

**SECURITIES AND EXCHANGE COMMISSION****17 CFR Parts 200 and 240**

[Release No. 34–86175; 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 and Segregation Requirements for Broker-Dealers****AGENCY:** Securities and Exchange Commission.**ACTION:** Final rule.

**SUMMARY:** In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), the Securities and Exchange Commission (“Commission”), pursuant to the Securities Exchange Act of 1934 (“Exchange Act”), is adopting 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 increasing the minimum net capital requirements for broker-dealers authorized to use internal models to compute net capital (“ANC broker-dealers”), and prescribing certain capital and segregation requirements for broker-dealers that are not SBSDs to the extent they engage in security-based swap and swap activity. The Commission also is making substituted compliance available with respect to capital and margin requirements under Section 15F of the Exchange Act and the rules thereunder and adopting a rule that specifies when a foreign SBSD or foreign MSBSP need not comply with the segregation requirements of Section 3E of the Exchange Act and the rules thereunder.

**DATES:***Effective date:* October 21, 2019.*Compliance date:* The compliance date is discussed in section III.B of this release.**FOR FURTHER INFORMATION CONTACT:**

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**SUPPLEMENTARY INFORMATION:****Table of Contents**

I. Introduction	
A. Background	
B. Overview of the New Requirements	
1. Capital Requirements	
2. Margin Requirements for Non-Cleared Security-Based Swaps	
3. Segregation Requirements	
4. Alternative Compliance Mechanism	
5. Cross-Border Application	
II. Final Rules and Rule Amendments	
A. Capital	
1. Introduction	
2. Capital Rules for Nonbank SBSDs	
3. Capital Rules for Nonbank MSBSPs	
4. OTC Derivatives Dealers	
B. Margin	
1. Introduction	
2. Margin Requirements for Nonbank SBSDs and Nonbank MSBSPs	
C. Segregation	
1. Background	
2. Exemption	
3. Segregation Requirements for Security-Based Swaps	
D. Alternative Compliance Mechanism	
E. Cross-Border Application of Capital, Margin, and Segregation Requirements	
1. Capital and Margin Requirements	
2. Segregation Requirements	
F. Delegation of Authority	
III. Explanation of Dates	
A. Effective Date	
B. Compliance Dates	
C. Effect on Existing Commission Exemptive Relief	
D. Application to Substituted Compliance	
IV. Paperwork Reduction Act	
A. Summary of Collections of Information Under the Rules and Rule Amendments	
1. Rule 18a–1 and Amendments to Rule 15c3–1	
2. Rule 18a–2	
3. Rule 18a–3	
4. Rule 18a–4 and Amendments to Rule 15c3–3	
5. Rule 18a–10	
6. Amendments to Rule 3a71–6	
B. Use of Information	
C. Respondents	
D. Total Initial and Annual Recordkeeping and Reporting Burden	
1. Rule 18a–1 and Amendments to Rule 15c3–1	
2. Rule 18a–2	
3. Rule 18a–3	
4. Rule 18a–4 and Amendments to Rule 15c3–3	
5. Rule 18a–10	
6. Rule 3a71–6	
E. Collection of Information Is Mandatory	
F. Confidentiality	
G. Retention Period for Recordkeeping Requirements	
V. Other Matters	
VI. Economic Analysis	

## A. Baseline

1. Market Participants
  2. Counterparty Credit Risk Mitigation
  3. Global Regulatory Efforts
  4. Capital Regulation
  5. Margin Regulation
  6. Segregation
  7. Historical Pricing Data
- B. Analysis of the Final Rules and Alternatives
1. The Capital Rules for Nonbank SBSDs—Rules 15c3–1 and 18a–1
  2. The Capital Rule for Nonbank MSBSPs—Rule 18a–2
  3. The Margin Rule—Rule 18a–3
  4. The Segregation Rules—Rules 15c3–3 and 18a–4
  5. Cross-Border Application
  6. Rule 18a–10
- C. Implementation Costs
- D. Effects on Efficiency, Competition, and Capital Formation
1. Efficiency and Capital Formation
  2. Competition
- VII. Regulatory Flexibility Act Certification
- VIII. Statutory Basis

**I. Introduction***A. Background*

Title VII of the Dodd-Frank Act (“Title VII”) established a new regulatory framework for the U.S. over-the-counter (“OTC”) derivatives markets.<sup>1</sup> Section 764 of the Dodd-Frank Act added Section 15F to the Exchange Act.<sup>2</sup> Section 15F(e)(1)(B) of the Exchange Act provides that the Commission shall prescribe capital and margin requirements for SBSDs and

<sup>1</sup> See Public Law 111–203, 701 through 774. The Dodd-Frank Act assigns primary responsibility for the oversight of the U.S. OTC derivatives markets to the Commission and the Commodity Futures Trading Commission (“CFTC”). 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 those terms. See *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) (“*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. 66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012) (“*Entity Definitions Adopting Release*”).

