

Furthermore, Rule 17Ad-22 will have the benefit of serving as a minimum benchmark for the Commission in making its required determinations regarding the rules of registered clearing agencies. For example, for a clearing agency to be registered under Section 17A, the Commission must find that it has the ability to facilitate the prompt and accurate clearance and settlement of transactions, to safeguard investor funds and securities, to remove impediments to and to perfect the mechanism of a national clearance and settlement system, and in general to protect investors and the public interest. Also, the clearing agency's rules must provide adequate

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560 For example, the Board also has proposed a rule that is modeled on the CPSS-IOSCO Recommendations and substantially similar to Rule 17Ad-22. See 76 FR 18452 (Apr. 4, 2011).

561 S. Rep. 94-75, 94th Cong., 1st Sess., at 184 (1975).

access to qualified participants, fair representation of shareholders and participants, equitable pricing, discipline of participants, and must not impose any undue burden on competition.

Rule 17Ad-22 will also have the benefit of augmenting the Commission's ability to regulate clearing agencies. Because clearing agencies are SROs, after a clearing agency has been registered with the Commission, the clearing agency must submit proposed rule changes to the Commission for approval under Exchange Act Rule 19b-4. To approve a clearing agency's proposed rule change, the Commission must find that it complies with Section 17A. The minimum benchmark established by Rule 17Ad-22 will help ensure and demonstrate that the existing operations of clearing agencies and their proposed rule changes meet or exceed international standards while remaining appropriate for the individual clearing agency. As a result, a clearing agency cannot use Rule 17Ad-22 to reduce the strength of its operational standards or adopt a new policy or procedure that the Commission believes does not meet the requirements of Section 17A.

Finally, the Commission believes Rule 17Ad-22 will help market participants be in a position to better compare the operations of U.S. clearing agencies with non-U.S. clearing organizations. In addition, the Commission's adoption of Rule 17Ad-22 will lead to greater confidence, both domestically and internationally, in the resiliency of clearing agencies and their ability to support the U.S. financial markets. The Commission's adoption of Rule 17Ad-22 may also reduce some of the potential regulatory burden for CCPs and CSDs that may be dually-regulated by the SEC and another domestic or foreign regulator because it is modeled on standards already employed by other regulatory authorities.

Below we discuss a number of costs and benefits that are related to the rule being adopted today. Many of these costs and benefits are difficult to quantify with any degree of certainty, especially as practices at clearing agencies are anticipated to evolve and appropriately adapt to changes in technology and market developments. In addition, the extent to which the increased ability to enforce standards that are incorporated in the rule will help limit future risks is unknown. Moreover, this difficulty is aggravated by the fact that limited public data exists that is related to a clearing agency's risk management practices that could assist in quantifying certain costs. Therefore, much of the discussion is qualitative in nature but where possible, we quantify the costs.

Many, but not all, of the costs of the rule involve a collection of information, and these costs and burdens were discussed in the Paperwork Reduction Act section. When monetized[562] those estimated burdens and costs total $3.7 million[563] in initial costs and $10.1 million[564] in

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562 To monetize the internal costs the Commission staff used data from the SIFMA publications, Management and Professional Earnings in the Security Industry- 2010, and Office Salaries in the Securities Industry – 2010, modified by the Commission staff to account for an 1800 hour work-year and multiplied by 5.35 (professionals) or 2.93 (office) to account for bonuses, firm size, employee benefits and overhead.

563 The total initial cost was calculated as follows: [for Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) (Assistant General Counsel for 60 hours at $430 per hour) + (Compliance Attorney for 85 hours at $320 per hour) + (Computer Operations Department Manager for 15 hours at $367 per hour) + (Senior Business Analyst for 15 hours at $232 per hour) = $61,985 x 10 respondents = $619,850]; + [for Rule 17Ad-22(b)(4) ((Assistant General Counsel for 87 hours at $430 per hour) + (Compliance Attorney for 77 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour) = $75,827 x 9 respondents = $682,443) + ((Chief Compliance Officer for 40 hours at $423 per hour) + (Computer Department Operations Manager for 40 hours at $367 per hour) + (Senior Programmer for 20 hours at $304 per hour) = $37,680 x 9 respondents = $339,120) = $1,021,563]; + [for Rules 17Ad-22(b)(5)–(7) (Assistant General Counsel for 87 hours at $430 per hour) + (Compliance Attorney for 77 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour)) = $75,827 x 9 respondents = $682,443]; + [for Rule 17Ad-22(c) ((Assistant General Counsel for 60 hours at $430 per hour) + (Compliance Attorney for 85 hours at $320 per hour) + (Computer Operations Department Manager for 23 hours at $367 per hour) + (Senior Business Analyst for 23 hours at $232 per hour) = $66,777 x 10 respondents = $667,770) + ((Chief Compliance Officer for 40 hours at $423 per hour) + (Computer Department Operations Manager for 40 hours at $367 per hour) + (Senior

annual ongoing costs. A detailed discussion of other economic costs of the rulemaking is provided below.

Many parts of Rule 17Ad-22 are consistent with current practice and therefore should not impose significant costs on registered clearing agencies to comply with those provisions. As noted above, Rule 17Ad-22 also will have the benefit of augmenting the Commission's ability to regulate clearing agencies. Rule 17Ad-22 should improve access to security-based swap clearing agencies. The extent to which security-based swap participants that will be eligible under new access requirements choose to become members is unknown and we are unaware of empirical data on the potential impact that this will have on competition in the security-based swap market. Therefore, the quantification of this benefit is not feasible.

3. Definitions (Rules 17Ad-22(a)(1)–(5))

a. Rule 17Ad-22(a)(1)

Rule 17Ad-22(a)(1) would define "central counterparty" as a clearing agency that interposes itself between counterparties to securities transactions to act functionally as the buyer

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Programmer for 20 hours at $304 per hour) = $37,680 x 10 respondents = $376,800) = $1,044,570] + [for Rule 17Ad-22(c)(2) (Senior Accountant for 500 hours at $198 per hour) x 4 respondents = $396,000] = $3,764,426.

564 The total ongoing cost was calculated as follows: [for Rules 17Ad-22(b)(1)–(3) and (d)(1)–(15) (Compliance Attorney for 60 hours at $320 per hour = $19,200 x 10 respondents = $192,000)]; + [for Rule 17Ad-22(b)(4) ((Compliance Attorney for 60 hours at $320 per hour = $19,200 x 9 respondents = $172,800) + (2 Independent Consultants for 30 hours per week at $600 per hour = $36,000 per week x 12 weeks = $432,000 x 9 respondents = $3,888,000) = $4,060,800]; + [for Rules 17Ad-22(b)(5)–(7) (Compliance Attorney for 60 hours at $320 per hour = $19,200 x 9 respondents = $172,800]; + [for Rule 17Ad-22(c) (Compliance Attorney for 60 hours at $320 per hour = $19,200 x 10 respondents = $192,000)]; [for Rule 17Ad-22(c)(1) (Compliance Attorney for 1 hour at $320 per hour) + (Computer Operations Department Manager for 2 hours at $367) = $1,054 per quarter x 4 quarters per year = $4,216 per year x 9 respondents = $37,944]; [for Rule 17Ad-22(c)(2) (Senior Accountant for 250 hours at $198 per hour) x 10 respondents = $495,000) + (Independent Audit Fee = $500,000 per year x 10 respondents = $5,000,000)] = $10,150,544.

to every seller and as the seller to every buyer. The definition contained in this rule is generally consistent with the common usage and understanding of that term.[565] The costs and benefits associated with the impacts of the definition are incorporated in the discussion below related to the costs and benefits of the provisions where the definition is used.

b. Rules 17Ad-22(a)(2) and (5)

Rule 17Ad-22(a)(2) would define "central securities depository services" to mean services of a clearing agency that is a securities depository as described in Section 3(a)(23) of the Exchange Act.[566] Rule 17Ad-22(a)(5) would define "net capital," for the limited purpose of Rule 17Ad-22(b)(7), to have the same meaning as set forth in Rule 15c3-1 under the Exchange Act for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.[567] The costs and benefits associated with the impacts of the definition are incorporated in the discussion below related to the costs and benefits of the provisions where the definition is used.

c. Rule 17Ad-22(a)(3)

Rule 17Ad-22(a)(3) would define "participant family," for the limited purposes of Rules 17Ad-22(b)(3) and 17Ad-22(d)(14), to mean that if a participant controls another participant, or is under common control with another participant, then the affiliated participants shall be

565 See RCCP, supra note 33, Annex 5: Glossary.

566 "[Clearing agency] also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates." 15 U.S.C. 78c(a)(23).

567 As appropriate, the clearing agency may develop risk adjusted capital calculations for prospective clearing members that are not broker-dealers.

collectively deemed to be a single participant. The Commission is not narrowing the definition of control in this context to mean ownership of 50% or more of the voting securities or other interests in a participant, as requested by one commenter.[568] We believe the more appropriate evaluation of control is based on the relation between the entities and the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. In conducting this evaluation, clearing agencies should also be guided by the definition of "control" set forth in Rule 405 under the Exchange Act, using the information available to them. The costs and benefits associated with the impacts of the definition are incorporated in the discussion below related to the costs and benefits of the provisions where the definition is used.

d. Rule 17Ad-22(a)(4)

Rule 17Ad-22(a)(4) would define "normal market conditions" for the limited purposes of Rules 17Ad-22(b)(1) and (2), to mean conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.[569]

The rule conforms to the generally recognized standard of "normal market conditions" as defined in the RCCP and is the benchmark for most CCPs' margin methodologies, many of which use risk-based models to ensure coverage at a 99% confidence interval, at minimum, over

568 See supra note 107 and accompanying text.

569 The definition of normal market conditions in Rule 17Ad-22(a)(4) is consistent with the corresponding explanation established in the CPSS-IOSCO Recommendations. See RCCP, supra note 33, at 21 (explanatory note number 1).

a designated time horizon.[570] The standard also comports with the international standard for bank capital requirements established by the Bank for International Settlements, which requires banks to measure market risks at a 99% confidence interval when determining regulatory capital requirements.[571] The costs and benefits associated with the impacts of the definition are incorporated in the discussion below related to the costs and benefits of the provisions where the definition is used.

4. Risk Management Requirements for CCPs (Rules 17Ad-22(b)(1)–(4))

Rules 17Ad-22(b)(1)–(4) concern risk management requirements for clearing agencies that perform CCP services. In particular, these rules will require a clearing agency that provides CCP services to have written policies and procedures reasonably designed to: measure its credit exposures at least once a day, use margin requirements to limit its exposures to potential losses from defaults by its participants, use risk-based models and parameters to set margin requirements and to review such requirements at least monthly, maintain sufficient financial resources to withstand a default by the two participant families, if clearing security-based swaps, or one participant family otherwise, to which it has the largest exposure,[572] and provide for an annual model validation process.

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570 See RCCP, supra note 33 , Annex 5: Glossary. See also supra discussion on 99% confidence interval as an accepted standard for measuring market risk in Section II.B.2.b and discussion of current industry baselines in Section V.B.

571 See Bank for International Settlements' Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2004), available at http://www.bis.org/publ/bcbs107.pdf; see also Darryll Hendricks and Beverly Hirtle, New Capital Rule Signals Supervisory Shift, available at http://www.bis.org/bcbs/ca/alrequse98.pdf. See also supra notes 526-529 and accompanying text.

572 See Rule 17Ad-22(a)(3), supra Section III.B.3 (defining "participant family" for purposes of proposed Rule 17Ad-22(b)(3)).

As described above, these rules are consistent with current practice. Registered clearing agencies already have written policies and procedures designed to meet these risk management requirements, particularly Rules 17Ad-22(b)(1)–(3). While Rules 17Ad-22(b)(1)–(3) reflect the CPSS-IOSCO Recommendations, which are observed by all clearing agencies, Rule 17Ad-22(b)(4) would establish certain new minimum practices for clearing agencies.

- First, Rule 17Ad-22(b)(1) requires that each CCP measure its credit exposures at least once per day. This rule codifies the current minimum baseline adhered to by the two clearing agencies presently registered with the Commission that provide CCP services.
- Second, Rule 17Ad-22(b)(2) requires that each CCP collect margin from its participants to limit exposures resulting from changes in prices or participant positions in current market conditions. This margin can also be used to minimize the CCPs losses in the event of a participant default. This rule is consistent with the current practice of each CCP to calculate daily margin requirements using risk-based models to ensure coverage at a 99% confidence interval (i.e., under "normal market conditions"), at minimum, over a designated time-horizon.
- Third, and consistent with Rule 17Ad-22(b)(3), each CCP currently maintains sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions.[573] In addition, both registered CCPs clearing security-based swap transactions maintain additional financial resources sufficient to withstand the

573 See, e.g., supra notes 168 and 183.

simultaneous default by the two participant families to which the CCPs have the largest exposures.

- Fourth, Rule 17Ad-22(b)(4) would ensure that all CCPs have annual model validations performed by a qualified person who is free from influence from the persons responsible for development or operation of the models being validated.

While not requiring major changes to existing operational practices and policies and procedures currently in place at most registered clearing agencies, Rules 17Ad-22(b)(1)–(4) provide enforceability to minimum standards regarding how clearing agencies manage counterparty credit and default risks. One of the primary roles of a CCP is to mitigate counterparty credit and default risk. Because of the role margin plays in a default, a CCP must have confidence that the liquidation value of available margin will be sufficient to cover amounts owed by a defaulting participant to the clearing agency, and that the margin will be available for liquidation without delay. As described in the baseline discussion,[574] CCPs have mechanisms and procedures in place to measure credit exposure. To effectively mitigate counterparty credit risk, a CCP must have accurate and timely measurements of its credit exposures to each of its counterparties, and must impose adequate margin requirements determined by risk-based models and parameters. CCPs may be faced with significant and rapid changes in counterparty credit exposures.

Frequent measurement of counterparty credit exposures and the use of validated risk-based modeling are essential to setting adequate margin requirements. A good margin setting methodology will help avoid both under- and over-collateralization. Under-collateralization

[574] See supra Section V.B.2.a.

exposes a CCP to increased credit risk in the event of a participant default, as the CCP may be unable to recover amounts owed to it from the participant on an unsecured basis. Incurring losses on a counterparty default could disrupt the operations of the clearing agency as well as its non-defaulting participants by exposing them to unanticipated liabilities. These disruptions could negatively impact price efficiency and capital formation if distressed liquidations result in prices away from fundamental values for significant periods of time. Over-collateralization imposes unnecessary costs on trading by tying up clearing member assets that could otherwise be used more efficiently, harming allocative efficiency and capital formation. The Commission believes that Rules 17Ad-22(b)(1)–(4) creates standards to mitigate a CCP's risks associated with counterparty credit exposures and defaults.

Rules 17Ad-22(b)(1)–(4) acknowledge that appropriate risk management will vary based on a number of factors relating to the markets and products a CCP serves. Subject to minimum standards, the rules permit each clearing agency the flexibility to develop the most effective and economically efficient risk measurement and risk-based modeling approaches for each of its unique markets and products to achieve an optimal level of risk mitigation. By setting only a minimum standard, the rules also allow each CCP to adapt its risk management strategies as needed in response to dynamic market conditions rather than locking the CCP into a fixed set of risk mitigation rules. The minimum standards also prevent a CCP from establishing risk monitoring procedures below a baseline in an effort to reduce costs and gain a competitive advantage.

The Commission believes that credit exposures should be measured at least once a day because a clearing agency that did not do so would not be able to effectively manage its risk. However, the Commission believes that it cannot reasonably determine the most appropriate frequency for CCPs to monitor their risk exposures in all circumstances. The minimum standards in Rules 17Ad-22(b)(1)–(4) are intentionally written to comply with CPSS-IOSCO Recommendations and limit systemic risk while not precluding entry to potential new entrant CCPs. Each CCP is exposed to participants in different markets characterized by different trading patterns, volumes, liquidity, transparency and other unique market characteristics. Rules 17Ad-22(b)(1)–(4) provide each CCP the flexibility to tailor its risk management practices to each of its unique markets and products, allowing it to develop the most economically efficient and effective risk mitigation strategies possible.

The Commission considered the range of practices at registered clearing agencies with respect to monitoring risk exposures and recognizes that there is a risk that by setting the minimum standards according to the highest level of current market practice, the standards could be too high for some potential market conditions or future security types. This could result in sub-optimal risk management practices for a period in the future to the extent such factors are not appropriately recognized by the Commission.

The Commission believes it is appropriate that CCPs clearing security-based swaps are held to the higher minimum standard in Rule 17Ad-22(b)(3) than CCPs that do not clear security-based swaps. In particular, the Commission believes that the requirement to maintain at a minimum financial resources capable of withstanding the default of its two largest participant families as opposed to only its largest participant family is at this time appropriate for clearing security-based swaps but not for other securities because of the unique and heightened risks posed by credit default swaps relative to traditional securities. Credit default swaps pose additional risk management challenges in that their value can change by a large amount in an extremely short time interval (i.e., they are subject to significant jump-to-default risk).[575] Unlike many equity and fixed income securities, but similar to other derivative contracts, a CCP's obligation when clearing credit default swaps does not end when the transaction settles, but at its expiration. In addition, unlike other products that also exhibit these characteristics, credit default swaps are unique in their size relative to their underlying markets. Recent research shows that notional outstanding in credit default swaps are often close to or greater than the outstanding value of the underlying instruments.[576]

Several other factors also complicate risk modeling for credit default swaps. CCPs have only recently introduced clearing for security-based swaps, so the risk models used by CCPs have not yet been stressed by a substantial range of market conditions. In addition, many security-based swaps are relatively illiquid, which complicates the default management process. For example, more than 98% of single-name credit default swap reference entities trade less than 10 times per day.[577] Low liquidity typically leads to wider bid-ask spreads, greater price impact of trades, and potentially higher costs when finding replacements for defaulted positions.

The Commission recognizes that requiring a different standard for CCPs for security-based swaps could discourage new entrants from entering into the market for these instruments because of higher financial resource requirements relative to other types of instruments. In

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575 See supra note 162.

576 See supra note 163.

577 See Memorandum by the Commission's Division of Risk, Strategy, and Financial Innovation, Security-Based Swap Block Trade Definition Analysis (Jan. 13, 2011), available at http://www.sec.gov/comments/s7-34-10/s73410-12.pdf. See also Che Sidanius and Anne Wetherilt, Thoughts on Determining Central Clearing Eligibility of OTC Derivatives, (Bank of England, Financial Stability Paper, No. 14, Mar. 2012), available at http://www.bankofengland.co.uk/publications/Documents/fsr/fs_paper14.pdf. The authors report that in the six months ending February 2012, 90% of their sample of 1,000 single name CDS contracts trade an average of less than 50 times per week.

particular, the higher the financial resource requirements, the higher the costs to establish a new clearing agency, potentially resulting in fewer clearing agencies.

While the Commission is sensitive to the consequences of establishing a different standard for CCPs for security-based swaps, the Commission believes that the financial resources of a CCP must be robust enough to accommodate the risks that are particular to each market served--irrespective of whether such analysis results in different standards. As described above, the Commission believes that Rule 17Ad-22(b)(3) does not represent a change in practice for any CCP that currently clears credit default swaps, and to the extent that it represents an increased financial resources requirement for potential competitors, this increased burden is justified by the greater difficulty of risk-management in credit default swaps as opposed to traditional securities.[578] Furthermore, the Commission believes that the burdens associated with this provision are minimized as the rule permits registered CCPs to comply with the "cover two" requirement by establishing a separate fund and related procedures for their security-based swap operations if they prefer this structure to the application of the "cover two" requirement to the entire legal entity. As security-based swap products with different characteristics are proposed for clearing over time, the Commission would evaluate risk profiles of such products to consider how they would be treated under the "cover two" standard.

The Commission further recognizes the benefits associated with establishing financial resource requirements that are consistent with the international standards, such as the benefit of reduced incentives for regulatory arbitrage. The Commission notes that the "cover two"

[578] See CFTC-SEC Staff Roundtable on Clearing of Credit Default Swaps (Oct. 2010), at 123, available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7_102210-transcrip.pdf (Stan Ivanov, ICE Clear Credit stating "at ICE we look at two simultaneous defaults of the two biggest losers upon extreme conditions…").

requirement for security-based swaps CCPs is consistent with the financial resource requirements for CCPs contained in the FMI Report[579] and in EMIR.

The Commission believes it is important to codify the practice of obtaining an annual model validation to ensure that a CCP can evaluate the continued appropriateness of its margin models. Rule 17Ad-22(b)(4) also should help CCPs better evaluate their margin models, which should promote greater confidence in clearing agencies' risk management practices.

The Commission is also mindful of the costs associated with the final rule. In particular, the Commission recognizes that though many parts of Rule 17Ad-22 being adopted by the Commission today are a codification of usual and customary practices at CCPs and clearing agencies, they may still impose costs.

As noted above, the standards contained in Rule 17Ad-22(b)(1)–(4) would impose certain burdens and related costs on respondent clearing agencies. As discussed in Section IV.C, based on policies and procedures requirements for Regulation NMS, and based on staff conversations with industry representatives, the Commission has estimated the burdens and related costs of these requirements for clearing agencies.

The clearing agency standards in Rules 17Ad-22(b)(1)–(4) may require respondent clearing agencies to review and amend their policies and procedures. The standards contained in Rule 17Ad-22(b)(4) also would impose one-time costs on clearing agencies to create policies and procedures as well as require one-time systems adjustments related to the capability to perform an annual model validation. The costs of creating these policies are included in the $3.7 million startup cost estimates discussed earlier.

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579 See FMI Report, Principles 4 and 7, supra note 32.

The standards contained in Rules 17Ad-22(b)(1)–(3) also would impose ongoing costs on clearing agencies such as monitoring and enforcement activities with respect to the policies and procedures the registered clearing agency creates in response to the standards. The ongoing costs of these monitoring and enforcement activities are included in the estimated $10.1 million annual costs discussed earlier.[580] These Rules may also impose additional incremental costs related to, for example, employee training, systems testing, and other operational considerations designed to ensure both initial and continued compliance with such policies and procedures.

The standards contained in Rule 17Ad-22(b)(4) would also impose ongoing costs on clearing agencies. For example, the clearing agency standards in Rule 17Ad-22(b)(4) would collectively require respondent CCPs to perform certain ongoing monitoring and enforcement activities with respect to the policies and procedures the clearing agency creates in response to the standard and to provide for an annual model validation. The Commission believes clearing agencies would hire a consulting firm[581] that dedicates two consultants to the project. The costs for the consultants are included in the $10.1 million annual paperwork cost discussed earlier. Rule 17Ad-22(b)(4) may also impose additional incremental costs associated with employee training, systems testing, and other operational considerations designed to ensure initial and continued compliance with the clearing agencies model validation policies and procedures.

Except as noted above, Rules 17Ad-22(b)(1)–(4) establish standards that are already largely adhered to in practice by each CCP registered with the Commission. Thus, while Rules 17Ad-22(b)(1)–(4) will require each currently registered CCP to continue the expenditures

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580 This number also reflects the costs of Rules 17Ad-22(d)(1)–(15).

581 Currently, the majority of the clearing agencies performing model validation employ a consulting firm; the remainder of the clearing agencies have created an internal model validation group that does not report to the person overseeing the development or operation of the models.

associated with maintaining current rules, policies, and procedures, they should impose limited incremental costs.

In the Proposing Release, the Commission identified potential costs and benefits resulting from Rules 17Ad-22(b)(1)–(4), as proposed, and requested comment on all aspects of the cost-benefit analysis, including the identification and assessment of any costs and benefits that were not discussed in the analysis. Although the Commission did not receive any comments on the specific cost-benefit analysis contained in the Proposing Release, several commenters raised concerns, which are discussed above in Section III.C.1.b, that have a bearing on the costs and benefits associated with the rule. In response to these comments, the Commission carefully considered alternatives to the approach we are adopting in Rule 17Ad-22, including more prescriptive alternatives (e.g., specifying how many times a day a clearing agency should measure its credit exposures to its participants). However, as noted above, clearing agencies match the frequency of credit exposure calculations to the horizon of the guarantee they provide. The requirement to measure credit exposure at least once per day does not preclude more frequent measurement of credit exposure, allowing those who guarantee intraday to measure exposures intraday. Therefore, the Commission believes the flexibility provided by Rules 17Ad-22(b)(1) and (2) appropriately reflects differences in clearing agency models.

The Commission also considered alternatives to Rule 17Ad-22(b)(3), such as (1) requiring each clearing agency, regardless of the securities cleared, to maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions, and (2) requiring each clearing agency, regardless of the securities cleared, to maintain sufficient financial resources to withstand, at a minimum, a default by the two participant families to which it has the largest exposure in extreme but plausible market conditions. The Commission decided to create separate standards for the two different kinds of CCPs because it believes that clearing security-based swaps is inherently riskier than clearing other types of securities, as discussed above.