<sup>2</sup> 15 U.S.C. 78o–10 (“Section 15F of the Exchange Act” or “Section 15F”).

MSBSPs that do not have a prudential regulator (respectively, “nonbank SBSBs” and “nonbank MSBSPs”).<sup>3</sup> Section 763 of the Dodd-Frank Act added Section 3E to the Exchange Act.<sup>4</sup> Section 3E provides the Commission with the authority to establish segregation requirements for SBSBs and MSBSPs.<sup>5</sup> The Commission also has separate and independent authority under Section 15 of the Exchange Act to prescribe capital and segregation requirements for broker-dealers.<sup>6</sup>

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”).<sup>7</sup> Section 15F(e)(1)(A) of the Exchange Act provides that the prudential regulators shall prescribe capital and margin requirements for SBSBs and MSBSPs that have a prudential regulator (respectively, “bank SBSBs” and “bank MSBSPs”). 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 (respectively, “bank swap dealers” and “bank swap

participants”).<sup>8</sup> The prudential regulators have adopted capital and margin requirements for bank SBSBs and MSBSPs and for bank swap dealers and major swap participants.<sup>9</sup> The CFTC has adopted margin requirements and proposed capital requirements for nonbank swap dealers and major swap participants.<sup>10</sup> The CFTC also has adopted segregation requirements for cleared and non-cleared swaps.<sup>11</sup>

In October 2012, the Commission proposed: (1) Capital and margin requirements for nonbank SBSBs and MSBSPs, segregation requirements for SBSBs, and notification requirements relating to segregation for SBSBs and MSBSPs; and (2) raising the minimum net capital requirements and establishing liquidity requirements for ANC broker-dealers.<sup>12</sup> The Commission received a number of comment letters in response to the 2012 proposals.<sup>13</sup> In May 2013, the Commission proposed provisions regarding the cross-border treatment of security-based swap capital, margin, and segregation requirements.<sup>14</sup> The Commission received comments on these proposals as well.<sup>15</sup> In 2014, the Commission proposed an additional capital requirement for nonbank SBSBs that

was inadvertently omitted from the 2012 proposals.<sup>16</sup>

Finally, in 2018, the Commission reopened the comment period and requested additional comment on the proposed rules and amendments (including potential modifications to proposed rule language).<sup>17</sup> Some commenters supported the reopening of the comment period as a means to help ensure that the final rules reflect current market conditions.<sup>18</sup> One commenter stated that the publication of the potential modifications to the proposed rule language provided important transparency in the development of this rulemaking.<sup>19</sup> Other commenters stated that the Commission did not provide them with an adequate basis upon which to comment, and argued that it was not possible to fully assess the potential modifications to the proposed rules without a full re-proposal.<sup>20</sup> The Commission disagrees. The potential modifications to the proposed rule language published in the release described how the rule text proposed in 2012 could be changed, including specific potential rule language. This approach provided the public with a meaningful opportunity to comment on potential modifications to the proposed rule text.

Today, the Commission is amending existing rules and adopting new rules. In particular, the Commission is amending existing rules 17 CFR 240.15c3-1 (“Rule 15c3-1”), 17 CFR

<sup>3</sup> Specifically, Section 15F(e)(1)(B) of the Exchange Act provides that each registered SBSB 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. 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 SBSB, MSBSP, swap participant, or major swap participant if the entity is directly supervised by that agency.

<sup>4</sup> 15 U.S.C. 78c-5 (“Section 3E of the Exchange Act” or “Section 3E”).

<sup>5</sup> Section 3E of the Exchange Act does not distinguish between bank and nonbank SBSBs and MSBSPs, and, consequently, provides the Commission with the authority to establish segregation requirements for SBSBs and MSBSPs (whether or not they have a prudential regulator).

<sup>6</sup> 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 market 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. 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).”

<sup>7</sup> See 7 U.S.C. 6s(e)(1)(B).

<sup>8</sup> See 7 U.S.C. 6s(e)(1)(A).

<sup>9</sup> See *Margin and Capital Requirements for Covered Swap Entities*, 80 FR 74840 (Nov. 30, 2015) (“*Prudential Regulator Margin and Capital Adopting Release*”). The prudential regulators, as part of their margin requirements for non-cleared security-based swaps, adopted a segregation requirement for collateral received as margin.

<sup>10</sup> See *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR 636 (Jan. 6, 2016) (“*CFTC Margin Adopting Release*”); *Capital Requirements of Swap Dealers and Major Swap Participants*, 81 FR 91252 (Dec. 16, 2016) (“*CFTC Capital Proposing Release*”).

<sup>11</sup> See *Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions*, 77 FR 6336 (Feb. 7, 2012); *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy*, 78 FR 66621 (Nov. 6, 2013); *Segregation of Assets Held as Collateral in Uncleared Swap Transactions*, 84 FR 12894 (Apr. 3, 2019).

<sup>12</sup> See *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, Exchange Act Release No. 68071, (Oct. 18, 2012), 77 FR 70214 (Nov. 23, 2012) (“*Capital, Margin, and Segregation Proposing Release*”).

<sup>13</sup> The comment letters are available at <https://www.sec.gov/comments/s7-08-12/s70812.shtml>.

<sup>14</sup> See *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*, Exchange Act Release No. 69490 (May 1, 2013), 78 FR 30968 (May 23, 2013) (“*Cross-Border Proposing Release*”).

<sup>15</sup> The comment letters are available at <https://www.sec.gov/comments/s7-02-13/s70213.shtml>.

<sup>16</sup> See *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers*, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 FR 25194, 25254 (May 2, 2014). The Commission received one comment addressing this proposal. See Letter from Suzanne H. Shatto (July 9, 2014) (“Shatto Letter”), available at <https://www.sec.gov/comments/s7-05-14/s70514.shtml>.

<sup>17</sup> See *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, Exchange Act Release No. 84409 (Oct. 11, 2018), 83 FR 53007 (Oct. 19, 2018) (“*Capital, Margin, and Segregation Comment Reopening*”).

<sup>18</sup> See Letter from Stephen John Berger, Managing Director, Government & Regulatory Policy, Citadel Securities (Nov. 19, 2018) (“Citadel 11/19/2018 Letter”); Letter from Bridget Polichene, Chief Executive Officer, Institute of International Bankers (Nov. 19, 2018) (“IIB 11/19/2018 Letter”).

<sup>19</sup> See Letter from Sebastian Crapanzano and Soo-Mi Lee, Managing Directors, Morgan Stanley (Nov. 19, 2018) (“Morgan Stanley 11/19/2018 Letter”).

<sup>20</sup> See, e.g., Letter from Carl B. Wilkerson, Vice President and Chief Counsel, Securities, American Council of Life Insurers (Nov. 19, 2018) (“American Council of Life Insurers 11/19/18 Letter”); Letter from Dennis M. Kelleher, President and Chief Executive Officer, Better Markets, Inc. (Nov. 19, 2018) (“Better Markets 11/19/2018 Letter”); Letter from Susan M. Olson, General Counsel, Investment Company Institute (Nov. 19, 2018) (“ICI 11/19/2018 Letter”).

240.15c3-1a ("Rule 15c3-1a"), 17 CFR 240.15c3-1b ("Rule 15c3-1b"), 17 CFR 240.15c3-1d ("Rule 15c3-1d"), 17 CFR 240.15c3-1e ("Rule 15c3-1e"), 17 CFR 240.15c3-3 ("Rule 15c3-3") and adopting new Rules 15c3-3b, 18a-1, 18a-1a, 18a1b, 18a1c, 18a-1d, 18a-2, 18a-3, 18a-4, 18a-4a, and 18a-10. The amendments and new rules establish capital and margin requirements for nonbank SBSDs, including for: (1) Broker-dealers that are registered as SBSDs ("broker-dealer SBSDs");<sup>21</sup> (2) broker-dealers that are registered as MSBSPs ("broker-dealer MSBSPs"); (3) nonbank SBSDs that are not registered as broker-dealers ("stand-alone SBSDs"); and (4) nonbank MSBSPs that are not registered as broker-dealers ("stand-alone MSBSPs"). They also establish segregation requirements for SBSDs and notification requirements with respect to segregation for SBSDs and MSBSPs. Further, the amendments provide that a nonbank SBSD that is also registered as an OTC derivatives dealer is subject to Rules 18a-1, 18a-1a, 18a-1b, 18a-1c, and 18a-1d rather than Rule 15c3-1 and its appendices.