Furthermore, the Commission considered a number of alternatives to provisions in Rule 17Ad-22(b)(4). For example, one alternative was to be more prescriptive in identifying who could perform the annual model validations. The Commission recognizes there is a tradeoff between the need for expertise in conducting model validations and the independence of the validator. Therefore, Rule 17Ad-22(b)(4) sets a principle that allows the clearing agencies to balance this trade-off in a way that satisfies the purpose of the validation. The Commission also considered alternatives, which would have required that model validations occur more or less frequently than annually. The Commission believes that requiring model validation at least annually is appropriate because it complies with CPSS-IOSCO Recommendations and clearing agencies have economic incentives to evaluate their models more frequently if market conditions change, whether or not they are required to do so by Commission rules.

5. Participant Access Standards for CCPs (Rules 17Ad(b)(5)–(7))

These rules establish requirements for policies and procedures detailing membership practices. Although we believe that these rules reflect current practices for some CCPs, they may require a change in practice for others. Specifically, Rules 17Ad-22(b)(5), (6) and (7) would introduce certain requirements regarding access to CCPs, including that each CCP must: (1) provide the opportunity for a person who does not perform any dealer or security-based swap dealer services to obtain membership; (2) preclude the use of minimum portfolio size thresholds and minimum transaction volume thresholds as conditions to membership; and (3) provide the ability to obtain membership to persons who maintain net capital equal to or greater than \$50 million.

The Commission is adopting Rules 17Ad-22(b)(5), (6) and (7) to establish a regulatory framework for registered CCPs regarding membership practices. These rules also address concerns about access to central clearing in light of the proposed implementation of mandatory clearing requirements around the world.[582] The Commission believes that Rules 17Ad-22(b)(5), (6) and (7) will complement Section 17A of the Exchange Act, which requires that a clearing agency shall not be registered unless the Commission determines, among other things, that the clearing agency's rules do not impose burdens on competition that are unnecessary or inappropriate to promote the purposes of the Exchange Act[583] and that the rules are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency.[584]

As described above, CCPs for securities other than security-based swaps generally do not engage in the practices that Rules 17Ad-22(b)(5), (6), and (7) are designed to prevent. However, CCPs for security-based swaps have required members to have a minimum portfolio size (e.g., $1 trillion outstanding) or minimum trading volume, meet very high minimum capital requirements (e.g., $5 billion), and require members to operate a dealer business. Rule 17Ad-22 is designed to prohibit these types of practices by all CCPs, irrespective of the types of products cleared, by establishing a minimum standard that would have the benefit of uniformity for currently registered CCPs and any future market entrants.

582 See, e.g., CFTC-SEC Staff Roundtable on Clearing of Credit Default Swaps (Oct. 2010), available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7_102210-transcrip.pdf.

583 15 U.S.C. 78q-1(b)(3)(F).

584 15 U.S.C. 78q-1(b)(3)(G).

CCPs have membership requirements so that the CCPs and their members can limit their exposures to less creditworthy market participants. However, as noted above, members may have the incentive to promote membership requirements that limit access to the CCP for competitive reasons. While such requirements have to date been adopted only by CCPs that engage in the clearance and settlement of credit default swaps, the Commission believes that preventing the introduction of such requirements also may be an important consideration for CCPs that clear other instruments.[585] If a clearing agency clears both security-based swaps and other securities, Rule 17Ad-22(b)(6) will prohibit the clearing agency from denying membership solely because the applicant did not maintain a minimum portfolio size or minimum volume in security-based swap transactions. The rule is being applied to all clearing agencies, regardless of the type of instrument cleared, so that an existing or future clearing agency could not use its market power to exclude potential applicants for the benefit of its existing members or unnecessarily restrict access to central clearing. Indeed, the concerns noted above about the incentives to control access to CCPs could apply to the clearing of any security. Accordingly, all CCPs, regardless of the type of security, will be subject to Rules 17Ad-22(b)(5), (6), and (7).

The Commission believes that no registered CCP should deny membership solely because a person does not perform any dealer or security-based swap dealer services or based on a minimum portfolio size or minimum transaction volume thresholds. The Commission does not believe that these factors are, by themselves, appropriate indicators of whether an applicant should be admitted to membership in a clearing agency. The Commission is adopting Rule 17Ad-22(b)(5) to help to foster the development of correspondent clearing arrangements that will allow market participants that are not dealers or security-based swap dealers to obtain access to a

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585 See supra Section V.B.2.b and note 547.

CCP, which should have the beneficial result of greater competition in and access to central clearing because these persons do not execute securities trades for their own account. Instead, they provide correspondent clearing services for market participants.[586] As a result, their ability to provide correspondent clearing services would tend to increase as competition and transaction volumes increased. The Commission further believes that imposing minimum thresholds on the size or transaction volume of a participant's portfolio would not function as a good indicator of whether the participant is able to meet its obligations to a clearing agency.[587] New participants in a CCP that do not initially intend to or have the capacity to transact in substantial size or volume may nevertheless have the operational and financial capacity to perform the activities that other participants are able to perform but at lower size or volume levels. Accordingly, the Commission believes that Rule 17Ad-22(b)(6) will help facilitate the requirement in Section 17A of the Exchange Act that the rules of a clearing agency must permit fair and open access to qualified participants.

Rule 17Ad-22(b)(7) will significantly increase access to clearing membership in CCPs that clear credit default swaps while still allowing CCPs to maintain what the Commission believes will be sufficient net capital standards for members. For example, the rule establishes a minimum net capital requirement of $50 million that only approximately 201 broker-dealers, or four percent of the total number of registered broker-dealers, can satisfy today according to broker-dealer data available to the Commission. A net capital threshold of $100 million would reduce the number of broker-dealers that could meet the standard by 73 (36%) to 128 eligible firms, while a further reduction of the net capital requirement to $25 million would increase the number of eligible broker-

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586 See supra note 235.

587 Proposed Rule 17Ad-22(b)(6) would not prohibit a clearing agency from imposing maximum portfolio sizes or transaction volume amounts.

dealer firms by 86 (42%) to 287 (6% of all registered broker-dealers).[588] The Commission believes that firms that maintain a net capital level of at least $50 million have sufficient financial resources to participate at some level in a CCP, provided that they are able to comply with other reasonable membership standards, and that the increase in the potential pool of clearing members is consistent with the Commission's intention of expanding access to clearing.

The Commission carefully considered the tradeoffs of selecting a lower or higher net capital threshold. A higher net capital requirement may permit CCPs to exercise market power for the benefit of members by limiting membership to an unduly small group of firms.[589] This could limit competition in the market for supplying dealer services as dealers who are CCP members would have an advantage over other dealers. It could also increase overall systemic risk by concentrating the counterparty risk in relatively few participants. A less restrictive capital requirement may also result in incentives for firms that are not capable of participating in the default management process of a CPP to effectively "free ride" on the default services provided by the rest of the membership.[590] The Commission believes that the $50 million capital requirement appropriately balances these concerns and bridges the differences in current membership standards across registered clearing agencies. At the same time, the Commission notes that having a $50 million capital level does not create a right to membership.

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588 As stated above, the $50 million net capital requirement affects access to CCPs that clear CDS. The Commission recognizes that the number of dealers that clear CDS is significantly smaller than the total number of broker-dealers, and that even if Proposed Rule 17Ad-22(b)(7) is successful in encouraging the broadening of membership in CCPs that clear CDS, the Commission believes the number of broker-dealers newly eligible for clearing membership that become clearing members as a result of this change is likely to be substantially less than 201.

589 See Craig Pirrong, The Economics of Central Clearing: Theory and Practice (ISDA Discussion Papers Series, No. 1, May 2011), at 28.

590 See id. at 28.

In addition, we note that the $50 million requirement is the same as the CFTC's capital requirement for DCO membership.[591] Establishing a different requirement than that adopted by the CFTC could create opportunities for regulatory arbitrage and would in effect make one regulator's standard irrelevant for dually registered clearing agencies like CME, ICE Clear Credit and OCC. Furthermore, some of these competing concerns are addressed by the flexibility contemplated by Rule 17Ad-22(b)(7), as it permits each clearing agency to develop scalable policies and procedures to limit the activities of participants based on their level of net capital.[592] For example, a clearing agency can place limits on its potential exposure to participants operating at certain net capital thresholds by restricting the maximum size of the portfolio such participants are permitted to maintain at the clearing agency. The Commission also believes that Rule 17Ad-22(b)(7) would facilitate sound risk management practices by encouraging clearing agencies to examine and articulate the benefits of higher net capital requirements as a result of having clearing agencies develop scalable membership standards that link the nature and degree of participation with the potential risks posed by the participant.[593]

The Commission believes that Rules 17Ad-22(b)(5), (6) and (7) will create the potential for greater access to clearing services for, and opportunities for competition among market participants, particularly for credit default swaps. The Commission believes that greater access to clearing should benefit market participants by allowing them to provide equivalent access to CCP clearing services for security-based swaps to their customers. Doing so should increase

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591 See supra note 38.

592 The Commission notes that some clearing agencies currently utilize capital-related requirements that differentiate among types of participants. For instance, FICC has maintained a $50 million net worth requirement and $10 million excess net capital requirement for its Category 1 Dealer Netting Members and a $25 million net worth requirement and $10 million excess net capital requirement for its Category 2 Dealer Netting Members.

593 See supra note 264.

opportunities for competition among clearing firms on both price and service which should, in turn, reduce costs to the ultimate customers for the financial services being offered.

Rules 17Ad-22(b)(5), (6) and (7) may impose some costs on clearing agencies due to the increased complexity of the policies and procedures regulating access to the clearing agency. The Commission acknowledges that lowering membership standards to increase the number of participants may increase the likelihood of a participant default. Nevertheless, broadening direct access will tend to reduce the concentration of risk in any individual direct clearing member. Further, while Rules 17Ad-22(b)(5),(6) and (7) prohibit certain barriers to entry, these provisions nevertheless still provide clearing agencies with the flexibility to develop membership standards that maintain a robust risk management framework.

Typically, dealers innovate and customize in new financial contracts to address specific risk-management problems of their clients. It is not uncommon for these contracts to become exchange-traded, as the market for the product matures. Dealers, however, may have an incentive to maintain wider bid-ask spreads associated with a customized contract relative to the spreads that might apply if it were a standardized product. Greater access to a CCP could promote greater standardization because all CCP members could submit transactions to the CCP based on the CCP's pre-established rules. Accordingly, the Commission believes that expanded membership will promote the natural evolution of customized contracts to standardized contracts with deeper liquidity and reduced bid-asked spreads.

In terms of comments received, one commenter believed that the proposed rules are unnecessary and pointed to the existing requirement in Section 17A(b)(3)(F) of the Exchange Act that a clearing agency shall not be registered unless the Commission determines that the clearing agency's rules are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency. The Commission believes Rules 17Ad-22(b)(5)–(7) will guide registered CCPs to practices that support the requirement to provide fair and open access.

The Commission is mindful of the costs associated with the final rules. In particular, the Commission recognizes that creating new policies and procedures can impose costs even if those policies and procedures largely codify current practice.

As noted above, the standards contained in Rules 17Ad-22(b)(5)–(7) would impose certain burdens and related costs on respondent clearing agencies. As discussed in Section IV.C.3, based on policies and procedures requirements for Regulation NMS, and based on staff conversations with industry representatives, the Commission has estimated the burdens and related costs of these requirements for clearing agencies.

The clearing agency standards in Rules 17Ad-22(b)(5)–(7) would require respondent clearing agencies to create policies and procedures. The standards contained in Rules 17Ad-22(b)(5)–(7) would also impose ongoing costs on clearing agencies. For example, the clearing agency standards in Rules 17Ad-22(b)(5)–(7) would collectively require respondent clearing agencies to perform certain ongoing monitoring and enforcement activities with respect to the policies and procedures the clearing agency creates in response to the standard. The costs of creating these policies and procedures, and performing ongoing monitoring and enforcement activities were included, respectively, in the $3.7 million startup costs and $10.1 million annual ongoing costs discussed earlier. These provisions may also impose incremental costs related to, for example, employee training, systems testing, and other operational considerations designed to ensure both initial and continued compliance with the clearing agency's participant access policies and procedures.

6. Record of Financial Resources and Annual Audited Financial Statements (Rules 17Ad-22(c)(1)–(2)).

Rule 17Ad-22(c)(1) provides that each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a CCP shall calculate and maintain a record[594] of the financial resources necessary to meet its requirement in proposed Rule 17Ad-22(b)(3) and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

Rule 17Ad-22(c)(2) requires a clearing agency, within 60 days after the end of its fiscal year, to post on its website annual audited financial statements. Such financial statements shall: (i) include, for the clearing agency and its subsidiaries, consolidated balance sheets as of the end of the two most recent fiscal years and statements of income, changes in stockholders' equity and other comprehensive income[595] and cash flows for each of the two most recent fiscal years; (ii) be prepared in accordance with U.S. GAAP, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the consolidated[596] financial statements may be prepared in accordance with U.S. GAAP or IFRS; (iii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in

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594 See Exchange Act Rule 17a-1 (17 CFR 240.17a-1). Clearing agencies may destroy or otherwise dispose of records at the end of five years consistent with Exchange Act Rule 17a-6 (17 CFR 240.17a-6).

595 The added language, "changes in stockholders' equity and other comprehensive income," does not change the substance of the rule as provided in the Proposing Release. This language has been added in the final rule to clarify the scope of what is meant by complete set of financial statements consistent with customary industry accounting practices.

596 The "consolidation" language does not change the substance of the rule as provided in the Proposing Release, but has been added to clarify that the financial statements requirement pertains to that of the clearing agencies and its subsidiaries on a consolidated basis.

accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iv) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02).

Rule 17Ad-22(c)(1) is, for the most part, identical to what is described in the baseline section above, and thus, this rule will, for the most part, codify an existing practice of clearing agencies. The difference is that CCPs will now have to format and synthesize existing information in a manner sufficient to explain the methodology the clearing agency uses to meet the requirement of Rule 17Ad-22(b)(3).

In addition, Rule 17Ad-22(c)(2) is substantially similar to what is described in the baseline section above. Most clearing agencies report financial statements in accordance with Rule 17Ad-22(c)(2) with one exception.[597] Accordingly, Rule 17Ad-22(c)(2) is largely consistent with current practice and will impose minimal costs on registered clearing agencies.[598]

As described above, these two rules, except where noted above, codify current practice. To the extent that current practice is not currently required by rule, the rules being adopted today allow for greater enforceability of these disclosure practices, and as a result ensure that CCPs continue to maintain an environment of transparency.

Rule 17Ad-22(c)(1) ensures that the Commission continues to be able to monitor whether CCPs maintain the financial resources necessary to meet its requirement in proposed Rule 17Ad-22(b)(3). The requirement that CCPs will have to format and synthesize existing information in a manner sufficient to explain the methodology the clearing agency uses to meet the requirement of Rule 17Ad-22(c)(1), facilitates the Commission's access to this information in a format that is

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597 See supra note 549.

598 Because BSECC and SCCP conduct no operations, we also expect their respective costs to be minimal.

clear and understandable, and ensures that the Commission can obtain sufficient documentation to understand and evaluate the methodology used by the CCP to compute such financial resource requirement.

Rule 17Ad-22(c)(2) ensures that CCPs continue to provide transparency to regulators and market participants. Transparency helps to ensure that market participants in general have better information about the stability of the system, and facilitates monitoring by the Commission and other regulators, clearing members, investors, academics and the public in general. Further, to the extent that CCPs are systemically important institutions, regulators may also be monitoring systemic risk when monitoring CCPs.

Transparency is particularly important to clearing members, whose capital is at risk if a clearing member fails. Clearing members can use the information codified in this rule to assess risks related to their participation in the CCP and manage those risks. The information codified in this rule can also be used by clearing members in a way that promotes competition. In situations where multiple CCPs clear the same product, clearing members may base their decision on which CCP to use on the financial information codified in Rule 17Ad-22(c)(2), which requires that CCPs make their financial information available to the public, even during times of market stress. It is possible that if the financial position of the CCP deteriorates, clearing members and investors may discontinue membership in or otherwise limit their use of that CCP, therefore driving CCPs with substandard risk management practices out of business.

The Commission carefully considered alternatives to these provisions. For example, an alternative to the requirements of Rule 17Ad-22(c)(2) would be to permit registered clearing agencies to post audited financial statements prepared in accordance with the laws of their country of origin, reconciled to U.S. GAAP. Indeed, one registered clearing agency, ICE Clear

Europe, currently posts on its website audited financial statements prepared according to UK GAAP. Having foreign CCPs prepare financial statements using more widely applied bases of accounting such as U.S. GAAP or IFRS may offer greater utility to market participants, regulators and other stakeholders of clearing agencies. Therefore, we have limited the different bases of accounting upon which the annual audited consolidated financial statements may be prepared to IFRS and U.S. GAAP. The Commission recognizes that there are costs associated with requiring that a registered CCP comply with these reporting standards. However, to the extent that the parent company of ICE Clear Europe already prepares financial statements according to U.S. GAAP, we expect the costs of this requirement to be less burdensome. The Commission also believes that allowing CCPs to prepare financial statements in accordance with the laws of their countries of origin and then reconcile the differences to U.S. GAAP would add complexity associated with the reconciliation that may offer less utility to market participants, regulators and other stakeholders of clearing agencies because of the burden of understanding and interpreting additional bases of accounting would create for users.

The Commission is mindful of the costs associated with the final rule. The exact nature of the procedures a clearing agency will establish to support this requirement is likely to vary between clearing agencies. Nevertheless, clearing agencies already make this type of information available to the Commission and/or on their websites. Therefore, the incremental cost of this Rule is unlikely to be significant.

As noted above, the standards contained in Rules 17Ad-22 (c)(1) and (2), would impose certain burdens and related costs on respondent clearing agencies. As discussed in Section IV.C.4, based on policies and procedures requirements for Regulation NMS, and based on staff conversations with industry representatives, the Commission has estimated the burdens and related costs of these requirements for clearing agencies.

The clearing agency standards in Rules 17Ad-22(c)(1) and (2) would require respondent clearing agencies to create policies and procedures. The requirements would impose one-time costs related to the adjustment of systems. These costs are included in the $3.7 million in startup costs discussed earlier.

The standards contained in Rule 17Ad-22(c) would also impose ongoing costs on clearing agencies. For example, the clearing agency standards in Rules 17Ad-22 (c)(1) and (2) would collectively require respondent clearing agencies to perform certain ongoing monitoring and enforcement activities with respect to the policies and procedures the clearing agency creates in response to the standard. These costs are included in the $10.1 million in annual costs discussed earlier. These rules may impose additional incremental costs related to, for example, employee training, systems testing, and other operational considerations designed to ensure both initial and continued compliance with such policies and procedures.

Rule 17Ad-22(c)(2) would require each clearing agency to post on its website its annual audited financial statements. The audited financial statements would have to (i) be a complete set of consolidated financial statements of the clearing agency and its subsidiaries for the most recent two fiscal years and be prepared in accordance with U.S. GAAP, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the consolidated financial statements may be prepared according to U.S. GAAP or IFRS; (ii) be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with Rule 2-01 of Regulation S-X (17 CFR 210.2-01); and (iii) include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of Rule 2-02 of Regulation S-X (17 CFR 210.2-02). This requirement would necessitate work hours of compliance personnel and finance personnel at the clearing agency to compile relevant data, organize and analyze that data, and then post it to the clearing agency's website consistent with the rule. The requirement would also require the services of a registered public accounting firm. These costs are included in the $10.1 million in annual costs discussed earlier.

7. Minimum Standards for All Clearing Agencies.

Rules 17Ad-22(d)(1)–(15) require certain minimum standards for rules and procedures to be met by all clearing agencies. Rule 17Ad-22(d)(1) requires that clearing agencies have rules and procedures that are well-founded, transparent and enforceable for each aspect of their activities in all relevant jurisdictions.[599] Rules 17Ad-22(d)(2)–(15) require that clearing agencies reasonably establish, implement, maintain and enforce written policies and procedures reasonably designed to:

- require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency
- hold assets in a manner whereby risk of loss or of delay in access to them is minimized,
- identify sources of operational risk and minimize these risks through the development of appropriate systems, controls, and procedures,
- employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks,

599 A relevant jurisdiction would include, among others, activities (i) in the United States, (ii) involving any means of interstate commerce, or (iii) in respect to providing clearing services to any U.S. person. Clearing agencies that operate in multiple jurisdictions may need to resolve possible conflicts of laws issues that they may encounter.

- provide that their operations are cost-effective in meeting the requirements of participants while maintaining the safety and security of operations,
- evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear or settle trades, and to ensure that these risks are managed prudently on an ongoing basis,
- have governance arrangements that are clear and transparent to fulfil the public interest requirements in Section 17A of Exchange Act applicable to clearing agencies,[600] to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures,
- provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using clearing agencies' services,
- immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides CSD services,
- make key aspects of their default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default,
- ensure that final settlement occurs no later than the end of the settlement day and that intraday or real-time finality is provided where necessary to reduce risks.

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600 Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency be designed to protect investors and the public interest. 15 U.S.C. 78q-1(b)(3)(F).

- eliminate principal risk by linking securities transfers to funds transfers to achieve delivery versus payment (DVP) [601],
- institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant family exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides CSD services[602] and extends intraday credit to participants.
- disclose to their participants the clearing agency's obligations with respect to physical deliveries.[603]

In the Proposing Release, the Commission identified potential costs and benefits resulting from Rules 17Ad-22(d)(1)–(15), as proposed, and requested comment on all aspects of the cost-benefit analysis, including the identification and assessment of any costs and benefits that were not discussed in the analysis. The Commission did not receive any comments on the specific cost-benefit analysis contained in the Proposing Release.

Rules 17Ad-22(d)(1)–(15) are consistent with CPSS-IOSCO Recommendations.[604] As discussed below, Rules 17Ad-22(d)(1)–(15) for the most part codify existing practices of clearing agencies registered with the Commission. Adopting rules that reflect current practices has the benefit of ensuring that future business practices are both consistent with current practice

[601] See supra note 422.

[602] See proposed Rule 17Ad-22(a)(2) for definition of "central securities depository services."

[603] The proposed rule would provide clearing agencies with the flexibility to determine the method by which the clearing agency will state this information to its participants. However, the clearing agencies should take care to develop an approach that provides sufficient notice to its participants regarding the clearing agency's obligations.

[604] See table in Section V.B.2.d.

and conform to international standards without subjecting clearing agencies to significant costs. Accordingly, the Commission believes that registered clearing agencies would not need to build new infrastructure or modify operations to meet the requirements of Rule 17Ad-22(d).[605] The primary costs of implementing such rules will be the incremental costs of enhancing and reviewing existing policies and procedures for compliance and updating existing policies and procedures where appropriate as discussed above in Section IV.

The requirements would impose one-time costs and ongoing costs to perform certain ongoing monitoring and enforcement activities with respect to the policies and procedures that are included in the $3.7 million in startup costs and $10.1 million in ongoing cost discussed earlier.[606] The Rules also may impose incremental costs related to, for example, employee training, systems testing, and other operational considerations designed to ensure both initial and continued compliance with such policies and procedures.

As stated above, there are currently seven clearing agencies registered with the Commission that provide CCP or CSD services. These clearing agencies are SROs so the rules and procedures governing each aspect of the clearance and settlement process are filed with the Commission for notice and approval. Rule 17Ad-22(d)(1) will codify the existing practices of registered clearing agencies of establishing a rule book and developing policies and procedures to address each aspect of their operations. Therefore, the SRO rule filing process should help to

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605 See generally International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the NSCC's Observance of the CPSS-IOSCO Recommendations for Central Counterparties (2010), at 4-29, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10129.pdf; International Monetary Fund, Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of the DTC's Observance of the CPSS-IOSCO Recommendations for Securities Settlement Systems (2010), at 4-40, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10128.pdf.

606 This number also reflects the costs of Rules 17Ad-22(b)(1)–(3).

ensure that such rules are well-founded, transparent, and provide an enforceable legal framework for its activities.

As described above, each registered clearing agency has established membership criteria and has procedures in place to monitor the sufficiency of its participants' financial resources. Rule 17Ad-22(d)(2) will codify these existing practices. The operational and financial stability of participants is subject to market forces and can therefore change over time. Because participants collectively contribute to the operational and financial stability of a registered clearing agency, the Commission believes that the proposed requirement to continue to monitor compliance with the registered clearing agency's participation requirements supports the Exchange Act requirement that clearing agencies are able to facilitate prompt and accurate clearance and settlement.[607]

In addition, clearing agencies would be required to have participation requirements that are objective,[608] publicly disclosed, and facilitate fair and open access.[609] The Commission believes this requirement would foster compliance with the requirement under Section 17A of

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607 15 U.S.C 78q-1(b)(3)(A).

608 Objective criteria would generally include, but not be limited to, criteria that are based on measureable facts such as capital requirements.