The rule amendments also increase the minimum tentative net capital and net capital requirements for ANC broker-dealers. In addition to the new requirements for ANC broker-dealers, some of the amendments to Rules 15c3-1 and 15c3-3 apply to broker-dealers that are not registered as an SBSD or MSBSP ("stand-alone broker-dealers") to the extent they engage in security-based swap activities.

Additionally, the Commission is amending its existing cross-border rule to provide a mechanism to seek substituted compliance with respect to the capital and margin requirements for foreign nonbank SBSDs and MSBSPs and providing guidance on how it will evaluate requests for substituted compliance.<sup>22</sup> The Commission is adopting rule-based requirements that address the application of the

segregation requirements to cross-border security-based swap transactions.

The Commission also is amending its rules governing the delegation of authority to provide the staff with delegated authority to take certain actions with respect to some of the requirements.

The Commission is not adopting the proposed liquidity stress test requirements at this time.<sup>23</sup> Instead, the Commission continues to consider the comments received on those proposals.

The Commission staff consulted with the CFTC and the prudential regulators in drafting the final rules and amendments.

Finally, the Commission recognizes that the firms subject to the requirements being adopted today are operating in a market that continues to experience significant changes in response to market and regulatory developments. Given the global nature of the security-based swap and swap markets, the regulatory landscape will continue to shift as U.S. and foreign regulators continue to implement and/or modify relevant regulatory frameworks that apply to participants in these markets and to their transactions. For example, the CFTC has proposed but not yet finalized its own capital requirements that will apply to swap dealers, some of which will also likely be registered with the Commission as SBSDs. The Commission intends to monitor these developments during the period before the compliance date for these rules and may consider modifications to the requirements that it is adopting today as circumstances dictate, such as the need to further harmonize with other regulators to minimize the risk of unnecessary market fragmentation, or to address other market developments.<sup>24</sup>

In addition, the Commission intends to monitor the impact of the capital, margin, and segregation requirements being adopted today using data about the security-based swap and swap activities of stand-alone broker-dealers and SBSDs once they are subject to these requirements. The data will include the capital they maintain, the liquidity they maintain, the leverage they employ, the scale of their security-based swap and swap activities, the types and amounts of collateral they hold to address credit exposures, and the risk management controls they establish. The Commission may

consider modifications to the requirements in light of these data.

## B. Overview of the New Requirements

### 1. Capital Requirements

#### a. SBSDs

Broker-dealer SBSDs will be subject to the pre-existing requirements of Rule 15c3-1, as amended, to account for security-based swap and swap activities. Stand-alone SBSDs (including firms also registered as OTC derivatives dealers) will be subject to Rule 18a-1. Rule 18a-1 is structured similarly to Rule 15c3-1 and contains many provisions that correspond to those in Rule 15c3-1, as amended.

These rules prescribe minimum net capital requirements for nonbank SBSDs that are the greater of a fixed-dollar amount and an amount derived by applying a financial ratio. A broker-dealer SBSD must be an ANC broker-dealer ("ANC broker-dealer SBSD") in order to use models to calculate market and credit risk charges in lieu of applying standardized deductions (also known as haircuts) for certain approved positions. An ANC broker-dealer, including an ANC broker-dealer SBSD, will be subject to a minimum fixed-dollar tentative net capital requirement of \$5 billion and a minimum fixed-dollar net capital requirement of \$1 billion. Stand-alone SBSDs that use models will be subject to a minimum fixed-dollar tentative net capital requirement of \$100 million and a minimum fixed-dollar net capital requirement of \$20 million. Broker-dealer and stand-alone SBSDs not authorized to use models will be subject to a fixed-dollar minimum net capital requirement of \$20 million but will not be subject to a fixed-dollar tentative net capital requirement.