609 Having open access, in part, involves having a process for admission of participants that does not unfairly discriminate. See 15 U.S.C. 78q-1(b)(3)(F) ("The rules of a registered clearing agency… are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the registered clearing agency"). In addition, the Dodd-Frank Act added Section 3C to the Exchange Act which provides in relevant part: "(2) OPEN ACCESS.—The rules of a registered clearing agency described in paragraph (1) shall— (A) prescribe that all security-based swaps submitted to the registered clearing agency with the same terms and conditions are economically equivalent within the registered clearing agency and may be offset with each other within the registered clearing agency; and (B) provide for non-discriminatory clearing of a security-based swap executed bilaterally or on or through the rules of an unaffiliated national securities exchange or security-based swap execution facility." Pub. L. No. 111-203 § 763(a) (adding Section 3C to the Exchange Act).

the Exchange Act that the rules of a registered clearing agency must not be designed to permit unfair discrimination in the admission of participants by requiring standards that are designed to be measurable, open and fair.[610]

During the clearance and settlement process, registered clearing agencies are responsible for safeguarding assets that secure participants' obligations. Registered clearing agencies currently seek to minimize the risk of loss or delay in access by holding assets that are highly-liquid (e.g., cash, U.S. Treasury securities or securities issued by a U.S. government agency) and engaging banks to custody the assets and facilitate settlement. The requirements of Rule 17Ad-22(d)(3) are intended to codify existing practices and help ensure the ability of the registered clearing agency to meet its settlement obligations by reducing the likelihood that assets securing participant obligations to the registered clearing agency would be unavailable or insufficient when the registered clearing agency needs to draw on them.

Pursuant to guidance provided by the Division's Automated Review Policy Statements[611], and Interagency White Paper on Disaster Recovery[612], all registered clearing agencies, among other things, develop and maintain plans to assure the safeguarding of securities and funds, the integrity of the automated data processing systems, and recovery of securities, funds, or data under a variety of loss or destruction scenarios. In addition, the rule requires that clearing agencies have business continuity plans that allow for timely recovery of operations and ensure the fulfillment of a registered clearing agency's obligations. Rule 17Ad-22(d)(4) would

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610 15 U.S.C. 78q-1(b)(3)(F).

611 See Automation Review Policy Statements, supra note 330. The Automation Review Policy Statements are not rules, but rather general statements of policy based on cooperation between the SROs and the Commission.

612 Sound Practices to Strengthen the Resilience of the U.S. Financial System (Interagency Paper), Release No. 34-47638; File No. S7-32-02 (Apr. 7, 2003).

codify existing practice and strengthen the requirement in Section 17A(b)(3)(F) of the Exchange Act, which requires that the rules of a registered clearing agency must be designed to ensure the safeguarding of securities and funds in the custody or control of the registered clearing agency or for which the registered clearing agency is responsible.[613] In this way, the Commission believes the rule also would promote protection of the financial market served by the registered clearing agency.

Registered clearing agencies use settlement banks to facilitate the cash portion of the securities transaction. Failure by that bank to effectuate timely and final settlement adversely affects the registered clearing agency by exposing it to credit and liquidity pressures that can adversely affect the registered clearing agency's ability to facilitate prompt and accurate clearance and settlement. Rule 17Ad-22(d)(5) is designed to reduce the risk that financial obligations related to the activities of a registered clearing agency are not settled in a timely manner or not discharged with finality. The Commission also believes that the rule would assist a registered clearing agency in meeting the requirement of Section 17A(b)(3)(F) of the Exchange Act, which requires the rules of a registered clearing agency to be designed to assure the safeguarding of securities and funds which are in the custody or control of the registered clearing agency or for which it is responsible.[614]

Registered clearing agencies have procedures to control costs and to regularly review pricing levels against operating costs. The Commission believes that Rule 17Ad-22(d)(6) codifies this practice and may help to reduce the fees a participant in a registered clearing agency incurs for clearance and settlement services while also helping to ensure that registered clearing agency maintains appropriate operational standards. Having clearing agencies be mindful of the

[613] 15 U.S.C. 78q-1(b)(3)(F).

[614] 15 U.S.C. 78q-1(b)(3)(F).

costs that are incurred by their participants, while maintaining such compliance, should help to reduce inefficiencies in the provision of clearance and settlement services. Because there is often only a single registered clearing agency per asset class per market, competitive forces may not be sufficient by themselves in creating incentives to be cost-effective in meeting the requirements of participants.

Section 17A(a)(1)(D) of the Exchange Act states that the linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.[615] Further, Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a registered clearing agency foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions.[616] Each registered clearing agency is linked to other clearing organizations, trading platforms, and service providers. The Commission believes that in the clearance and settlement process, links should help improve market liquidity and make it easier for participants to trade in other markets.[617] Rule 17Ad-22(d)(7) promotes these statutory requirements under the Exchange Act and establishes a requirement that links created between clearing agencies are managed in a safe and prudent manner.

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[615] 15 U.S.C. 78q-1(a)(1)(D).

[616] 15 U.S.C. 78q-1(b)(3)(F).

[617] For example, DTC Canadian Link Service allows qualifying DTC participants to clear and settle valued securities transactions with participants of a Canadian securities depository. The link is designed to facilitate cross-border transactions by allowing participants to use a single depository interface for U.S. and Canadian dollar transactions and eliminate the need for split inventories. See Exchange Act Release Nos. 52784 (Nov. 16, 2005), 71 FR 70902 (Nov. 23, 2005) and 55239 (Feb. 5, 2007), 72 FR 6797 (Feb. 13, 2007) (File No. SR-DTC 2006-15).

Each registered clearing agency has a board that governs the operations of the entity and supervises its senior management. Rule 17Ad-22(d)(8) is designed enhance the board's governance of the registered clearing agency and the ability of the registered clearing agency to serve the interests of its various constituencies while maintaining prudent risk management processes. Clear and transparent governance arrangements promote accountability and reliability in the decisions, rules and procedures of the registered clearing agency because they provide interested parties (such as owners, participants, and the general public) with information about how such decisions are made and what the rules and procedures are designed to accomplish.[618]

Governance arrangements have the potential to play an important role in making sure that clearing agencies fulfill the Exchange Act requirements that the rules of a registered clearing agency be designed to protect investors and the public interest and to support the objectives of owners and participants. Similarly, governance arrangements may promote the effectiveness of a registered clearing agency's risk management procedures by creating an oversight framework that fosters a focus on the critical role that risk management plays in promoting prompt and accurate clearance and settlement.[619]

Because clearing agencies are SROs, their rules are published by the Commission and are available on each registered clearing agency's website. In addition information regarding the operations and services of each clearing agency can be found either on the clearing agency's

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618 The Exchange Act currently requires that certain aspects of a registered clearing agency's governance arrangements be made clear and transparent. Section 19(b) of the Exchange Act requires that clearing agencies, as SROs, file with the Commission any proposed rule or any proposed change in, addition to, or deletion from the rules of the registered clearing agency, accompanied by a concise general statement of the basis and purpose of the proposed rule change. 15 U.S.C. 78s(b).

619 The role of governance arrangements in promoting effective risk management has also been a focus of rules recently proposed by the Commission to mitigate conflicts of interest at security-based swap clearing agencies. See Exchange Act Release No. 63107, 75 FR 65882, supra note 231.

website or a website maintained by an affiliated entity of the clearing agency. Rule 17Ad-22(d)(9) will maintain and enhance this existing practice by requiring a registered clearing agency to disclose information sufficient for participants to identify risks and costs associated with using the registered clearing agency, thereby allowing participants to make informed decisions about the use of the registered clearing agency and to take appropriate actions to mitigate their risks and costs associated with the use of the registered clearing agency.

While U.S. markets have made great strides in achieving immobilization and/or dematerialization for institutional and broker-to-broker transactions, many industry representatives believe that the small percentage of securities held in certificated form impose unnecessary risk and expense to the industry and to investors. Rule 17Ad-22(d)(10) will codify the existing practice, and promote further immobilization and dematerialization of securities and their transfer by book entry. This would result in reduced costs and risks associated with securities settlements and custody for both clearing agencies and participants by removing the need to hold and transfer many, if not most, physical certificates.[620]

Each registered clearing agency makes public rules, policies or procedures that set forth the actions the clearing agency may take in the event of a participant default and each makes key aspects of their default procedures publicly available, with the exception of certain of their policies and procedures that are kept non-public to ensure their integrity, such as those associated with the oversight of clearing participants. Rule 17Ad-22(d)(11) codifies this existing practice. The Commission believes that default procedures reduce the likelihood that a default by a participant, or multiple participants, will disrupt the operations of the clearing agency and have a cascading effect on the viability of the other participants of the clearing agency. Default

620 See Exchange Act Release No. 8398 (Mar. 11, 2004), 69 FR 12921 (Mar. 18, 2004).

procedures also allow a clearing agency to wind down positions in an orderly way and continue to perform its obligations in the event of a participant default, assuring continued functioning of the securities market in times of stress and reducing systemic risk.

The Commission believes that Rule 17Ad-22(d)(11) would increase the probability that defaults by participants, should they occur, would proceed in an orderly and transparent manner. This is the case because the rule would help to ensure that all participants are aware of the default process and are able to plan accordingly and that clearing agencies would have sufficient time to take corrective actions to mitigate potential losses. In addition, the transparency of default procedures will increase the confidence of market participants as well as members of the general public, that should a default occur, the proper procedures would be followed, decreasing uncertainty and lessening the likelihood of further market stress.

Each registered clearing agency has rules, policies or procedures that provide for the settlement of its respective securities transactions no later than the end of a pre-defined settlement day. Rule 17Ad-22(d)(12) codifies this existing practice. The Commission believes that settlement finality should occur no later than the end of the settlement day to limit the volume of outstanding obligations that are subject to settlement at any one time and thereby reduce the settlement risk exposure of participants and the registered clearing agency. Intraday or real-time finality may be necessary to reduce risk in circumstances where the lack of intraday or real-time finality may impede the registered clearing agency's ability to facilitate prompt and accurate clearance and settlement, cause the registered clearing agency's participants to fail to meet their obligations, or cause significant disruptions in the securities markets.[621]

[621] See FMI Report, Principle 8, supra note 32.

Generally, Rules 17Ad-22(d)(13)–(15) would apply to registered clearing agencies that provide CSD services. DTC currently is the only registered clearing agency that is a CSD. DTC operates a Model 2 DVP system which provides for gross settlements of securities transfers during the day followed by an end of day net funds settlement.[622] Rule 17Ad-22(d)(13) codifies this existing practice. Delivery versus payment eliminates the risk that a buyer would lose the purchase price of a security purchased from a defaulting seller (or that a seller would lose the sold security without receiving payment for a security acquired by a defaulting buyer), because payment is made only if securities are delivered. While the use of this payment method eliminates principal risk, DVP procedures do not eliminate the risk that the failure of the defaulting participant could result in systemic disruptions, because the failure of a participant could produce substantial liquidity pressures and replacement costs.

As discussed above, DTC has policies and procedures in place to ensure that timely settlement can be completed in the event of the default participant with the largest settlement obligation. DTC establishes setting limits (called net debit caps) for each participant. The net debit cap ensures that the amount of cash that a participant owes the clearing agency does not exceed this pre-defined limit or cap. Rule 17Ad-22(d)(14) codifies this existing practice. The Commission believes it is important for clearing agencies that provide CSD services to institute risk controls, including collateral requirements and limits to cover the registered clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in these circumstances to address the risk that the participant may fail to settle after credit has been extended. The Commission also believes that requiring the controls to be designed to withstand

622 See DTC's Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties (Dec. 12, 2011), available at http://www.dtcc.com/legal/compliance/DTC_Self-Assessment.pdf.

the inability of the participant with the largest payment obligation to settle, in such circumstances, would reduce the likelihood of disruptions at the registered clearing agency by having controls in place to account for the largest possible loss from any individual participant and thereby help the registered clearing agency to provide prompt and accurate clearance and settlement during times of market stress.

A registered clearing agency faces both credit and liquidity risks from the delivery process. At delivery, the entire principal value of a transaction may be at risk, and this form of credit risk is often termed principal risk. Liquidity risk arises because the registered clearing agency, faced with a defaulting participant, must still make payment to the non-defaulting party. The Commission believes that a registered clearing agency should therefore ensure that its rules and procedures provide clear risk management controls so that it can identify and mitigate the credit and liquidity risks to which it is exposed in the delivery process. These procedures should ensure that the registered clearing agency will be able to adapt its risk management framework as appropriate, as the steps necessary to mitigate risks will depend on the obligations the registered clearing agency has assumed, the mechanisms available for settlement, and the importance of the risks from physical settlement to its overall operations.

The Commission also believes that providing such information to participants would promote a shared understanding regarding physical delivery practices between the registered clearing agency and its participants that could help reduce the potential for fails and thereby facilitate prompt and accurate clearance and settlement.

Registered clearing agencies have rules and procedures that describe their obligations to its participants when they assume deliveries of physical instruments. The Commission believes that Rule 17Ad-22(d)(15), by requiring a statement by the registered clearing agency to its participants about the cleaning agency's obligations with respect to physical deliveries, among other things, would ensure that participants have information that is likely to enhance the participants' understanding of their rights and responsibilities with respect to using the clearance and settlement services of the registered clearing agency. The Commission believes that ensuring delivery of this information to participants about the clearing agency's physical delivery obligations would promote a shared understanding about physical delivery practices between the clearing agency and its participants that would help mitigate misunderstandings in the clearing agency's physical delivery operations and would therefore facilitate prompt and accurate clearance and settlement.

The Commission carefully considered alternatives to Rule 17Ad-22(d), including a more prescriptive approach suggested by some of the commenters, and has decided to adopt the rule, modeled after recognized international standards, in the form proposed. The Commission believes the final rule will have the effect of harmonizing the Commission's regulatory requirements with such standards as are now contemplated by the Exchange Act and the Clearing Supervision Act, as well as international standards. In particular, the Commission believes Rule 17Ad-22(d) will help market participants compare the operations of U.S. clearing agencies with non-U.S. clearing organizations. The Commission's adoption of Rule 17Ad-22(d) may also reduce some of the potential regulatory burden for CCPs and CSDs that may be dually-regulated by the SEC and another domestic or foreign regulator because it is modeled on standards already employed by other regulatory authorities.

VI. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")[623] requires the Commission, in promulgating

[623] 5 U.S.C. 601 et seq.

rules, to consider the impact of those rules on small entities. The Commission certified in the Proposing Release, pursuant to Section 605(b) of the Regulatory Flexibility Act of 1980 ("RFA"),[624] that the proposed rule would not, if adopted, have a significant impact on a substantial number of small entities. We received no comments on this certification.

A. Registered Clearing Agencies

Rule 17Ad-22 applies to all registered clearing agencies and sets standards for such clearing agencies. For the purposes of Commission rulemaking and as applicable to Rule 17Ad-22, a small entity includes, when used with reference to a clearing agency, a clearing agency that (i) compared, cleared and settled less than $500 million in securities transactions during the preceding fiscal year, (ii) had less than $200 million of funds and securities in its custody or control at all times during the preceding fiscal year (or at any time that it has been in business, if shorter) and (iii) is not affiliated with any person (other than a natural person) that is not a small business or small organization.[625] Under the standards adopted by the Small Business Administration, small entities in the finance industry include the following: (i) for entities engaged in investment banking, securities dealing and securities brokerage activities, entities with $6.5 million or less in annual receipts; (ii) for entities engaged in trust, fiduciary and custody activities, entities with $6.5 million or less in annual receipts; and (iii) funds, trusts and other financial vehicles with $6.5 million or less in annual receipts.[626]

Based on the Commission's existing information about the clearing agencies currently registered with the Commission, the Commission believes that such entities exceed the thresholds defining "small entities" set out above. While other clearing agencies may emerge

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624 See 5 U.S.C. 605(b).

625 17 CFR 240.0-10(d).

626 13 CFR 121.201, Sector 52.

and become eligible to operate as registered clearing agencies and while other security-based swap lifecycle event service providers may be required to register as clearing agencies, the Commission does not believe that any such entities would be "small entities" as defined in Exchange Act Rule 0-10.[627] Furthermore, we believe it is unlikely that any registered clearing agencies, security-based swap clearing agencies or security-based swap lifecycle event services providers would have annual receipts of less than $6.5 million. Accordingly, the Commission believes that any registered clearing agencies will exceed the thresholds for "small entities" set forth in Exchange Act Rule 0-10.

B. Certification

For the reasons described above, the Commission again certifies that Rule 17Ad-22 will not have a significant economic impact on a substantial number of small entities.

VII. Statutory Authority and Text of Rule 17Ad-22

Pursuant to the Exchange Act, particularly, Sections 17A(d) thereof, 15 U.S.C. 78q-1(d), Sections 17A(i), 17A(j) and 3C(j) thereof, 15 U.S.C. 78q-1(i), 78q-1(j) and 78c-3(j), respectively, Pub. L. 111-203, §763, 124 Stat. 1841 (2010), and Sections 30(b) and 30(c) thereof, 15 U.S.C. 78dd(b)and (c), and Section 805(a)(2) of the Clearing Supervision Act, 12 U.S.C. 5464(a)(2), the Commission adopts new Rule 17Ad-22 to govern clearing agencies.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

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[627] See 17 CFR 240.0-10(d). The Commission based this determination on its review of public sources of financial information about existing CCPs serving the OTC derivatives market and lifecycle event service providers.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE

1. The authority citation for Part 240 is revised in numerical order to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et. seq.; 12 U.S.C. 5221(e)(3), 15 U.S.C. 8302, and 18 U.S.C. 1350, unless otherwise noted.

*   *   *   *   *

Section 240.17Ad-22 is also issued under 12 U.S.C. 5464(a)(2).

*   *   *   *   *

2. Section 240.17Ad-22 is added to read as follows:

§ 240.17Ad-22 Standards for clearing agencies.

(a) Definitions. For purposes of this section:

(1) Central counterparty means a clearing agency that interposes itself between the counterparties to securities transactions, acting functionally as the buyer to every seller and the seller to every buyer.

(2) Central securities depository services means services of a clearing agency that is a securities depository as described in Section 3(a)(23) of the Act (15 U.S.C. 78c(a)(23)(A)).

(3) Participant family means that if a participant directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, another participant then the affiliated participants shall be collectively deemed to be a single participant

family for purposes of paragraphs (b)(3) and (d)(14) of this section.

(4) Normal market conditions as used in paragraphs (b)(1) and (2) of this section means conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time.

(5) Net capital as used in paragraph (b)(7) of this section means net capital as defined in § 240.15c3-1 for broker-dealers or any similar risk adjusted capital calculation for all other prospective clearing members.

(b) A registered clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to:

(1) Measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants under normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

(2) Use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements and review such margin requirements and the related risk-based models and parameters at least monthly.

(3) Maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions; provided that a registered clearing agency acting as a central counterparty for security-based swaps shall maintain additional financial resources sufficient to withstand, at a

minimum, a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions, in its capacity as a central counterparty for security-based swaps. Such policies and procedures may provide that the additional financial resources may be maintained by the security-based swap clearing agency generally or in separately maintained funds.

(4) Provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who is free from influence from the persons responsible for the development or operation of the models being validated.

(5) Provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership on fair and reasonable terms at the clearing agency to clear securities for itself or on behalf of other persons.

(6) Have membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume.

(7) Provide a person that maintains net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency, provided that such persons are able to comply with other reasonable membership standards, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency; provided, however, that the clearing agency may provide for a higher net capital requirement as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application.

(c) Record of financial resources and annual audited financial statements.

(1) Each fiscal quarter (based on calculations made as of the last business day of the clearing agency's fiscal quarter), or at any time upon Commission request, a registered clearing agency that performs central counterparty services shall calculate and maintain a record, in accordance with § 240.17a-1 of this chapter, of the financial resources necessary to meet the requirements of paragraph (b)(3) of this section, and sufficient documentation to explain the methodology it uses to compute such financial resource requirement.

(2) Within 60 days after the end of its fiscal year, each registered clearing agency shall post on its website its annual audited financial statements. Such financial statements shall:

(i) Include, for the clearing agency and its subsidiaries, consolidated balance sheets as of the end of the two most recent fiscal years and statements of income, changes in stockholders' equity and other comprehensive income and cash flows for each of the two most recent fiscal years;

(ii) Be prepared in accordance with U.S. generally accepted accounting principles, except that for a clearing agency that is a corporation or other organization incorporated or organized under the laws of any foreign country the consolidated financial statements may be prepared in accordance with U.S. generally accepted accounting principles or International Financial Reporting Standards as issued by the International Accounting Standards Board;

(iii) Be audited in accordance with standards of the Public Company Accounting Oversight Board by a registered public accounting firm that is qualified and independent in accordance with 17 CFR 210.2-01; and

(iv) Include a report of the registered public accounting firm that complies with paragraphs (a) through (d) of 17 CFR 210.2-02.

(d) Each registered clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:

(1) Provide for a well-founded, transparent, and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

(2) Require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency; have procedures in place to monitor that participation requirements are met on an ongoing basis; and have participation requirements that are objective and publicly disclosed, and permit fair and open access.

(3) Hold assets in a manner that minimizes risk of loss or of delay in its access to them; and invest assets in instruments with minimal credit, market and liquidity risks.

(4) Identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient and secure, and have adequate, scalable capacity; and have business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations.

(5) Employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants; and require funds transfers to the clearing agency to be final when effected.

(6) Be cost-effective in meeting the requirements of participants while maintaining safe and secure operations.

(7) Evaluate the potential sources of risks that can arise when the clearing agency

establishes links either cross-border or domestically to clear or settle trades, and ensure that the risks are managed prudently on an ongoing basis.

(8) Have governance arrangements that are clear and transparent to fulfill the public interest requirements in Section 17A of the Act (15 U.S.C. 78q-1) applicable to clearing agencies, to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures.

(9) Provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using its services.

(10) Immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides central securities depository services.

(11) Make key aspects of the clearing agency's default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default.

(12) Ensure that final settlement occurs no later than the end of the settlement day; and require that intraday or real-time finality be provided where necessary to reduce risks.

(13) Eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

(14) Institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant family exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and extends intraday

credit to participants.

(15) State to its participants the clearing agency's obligations with respect to physical deliveries and identify and manage the risks from these obligations.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: October 22, 2012

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68079 / October 22, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-11780

In the Matter of **EDWARD D. JONES & CO., L.P.** **Respondent.**	**ORDER AUTHORIZING THE TRANSFER OF RESIDUAL FUNDS AND ANY FUTURE FUNDS RETURNED TO THE FAIR FUND TO THE U.S. TREASURY, DISCHARGING THE FUND ADMINISTRATOR, AND TERMINATING THE FAIR FUND**

On December 22, 2004, the U.S. Securities and Exchange Commission ("Commission") instituted administrative and cease-and-desist proceedings against Edward D. Jones & Co., L.P. ("Edward Jones") for its failure to adequately disclose certain material facts to its customers relating to the offer and sale of mutual funds participating in its "Preferred Mutual Fund Family Program" and its college savings plans established under Section 529 of the Internal Revenue Code ("529 plans") in violation of Section 17(a)(2) of the Securities Act of 1933, Section 15B(c)(1) of the Securities Exchange Act of 1934 and Rule 10b-10 thereunder, and Municipal Securities Rulemaking Board Rule G-15 ("Order"). Securities Exchange Act Release No. 50910 (Dec. 22, 2004). The Order: (1) censured Edward Jones; (2) required it to cease and desist from further violating securities laws and to comply with undertakings regarding certain remedial measures; and (3) required it to pay disgorgement plus prejudgment interest of $37.5 million and a civil money penalty of $37.5 million. Finally, the Order created a Fair Fund for a distribution pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002.

On June 1, 2006, the Commission issued a Corrected Order Approving Distribution Plan and Appointing an Administrator, which appointed James R. Doty, Esq. of the law firm of Baker Botts, L.L.P. as the Fund Administrator. Securities Exchange Act Release No. 53918A (June 1, 2006). The Distribution Plan ("Plan") called for the Edward Jones Fair Fund ("Fair Fund") to be disbursed to investors according to their *pro rata* shares. Investors eligible to receive a disbursement from the Fair Fund were Edward Jones customers who purchased shares of mutual funds between 1999 and 2004 and customers who purchased shares of Edward Jones's 529 plans from 1999 through 2004 that were part of Edward Jones's "Preferred Mutual Fund Family Program" ("Customers").

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On October 20, 2006, the Commission issued an Order Directing Distribution of Fair Fund and Extending the Date for Distribution, providing for the disbursement of $77,924,565 pursuant to the Plan. Securities Exchange Act Release No. 54637 (Oct. 20, 2006). The $75 million Fair Fund earned approximately $7.2 million in interest and paid approximately $2.5 million in taxes. After an initial disbursement and extensive outreach efforts, $75,288,769.38, or ninety-two percent, of the Fair Fund was distributed to approximately 3.2 million Customer accounts. The Independent Distribution Consultant attempted to distribute the full amount authorized to be distributed by the Commission, and the undistributed amount of $2,635,795.62, which included un-cashed checks and checks to investors that were returned because of multiple bad addresses, was returned to the Commission. 1,574,610 Customer accounts were reimbursed directly through electronic credits, and Edward Jones sent Customers approximately 1,648,243 checks. As a result, 3,222,853 Customers were sent some form of payment. The average distribution was in the amount of $24.60.

The Plan provided that the Fair Fund would be eligible for termination on the later of October 1, 2006, or ninety days after the final disbursement and the resolution of any uncashed/unclaimed checks or pending disputes. The last Fair Fund check was issued on January 23, 2008, and no further disbursements have been made since then; nor have there been any disputes or reports of uncashed or unclaimed checks.

The Plan further provided that residual funds should be transmitted to the U.S. Treasury. There is also a remote possibility that additional funds may be returned to the Fair Fund in the future; the Commission also should authorize that these funds be sent to the U.S. Treasury.

The Fund Administrator submitted a Final Accounting of the Fair Fund for Commission approval pursuant to the Plan and Rule 1105(f) of the Commission's Rules on Fair Fund and Disgorgement Plans. Subsequently, the Tax Administrator submitted a Consolidated Standardized Fund Accounting Report ("CFAR") of the Fair Fund.[1] The CFAR was approved by the Commission. According to the CFAR, all liabilities have been satisfied and an amount of $4,413,744.35 remains in the Fair Fund.

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[1] The CFAR was prepared by Damasco and Associates, the Tax Administrator, in this matter because the Fund Administrator has left Baker Botts, L.L.P. and staff determined that due to the age of the matter and the highly unlikely possibility that he has any additional documents or information that were not provided at the time of the distribution, it would not be a practical use of resources to attempt to reach out to him at this time. Damasco has noted in the CFAR that "[t]his information has been supplied to us and has not been audited or verified by us and we take no responsibility for the accuracy of the underlying support." The staff recommended that the Commission approve the CFAR with this statement under the circumstances because the CFAR is supported by ample documentation, including: (1) monthly statements of accounts from the Bureau of Public Debt; (2) an accounting report prepared by the Commission's Office of Financial Management; (3) extensive correspondence with staff regarding the Commission's U.S. Treasury account; (4) various income tax returns; (5) tax payment receipts; (6) tax refund checks; (7) payment records for transfers of funds to and from Damasco; (8) monthly bank statements from the Northern Trust accounts controlled by the Fund Administrator; and (9) supplemental correspondences with the Fund Administrator.

ACCORDINGLY, IT IS ORDERED that:

1. The Fair Fund's remaining balance of $4,413,744.35 and any future funds returned to the Fair Fund shall be sent to the U.S. Treasury;
2. The Fund Administrator is hereby discharged; and
3. The Fair Fund is terminated.

By the Commission.

Elizabeth M. Murphy
Secretary

Lynn M Powalski

By: Lynn M. Powalski
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68083 / October 23, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15073

In the Matter of Fearless International, Inc., Glassmaster Company, Global Entertainment Holdings/Equities, Inc., Global Realty Development Corp., Global Roaming Distribution, Inc., and Gottaplay Interactive, Inc., Respondents.	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against the Respondents named in the caption.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Fearless International, Inc. ("FRLE") [1] (CIK No. 1357800) is a revoked Nevada corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FRLE is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 31, 2007, which reported a net loss of $3,184,020 for the prior nine months. On July 23, 2008, FRLE filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Southern District of Florida, which was converted to a Chapter 7 petition on October 22, 2008, and was still pending as of October 18, 2012. As of October 18, 2012, the common stock of FRLE was quoted on OTC Link (formerly "Pink Sheets") operated by OTC Markets Inc. ("OTC

[1] The short form of each issuer's name is also its stock symbol.

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Link"), had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Glassmaster Company ("GLMA") (CIK No. 109870) is a dissolved South Carolina corporation located in Lexington, South Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GLMA is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 3, 2006, which reported a net loss of $122,673 for the prior quarter. On April 27, 2011, GLMA filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of South Carolina, which was converted to a Chapter 7 petition on February 22, 2008, and was still pending as of October 18, 2012. As of October 18, 2012, the common stock of GLMA was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Global Entertainment Holdings/Equities, Inc. ("GAMT") (CIK No. 1096050) is a delinquent Colorado corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GAMT is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2007, which reported a net loss of $1,406,135 for the prior six months. On August 24, 2007, GAMT filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Central District of California, which was dismissed on March 24, 2008. As of October 18, 2012, the common stock of GAMT was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Global Realty Development Corp. ("GRLY") (CIK No. 1118629) is a forfeited Delaware corporation located in Coral Springs, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GRLY is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2008, which reported a net loss of $2,978,422 for the prior six months. As of October 18, 2012, the common stock of GRLY was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Global Roaming Distribution, Inc. ("GRDB") (CIK No. 1160217) is a dissolved Florida corporation located in Miami, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GRDB is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of $557,414 for the prior nine months. As of October 18, 2012, the common stock of GRDB was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. Gottaplay Interactive, Inc. ("GTAP") (CIK No. 831232) is a revoked Nevada corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GTAP is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2009, which reported a net loss of $848,146 for the prior nine months. As

of October 18, 2012, the common stock of GTAP was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

7. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

8. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

9. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
October 23, 2012

In the Matter of **Fearless International, Inc.,** **Glassmaster Company,** **Global Entertainment Holdings/Equities, Inc.,** **Global Realty Development Corp.,** **Global Roaming Distribution, Inc., and** **Gottaplay Interactive, Inc.,** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Fearless International, Inc. because it has not filed any periodic reports since the period ended December 31, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Glassmaster Company because it has not filed any periodic reports since the period ended December 3, 2006.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Global Entertainment Holdings/Equities, Inc. because it has not filed any periodic reports since the period ended June 30, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Global Realty Development Corp. because it has not filed any periodic reports since the period ended June 30, 2008.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Global Roaming Distribution, Inc. because it has not filed any periodic reports since the period ended September 30, 2008.

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It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Gottaplay Interactive, Inc. because it has not filed any periodic reports since the period ended June 30, 2009.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on October 23, 2012, through 11:59 p.m. EST on November 5, 2012.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68087 / October 23, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15075

In the Matter of **JACQUES NICHOLS,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Jacques Nichols ("Respondent") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

[1] Rule 102(e)(3)(i) provides, in relevant part, that:

> The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . attorney . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

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II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Jacques Nichols, age 75, is a resident of Camas, Washington. Until January 2012, he was a licensed attorney in the State of Oregon.

2. From at least March 2009 through 2011, Nichols represented himself as Senior Trustee and Director of Merchant Securities and Trust ("Merchant") and the Senior Director and Special Counsel of QFF Securities Funds, Ltd. and QFF Holdings LLC (the "QFF Entities").

3. On September 20, 2012, the Commission filed a complaint against Nichols in SEC v. Nichols (Civil Case No. 3:12-cv-01698-HZ). On September 26, 2012, a final judgment was entered by consent against Nichols permanently enjoining him from future aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder. Nichols was also ordered to pay $42,500 in disgorgement of ill-gotten gains, and $99 in prejudgment interest. However, based on Nichols' sworn representations and other information of his financial condition, the Court did not impose a civil penalty or require payment of $42,599 of disgorgement and prejudgment interest.

4. The Commission's complaint alleged, among other things, that Nichols aided and abetted a Ponzi scheme involving various funds managed by Yusaf Jawed and his entities, Grifphon Asset Management, LLC and Grifphon Holdings, LLC. Nichols and others represented that Merchant and the QFF Entities had promised to pay tens of millions of dollars to buy Grifphon fund assets. In actuality, Merchants and the QFF entities were sham entities with no ability to pay anything for Grifphon's alleged assets. Nichols' misrepresentations enabled Jawed to continue his fraud. They also resulted in Jawed raising over $1.2 million from investors.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Nichols' Offer.

Accordingly, it is hereby ORDERED, effective immediately:

Pursuant to Section 102(e) of the Commission's Rules of Practice that Respondent Nichols be and hereby is suspended from appearing or practicing before the Commission as an attorney.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3492 / October 23, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15074

In the Matter of LYMAN J. BRUHN, Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Lyman J. Bruhn ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Lyman J. Bruhn, age 50, is a resident of Vancouver, Washington. Bruhn served as the sole principal of Sasquatch Capital, LLC ("Sasquatch") and Pearl Asset Management, LLC ("Pearl") from at least 2002 through the present. Sasquatch and Pearl are Oregon limited liability companies and investment advisers not registered with the Commission. They served as advisers to various hedge funds formed by Bruhn, including the Blue Chip Focus Fund.

2. On September 20, 2012, the Commission filed a complaint against Bruhn in SEC v. Bruhn, *et al.* (Civil Case No. 3:12-cv-01697-ST). On September 24, 2012, a final judgment was entered by consent against Bruhn permanently enjoining Bruhn from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, Section 17(a) of the Securities Act of 1933, and Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder. Bruhn was also ordered to pay $600,618 in disgorgement of ill-gotten gains from investors' funds, and $47,498 in prejudgment interest. However, based on Bruhn's sworn representations and other information of his financial condition, the Court did not impose a civil penalty or require payment of $648,111 of disgorgement and prejudgment interest.

3. The Commission's complaint alleges, among other things, that from 2002 to 2010, Bruhn employed a device, scheme, or artifice to defraud investors and/or potential investors in hedge funds he managed, including the Blue Chip Focus Fund. In doing so, Bruhn defrauded his hedge fund clients, including the Blue Chip Focus Fund, by misappropriating fund assets and engaging in a Ponzi scheme. Bruhn induced investments through false marketing materials claiming his funds invested in "blue chip" stocks (*i.e.*, well-established, financially sound companies, which stocks are publicly traded, less volatile and considered lower risk), when in fact, the funds did not invest in blue chip stocks. Bruhn also sent false and misleading account statements showing positive returns that did not exist.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Bruhn's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act that Respondent Bruhn be, and hereby is:

> barred from association with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
ECURITIES AND EXCHANGE COMMISSION

October 24, 2012

of olding Corp., h Pharmaceuticals, Inc., nologies Holdings, Inc., , lecommunications.com, Inc. eet Management Solutions, Inc.), puter Specialists, Inc., and Entertainment, Inc. (n/k/a Legacy Holding, Inc.), File No. 500-1	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of China Voice Holding Corp. because it has not filed any periodic reports since the period ended December 31, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of China Yongxin Pharmaceuticals, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Creative Technologies Holdings, Inc. because it has not filed any periodic reports since the period ended March 31, 2002.

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It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Crestek, Inc. because it has not filed any periodic reports since the period ended March 31, 1993.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Crys*Tel Telecommunications.com, Inc. (n/k/a Fleet Management Solutions, Inc.) because it has not filed any periodic reports since January 19, 2001.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of CSI Computer Specialists, Inc. because it has not filed any periodic reports since the period ended June 30, 2000.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of CST Entertainment, Inc. (n/k/a Legacy Holding, Inc.) because it has not filed any periodic reports since the period ended September 30, 2008.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on October 24, 2012, through 11:59 p.m. EST on November 6, 2012.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68091 / October 24, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15076

In the Matter of China Voice Holding Corp., China Yongxin Pharmaceuticals, Inc., Creative Technologies Holdings, Inc., Crestek, Inc., Crys*Tel Telecommunications.com, Inc. (n/k/a Fleet Management Solutions, Inc.), CSI Computer Specialists, Inc., and CST Entertainment, Inc. (n/k/a Legacy Holding, Inc.), Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents China Voice Holding Corp., China Yongxin Pharmaceuticals, Inc., Creative Technologies Holdings, Inc., Crestek, Inc., Crys*Tel Telecommunications.com, Inc. (n/k/a Fleet Management Solutions, Inc.), CSI Computer Specialists, Inc., and CST Entertainment, Inc. (n/k/a Legacy Holding, Inc.).

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. China Voice Holding Corp. (CIK No. 1333491) is a revoked Nevada corporation located in Addison, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). China Voice Holding is

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delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended December 31, 2010, which reported a net loss of over $909,000 for the prior six months. As of October 15, 2012, the company's stock (symbol "CHVC") was quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group Inc. ("OTC Link"), had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. China Yongxin Pharmaceuticals, Inc. (CIK No. 1087848) is a void Delaware corporation located in City of Industry, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). China Yongxin Pharmaceuticals is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2010, which reported a net loss of over $168,000 for the prior three months. As of October 15, 2012, the company's stock (symbol "CYXN") was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Creative Technologies Holdings, Inc. (CIK No. 1096652) is a permanently revoked Nevada corporation located in Van Nuys, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Creative Technologies Holdings is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2002, which reported a net loss of over $82,000 for the prior three months. As of October 15, 2012, the company's stock (symbol "CRTV") was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Crestek, Inc. (CIK No. 25652) is a Delaware corporation located in Trenton, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Crestek is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1993. As of October 15, 2012, the company's stock (symbol "CRST") was quoted on OTC Link, had nine market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Crys*Tel Telecommunications.com, Inc. (n/k/a Fleet Management Solutions, Inc.) (CIK No. 1084813) is a Florida corporation located in La Jolla, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Crys*Tel Telecommunications.com is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB/A registration statement on January 19, 2001, which reported a net loss of over $288,000 for the year ended June 30, 1999. As of October 15, 2012, the company's stock (symbol "FLMG") was quoted on OTC, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. CSI Computer Specialists, Inc. (CIK No. 923141) is a Delaware corporation located in Gaithersburg, Maryland with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CSI Computer Specialists is

delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2000, which reported a net loss of over $542,000 for the prior six months. As of October 15, 2012, the company's stock (symbol "CSIS") was quoted on OTC Link, had three market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

7. CST Entertainment, Inc. (n/k/a Legacy Holding, Inc.) (CIK No. 771617) is a Delaware corporation located in Fremont, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CST Entertainment is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of over $70,000 for the prior three months. As of October 15, 2012, the company's stock (symbol "LGYH") was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

8. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

9. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

10. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the

Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

October 24, 2012

In the Matter of **MedLink International, Inc.** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of MedLink International, Inc. ("MedLink"). Questions have arisen concerning the accuracy of publicly disseminated information concerning the company's public filings and financial statements. MedLink's securities are quoted on OTC Link operated by OTC Markets Group Inc. under the ticker symbol MLKNA.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EDT on October 24, 2012, through 11:59 p.m. EST on November 6, 2012.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68097 / October 24, 2012

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3419 / October 24, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15077

In the Matter of **STORMY L. DEAN,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS AND IMPOSING TEMPORARY SUSPENSION PURSUANT TO RULE 102(e)(3) OF THE COMMISSION'S RULES OF PRACTICE**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Rule 102(e)(3)[1] of the Commission's Rules of Practice against Stormy L. Dean ("Respondent" or "Dean").

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[1] Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

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II.

The Commission finds that:

A. RESPONDENT

1. Stormy L. Dean, age 54, is a resident of Ralston, Nebraska. From 1995 through 2008, Dean served in various capacities in the accounting department of infoUSA, Inc. ("Info"), an Omaha-based database marketing company. At Info, Dean served as controller, principal accounting officer, and chief financial officer ("CFO"). Dean was Info's CFO from January 2000 to September 2003, and then again from January 2006 through December 2008. As Info's CFO, Dean signed and certified Info's public filings. Dean passed the certified public accountant ("CPA") examination in 1995 and holds a CPA certificate in the state of Nebraska. Dean has never obtained a CPA license.

B. CIVIL INJUNCTION AND FINDING OF LIABILITY FOR VIOLATIONS

2. On May 29, 2012, the U.S. District Court for the District of Nebraska entered a final judgment against Dean, permanently enjoining him from future violations, direct or indirect, of Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), 13(b)(5), and 14(a) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, 13a-14, 13b2-1, 13b2-2, 14a-3, and 14a-9 thereunder. Securities and Exchange Commission v. Stormy L. Dean, et al., Civil Action Number 8:10-cv-00102-LSC-FG3. In the final judgment, the court declared that Dean "acted in bad faith toward shareholders of [Info], when committing the acts and omissions that led to this proceeding, and knew his actions were contrary to the interests of [Info] and its shareholders."

3. Previously, on March 2, 2012, after a trial, a jury for the U.S. District Court for the District of Nebraska, issued a verdict finding Dean liable for violations of Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), 13(b)(5), 14(a) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, 13a-14, 13b2-1, 13b2-2, 14a-3, and 14a-9 thereunder. Securities and Exchange Commission v. Stormy L. Dean, et al., Civil Action Number 8:10-cv-00102-LSC-FG3.

4. The Commission's complaint alleged that Dean signed and certified Info's false Forms 10-K and proxy statements that materially understated and failed to properly disclose the perquisite compensation of Vinod Gupta, Info's former chief executive officer and Chairman of the Board of Directors, and failed to properly disclose related party transactions involving Gupta. The complaint alleged that for the years 2003 through 2007, Gupta used Info to pay for his personal expenses associated with private jet flights, a yacht, homes, automobiles, credit card expenses, country club memberships, and life insurance policies. As CFO, Dean approved Info's payment of Gupta's personal expenses and signed and certified Info's false Forms 10-K for 2005 and 2006 which incorporated information from Info's proxy statements. The complaint also alleged that Dean aided and abetted the filing of Info's false Form 10-K for 2003 which incorporated information from Info's proxy statements.

III.

Based upon the foregoing, the Commission finds that a court of competent jurisdiction has found Respondent to have violated the Federal securities laws and permanently enjoined him from violations of the Federal securities laws within the meaning of Rule 102(e)(3)(i)(A) and (B) of the Commission's Rules of Practice. In view of these findings, the Commission deems it appropriate and in the public interest that Respondent be temporarily suspended from appearing or practicing before the Commission.

IT IS HEREBY ORDERED that Stormy L. Dean be, and hereby is, temporarily suspended from appearing or practicing before the Commission. This Order shall be effective upon service on the Respondent.

IT IS FURTHER ORDERED that Respondent may within thirty days after service of this Order file a petition with the Commission to lift the temporary suspension. If the Commission within thirty days after service of the Order receives no petition, the suspension shall become permanent pursuant to Rule 102(e)(3)(ii).

If a petition is received within thirty days after service of this Order, the Commission shall, within thirty days after the filing of the petition, either lift the temporary suspension, or set the matter down for hearing at a time and place to be designated by the Commission, or both. If a hearing is ordered, following the hearing, the Commission may lift the suspension, censure the petitioner, or disqualify the petitioner from appearing or practicing before the Commission for a period of time, or permanently, pursuant to Rule 102(e)(3)(iii).

This Order shall be served upon Respondent personally or by certified mail at his last known address.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68098 / October 24, 2012

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3420 / October 24, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15078

In the Matter of **RAJNISH K. DAS,** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS AND IMPOSING TEMPORARY SUSPENSION PURSUANT TO RULE 102(e)(3) OF THE COMMISSION'S RULES OF PRACTICE**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Rule 102(e)(3)[1] of the Commission's Rules of Practice against Rajnish K. Das ("Respondent" or "Das").

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[1] Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

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II.

The Commission finds that:

A. RESPONDENT

1. Rajnish K. Das, age 42, is a resident of New York, New York. From approximately September 2003 through January 2006, Das was employed as chief financial officer ("CFO") of infoUSA, Inc. ("Info"), a database marketing company. As CFO, Das signed and certified Info's Forms 10-K which incorporated information from the company's proxy statements. Das was terminated from Info in approximately July 2006. Das has not passed the certified public accountant ("CPA") exam and has not been a licensed CPA.

2. Prior to working at Info, Das was employed with various investment banking firms. Following his employment at Info, Das has owned and operated POM Partners, LLC, which offers investment banking advisory services. Das has held Series 7 and 63 securities licenses.

B. CIVIL INJUNCTION AND FINDING OF LIABILITY FOR VIOLATIONS

3. On May 29, 2012, the U.S. District Court for the District of Nebraska entered a final judgment against Das, permanently enjoining him from future violations, direct or indirect, of Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), 13(b)(5), and 14(a) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13a-14, 13b2-1, 13b2-2, 14a-3, and 14a-9 thereunder. Securities and Exchange Commission v. Rajnish K. Das, et al., Civil Action Number 8:10-cv-00102-LSC-FG3. In the final judgment, the court declared that Das "acted in bad faith toward shareholders of [Info], when committing the acts and omissions that led to this proceeding, and knew his actions were contrary to the interests of [Info] and its shareholders."

4. Previously, on March 2, 2012, after a trial, a jury for the U.S. District Court for the District of Nebraska, issued a verdict finding Das liable for violations of Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), 13(b)(5), 14(a) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13a-14, 13b2-1, 13b2-2, 14a-3, and 14a-9 thereunder. Securities and Exchange Commission v. Rajnish K. Das, et al., Civil Action Number 8:10-cv-00102-LSC-FG3.

5. The Commission's complaint alleged that Das signed and certified Info's false Forms 10-K and proxy statements that materially understated and failed to properly disclose the perquisite compensation of Vinod Gupta, Info's former chief executive officer and Chairman of the Board of Directors, and failed to properly disclose related party transactions involving Gupta. The complaint alleged that for the years 2003 through 2007, Gupta used Info to pay for his personal expenses associated with private jet flights, a yacht, homes, automobiles, credit card expenses, country club memberships, and life insurance policies. As CFO, Das approved Info's payment of Gupta's personal expenses and signed and certified Info's false Forms 10-K for 2003 and 2004 which incorporated information from Info's proxy statements. The complaint also alleged that Das aided and abetted the filing of Info's false Form 10-K for 2005 which incorporated information from Info's proxy statements.

III.

Based upon the foregoing, the Commission finds that a court of competent jurisdiction has found Respondent to have violated the Federal securities laws and permanently enjoined him from violations of the Federal securities laws within the meaning of Rule 102(e)(3)(i)(A) and (B) of the Commission's Rules of Practice. In view of these findings, the Commission deems it appropriate and in the public interest that Respondent be temporarily suspended from appearing or practicing before the Commission.

IT IS HEREBY ORDERED that Rajnish K. Das be, and hereby is, temporarily suspended from appearing or practicing before the Commission. This Order shall be effective upon service on the Respondent.

IT IS FURTHER ORDERED that Respondent may within thirty days after service of this Order file a petition with the Commission to lift the temporary suspension. If the Commission within thirty days after service of the Order receives no petition, the suspension shall become permanent pursuant to Rule 102(e)(3)(ii).

If a petition is received within thirty days after service of this Order, the Commission shall, within thirty days after the filing of the petition, either lift the temporary suspension, or set the matter down for hearing at a time and place to be designated by the Commission, or both. If a hearing is ordered, following the hearing, the Commission may lift the suspension, censure the petitioner, or disqualify the petitioner from appearing or practicing before the Commission for a period of time, or permanently, pursuant to Rule 102(e)(3)(iii).

This Order shall be served upon Respondent personally or by certified mail at his last known address.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

[Release No. PA-49; File No. S7-10-12]

Privacy Act of 1974: Systems of Records.

AGENCY: Securities and Exchange Commission.

ACTION: Notice to establish a new system of records and to revise two existing systems of records.

SUMMARY: In accordance with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. § 552a, the Securities and Exchange Commission ("Commission" or "SEC") proposes to establish a new system of records, "Backup Care Employee and Family Records (SEC-66)." Additionally, two existing systems of records are being revised: "Freedom of Information Act Requests (SEC-24)" last published in the Federal Register Volume 62, Number 176 on Thursday, September 11, 1997 and "Child Care Subsidy Program (SEC-41)", last published in the Federal Register Volume 65, Number 155 on Thursday, August 10, 2000.

DATES: The proposed systems will become effective [insert date that is 40 days after publication in the Federal Register] unless further notice is given. The Commission will publish a new notice if the effective date is delayed to review comments or if changes are made based on comments received. To be assured of consideration, comments should be received on or before [insert date that is 30 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7 – 10-12 on the subject line.

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Paper Comments:

Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions should refer to File Number S7 -10-12. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/other.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Todd Scharf, Acting Chief Privacy Officer, Office of Information Technology, 202-551-8800.

SUPPLEMENTARY INFORMATION:

The Commission proposes to establish a new system of records, "Backup Care Employee and Family Records (SEC-66)", and to revise two existing systems of records, "Freedom of Information Act Requests (SEC-24)" and "Child Care Subsidy Program (SEC-41)". The Backup Care Employee and Family Records (SEC-66) system of records contains records of current SEC employees who voluntarily sign up for backup care benefits and their family members for whom care is needed.

The Freedom of Information Act Requests (SEC-24) system of records consists of records used by Commission staff to process FOIA and Privacy Act requests and appeals, and to prepare reports to the Department of Justice, the Office of Management and Budget, and other oversight entities on the Commission's FOIA and PA activities. Minor administrative changes to SEC-24 have been incorporated to update the Commission's current address in the following sections: System Location, and Notification, Access and Contesting Records Procedures. Substantive changes to the notice have been made to the following sections: (1) System Name, changing the title to: "Freedom of Information and Privacy Act Requests (SEC-24)"; (2) Categories of Individuals, updating the types of individuals whose personally identifiable information is contained in the system; (3) Categories of Records, updating the types of records maintained in the system; (4) Routine Uses, updating existing routine uses and adding new routine uses as applicable to this system of records (those numbered 1 through 16); and (5) Record Source, updating the sources from which records are received.

The Child Care Subsidy Program (SEC-41) system of records consist of records used to determine eligibility for, and the amount of, the child care tuition subsidy for eligible SEC employees. Minor administrative changes to SEC-41 have been incorporated to update the Commission's current address in the following sections: Notification, Access and Contesting Records Procedures. Substantive changes to the notice have been made to the following sections: (1) System Location, updating the current locations where records are maintained; and (2) Routine Uses, updating existing routine uses and adding new routine uses as applicable to this system of records (those numbered 1 through 5).