The financial ratio-derived minimum net capital requirement applicable to an ANC broker-dealer, including an ANC broker-dealer SBSD, and a broker-dealer SBSD not authorized to use models will be the amount computed using one of the two pre-existing (*i.e.*, were part of the rule before today's amendments) financial ratios in Rule 15c3-1 plus an amount computed using a new financial ratio tailored specifically to the firm's security-based swap activities. This new financial ratio requirement is 2% of an amount determined by calculating the firm's exposures to its security-based swap customers ("2% margin factor"). A stand-alone SBSD will be subject to the 2% margin factor but will not be subject to either of the pre-existing financial ratios in Rule 15c3-1. The 2% margin factor multiplier will remain at 2% for 3 years after the compliance date of the

<sup>21</sup> The term "broker-dealer" when used in this release generally does not refer to an OTC derivatives dealer. See 17 CFR 240.3b-12 ("Rule 3b-12") (defining the term "OTC derivatives dealer"). Instead, this class of dealer is referred to as an "OTC derivatives dealer" and, except when discussing the alternative compliance mechanism of Rule 18a-10, the term "stand-alone SBSD" includes a nonbank SBSD that is also registered as an OTC derivatives dealer. The alternative compliance mechanism is discussed below in sections I.B.4., II.D., IV.A.6., IV.D.6., and VI.B.1. of this release, among other sections. As discussed below, the alternative compliance mechanism is not available to nonbank SBSDs that are registered as either a broker-dealer or an OTC derivatives dealer. Consequently, the term "stand-alone SBSD," in the context of discussing the alternative compliance mechanism, refers to a stand-alone SBSD that is not also registered as an OTC derivatives dealer.

<sup>22</sup> 17 CFR 240.3a71-6 ("Rule 3a71-6").

<sup>23</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70252-54.

<sup>24</sup> The compliance date for the amendments and rules being adopted today is discussed below in section III.B. of this release.

rule. After 3 years, the multiplier could increase to not more than 4% by Commission order, and after 5 years the multiplier could increase to not more than 8% by Commission order if the Commission had previously issued an order raising the multiplier to 4% or

less. The final rules further provide that the Commission will consider the capital and leverage levels of the firms subject to these requirements as well as the risks of their security-based swap positions and will provide notice before issuing an order raising the multiplier.

This approach will enable the Commission to analyze the impact of the new requirement.

The following table summarizes the minimum net capital requirements applicable to nonbank SBSBs as of the compliance date of the rule.

Type of registrant	Rule	Tentative net capital	Net capital	
			Fixed-dollar	Financial ratio
Stand-alone SBSB (not using internal models).	18a-1 .....	N/A .....	\$20 million .....	2% margin factor.
Stand-alone SBSB (using internal models) <sup>1</sup>	18a-1 .....	\$100 million .....	20 million .....	2% margin factor.
Broker-dealer SBSB .....	15c3-1 .....	N/A .....	20 million .....	2% margin factor +
(not using internal models) .....				Rule 15c3-1 ratio.
Broker-dealer SBSB (using internal models)	15c3-1 .....	\$5 billion .....	1 billion .....	2% margin factor +
				Rule 15c3-1 ratio.

<sup>1</sup> Includes a stand-alone SBSB that also is an OTC derivatives dealer.

Nonbank SBSBs will compute net capital by first determining their net worth under U.S. generally accepted accounting principles ("GAAP"). Next, the firms will need to deduct illiquid assets and take other deductions from net worth, and may add qualified subordinated loans. The deductions will be the same as required under the pre-existing requirements of Rule 15c3-1.

In addition, the Commission is prescribing new deductions tailored specifically to security-based swaps and swaps. For example, stand-alone broker-dealers and nonbank SBSBs will be required to take a deduction for undermargined accounts because of a failure to collect margin required under Commission, CFTC, clearing agency, derivatives clearing organization ("DCO"), or designated examining authority ("DEA") rules (*i.e.*, a failure to collect margin when there is no exception from collecting margin). Nonbank SBSBs also will be required to take deductions when they elect not to collect margin pursuant to exceptions in the margin rules of the Commission and the CFTC for non-cleared security-based swaps and swaps, respectively. These deductions for electing not to collect margin must equal 100% of the amount of margin that would have been required to be collected from the security-based swap or swap counterparty in the absence of an exception (*i.e.*, the size of the deduction will be computed using the standardized or model-based approach prescribed in the margin rules of the Commission or the CFTC, as applicable). These deductions can be reduced by the value of collateral held in the account after applying applicable haircuts to the value of the collateral. In addition, as discussed below, nonbank SBSBs authorized to use models may

take credit risk charges instead of these deductions for electing not to collect margin under exceptions in the margin rules of the Commission and the CFTC for non-cleared security-based swaps and swaps.