The Commission has submitted a report of the new system of records and the amended existing systems of records to the appropriate Congressional Committees and to the Director of the Office of Management and Budget ("OMB") as required by 5 U.S.C. § 552a(r) (Privacy Act of 1974) and guidelines issued by OMB on December 12, 2000 (65 FR 77677).

Accordingly, the Commission is proposing to establish one new system of records and revise two existing systems of records to read as follows:

SEC-66

SYSTEM NAME:

Backup Care Employee and Family Records.

SYSTEM LOCATION:

Bright Horizons Family Solutions, 200 Talcott Avenue, Watertown, MA 02472. Records may also be maintained at subcontracted childcare center locations. Electronic Reports of SEC employees' registrations and uses are maintained at the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:

Current SEC employees who voluntarily sign up for backup care benefits and their family members for whom care is needed.

CATEGORIES OF RECORDS IN THE SYSTEM:

Records may contain employee name, email address, home address, home and cell telephone numbers, and date of birth; family member's name, address, date of birth, physician medical form, and medical identification number; photos of child, and individuals authorized to pick up child; and provider's name.

AUTHORITY FOR MAINTENANCE OF THE SYSTEM:

40 U.S.C §590

PURPOSE(S):

The records are used to determine an employee's eligibility to request backup care benefits for family members.

ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:

In addition to those disclosures generally permitted under 5 U.S.C. § 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. § 552 a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.
2. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.
3. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data

analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. § 552a.

4. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
5. To members of Congress, the Government Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.
6. To a commercial contractor in connection with benefit programs administered by the contractor on the Commission's behalf, including, but not limited to, supplemental health, dental, disability, life and other benefit programs. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. § 552a.

POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:

STORAGE:

Records are maintained in electronic format. Electronic records are stored in computerized databases and/or on computer disc. Paper records and records on computer disc are stored in locked file rooms and/or file cabinets.

RETRIEVABILITY:

Records are retrieved by the individual's name.

SAFEGUARDS:

Records are safeguarded in a secured environment. The records are kept in limited access areas and/or locked offices or file rooms at all other times. Computerized records are safeguarded through use of access codes and information technology security. Access is limited to those personnel whose official duties require access. Contractors and other recipients providing services to the Commission shall be required to maintain equivalent safeguards.

RETENTION AND DISPOSAL:

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration.

SYSTEM MANAGER(S) AND ADDRESS:

Associate Executive Director, Office of Human Resources, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3901.

NOTIFICATION PROCEDURE:

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

RECORD ACCESS PROCEDURE:

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

CONTESTING RECORD PROCEDURE:

See Record access procedures above.

RECORD SOURCE CATEGORIES:

All information is provided by SEC employees registering for the services.

EXEMPTION CLAIMED FOR THE SYSTEM:

None.

SEC-24

SYSTEM NAME:

Freedom of Information and Privacy Act Requests.

SYSTEM LOCATION:

Securities and Exchange Commission, Office of Freedom of Information Act (FOIA) Services, 100 F Street, NE, Washington, DC 20549. Other offices involved in the processing of requests may also maintain copies of the requests and related internal administrative records.

CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:

Records are maintained on persons requesting information from the Commission pursuant to provisions of the Freedom of Information Act; persons who are the subject of Freedom of Information Act requests; individuals who have submitted requests for information about themselves or on behalf of an individual under the provisions of the Privacy Act of 1974; and individuals filing an administrative appeal of a denial, in whole or part, of any such request.

CATEGORIES OF RECORDS IN THE SYSTEM:

Records received, created or compiled in processing FOIA and PA requests or appeals, including internal memoranda, correspondence to or from other Federal agencies, correspondence and response letters, appeal of denials under the FOIA, request for amendment of records under the Privacy Act, appeal for denials under the Privacy Act, appeal determinations, and electronic tracking data. These records may contain personal information retrieved in response to a request including requesters' and their attorneys' or representatives' names, addresses, e-mail, telephone numbers, and FOIA and PA case numbers; office telephone numbers of SEC employees and contractors; Names, telephone numbers, and addresses of the submitter of the information requested; Unique case identifier; Social security number; or other identifier assigned to the request or appeal.

AUTHORITY FOR MAINTENANCE OF THE SYSTEM:

5 U.S.C. §552, and §552a; Executive Order 9397.

PURPOSE(S):

The records are used by Commission staff to process FOIA and Privacy Act requests and appeals, and to prepare reports to the Department of Justice, the Office of Management and Budget, and other oversight entities on the Commission's FOIA and PA activities.

ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:

In addition to those disclosures generally permitted under 5 U.S.C. § 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. § 552a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.

2. To other federal, state, local, or foreign law enforcement agencies; securities self-regulatory organizations; and foreign financial regulatory authorities to assist in or coordinate regulatory or law enforcement activities with the SEC.
3. To national securities exchanges and national securities associations that are registered with the SEC, the Municipal Securities Rulemaking Board; the Securities Investor Protection Corporation; the Public Company Accounting Oversight Board; the federal banking authorities, including, but not limited to, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation; state securities regulatory agencies or organizations; or regulatory authorities of a foreign government in connection with their regulatory or enforcement responsibilities.
4. In any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity.
5. To a federal, state, local, tribal, foreign, or international agency in response to its request for information concerning the hiring or retention of an employee; the issuance of a security clearance; the reporting of an investigation of an employee; the letting of a contract; or the issuance of a license, grant, or other benefit by the requesting agency, to the extent that the information is relevant and necessary to the requesting agency's decision on the matter.
6. To any persons during the course of any inquiry, examination, or investigation conducted by the SEC's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.

7. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. § 552a.
8. To members of advisory committees that are created by the Commission or by Congress to render advice and recommendations to the Commission or to Congress, to be used solely in connection with their official designated functions.
9. To respond to subpoenas in any litigation or other proceeding.
10. To a third party authorized in writing to receive such information by the individual about whom the information pertains.
11. To another Federal agency to (a) permit a decision as to access, amendment or correction of records to be made in consultation with or by that agency, (b) verify the identify of an individual or the accuracy of information submitted by an individual who has requested access to or amendment or correction of records, or (c) to process payment of fees associated with FOIA/PA requests.
12. To the Department of Justice (DOJ) in order to obtain that department's advice on FOIA matters or regarding the agency's FOIA disclosure obligations.
13. To the Office of Management and Budget for the purpose of obtaining its advice on Privacy Act matters.
14. To the public pursuant to the provisions of the FOIA, 5 U.S.C. § 552.

15. To the Office of Government Information Services (OGIS) National Archives and Records Administration, in connection with mediation of FOIA requests.
16. To members of Congress, the Government Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.
17. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.
18. To any person who is or has agreed to be subject to the Commission's Rules of Conduct, 17 CFR 200.735-1 to 200.735-18, and who assists in the investigation by the Commission of possible violations of the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(47)), in the preparation or conduct of enforcement actions brought by the Commission for such violations, or otherwise in connection with the Commission's enforcement or regulatory functions under the federal securities laws.
19. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
20. In connection with any litigation challenging or seeking to enjoin actions by the Commission under the Freedom of Information Act, as amended.

POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:

STORAGE:

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or on computer disc. Paper records and records on computer disc are stored in locked file rooms and/or file cabinets.

RETRIEVABILITY:

Electronic files and paper format records are indexed and retrieved by a unique case number assigned to the request. Records may also be retrieved by the requestor name and/or the subject of the request.

SAFEGUARDS:

Records are safeguarded in a secured environment. Buildings where records are stored have security cameras and 24 hour security guard service. The records are kept in limited access areas during duty hours and in locked file cabinets and/or locked offices or file rooms at all other times. Access is limited to those personnel whose official duties require access. Computerized records are safeguarded through use of access codes and information technology security. Contractors and other recipients providing services to the Commission shall be required to maintain equivalent safeguards.

RETENTION AND DISPOSAL:

These records are maintained in accordance with general records schedules of the National Archives and Records Administration, General Records Schedule 14.

SYSTEM MANAGER(S) AND ADDRESS:

FOIA/PA Officer, Office of FOIA Services, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

NOTIFICATION PROCEDURE:

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

RECORD ACCESS PROCEDURE:

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

CONTESTING RECORD PROCEDURE:

See Record access procedures above.

RECORD SOURCE CATEGORIES:

Persons requesting information from the Commission pursuant to the Freedom of Information Act and the Privacy Act; agency employees assigned to handle processing the requests; agency records searched and identified as responsive in the process of responding to such requests; other agencies or entities that have referred to SEC requests concerning SEC records, or that have consulted with SEC regarding handling of particular requests; and submitters or subjects of records or information that have provided assistance to SEC in making access or amendment determinations.

EXEMPTIONS CLAIMED FOR THE SYSTEM:

None.

SEC-41

SYSTEM NAME:

Child Care Subsidy Program.

SYSTEM LOCATION:

Childcare Subsidy Program Applications: Federal Employee Education and Assistance Fund (FEEA) - SEC Child Care Subsidy, 8441- W. Bowles Ave, Suite 200, Littleton, CO 80123-9501. Utilization reports and other related records: Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:

Present and former SEC employees and their children and child care providers.

CATEGORIES OF RECORDS IN THE SYSTEM:

Records contain (1) employee's name, social security number, telephone numbers, address, grade, gross annual salary, gross family income that was reported on the latest Federal income tax return, and number of dependent children; (2) employee's child's name, date of birth, social security number, weekly tuition cost, amount of child care tuition subsidy from state or local government; and (3) employee's child care provider's name, address, telephone number, tax identification number, and license number.

AUTHORITY FOR MAINTENANCE OF THE SYSTEM:

40 U.S.C. 590(g); Executive Order 9397.

PURPOSE(S):

To determine eligibility for, and the amount of, the child care tuition subsidy for lower income SEC employees.

ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:

In addition to those disclosures generally permitted under 5 U.S.C. § 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. § 552 a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.
2. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.
3. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
4. To members of Congress, the Government Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.
5. To a commercial contractor in connection with benefit programs administered by the contractor on the Commission's behalf, including, but not limited to, supplemental health, dental, disability, life and other benefit programs. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. § 552a.

6. To interns, gra[...] experts, contractors, and others who have been engaged by the Commissio[...] [...]ist in the performance of a service related to this system of records and who n[...] to the records for the purpose of assisting the Commission in the efficient [...] of its programs, including by performing clerical, stenographic, or data a[...]ctions, or by reproduction of records by electronic or other means. Recipients of [...]rds shall be required to comply with the requirements of the Privacy Act of 1974, [...]nded, 5 U.S.C. § 552a.

[...]y Federal, state, or local government authority implementing child care subsidy [...]grams or investigating a violation or potential violation of a statute, rule, regulation, or [...]order.

8. To the Office of Personnel Management to be used for evaluating the child care subsidy program.

POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:

STORAGE:

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or on computer disc. Paper records and records on computer disc are stored in locked file rooms and/or file cabinets.

RETRIEVABILITY:

These records are retrieved by the employee name or social security number.

SAFEGUARDS:

Records are safeguarded in a secured environment. Buildings where records are stored have security cameras and 24 hour security guard service. The records are kept in limited access areas during duty hours and in locked file cabinets and/or locked offices or file rooms at all other times. Access is limited to those personnel whose official duties require access. Computerized records are safeguarded through use of access codes and information technology security. Contractors and other recipients providing services to the Commission shall be required to maintain equivalent safeguards.

RETENTION AND DISPOSAL:

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration.

SYSTEM MANAGER(S) AND ADDRESS:

Associate Executive Director, Office of Human Resources, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3901

NOTIFICATION PROCEDURE:

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

RECORD ACCESS PROCEDURE:

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

CONTESTING RECORD PROCEDURE:

See Record access procedures above.

RECORD SOURCE CATEGORIES:

Applications for child care subsidy and supporting records, which are voluntarily submitted by employees.

EXEMPTIONS CLAIMED FOR THE SYSTEM:

None.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: October 25, 2012

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68106 / October 25, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14949

In the Matter of **Charles M. Vaughn,** **Respondent.**	**ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS**

I.

On July 12, 2012, the Securities and Exchange Commission ("Commission") instituted public administrative proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Charles M. Vaughn ("Vaughn" or "Respondent"). Respondent has submitted an Offer of Settlement that the Commission has determined to accept.

II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and to the entry of this Order Making Findings and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. From August 2001 through March 2008, Vaughn was the sole owner and principal of CM Vaughn, LLC, an unregistered broker based in multiple locations in and around Atlanta, Georgia. Vaughn, 43 years old, was a resident of Ellijay, Georgia when he operated CM Vaughn, LLC.

2. On October 24, 2011, Vaughn entered a guilty plea in U.S. District Court for the Northern District of Georgia to one count of wire fraud in violation of Title 18 United States Code, Sections 1343 and 2, in United States v. Charles Michael Vaughn, Crim. Case No. 1:11-CR-310-RWS. On February 7, 2012, Vaughn was sentenced to a term of one hundred (100) months in

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prison and three (3) years of supervised release, and ordered to pay restitution in the amount of $8,833,686.41. Vaughn began serving his prison sentence on March 28, 2012.

3. As alleged in Vaughn's negotiated plea agreement, between July 2004 and October 2007, Vaughn induced more than 50 individuals to invest in a purported pooled investment fund called CM Vaughn Emerging Ventures Fund ("Emerging Ventures Fund" or "Fund"). As further alleged in the plea agreement, Vaughn represented to investors that the Fund earned annual returns from 15 to 50 percent, and stated that investors' funds were "insured." The plea agreement also alleges that Vaughn represented that the Fund was subject to a "stop loss" policy where, if the investments dropped below a certain value, Vaughn would terminate all investment activity in order to prevent further losses. However, as alleged in the plea agreement, rather than actually investing investor funds in the Emerging Ventures Fund, Vaughn misappropriated such funds to finance various private companies he owned and/or operated and also to pay his personal expenses and to repay earlier investors. Finally, the plea agreement alleges that Vaughn hid his actions by generating statements reflecting fictitious investment gains and account balances.

4. CM Vaughn, LLC solicited investors in the Emerging Ventures Fund through Vaughn, providing Fund information on the firm's letterhead. The Fund purportedly invested in exchange-listed stocks. Investors in the Fund opened individual accounts at CM Vaughn, LLC, through which the firm purportedly purchased their interests in the Fund. Finally, CM Vaughn, LLC purportedly charged Fund investors "commissions and trade fees" associated with the Fund's purported underlying stock trading.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Vaughn be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Schapiro
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3493 / October 25, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15079

In the Matter of RYAN M. JINDRA, Respondent.	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Ryan M. Jindra ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and to the entry of this Order Instituting Administrative Proceedings Pursuant to Section Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. During at least 2008 through June 2009, Respondent, through his wholly-owned entity, Envision Investment Advisors, LLC ("Envision") acted as an investment adviser, offering portfolio management services primarily to individual customers. As of August 2008, Envision had approximately $41.7 million in customer assets under management. During the period at issue, Jindra resided in Omaha, Nebraska.

2. On September 25, 2012, a final judgment was entered by consent against Jindra, permanently enjoining him from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 204 and 206 of the Advisers Act and Rules 204-2(a)(7)(B) and 206(4)-7 thereunder, in the civil action entitled Securities and Exchange Commission v. Ryan M. Jindra, et al., Civil Action Number 8:09-cv-00216-JFB-TDT, in the United States District Court for the District of Nebraska.

3. The Commission's complaint alleged that from at least August 2008 through June 2009, Jindra caused at least $773,000 to be misappropriated out of accounts held by Envision customers purportedly as advisory fees. The purported advisory fees were fraudulent, excessive and unauthorized. Jindra used the misappropriated funds for improper purposes, including to cover Envision's business debts and for his own personal benefit.

4. On November 18, 2011, Jindra pled guilty to one count of wire fraud in violation of Title 18, United States Code, Section 1343 before the United States District Court for the District of Nebraska, in United States v. Ryan M. Jindra, 8:10-cr-00043-LES-TDT. On April 27, 2012, a judgment in the criminal case was entered against Jindra. He was sentenced to a prison term of 48 months followed by three years of supervised release and ordered to make restitution of $484,235.52.

5. In connection with that plea, Jindra admitted, among other things, that commencing in the summer of 2008, Jindra caused the unauthorized withdrawal of funds from client accounts being managed by Envision. Such unauthorized withdrawals were falsely characterized as "adviser fees," "investment mgr fees", "other plan fees," or "quarterly" management fees. The withdrawn funds were transferred to accounts under Jindra's control and used for paying expenses not associated with the management of client funds.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Jindra's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act, that Respondent Jindra be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Lynn M. Powalski

By: Lynn M. Powalski
Deputy Secretary

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68118 / October 29, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3494 / October 29, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15081

In the Matter of **TILDEN LOUCKS & WOODNORTH, LLC, LASALLE ST. SECURITIES, LLC, and RALPH B. LOUCKS,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), against Tilden Loucks & Woodnorth, LLC, LaSalle St. Securities, LLC, and Ralph B. Loucks (collectively the "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of

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1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

Summary

1. From October 1, 2007 through March 22, 2012, registered investment adviser Tilden, Loucks & Woodnorth, LLC ("Tilden") obtained undisclosed compensation by charging increased commissions on trades for its clients through its affiliated registered broker-dealer, LaSalle St. Securities, LLC ("LaSalle"). Tilden inaccurately told clients they received a discount to LaSalle's commission rates when actually Tilden set those commission rates at increased levels.

2. Most trades for Tilden's clients are executed by LaSalle. From October 1, 2007 through March 22, 2012, Tilden's clients paid commissions at LaSalle that averaged more than $143 per trade, even though the majority of trades consisted of buys and sells of large cap equities. Tilden did not tell its clients the true nature of the commissions they were charged by stating in its Forms ADV that clients obtained a significant "discount" to LaSalle's scheduled retail brokerage charges. However, LaSalle had no scheduled retail brokerage charges or commission schedules. Instead, unbeknownst to Tilden's clients, Tilden set LaSalle's commission charges at rates exceeding LaSalle's charge to Tilden to execute a trade and the "discount" was in reality only a price lower than those reflected on a commission schedule used by Tilden that dated to at least 1988. Tilden's undisclosed compensation practices netted it more than $186,000 in higher commissions paid by advisory clients. Ralph B. Loucks ("Loucks"), Tilden's former senior vice-president, who also served as a registered representative of LaSalle, shared in these commissions.

3. Loucks was aware of the inaccurately disclosed compensation arrangement. When forming Tilden in 1991, Loucks implemented Tilden's compensation structure with LaSalle. Loucks was responsible for reviewing and approving the Forms ADV that contained the incomplete statements.

4. By setting commission rates that exceeded LaSalle's charge to execute a trade, Tilden failed to seek best execution for its clients' securities transactions. Further, Tilden made misleading statements in its Forms ADV concerning the steps it would take to evaluate execution of client trades and ensure that commission rates were reasonable.

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[1] The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

5. As a result of the conduct described above, Tilden willfully violated Sections 206(2) and 207 of the Advisers Act; Loucks caused Tilden's violations of Section 206(2) of the Advisers Act and willfully caused Tilden's violations of Section 207 of the Advisers Act; and LaSalle, through Loucks, caused Tilden's violations of Section 206(2) of the Advisers Act.

Respondents

6. Tilden is a Delaware corporation headquartered in Chicago, Illinois. It has been registered with the Commission as an investment adviser since August 1994. It is a wholly owned subsidiary of a holding company, McDermott-Holdings 1, LP. Tilden manages 152 accounts for 103 clients with assets under management of approximately $107 million. Two of Tilden's three employees are advisers who also are registered representatives of LaSalle.

7. LaSalle is a Delaware corporation headquartered in Elmhurst, Illinois. It has been registered with the Commission as a broker-dealer since December 1975. Like Tilden, LaSalle is a wholly owned subsidiary of McDermott-Holdings 1, LP. LaSalle clears trades through National Financial Services, LLC. LaSalle executes trades for over 25 advisers, including Tilden, and over 250 registered representatives who are, for the most part, affiliated with LaSalle as independent contractors.

8. Ralph B. Loucks, age 87, resides in Chicago, Illinois. Loucks formed Tilden in 1991. He was in overall charge of Tilden's day-to-day operations and served as its senior vice president until he retired from Tilden in June 2011. Loucks has been associated with LaSalle as a registered representative since April 1988. He holds series 7, 18, 24 and 63 licenses.

Facts

Background

9. All of Tilden's clients maintain brokerage accounts at LaSalle. LaSalle administers Tilden's back-office functions.

10. Tilden primarily recommends to its clients a "buy-and-hold" investment strategy. Most trades for Tilden's clients are initiated by Tilden's recommendation of the trade to the client.

11. Most trades for Tilden's clients are executed by LaSalle. Under the arrangement that Loucks established between the two firms, LaSalle charges Tilden certain fees for executing each trade. The fees that LaSalle charges Tilden are different than the commissions paid by a Tilden client for the same trade. LaSalle allows Tilden to set the amount to be charged to the clients as commissions. LaSalle has not created or maintained a standard commission schedule. Instead, LaSalle uses a commission schedule that Loucks provided to LaSalle when Loucks began executing trades through LaSalle. The commission schedule Loucks provided dates to at least 1988.

The Undisclosed Compensation

12. From October 1, 2007 through March 22, 2012, Tilden charged its clients commissions exceeding the fees it paid LaSalle to execute trades. The higher commissions paid by Tilden's clients represented undisclosed compensation for the benefit of Tilden and Loucks. During this period, clients paid on average $143.77 per trade. However, Tilden paid LaSalle on average $37.47 to execute Tilden's clients' trades. The amounts in excess of LaSalle's charges were paid to Tilden. These compensation practices, which were not adequately disclosed to Tilden's clients, netted Tilden $186,608.12 in higher commissions paid by advisory clients. Although retired from Tilden, Loucks continues to receive 50% of the commissions charged to his former clients. From October 1, 2007 through March 22, 2012, Loucks received $16,288.18 from the higher commissions charged to his former clients.

Inaccurate Disclosures to Clients

13. Tilden's Forms ADV, which Loucks reviewed and approved, contained inaccurate disclosures about commissions and he knew or should have known that he was contributing to Tilden's violations. Tilden filed its Forms ADV with the Commission and provided them to advisory clients.

14. Prior to the Form ADV filed by Tilden on September 17, 2008, Tilden's Form ADV provided limited disclosures regarding commissions and failed to inform clients that Tilden's affiliation with LaSalle resulted in increased commissions paid by the clients. Specifically, the Form ADV disclosed that Loucks was a registered representative of LaSalle and received compensation for executing trades through LaSalle, which created a conflict of interest. The Form ADV, however, stated: "The amount of commission paid is determined in relation to the amount of advisory fees paid (i.e. higher advisory fee, lower commission rates or vice-versa)." In fact, the commissions charged bore no relationship to the level of Tilden's advisory fees.

15. Tilden's Forms ADV filed after September 17, 2008 added disclosures regarding commissions, though the disclosures remained inaccurate. During that period, Tilden's Form ADV stated that, for all transactions executed through LaSalle, "clients may pay higher commission rates by using [LaSalle] than are available at other broker-dealers," and that there was a conflict of interest between "the client's desire to effect all transactions at the lowest possible cost and [Tilden's] desire to maximize income." However, Tilden's Form ADV disclosures during that period continued to be inaccurate because the ADVs inaccurately suggested that Tilden's affiliation with LaSalle worked to the clients' benefit. For example, the Form ADV stated:

> Regarding trades affected through LaSalle St. Securities, LLC, the client is given a discount, usually in the range of 20%-35%, from LaSalle St. Securities, LLC's scheduled retail brokerage charges.

***

> The amount of the discount, and hence the total amount of commission charged, is determined by Tilden, Loucks & Woodnorth, LLC and LaSalle St. Securities, LLC.
>
> ***
>
> On a case-by-case basis, there may be instances where the discount may be further increased at the Portfolio Manager/Registered Representative's discretion.
>
> ***
>
> If the client so elects to use an unaffiliated broker for some or all of his/her trades, [Tilden's] ability to negotiate commission discounts and otherwise obtain best price and execution (for example, in placing client over-the-counter stock or bond transactions with market makers) may be limited.

16. Despite these additional disclosures, Tilden's Forms ADV after September 17, 2008 did not describe the true arrangement with LaSalle. The "discount" described in the Forms ADV referred to prices lower than those reflected on an outdated commission schedule provided by Tilden and Loucks, not LaSalle. According to these disclosures, LaSalle charged commissions based on LaSalle's commission schedules. LaSalle, however, did not create or maintain commission schedules for purposes of executing trades for Tilden's clients. Finally, Tilden failed to disclose that it nearly always chose to increase commissions above LaSalle's charges to Tilden to execute a trade.

Tilden Failed to Seek Best Execution and Made Misleading Statements About Its Best Execution Policies

17. In its Forms ADV, Tilden included the following discussion of the firm's best execution policies:

> [Tilden], although effecting trades through [LaSalle] in lieu of a decision by the client to use a different broker or brokers, will nonetheless conduct an annual survey of execution to ensure that transactions executed through [LaSalle] are producing reasonable commission rates and "best execution" of trades as that term is commonly understood. The annual survey will examine at least the following criteria: (1) quality of execution as evaluated with past experience and reputation; (2) accuracy and speed on oral and written confirmations and monthly statements; (3) demonstrated capability for prompt and timely delivery of cash and securities; (4) capital and financial resources of the broker/dealer relative to volume of customer transactions; and (5) other costs.

These disclosures were inaccurate because, in fact, Tilden did not ensure that trades executed through LaSalle produced reasonable commission rates or best execution. Tilden arranged for its clients to pay commissions that far exceeded what LaSalle charged Tilden to execute trades. Moreover, prior to December 2011, Tilden's annual best execution survey was incomplete and did not comply with the requirements described in its Forms ADV. Before 2009, there is no record of Tilden's best execution review. Beginning in 2009, Tilden documented a best execution review that used a template of at least 9 best execution factors to compare LaSalle with two other firms.

Most of the criteria for the comparison firms were marked "N/A," which meant that Tilden failed to obtain any information to make a comparison. Tilden used this incomplete review to conclude that it obtained best execution on client trades with LaSalle.

Violations

18. As a result of the conduct described above, Tilden willfully violated Section 206(2) of the Advisers Act, which prohibits fraudulent conduct by an investment adviser, and Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission…or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

19. As a result of the conduct described above, Loucks caused Tilden's violations of Section 206(2) of the Advisers Act, which prohibits fraudulent conduct by an investment adviser, and Loucks willfully caused Tilden's violations of Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission…or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

20. As a result of the conduct described above, LaSalle caused Tilden's violations of Section 206(2) of the Advisers Act, which prohibits fraudulent conduct by an investment adviser.

Undertakings

21. Tilden has undertaken within thirty (30) days to: (1) revise its Form ADV to disclose its compensation structure, how commissions charged to its clients by LaSalle are determined and the amounts LaSalle charges Tilden to execute trades; (2) provide the revised Form ADV to its clients; and (3) provide a copy of this Order to its clients.

22. Tilden shall certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Tilden agrees to provide such evidence. The certification and supporting material shall be submitted to John J. Sikora, Jr., Assistant Director, Asset Management Unit, Chicago Regional Office, 175 W. Jackson Boulevard, Suite 900, Chicago, IL 60604, or such other address as the Commission staff may provide, with a copy to the Office of Chief Counsel of the Enforcement Division, 100 F Street, NE, Washington, DC 20549, no later than sixty (60) days from the date of the completion of the undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate, in the public interest to impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Section 15(b) of the Exchange Act and Sections 203(e), 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Tilden and Loucks cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 207 of the Advisers Act.

B. LaSalle cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act.

C. Tilden and Loucks are censured.

D. Tilden, LaSalle and Loucks shall pay disgorgement and prejudgment interest as follows:

(1) Tilden and LaSalle shall jointly and severally pay disgorgement of $170,319.94 and prejudgment interest of $16,531.06, and Tilden, LaSalle and Loucks shall jointly and severally pay disgorgement of $16,288.18 and prejudgment interest of $1,579.43, consistent with the provisions of this Subsection D. Within ten (10) days of the entry of this Order, Tilden, LaSalle and Loucks (up to $16,288.18 of the total disgorgement) shall deposit the full amount of the disgorgement (the "Disgorgement Fund") into an escrow account acceptable to the Commission staff and Respondents shall provide the Commission staff with evidence of such deposit in a form acceptable to the Commission staff. In addition, within ten (10) days of the entry of this Order, Tilden, LaSalle and Loucks (up to $1,579.43 of the total prejudgment interest) shall pay the full amount of the prejudgment interest to the Commission for transmittal to the United States Treasury, in the manner provided in Subsection H below. If timely deposit of the Disgorgement Fund or timely payment of the prejudgment interest is not made, interest shall accrue pursuant to SEC Rule of Practice 600.

(2) Tilden and LaSalle (the "Administrators") shall be responsible for administering the Disgorgement Fund. The Administrators shall pay applicable portions of the Disgorgement Fund to affected current and former advisory clients of Tilden who paid from October 1, 2007 through March 22, 2012 commissions greater than the minimum commission charges ("Relevant Overcharged Commissions"), pursuant to a disbursement calculation (the "Calculation") that has been submitted to, reviewed and approved by the Commission staff in accordance with this Subsection D. No portion of the Disgorgement Fund shall be paid to any client account directly or indirectly in the name of or for the benefit of Respondents. Any such funds shall be transferred to the Commission for transfer to the United States Treasury in accordance with Subsection D.5. below.

(3) The Administrators shall, within sixty (60) days from the entry of this Order, submit a proposed Calculation to the Commission staff for its review and approval that identifies, at a minimum: (i) the name and account number(s) of each affected advisory

client; (ii) the exact amount of the payment to be made to such client; and (iii) descriptions of the relevant transactions for which the clients are receiving payment. The Administrators also shall provide to the Commission staff such additional information and supporting documentation relating to the Relevant Overcharged Commissions as the Commission staff may request for the purpose of its review. In the event of one or more objections by the Commission staff to the Administrators' proposed Calculation and/or any of its information or supporting documentation, the Administrators shall submit a revised Calculation for the review and approval of the Commission staff and/or additional information or supporting documentation within ten (10) days of the date that the Administrators are notified of the objection, which revised Calculation shall be subject to all of the provisions of this Subsection D.

(4) The Administrators shall complete the transmission of all amounts otherwise payable to affected advisory clients pursuant to a Calculation approved by the Commission staff within one hundred and twenty (120) days of the entry of this Order, unless such time period is extended as provided in paragraph (9) of this Subsection D.

(5) If the Administrators do not distribute any portion of the Disgorgement Fund for any reason, including an inability to locate an affected advisory client after all reasonable efforts or any other factors beyond the Administrators' control, the Administrators shall send any such undistributed funds to the Commission for transfer to the United States Treasury after the final accounting provided for in this Subsection D is approved by the Commission. Any such payment shall be made in the manner provided in Subsection H below.

(6) The Administrators shall be responsible for any and all tax compliance responsibilities associated with the Disgorgement Fund and may retain any professional services necessary. The costs and expenses of any such professional services shall be borne by the Administrators and shall not be paid out of the Disgorgement Fund.

(7) Within one hundred and eighty (180) days after the date of entry of this Order, the Administrators shall submit to the Commission staff for its approval a final accounting and certification of the disposition of the Disgorgement Fund, which final accounting and certification shall be in a format to be provided by the Commission staff. The final accounting and certification shall include, but not be limited to: (i) the amount paid to each payee; (ii) the date of each payment; (iii) the check number or other identifier of money transferred; (iv) the date and amount of any returned payment; (v) a description of any effort to locate a prospective payee whose payment was returned or to whom payment was not made for any reason; and (vi) any amounts to be forwarded to the Commission for transfer to the United States Treasury. The Administrators shall submit proof and supporting documentation of such payment (whether in the form of fee credits, cancelled checks, or otherwise) in a form acceptable to the Commission staff and under a cover letter that identifies each respective Respondent (Tilden, LaSalle and Loucks) as Respondents in these proceedings and the file number of these proceedings to John J. Sikora, Jr., Assistant Director, Asset Management Unit, Chicago

Regional Office, Securities and Exchange Commission, 175 W. Jackson Boulevard, Suite 900, Chicago, Illinois, 60604, or such other address the Commission staff may provide. The Administrators shall provide any and all supporting documentation for the accounting and certification to the Commission staff upon its request and shall cooperate with any additional requests by the Commission staff in connection with the accounting and certification.

(8) After the Administrators have submitted the final accounting to the Commission staff, the staff shall submit the final accounting to the Commission for approval and shall request Commission approval to send any remaining amount to the United States Treasury.

(9) The Commission staff may extend any of the procedural dates set forth in this Subsection D for good cause shown. Deadlines for dates relating to the Disgorgement Fund shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday the next business day shall be considered to be the last day.

E. Tilden shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury. If timely payment is not made, interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in the manner provided in Subsection H below.

F. LaSalle shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury. If timely payment is not made, interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in the manner provided in Subsection H below.

G. Loucks shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $25,000 to the United States Treasury. If timely payment is not made, interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in the manner provided in Subsection H below.

H. Payment of any amount stated herein must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying the respective Respondent making the payment (either Tilden, LaSalle and/or Loucks) as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to John J. Sikora, Jr., Assistant Director, Asset Management Unit, Chicago Regional Office, Securities and Exchange Commission, 175 W. Jackson Boulevard, Suite 900, Chicago, Illinois, 60604, or such other address the Commission staff may provide.

I. Tilden shall comply with the undertakings enumerated in Section III, paragraphs 21 and 22 above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68111; File No. SR-OCC-2012-14)

October 26, 2012

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Extension of Review Period of Advance Notice to Establish the Legal and Operational Framework for Providing Central Clearing of OTC Index Options on the S&P 500 Index That are Negotiated Bilaterally in the Over-The-Counter Market and Submitted to OCC for Clearance

On August 30, 2012, the Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change and Advance Notice SR-OCC-2012-14 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder.[2] The proposed rule change was published for comment in the Federal Register on September 18, 2012[3] and the Advance Notice was published for comment in the Federal Register on September 27, 2012.[4]

Section 806(e)(1)(G) of the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act")[5] provides that changes proposed in an Advance Notice may be implemented if the Commission does not object to the proposed changes within 60 days of the later of (i) the date that the Advance Notice was filed with the Commission or (ii) the date that any additional information requested by the Commission is received, unless extended as

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 Securities Exchange Act Release No. 67835 (September 12, 2012), 77 FR 57602 (September 18, 2012).

4 Securities Exchange Act Release No. 67906 (September 21, 2012), 77 FR 59431 (September 27, 2012).

5 12 U.S.C. 5465(e)(1)(G).

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described below. The date that is 60 days from the time of the filing is October 29, 2012.

Pursuant to Section 806(e)(1)(H) of the Clearing Supervision Act,[6] the Commission may extend the review period for an additional 60 days if the proposed changes raise novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension.

The Commission finds it is appropriate to extend the review period for the Advance Notice. In particular, the Advance Notice is novel because OCC does not currently provide clearing services for OTC products and because no registered clearing agency currently provides clearing services for OTC S&P 500 Index options.

Accordingly, the Commission, pursuant to 806(e)(1)(H) of the Clearing Supervision Act,[7] extends the review period for an additional 60 days so that the Commission shall have until December 28, 2012 to issue an objection or non-objection of the Advance Notice (File No. SR-OCC-2012-14).

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

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6 12 U.S.C. 5465(e)(1)(H).

7 Id.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3495 / October 29, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15082

In the Matter of **BTS Asset Management, Inc.,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against BTS Asset Management, Inc. ("BTS" or the "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

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Summary

1. From at least the 1990s to 2010, BTS' advertisements for its High Yield Bond Fund Program ("HYP") claimed that the program had experienced "no down years" since 1981. The advertisements based the "no down years" claim on the performance of a model that applied BTS' buy/sell signals to, at various times, a single high yield bond fund, a composite of six high yield bond funds, or a composite of five high yield bond funds.[1] The advertisements contained disclosures stating that (1) the "no down years" claim was based on the application of HYP buy/sell signals to a single fund or a composite of five or six funds; (2) BTS would furnish the name(s) of the fund or funds on which the claim was based upon request; and (3) "results will vary with fund used."

2. In 2005, BTS became aware that, in contrast to the model performance reflected in the advertisements, approximately half of HYP's clients would have experienced a down year in 2004 (with losses of up to 3.3%) based on the application of HYP's buy/sell signals to the funds known by BTS to be held by the clients in the program. The fact that, on this basis, a significant percentage of HYP clients likely experienced investment results in 2004 that were materially different (*i.e.*, they had a down year) from the claims made in the advertisements BTS disseminated from 2005 to 2010 rendered those advertisements misleading.

Respondent

3. **BTS Asset Management, Inc.**, headquartered in Lexington, Massachusetts, is a registered investment adviser (SEC File No. 801-14895). BTS reported that, as of May 10, 2012, it had approximately $1.5 billion in regulatory assets under management and about 14,000 client accounts.

The BTS High Yield Bond Fund Program

4. The HYP, whose inception date was January 2, 1981, is a high yield bond fund program that seeks to apply buy/sell signals to mutual funds or variable annuities in the high yield bond sector that are not affiliated with BTS with the goal of investing in the high yield bond market when it is moving up, and moving assets into a related money market fund when high yield bonds are moving down. For the typical HYP client, capital preservation is a primary consideration. Since 1981, most of the investors who became HYP clients came to BTS through referrals from registered representatives of unaffiliated broker-dealers ("referring agents") who received a portion of the advisory fees that these clients paid to BTS. The remaining HYP clients came to BTS through registered representatives of BTS' affiliated broker-dealer.

5. Each HYP client chooses the high yield bond fund and money market fund in which to

[1] None of these funds were affiliated with BTS.

invest and to which BTS applies its buy/sell signals. When it issues a buy/sell signal, BTS moves each HYP client's investment between the high yield bond fund and the money market fund the client has chosen pursuant to discretionary authority provided to BTS by the client.

The 2005 "No Down Years" Advertisement

6. From at least the 1990s, BTS' advertisements for the HYP claimed that the program had experienced "no down years" since its inception in January 1981. In early 2005, BTS disseminated a one-page advertisement to prospective referring agents, the form of which it had been using since at least 1997. BTS knew when it distributed this advertisement that the registered representatives to whom it sent the advertisement might ultimately show the advertisement or describe its contents to prospective HYP clients. In the top left section of this advertisement, in large print, BTS made the following statements:

> Lost money in the past 5 years with stocks?
> BTS High Yield program has:
> 1) No down year in 24 years[1] . . .

The footnote placed at the end of the "no down years" claim, which appeared in small print on the right side of the advertisement, stated that:

> [1]The performance shown reflects the highest advisory fees charged by BTS during the applicable period. Advisory fees will vary depending on account size. The returns presume all dividends and capital gains are reinvested. Past performance is not indicative of future results, including the possibility of principal loss.
>
> The performance shown reflects hypothetical results based upon investment in a single popular high yield bond fund during buy signals issued by BTS and investment in a single money-market during sell signals issued by BTS. High Yield bond fund name furnished upon request. The performance shown is net of applicable sales loads and timing fees. Results will differ depending on the specific fund(s) selected. Actual results may vary.

This advertisement is attached as Exhibit A.

The 2005-2010 "No Negative Years" Advertisements

7. In 2005, BTS distributed to its existing referring agents a two-page advertisement, the form of which it had been using since at least 1995. At the top of the second page of this advertisement, BTS set forth the following statement:

BTS High Yield Bond Program Vs. Investment Benchmarks

$100,000 INITIAL INVESTMENT
24 Years (since inception)* ending December 31, 2004

	Number of negative Years	Worst Year	
BTS High Yield Bond Program	0	2.04%	2004
S&P 500	5**	-22.09%	2002
Lehman Credit Bond Index	2**	-3.92%	1994
Lehman Gov't Bond Index	2**	-3.37%	1994

Below it, BTS stated:

> BTS = total dollar and annual compound return of the most popular High Yield bond fund in terms of assets using BTS buy/sell signals; name of fund furnished upon request. Performance includes reinvestment of dividends and capital gains. Advisory fees and sales charges have been deducted. Results will vary with fund used.

BTS knew when it distributed this advertisement that the registered representatives to whom it sent the advertisement might ultimately show the advertisement or describe its contents to prospective HYP clients. This advertisement is attached as Exhibit B.

8. During each year from 2006 to 2010, BTS distributed an updated version of the advertisement referred to in paragraph 7 above to its existing referring agents (*e.g.*, the 2010 advertisement stated that the program had experienced no negative years over the last 29 years). At the end of each of these advertisements, BTS placed a disclaimer that was substantively similar to the disclaimer set forth above. These advertisements are attached as Exhibit C.

The Fall 2008 Advertisements

9. In the fall of 2008, BTS created and disseminated to its referring agents three one-page advertisements that were intended to be mailed out by the referring agents to prospective HYP clients.

One of these advertisements read as follows:

> Are you tired of trying to ride out market corrections? Are you looking for a way to reduce the risk in your portfolio without giving up all of the growth potential? If the answers to these questions is yes, then you may be interested in learning about a bond strategy that seeks to preserve capital during market declines while still producing strong returns over time. This strategy has avoided negative annual returns for 27 years.*

At the bottom of the advertisement, there appeared an asterisk that said "Please see important information on the reverse side→." The disclaimer on the reverse side read as follows:

> Results are based on the performance of the BTS Asset Management High Yield Program (inception date of 1/2/1981) using a composite of five high yield bond funds using BTS buy/sell signals. The composite is a BTS derived composite of high yield bond funds that have existed since the inception of the BTS High Yield Program and have been used with the High Yield Program. Depending on the high yield mutual funds or variable annuity sub-accounts used, not all clients experienced no down years in 27 years. Results will vary with fund used.

This advertisement is attached as Exhibit D.

10. The other two fall 2008 advertisements had very similar content and included the same disclaimer as the advertisement described above. These advertisements are attached as Exhibit E.

11. The statement that "Depending on the high yield mutual funds or variable annuity sub-accounts used, not all clients experienced no down years" was not included in either the 2009 or the 2010 versions of the "No Negative Years" advertisement. These advertisements are included in attached Exhibit C.

The Performance Results Experienced by HYP Clients and BTS' Knowledge of Same

12. In 2005, BTS knew that approximately half of HYP's clients would have experienced losses in 2004 of up to 3.3% based on the application of HYP's buy/sell signals to the funds used by the clients in the program.[2] Nonetheless, BTS negligently distributed the above-referenced advertisements.

Violations

13. Each of the advertisements referred to in paragraphs 6 through 11 above was materially misleading because it failed to disclose with sufficient prominence and detail that, in 2004, a significant number of HYP clients would have experienced investment results that were materially different from the results portrayed in the model based on the application of HYP's buy/sell signals to the funds used by the clients in the program. By reason of the foregoing, BTS willfully[3] violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder because by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, BTS negligently engaged in acts, practices, or courses of business which were fraudulent, deceptive or manipulative by, directly or indirectly, publishing, circulating, or distributing an advertisement that was misleading.

BTS' Remedial Efforts

14. In determining to accept Respondent's Offer, the Commission considered the remedial acts undertaken by BTS and the cooperation BTS afforded the Commission staff.

Undertakings

15. Order Notification

a. Within thirty (30) days of the issuance of this Order, BTS undertakes to mail a copy of the Form ADV which incorporates the paragraphs contained in Section III of this Order to each of BTS' existing clients, and specifies that the entire Order will be posted on the homepage of BTS' website.

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[2] In fact, an analysis conducted by a forensic accounting firm retained by BTS in 2011 estimated that, based on the application of HYP's buys/sell signals to the funds used by the clients in the program, 1,704 clients, representing 54.1% of the total (and 55.3% of the assets under management in the HYP), experienced a down year in 2004 and that the most any single client lost in that year was 3.3%.

[3] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

b. Within thirty (30) days of the issuance of this Order, BTS also undertakes to post a copy of this Order on the homepage of BTS' website and to maintain this copy of the Order on the homepage of BTS' website for a period of six (6) months.

c. BTS further undertakes to provide a copy of the Form ADV to any new client that engages BTS within one (1) year of the issuance of this Order.

16. Independent Compliance Consultant

a. BTS shall retain, within 30 days of the date of entry of the Order, the services of an Independent Compliance Consultant not unacceptable to the staff of the Commission. The Independent Compliance Consultant's compensation and expenses shall be borne exclusively by BTS. BTS shall require the Independent Compliance Consultant to conduct a review of the BTS compliance policies and procedures that the Independent Compliance Consultant deems relevant with respect to the publication, circulation, or distribution of advertisements under Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder;

b. At the end of the review, which in no event shall be more than three (3) months after the date of the issuance of this Order, BTS shall require the Independent Compliance Consultant to submit to BTS and to the Asset Management Unit in the Commission's Boston Regional Office an Initial Report. The Initial Report shall describe the review performed, the conclusions reached, and shall include any recommendations deemed necessary to make the policies and procedures adequate. BTS may suggest an alternative procedure designed to achieve the same objective or purpose as that of the recommendation of the Independent Compliance Consultant. The Independent Compliance Consultant shall evaluate any alternative procedure proposed by BTS. However, BTS shall abide by the Independent Compliance Consultant's final recommendation;

c. Within six (6) months after the date of issuance of this Order, BTS shall, in writing, advise the Independent Compliance Consultant and the Asset Management Unit in the Commission's Boston Regional Office of the recommendations it is adopting;

d. Within nine (9) months after the date of issuance of this Order, BTS shall require the Independent Compliance Consultant to complete its review and submit a written final report to BTS and the Asset Management Unit in the Commission's Boston Regional Office. The Final Report shall describe the review made of BTS' compliance policies and procedures relating to the publication, circulation, or distribution of advertisements under Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder; set forth the conclusions reached and the recommendations made by the Independent Compliance Consultant, as well as any proposals made by BTS; and describe how BTS is implementing the Independent Compliance Consultant's final recommendations;

e. BTS shall take all necessary and appropriate steps to adopt and implement all recommendations contained in the Independent Compliance Consultant's Final Report;

f. No later than three (3) months after the date of the Independent Compliance Consultant's Final Report, BTS shall submit to the Asset Management Unit in the Commission's Boston Regional Office an affidavit setting forth the details of its efforts to implement the Independent Compliance Consultant's recommendations as set forth in the Final Report and its compliance with same;

g. For good cause shown and upon timely application by the Independent Compliance Consultant or BTS, the Commission's staff may extend any of the deadlines set forth in these undertakings;

h. BTS shall require the Independent Compliance Consultant to enter into an agreement providing that for the period of the engagement and for a period of two years from completion of the engagement, the Independent Compliance Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with BTS, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Independent Compliance Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Compliance Consultant in the performance of his or her duties under this Order shall not, without prior written consent of the Asset Management Unit in the Commission's Boston Regional Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with BTS, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

17. BTS shall certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission's staff may make reasonable requests for further evidence of compliance, and BTS agrees to provide such evidence. The certification and supporting material shall be submitted to Kevin M. Kelcourse, Assistant Director, Asset Management Unit, Boston Regional Office, Securities and Exchange Commission, 33 Arch Street, Suite 2300, Boston, MA 02110, with a copy to the Office of the Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of completion of the undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 203(e), 203(i), and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. BTS shall cease and desist from committing or causing any violation and any future violation of Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder.

B. BTS is censured.

C. BTS shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $200,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies BTS as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order, check, or proof of wire transfer shall be sent to Kevin M. Kelcourse, Assistant Director, Asset Management Unit, Boston Regional Office, Securities and Exchange Commission, 33 Arch Street, Suite 2300, Boston, MA 02110.

D. BTS shall comply with the undertakings as enumerated in Sections III.15.-17. above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Exhibit A

Lost money in the past 5 years with stocks?

BTS ASSET MANAGEMENT

BTS High Yield program has:

1) No down year in 24 years[1]
2) Less risk than the stock market[2]
3) Beat the S&P 500[3]
4) High Yields beat the S&P 500 after the last recession (1991-1993)[4]
   99.4% vs. 54.6% total return
5) 7% current yield on most high yield funds[5]

December 2004	[illegible]	[illegible]
2002	1.74Mil	133K
2000	1.48 Mil	115K
1998	1.28Mil	102K
1996	1.06Mil	88
1994	820K	70K
1992	677K	50K
1990	426K	38K
1988	373K	34K
1986	297K	28K
1984	235K	22K
January 1981	100K	10K

Program Inception

For more information call or fax this form to:
BTS Asset Management
Fax: 1-781-860-9051 Phone: 1-800-343-3040
Or reply with enclosed return envelope

Name: ____________________

Address: ____________________

____

Phone: ____________________

Email: ____________________

Mutual Funds and Variable Annuities currently using:

____

Past Performance is no guarantee of future results

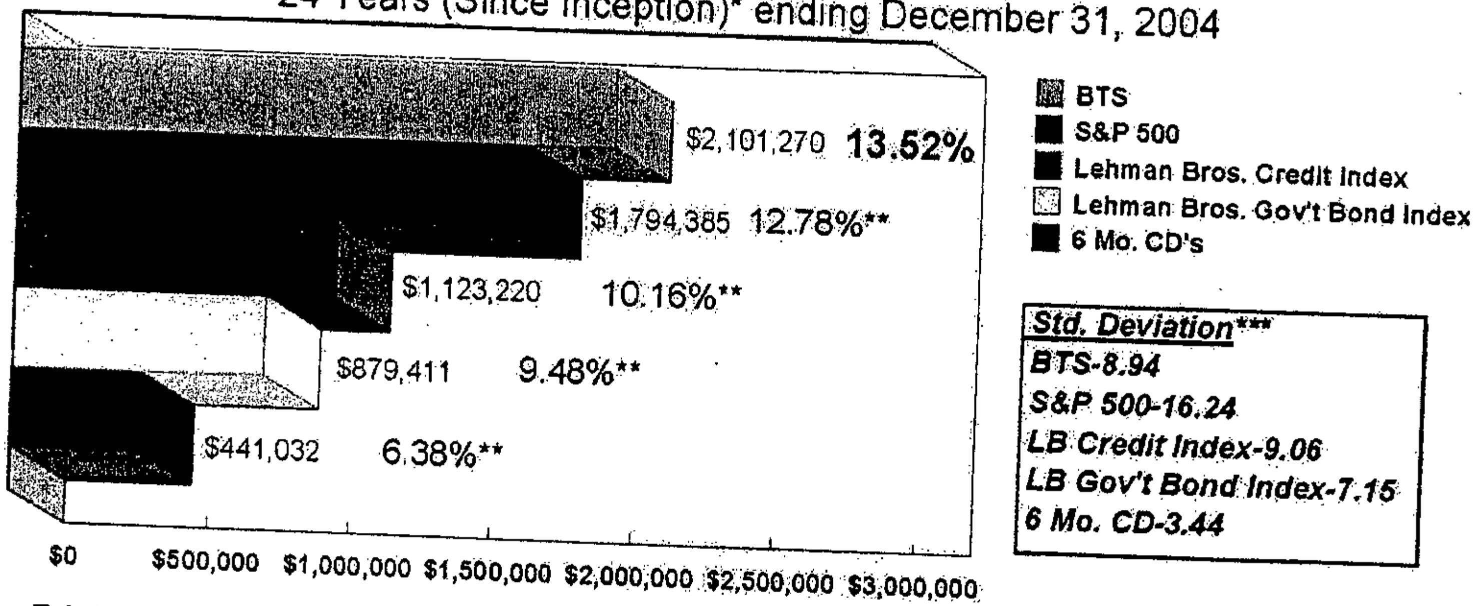
Exhibit B

BTS ASSET MANAGEMENT

BTS High Yield Bond Program versus Investment Benchmarks

$100,000 INITIAL INVESTMENT

24 Years (Since Inception)* ending December 31, 2004



Std. Deviation**
BTS-8.94
S&P 500-16.24
LB Credit Index-9.06
LB Gov't Bond Index-7.15
6 Mo. CD-3.44

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

BTS=total dollar and annual compound return of the most popular High Yield bond fund in terms of assets using BTS buy/sell signals; name of fund furnished upon request. Performance includes reinvestment of dividends and capital gains. Advisory Fees and sales charges have been deducted. Results will vary with fund used. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within this 2-3 day time period is likely to affect the results of the above illustration. All recommendations for the past year furnished upon request. Results reflect generally rising securities markets and will fluctuate with market and other economic conditions. This illustration uses the maximum fee based on the size of the investment as noted at the top of this sheet. BTS fees vary depending on investment amount and program.