After taking these deductions and making other adjustments to net worth, the amount remaining is defined as "tentative net capital." The final steps a stand-alone broker-dealer or nonbank SBSB will need to take in computing net capital are: (1) To deduct haircuts (standardized or model-based) on their proprietary securities and commodity positions; and (2) for firms authorized to use models, to deduct credit risk charges computed using credit risk models.

The haircuts for proprietary securities and commodity positions will be determined using standardized or model-based haircuts. The standardized haircuts for positions—other than security-based swaps and swaps—generally are the pre-existing standardized haircuts required by Rule 15c3-1. With respect to security-based swaps and swaps, the Commission is prescribing standardized haircuts tailored to those instruments. In the case of a cleared security-based swap or swap, the standardized haircut is the applicable clearing agency or DCO margin requirement. For a non-cleared credit default swap ("CDS"), the standardized haircut is set forth in two grids (one for security-based swaps and one for swaps) in which the amount of the deduction is based on two variables: the length of time to maturity of the CDS contract and the amount of the current offered basis point spread on the CDS. For other types of non-cleared security-based swaps and swaps, the standardized haircut generally is the percentage deduction of the

standardized haircut that applies to the underlying or referenced position multiplied by the notional amount of the security-based swap or swap.

Instead of applying these standardized haircuts, stand-alone broker-dealers and nonbank SBSBs may apply to the Commission to use a model to calculate market and credit risk charges (model-based haircuts) for their positions, including derivatives instruments such as security-based swaps and swaps. The application and approval process will be similar to the process used for stand-alone broker-dealers applying to the Commission for authorization to use models under the pre-existing provisions of Rules 15c3-1 and 15c3-1e (*i.e.*, stand-alone broker-dealers applying to become ANC broker-dealers). If approved, the firm may compute market risk charges for certain of its proprietary positions using a model.

In addition, an ANC broker-dealer (including an ANC broker-dealer SBSB) and a stand-alone SBSB approved to use models for capital purposes can apply a credit risk charge with respect to uncollateralized exposures arising from derivatives instruments, including exposures arising from not collecting variation and/or initial margin pursuant to exceptions in the non-cleared security-based swap and swap margin rules of the Commission and CFTC, respectively. Consequently, these credit risk charges may be taken instead of the deductions described above when a nonbank SBSB does not collect variation and/or initial margin pursuant to exceptions in these margin rules.

In applying the credit risk charges, an ANC broker-dealer (including an ANC broker-dealer SBSB) is subject to a portfolio concentration charge that has a threshold equal to 10% of the firm's tentative net capital. Under the portfolio

concentration charge, the application of the credit risk charges to uncollateralized *current* exposure across all counterparties arising from derivatives transactions is limited to an amount of the current exposure equal to no more than 10% of the firm's tentative net capital. The firm must take a charge equal to 100% of the amount of the firm's aggregate current exposure in excess of 10% of its tentative net capital. Uncollateralized *potential*

future exposures arising from electing not to collect initial margin pursuant to exceptions in the margin rules of the Commission and the CFTC are not subject to this portfolio concentration charge. In addition, a stand-alone SBSB, including an SBSB operating as an OTC derivatives dealer, is not subject to a portfolio concentration charge with respect to uncollateralized current exposure. However, all these entities (*i.e.*, ANC broker-dealers, ANC broker-

dealer SBSBs, stand-alone SBSBs, and stand-alone SBSBs that also are registered as OTC derivatives dealers) are subject to a concentration charge for large exposures to single a counterparty that is calculated using the existing methodology in Rule 15c3-1e.<sup>25</sup>

The following table summarizes the entities that are subject to the portfolio concentration charge and/or the counterparty concentration charge.

Entity type (must be approved to use models)	10% TNC portfolio concentration charge	Counterparty concentration charge
ANC broker-dealer .....	Yes .....	Yes.
ANC broker-dealer SBSB .....	Yes .....	Yes.
Stand-alone SBSB .....	No .....	Yes.
Stand-alone SBSB/OTC derivatives dealer .....	No .....	Yes.

Nonbank SBSBs also must comply with Rule 