*Inception=beginning of BTS High Yield Program: Jan. 2nd, 1981

**Source; Dec. 2004 Morningstar

***Standard Deviation=a financial industry standard used to measure risk correlation to returns over time.

BTS High Yield Bond Program Vs. Investment Benchmarks

$100,000 INITIAL INVESTMENT
24 Years (since inception)* ending December 31, 2004

	Number of negative Years	Worst Year	
BTS High Yield Bond Program	0	2.04%	2004
S&P 500	5**	-22.09%	2002
Lehman Credit Bond Index	2**	-3.92%	1994
Lehman Gov't Bond Index	2**	-3.37%	1994

PAST PERFORMANCE DOES NOT GAURANTEE FUTURE RESULTS

BTS=total dollar and annual compound return of the most popular High Yield bond fund in terms of assets using BTS buy/sell signals, name of fund furnished upon request. Performance includes reinvestment of dividends and capital gains. Advisory Fees and sales charges have been deducted. Results will vary with fund used. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within this 2-3 day time period is likely to affect the results of the above illustration. All recommendations for the past year furnished upon request. Results reflect generally rising securities markets and will fluctuate with market and other economic conditions. This illustration uses the maximum fee based on the size of the investment as noted at the top of this sheet. BTS fees vary depending on investment amount and program.
*Inception=beginning of BTS High Yield Program, Jan. 2nd, 1981
**Source: Dec. 2004 Morningstar

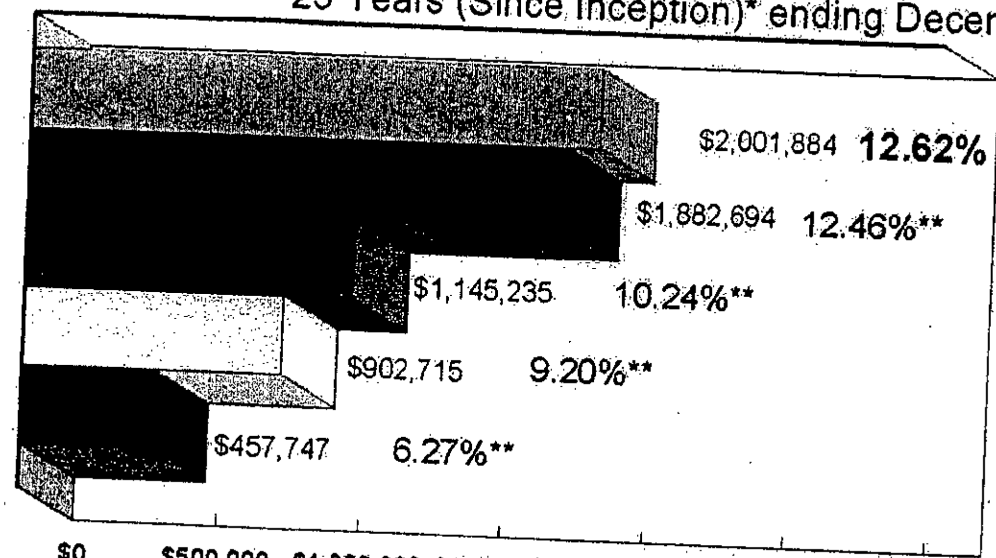
Exhibit C

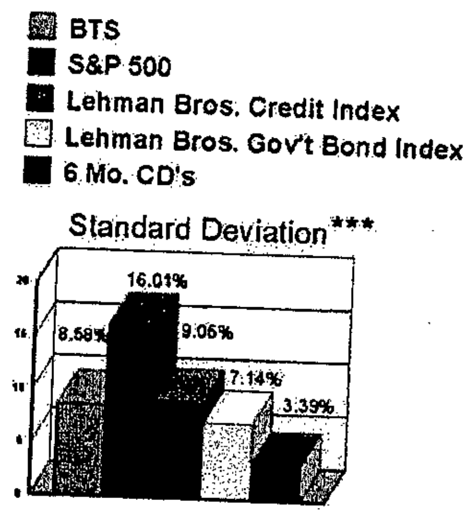
BTS ASSET MANAGEMENT

BTS High Yield Bond Program versus Investment Benchmarks

$100,000 INITIAL INVESTMENT

25 Years (Since Inception)* ending December 31, 2005





PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

BTS=total dollar and annual compound return of a composite of six high yield bond funds using BTS buy/sell signals. The composite is a BTS derived composite of high yield bond funds that have existed since at least the inception of the BTS High Yield Program and have a history of working well with the High Yield Program. The composite consists of high yield funds that clients may or may not be able to invest in directly while employing the BTS High Yield Program. Name of funds furnished upon request. Performance includes reinvestment of dividends and capital gains. Advisory fees and sales charges have been deducted. This illustration uses the maximum fee based on the size of the investment as noted at the top of this sheet. BTS fees vary depending on investment amount and program. Results will vary with fund used. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within this 2-3 day time period is likely to affect the results of the above illustration. All recommendations for the past year furnished upon request. Results reflect generally rising securities markets and will fluctuate with market and other economic conditions.

*Inception=beginning of BTS High Yield Program: January 2nd, 1981

**Source; Morningstar December 2005

***Standard deviation is applied to the annual rate of return of an investment, to measure the investment's volatility, or "risk".

BTS High Yield Bond Program Vs. Investment Benchmarks

$100,000 INITIAL INVESTMENT
25 Years (since inception)* ending December 31, 2005

	Number of negative Years	Worst Year	
BTS High Yield Bond Program	0	2.79%	2004
S&P 500	5**	-22.09%	2002
Lehman Credit Bond Index	2**	-3.92%	1994
Lehman Gov't Bond Index	2**	-3.37%	1994

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

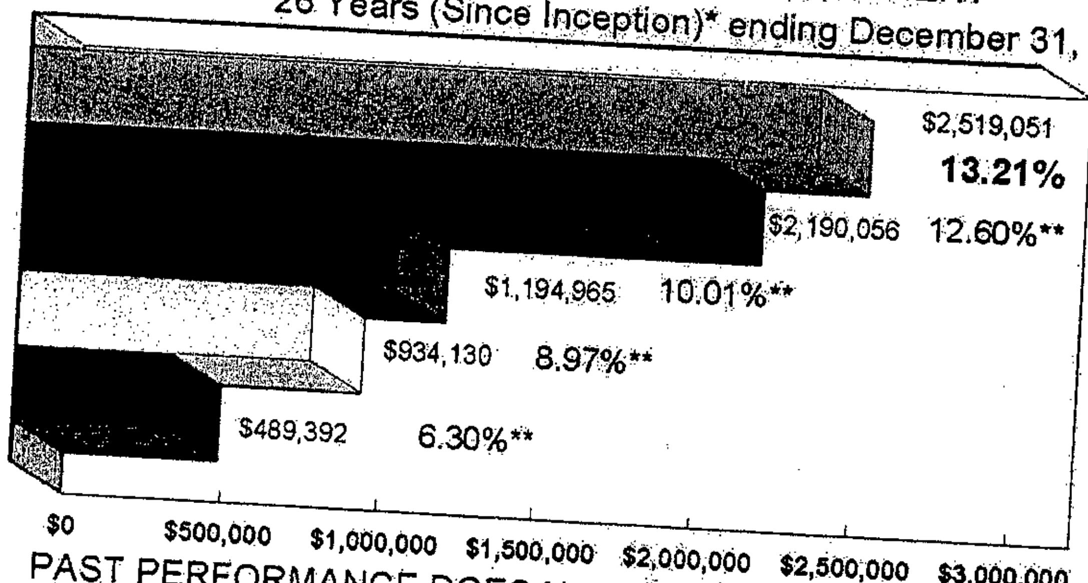
BTS=total dollar and annual compound return of a composite of six high yield bond funds using BTS buy/sell signals. The composite is a BTS derived composite of high yield bond funds that have existed since at least the inception of the BTS High Yield Program and have a history of working well with the High Yield Program. The composite consists of high yield funds that clients may or may not be able to invest in directly while employing the BTS High Yield Program. Name of funds furnished upon request. Performance includes reinvestment of dividends and capital gains. Advisory fees and sales charges have been deducted. This illustration uses the maximum fee based on the size of the investment as noted at the top of this sheet. BTS fees vary depending on investment amount and program. Results will vary with fund used. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within this 2-3 day time period is likely to affect the results of the above illustration. All recommendations for the past year furnished upon request. Results reflect generally rising securities markets and will fluctuate with market and other economic conditions
*Inception=beginning of BTS High Yield Program, January 2nd, 1981
**Source; Morningstar December 2005

BTS ASSET MANAGEMENT

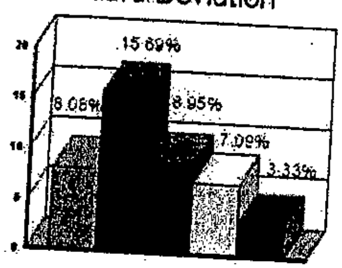
BTS High Yield Bond Program versus Investment Benchmarks

$100,000 INITIAL INVESTMENT

26 Years (Since Inception)* ending December 31, 2006



Standard Deviation***



PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

BTS=total dollar and annual compound return of a composite of five high yield bond funds using BTS buy/sell signals. The composite is a BTS derived composite of high yield bond funds that have existed since at least the inception of the BTS High Yield Program and have a history of working well with the High Yield Program. The composite consists of high yield funds that clients may or may not be able to invest in directly while employing the BTS High Yield Program. Name of funds furnished upon request. Performance includes reinvestment of dividends and capital gains. Advisory fees and sales charges have been deducted. This illustration uses the maximum fee based on the size of the investment as noted at the top of this sheet. BTS fees vary depending on investment amount and program. Results will vary with fund used. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within this 2-3 day time period is likely to affect the results of the above illustration. All recommendations for the past year furnished upon request. Results reflect generally rising securities markets and will fluctuate with market and other economic conditions.

*Inception=beginning of BTS High Yield Program: January 2nd, 1981

**Source; Morningstar December 2006

***Standard deviation is applied to the annual rate of return of an investment, to measure the investment's volatility, or "risk".

BTS High Yield Bond Program Vs. Investment Benchmarks

$100,000 INITIAL INVESTMENT
26 Years (since inception)* ending December 31, 2006

	Number of negative Years	Worst Year	
BTS High Yield Bond Program	0	3.28%	2004
S&P 500	5**	-22.10%	2002
Lehman Credit Bond Index	2**	-3.92%	1994
Lehman Gov't Bond Index	2**	-3.37%	1994

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

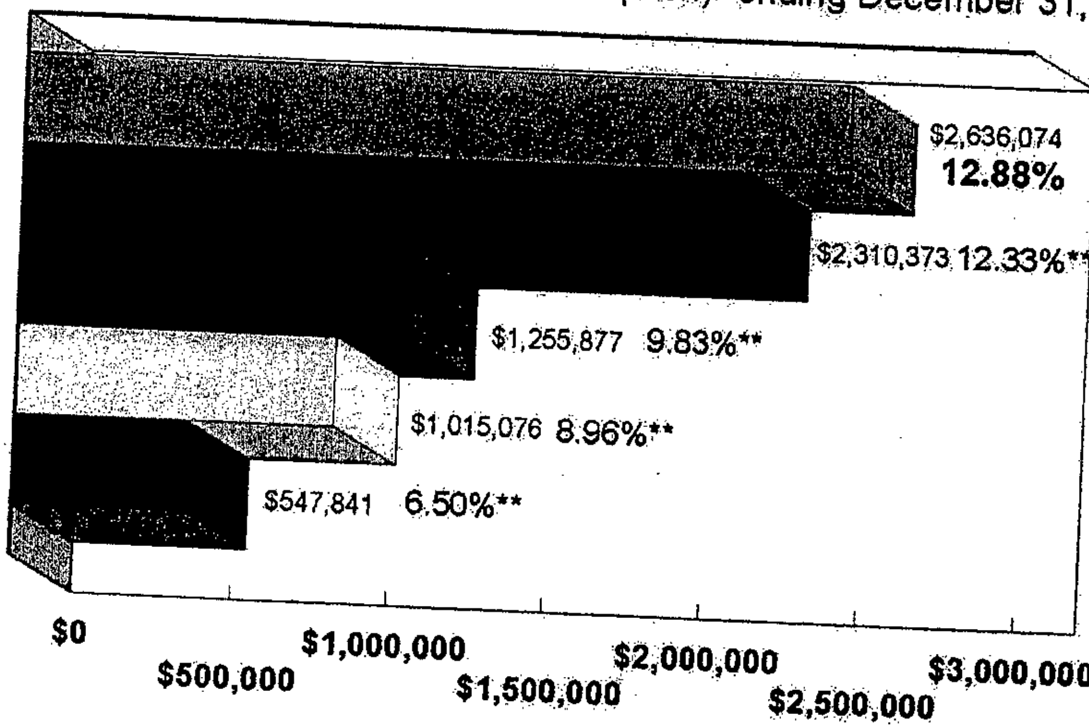
BTS=total dollar and annual compound return of a composite of five high yield bond funds using BTS buy/sell signals. The composite is a BTS derived composite of high yield bond funds that have existed since at least the inception of the BTS High Yield Program and have a history of working well with the High Yield Program. The composite consists of high yield funds that clients may or may not be able to invest in directly while employing the BTS High Yield Program. Name of funds furnished upon request. Performance includes reinvestment of dividends and capital gains. Advisory fees and sales charges have been deducted. This illustration uses the maximum fee based on the size of the investment as noted at the top of this sheet. BTS fees vary depending on investment amount and program. Results will vary with fund used. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within this 2-3 day time period is likely to affect the results of the above illustration. All recommendations for the past year furnished upon request. Results reflect generally rising securities markets and will fluctuate with market and other economic conditions.
*Inception=beginning of BTS High Yield Program: January 2nd, 1981
**Source, Morningstar December 2006

BTS ASSET MANAGEMENT

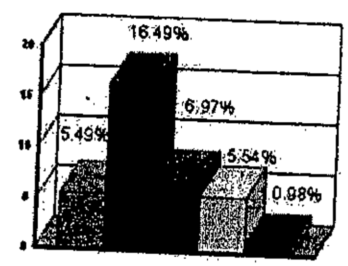
BTS High Yield Bond Program versus Investment Benchmarks

$100,000 INITIAL INVESTMENT

27 Years (Since Inception)* ending December 31, 2007



Standard Deviation***



PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

See additional information on the bottom of page 2.

BTS High Yield Bond Program Vs. Investment Benchmarks

$100,000 INITIAL INVESTMENT

27 Years (since inception)* ending December 31, 2007

	Number of negative Years	Worst Year	
BTS High Yield Bond Program	0	3.28%	2004
S&P 500	5**	-22.10%	2002
Lehman Credit Bond Index	2**	-3.92%	1994
Lehman Gov't Bond Index	2**	-3.37%	1994

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

BTS=total dollar and annual compound return of a composite of five high yield bond funds using BTS buy/sell signals. The composite is a BTS derived composite of high yield bond funds that have existed since at least the inception of the BTS High Yield Program and have been used with the High Yield Program. The composite consists of high yield funds that clients may or may not be able to invest in directly while employing the BTS High Yield Program. Name of funds furnished upon request. Performance includes reinvestment of dividends and capital gains. Advisory fees and sales charges have been deducted. This illustration uses the maximum fee based on the size of the investment as noted at the top of this sheet. BTS fees vary depending on investment amount and program. Results will vary with fund used. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within this 2-3 day time period is likely to affect the results of the above illustration. All recommendations for the past year furnished upon request. Results reflect generally rising securities markets and will fluctuate with market and other economic conditions.

S&P – A basket of 500 stocks that are considered to be widely held. The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole.

Lehman Brothers Credit Index – Includes all publicly issued, fixed rate, non-convertible investment grade corporate debt. The index is composed of both U.S. and Brady bonds.

Lehman Brothers Government Bond Index – Measures all publicly issued bonds issued by the U.S. government or its agencies with maturities of over one year.

6 Month CD - The Citigroup U.S. Domestic 6 Mo CD TR is an index created from a rotating sample of five banks and dealers surveyed daily on secondary market dealer offer rates for jumbo certificates of deposit

*Inception=beginning of BTS High Yield Program, January 2nd, 1981

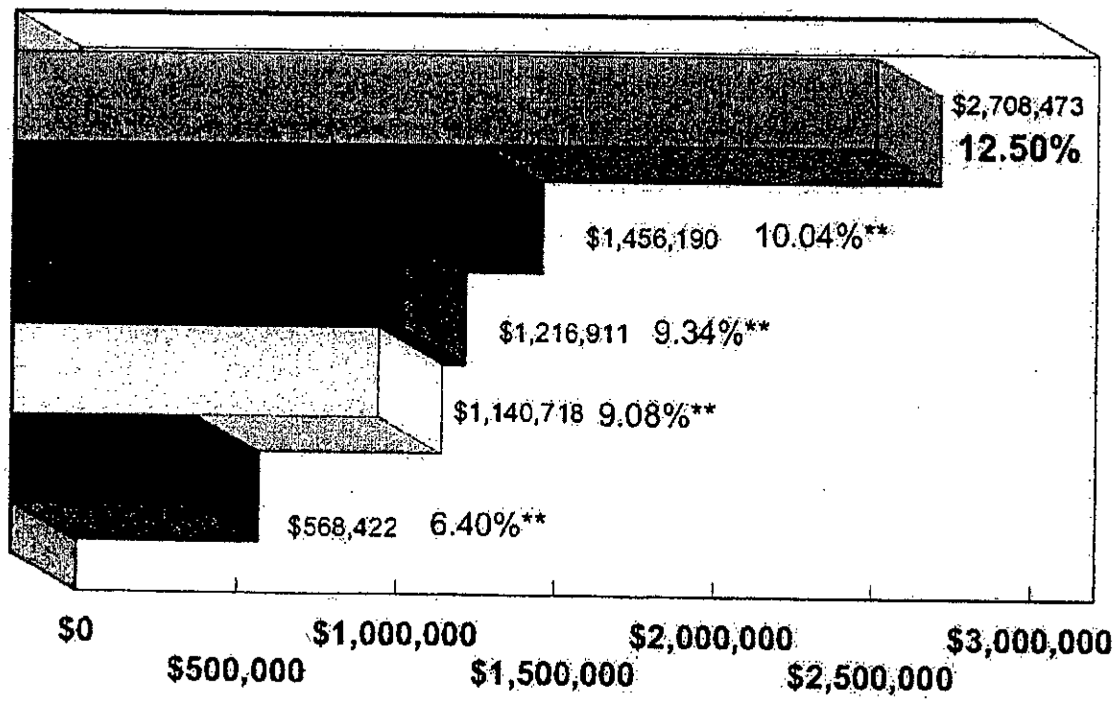
**Source, Morningstar December 2007

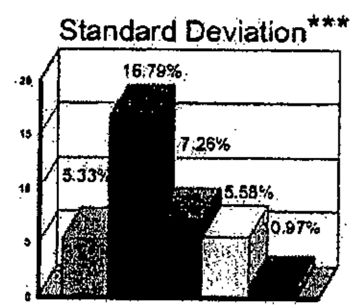
BTS ASSET MANAGEMENT

BTS High Yield Bond Program versus Investment Benchmarks

$100,000 INITIAL INVESTMENT

28 Years (Since Inception)* ending December 31, 2008





PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

See additional information on the bottom of page 2.

BTS High Yield Bond Program Vs. Investment Benchmarks

$100,000 INITIAL INVESTMENT

28 Years (since inception)* ending December 31, 2008

	Number of negative Years	Worst Year	
BTS High Yield Bond Program	0	2.82%	2008
S&P 500	6**	-37.00%	2008
BarCap US Credit Index	3**	-3.93%	1994
BarCap US Gov't Index	2**	-3.38%	1994

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

BTS: Total dollar and annual compound return of a composite of five high yield bond funds using BTS buy/sell signals. The composite is a BTS derived composite of high yield bond funds that have existed since at least the inception of the BTS High Yield Program and have been used with the High Yield Program. The composite consists of high yield funds that clients may or may not be able to invest in directly while employing the BTS High Yield Program. Name of funds furnished upon request. Performance includes reinvestment of dividends and capital gains. Advisory fees and sales charges have been deducted. This illustration uses the maximum fee based on the size of the investment as noted at the top of this sheet. BTS fees vary depending on investment amount and program. Results will vary with fund used. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within this 2-3 day time period is likely to affect the results of the above illustration. All recommendations for the past year furnished upon request. Results reflect generally rising securities markets and will fluctuate with market and other economic conditions. As with any investment, loss of capital is possible.

Risks: Investing in bond mutual funds carries some risks including; credit risk, which is the risk that the issuers of the bonds owned by a fund may default (fail to pay the debt that they owe on the bonds that they have issued), prepayment risk, which is the risk that the issuers of the bonds owned by a fund will prepay them at a time when interest rates have declined, and interest rate risk, which is the risk that the market value of the bonds owned by a fund will fluctuate as interest rates go up and down. High yield bonds generally have higher default risk than other types of bonds.

Indices: S&P -- A basket of 500 stocks that are considered to be widely held. The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole; Barclays Capital Credit Index -- Includes all publicly issued, fixed-rate, non-convertible investment grade corporate debt, the index is composed of both U.S. and Brady bonds, Barclays Capital Government Bond Index -- Measures all publicly issued bonds issued by the U.S. government or its agencies with maturities of over one year. Volatility of the indexes is materially different from that of the portfolio.
6 Month CD - The Citigroup U.S. Domestic 6 Mo CD TR is an index created from a rotating sample of five banks and dealers surveyed daily on secondary market dealer offer rates for jumbo certificates of deposit. Bank CDs are FDIC insured.

BTS Asset Management is affiliated with BTS Securities Corporation. Securities offered through BTS Securities Corporation and other FINRA member firms. Advisory services offered through BTS Asset Management.

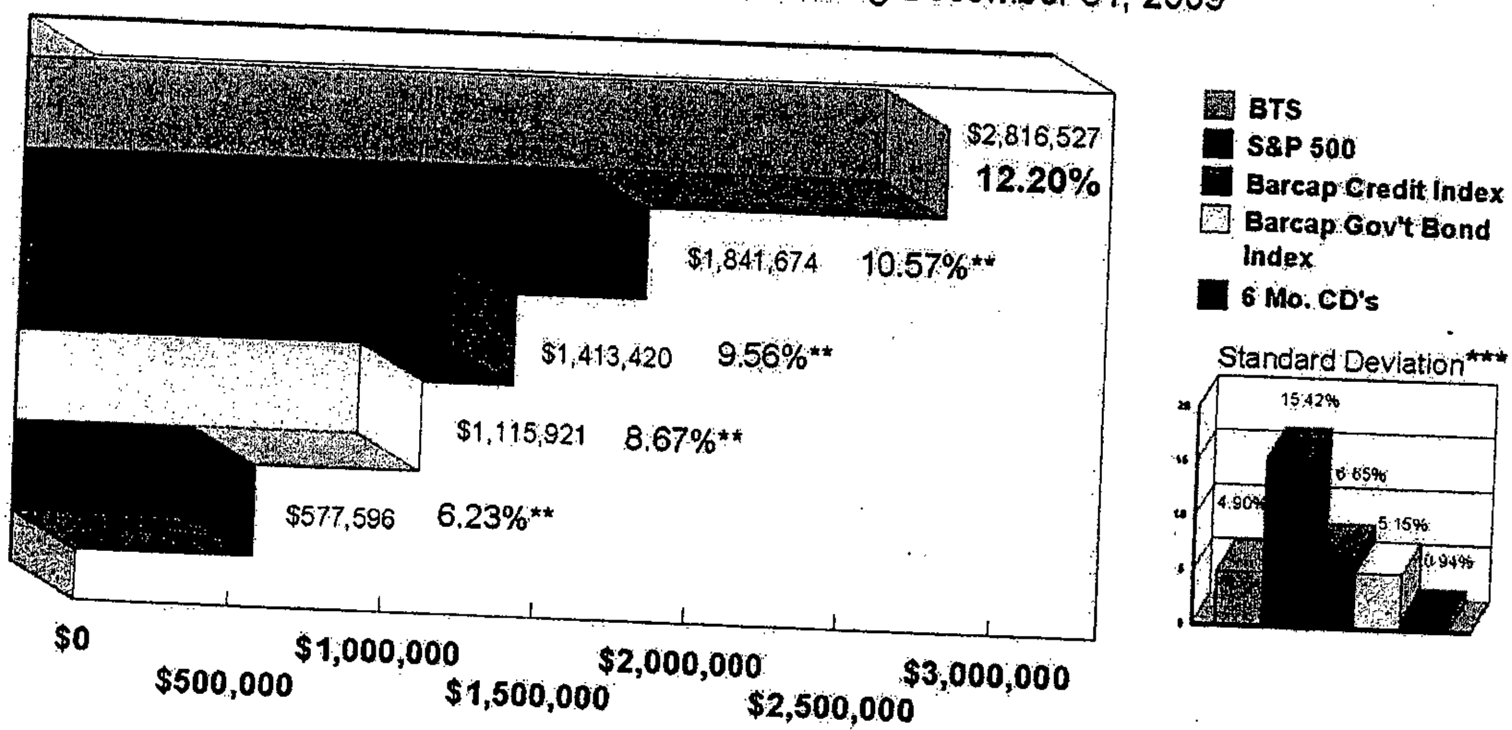
*Inception = beginning of BTS High Yield Program: January 2nd 1981
**Source, Morningstar December 2008
*** Standard Deviation = measures the degree of variation of returns around the average return, the higher the volatility the higher the standard deviation

BTS ASSET MANAGEMENT

BTS High Yield Bond Program versus Investment Benchmarks

$100,000 INITIAL INVESTMENT

29 Years (Since Inception)* ending December 31, 2009



PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

See additional information on the bottom of page 2.

BTS High Yield Bond Program vs. Investment Benchmarks

$100,000 INITIAL INVESTMENT

29 Years (since inception)* ending December 31, 2009

	Number of negative Years	Worst Year	
BTS High Yield Bond Program	0	2.82%	2008
S&P 500	6**	-37.00%	2008
BarCap Credit Bond Index	3**	-3.92%	1994
BarCap Gov't Bond Index	3**	-3.37%	1994

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

BTS. Returns of the High Yield Program from its inception on 1/2/81 through 6/30/06 uses a high yield bond composite and T-Bill. The high yield composite consists of 5 high yield mutual funds that have been in existence since the program's inception and have been used with BTS programs. Clients may or may not have been able to invest directly in these funds while employing the BTS High Yield Program. Name of funds furnished upon request. For performance since 7/1/06, Select HY returns were used. All recommendations for the past year furnished upon request. In Select HY, BTS selects the funds. The inception date of Select HY is 7/1/06. Select HY returns are used to show performance since 7/1/06 because BTS believes this to be the more desirable HY Program. The average annual return for the HY Program from 1/2/81 to 6/30/06 was 11.91%. The average annual return for the Select HY Program from 7/1/06 to 12/31/09 was 4.28%. Performance results are net of the maximum annual fees for a hypothetical $100,000 account charged quarterly, in advance. BTS fees vary depending on investment amount and program. Performance includes reinvestment of dividends and capital gains. Results will vary with fund used. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within this 2-3 day time period is likely to affect the results of the above illustration. Results reflect generally rising securities markets and will fluctuate with market and other economic conditions. As with any investment, loss of capital is possible.

Risks. Investing in bond mutual funds carries some risks including: credit risk, which is the risk that the issuers of the bonds owned by a fund may default (fail to pay the debt that they owe on the bonds that they have issued), prepayment risk, which is the risk that the issuers of the bonds owned by a fund will prepay them at a time when interest rates have declined, and interest rate risk, which is the risk that the market value of the bonds owned by a fund will fluctuate as interest rates go up and down. High yield bonds generally have higher default risk than other types of bonds.

Indexes: S&P – A basket of 500 stocks that are considered to be widely held. The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole; Barclays Capital Credit Index – includes all publicly issued, fixed-rate, non-convertible investment grade corporate debt; the index is composed of both U.S. and Brady bonds. Barclays Capital Government Bond Index – Measures all publicly issued bonds issued by the U.S. government or its agencies with maturities of over one year. Volatility of the indexes is materially different from that of the portfolio. 6 Month CD - The Citigroup U.S. Domestic 6 Mo CD TR is an index created from a rotating sample of five banks and dealers surveyed daily on secondary market dealer offer rates for jumbo certificates of deposit. Bank CDs are FDIC insured.

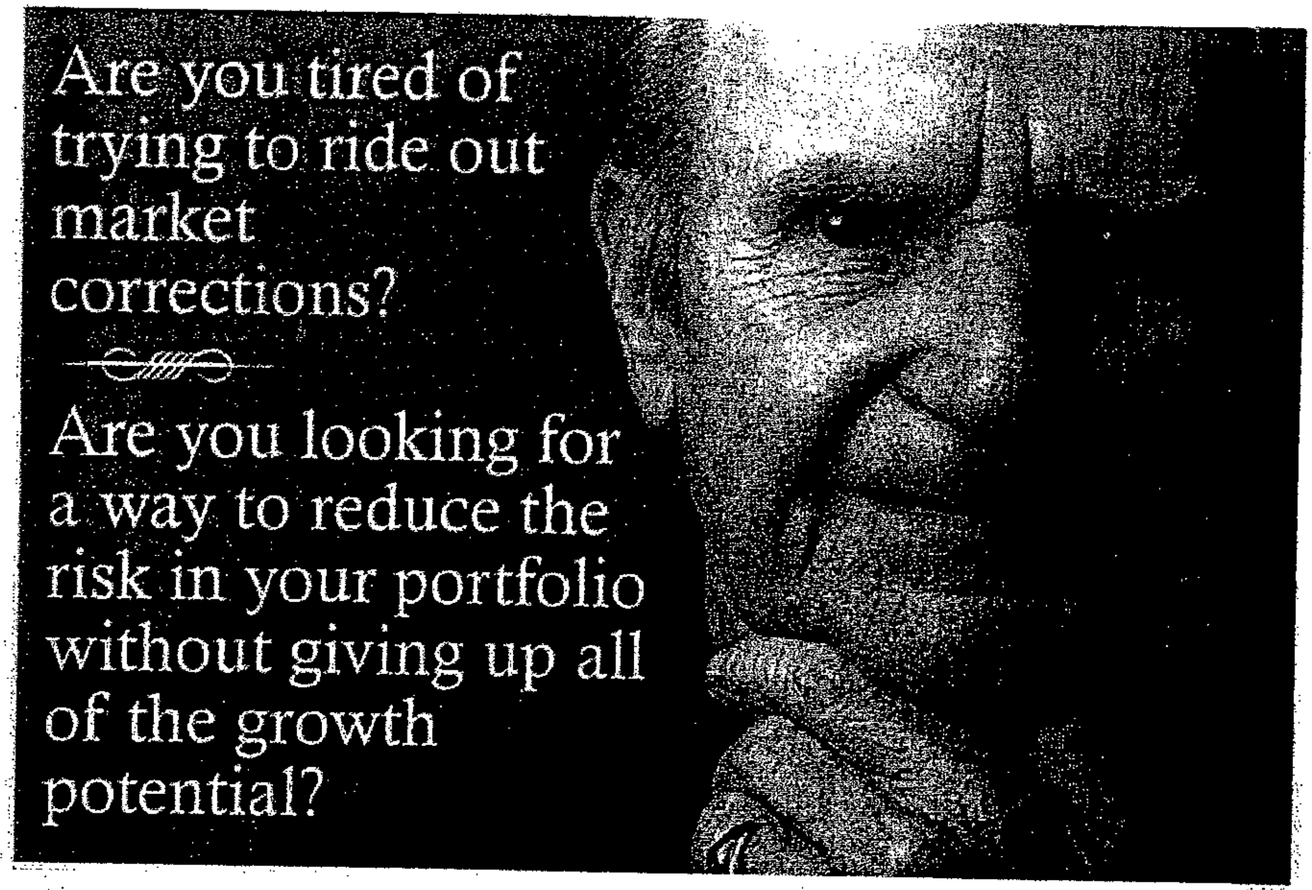
BTS Asset Management is affiliated with BTS Securities Corporation. Securities offered through BTS Securities Corporation and other FINRA member firms. Advisory services offered through BTS Asset Management.

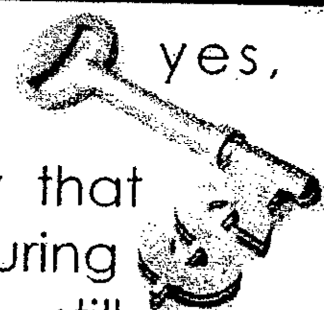
*Inception = beginning of BTS High Yield Program: January 2nd, 1981

**Source: Morningstar December 2009

*** Standard Deviation = measures the degree of variation of returns around the average return, the higher the volatility the higher the standard deviation

Exhibit D





If the answer to these questions is yes, then you may be interested in learning about a bond strategy that seeks to preserve capital during market declines while still producing strong returns over time. This strategy has avoided negative annual returns for 27 years*.

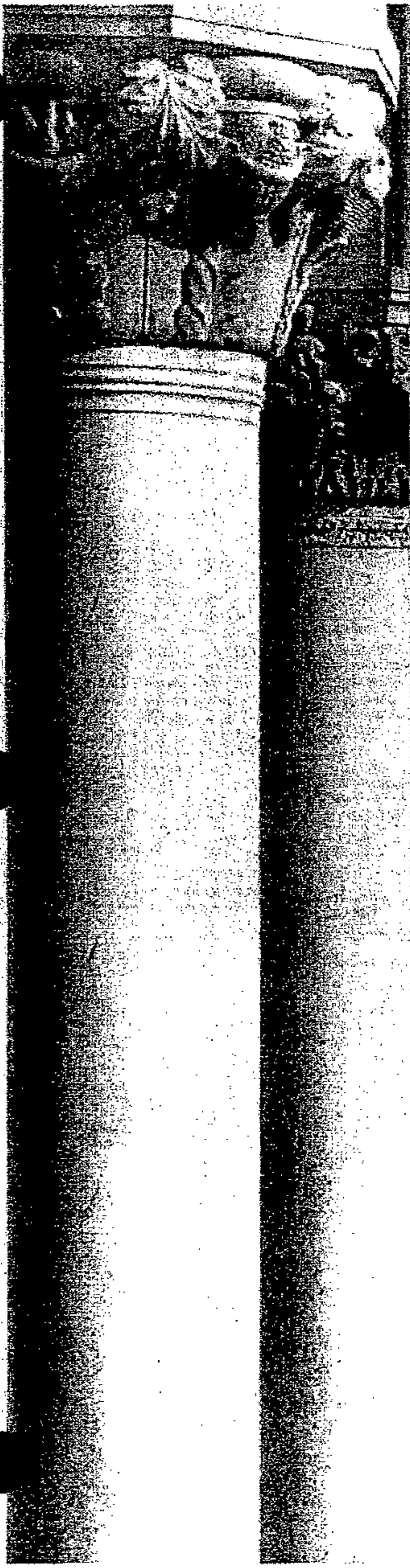
*Please see important information on the reverse side. →

BTS ASSET MANAGEMENT

*Results are based on the performance of the BTS Asset Management High Yield Program (inception date of 1/2/1981) using a composite of five high yield bond funds using BTS buy/sell signals. The composite is a BTS derived composite of high yield bond funds that have existed since at least the inception of the BTS High Yield Program and have been used with the High Yield Program. Depending on the high yield mutual funds or variable annuity sub-accounts used, not all clients experienced no down years in 27 years. Results will vary with the fund used. Results include the reinvestment of dividends and capital gains and after the deduction of BTS' maximum annual advisory fee. All recommendations for the past year furnished upon request. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within the 2-3 day time period is likely to affect the results. Results reflect generally rising securities markets and will fluctuate with the market and other economic conditions. Loss of capital is possible. Client may ultimately invest in a similar, but different, BTS program that does not have a 27 year track record. Please review the performance of the specific program you may invest in prior to investing in the BTS program.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Exhibit E



TIRED OF BEING TOLD TO RIDE OUT MARKET CORRECTIONS? STUCK IN A PORTFOLIO THAT OFFERS TOO MUCH RISK?

WOULD YOU BE INTERESTED IN HEARING ABOUT A BOND STRATEGY THAT HAS BEEN MANAGED IN SUCH A WAY AS TO AVOID A LOSING YEAR FOR OVER 27 CONSECUTIVE YEARS*?

FIND OUT MORE IN WORKSHOPS COMING THIS FALL

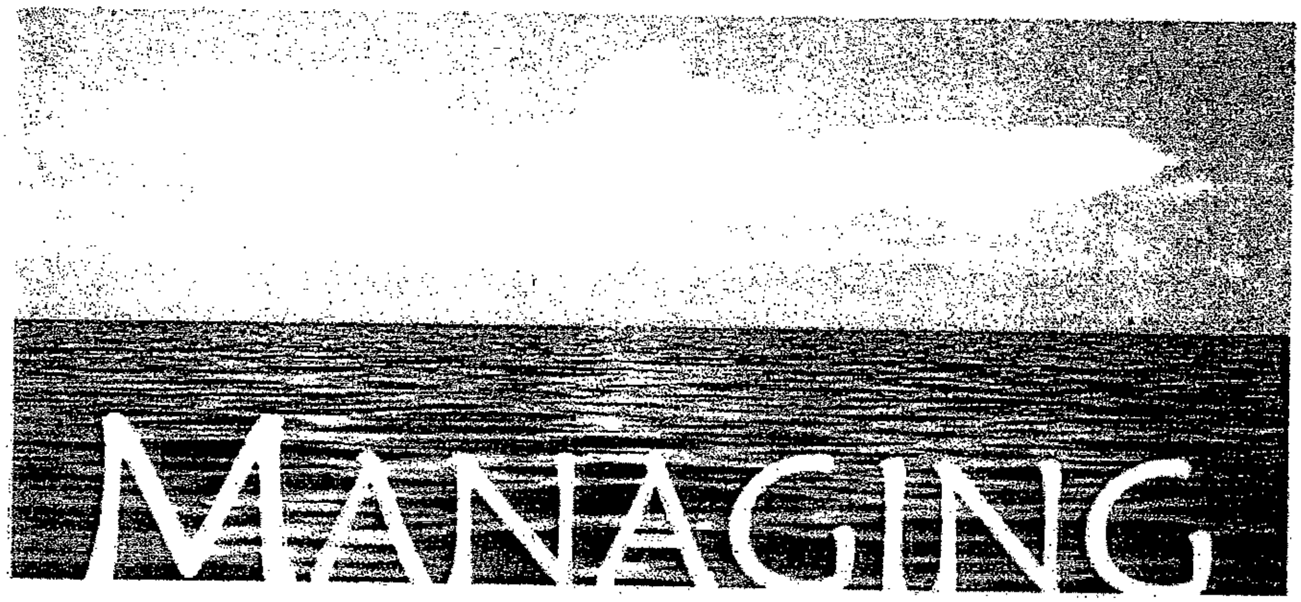
OR

CALL TODAY TO SETUP A PERSONAL WEBINAR

Securities and advisory services offered through Clove Capital Securities, member FINRA & SIPC.

*Results are based on the performance of the BTS Asset Management High Yield Program (inception date of 1/2/1981), using a composite of five high yield bond funds using BTS buy/sell signals. The composite is a BTS derived composite of high yield bond funds that have existed since at least the inception of the BTS High Yield Program and have been used with the High Yield Program. Depending on the high yield mutual funds or variable annuity sub-accounts used, not all clients experienced no down years in 27 years. Results will vary with the fund used. Results include the reinvestment of dividends and capital gains and after the deduction of BTS' maximum annual advisory fee. All recommendations for the past year furnished upon request. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within the 2-3 day time period is likely to affect the results. Results reflect generally rising securities markets and will fluctuate with the market and other economic conditions. Loss of capital is possible. Client may ultimately invest in a similar, but different, BTS program that does not have a 27 year track record. Please review the performance of the specific program you may invest in prior to investing in the BTS program.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

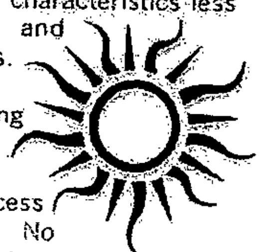


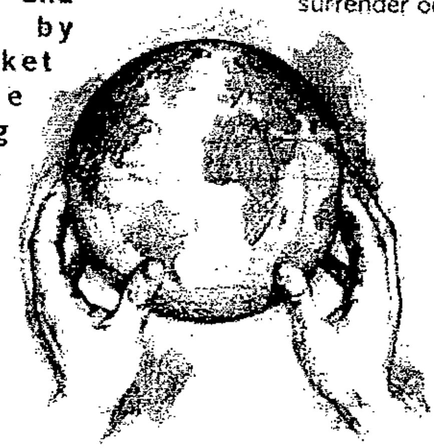
MANAGING YOUR INVESTMENTS

Tired of being told to ride out market corrections? Avoiding loss of principal is a primary key to long-term investment success. The risk of loss of principal is greatest in times of significant market volatility and uncertainty. Our goal is to help you achieve growth, income and capital preservation by participating in market advances and more importantly, by avoiding major losses during market declines. Would you be interested in hearing about a bond strategy that has been managed in such a way as to avoid a losing year for over 27 consecutive years*?

This tactical asset allocation program:

- Has produced strong investment returns over time with standard deviation characteristics less than government bonds and slightly higher than treasuries.
- Has preserved capital during market declines.
- Provides liquidity and full access to investment funds. No surrender or withdrawal charges.





BTS ASSET MANAGEMENT

*Please see important information on the reverse side

*Results are based on the performance of the BTS Asset Management High Yield Program (inception date of 1/1/1981) using certain high yield bond funds. Depending on the high yield mutual funds or variable annuity sub-accounts used, not all clients experienced no down years in 27 years. Results will vary with the fund used. Results include the reinvestment of dividends and capital gains and after the deduction of BTS' maximum annual advisory fee. All recommendations for the past year furnished upon request. Delays of 2-3 days may occur in implementing an exchange signal and may affect performance. Any exchange missed or not made within the 2-3 day time period is likely to affect the results. Results reflect generally rising securities markets and will fluctuate with the market and other economic conditions. Loss of capital is possible. Client may ultimately invest in a similar, but different, BTS program that does not have a 27 year track record. Please review the performance of the specific program you may invest in prior to investing in the BTS program.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Commissioner Walter not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3496 / October 31, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15084

In the Matter of **REEMA D. SHAH,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Reema D. Shah ("Shah" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over her and the subject matter of these proceedings and to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

Document 38 of 39

1. Shah, age 39, was a portfolio manager at J. & W. Seligman & Co., Inc., a New York, New York based investment advisor registered with the Commission that, in November 2008, was acquired by Ameriprise Financial, Inc., ("Ameriprise"), a Delaware holding company. Thereafter, Shah continued as a portfolio manager at RiverSource Investments, LLP ("RiverSource"), a registered investment advisor and a wholly-owned subsidiary of Ameriprise. Shah left Ameriprise in March 2011. She is a resident of Menlo Park, California. Shah received a bachelor's degree from the University of Pennsylvania and a Masters of Business Administration from the Kellogg School of Management at Northwestern University.

2. On October 12, 2012, a judgment was entered by consent against Shah, permanently enjoining her from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Reema Shah, Civil Action Number 12-CV-4030, in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged, inter alia, that, while working as a portfolio manager at RiverSource in 2009, Shah was tipped material, nonpublic information concerning a potential transaction between Yahoo!, Inc. ("Yahoo") and Microsoft Corporation ("Microsoft") by Robert Kwok ("Kwok"), a Senior Director at Yahoo, in violation of Kwok's duty to Yahoo. The complaint further alleged that Shah caused certain of the funds she managed to purchase shares of Yahoo based on that material, nonpublic information, and that she knew that the information was obtained in breach of a fiduciary duty or other duty of trust and confidence owed to the source of the information. The complaint also alleged that in April 2008 Shah tipped Kwok inside information regarding the acquisition of Moldflow Corp. ("Moldflow") by Autodesk, Inc. ("Autodesk") that had been misappropriated by an Autodesk insider.

4. On May 23, 2012, Shah pled guilty to one count of securities fraud and one count of conspiracy to commit securities fraud in violation of 15 U.S.C. §§ 78j(b) and 78ff and 18 U.S.C. § 371 before the United States District Court for the Southern District of New York in United States v. Reema Shah, 12-CR-404.

5. The counts of the criminal information to which Shah pled guilty alleged, inter alia, that Shah received information concerning the announcement of the potential deal between Yahoo and Microsoft from Kwok. Based on that information, Shah caused the purchase of approximately 700,000 shares of Yahoo. The criminal information also charged Shah with tipping Kwok inside information about Autodesk's acquisition of Moldflow.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Shah's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act that Respondent Shah be, and hereby is: barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 68125 / October 31, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-15085

In the Matter of **Careside, Inc.,** **Castcity.com, Inc.,** **Castle Corp. International,** **Cayenne Entertainment, Inc. (f/k/a Boeing Run, Inc.),** **CDT, Inc. (n/k/a CDT Acquisition, Inc.),** **Centurion Communications Corp.,** **Champion American Energy Reserves, Inc.,** **Charter Resources International, Inc.,** **Clemmy Technologies Corp., and** **Cryocon, Inc.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Careside, Inc., Castcity.com, Inc., Castle Corp. International, Cayenne Entertainment, Inc. (f/k/a Boeing Run, Inc.), CDT, Inc. (n/k/a CDT Acquisitions, Inc.), Centurion Communications Corp., Champion American Energy Reserves, Inc., Charter Resources International, Inc., Clemmy Technologies Corp., and Cryocon, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

Document 39 of 39

1. Careside, Inc. (CIK No. 1070602) is a void Delaware corporation located in Culver City, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Careside is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2002, which reported a net loss of over $10 million for the prior nine months. On October 11, 2002, Careside filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Central District of California, and the case was terminated on June 26, 2007. As of October 23, 2012, the company's stock (symbol "CASI") was traded on the over-the-counter markets.

2. Castcity.com, Inc. (CIK No. 1140295) is a permanently revoked Nevada corporation located in Irvine, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Castcity.com is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2002, which reported a net loss of over $7,000 for the prior nine months.

3. Castle Corp. International (CIK No. 1085066) is a permanently revoked Nevada corporation located in Santa Barbara, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Castle Corp. International is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2001, which reported a net loss of over $3,700 for the prior three months.

4. Cayenne Entertainment, Inc. (f/k/a Boeing Run, Inc.) (CIK No. 1103220) is a Colorado corporation located in Phoenix, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Cayenne Entertainment is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended January 31, 2001, which reported a net loss of over $3,100 for the prior nine months.

5. CDT, Inc. (n/k/a CDT Acquisitions, Inc.) (CIK No. 1103011) is a revoked Nevada corporation located in Salt Lake City, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CDT is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2001, which reported a net loss of over $6,600 for the prior nine months.

6. Centurion Communications Corp. (CIK No. 1108211) is a dissolved Colorado corporation located in Beverly Hills, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Centurion Communications is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2000.

7. Champion American Energy Reserves, Inc. (CIK No. 315263) is a Florida corporation located in Holladay, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Champion American Energy Reserves is delinquent in its periodic filings with the Commission, having not filed any

periodic reports since it filed a Form 10-QSB for the period ended September 30, 2001, which reported a net loss of over $10.1 million for the prior nine months. As of October 23, 2012, the company's stock (symbol "CGYJ") was traded on the over-the-counter markets.

8. Charter Resources International, Inc. (CIK No. 1139178) is a Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Charter Resources International is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 31, 2001, which failed to include financial statements.

9. Clemmy Technologies Corp. (CIK No. 1080934) is a revoked Nevada corporation located in Las Vegas, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Clemmy Technologies is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2006, which reported a net loss of $35 for the prior three months.

10. Cryocon, Inc. (CIK No. 837014) is a delinquent Colorado corporation located in Ogden, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Cryocon is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 31, 2002, which reported a net loss of over $1.4 million for the prior nine months.

B. DELINQUENT PERIODIC FILINGS

11. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

12. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

13. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary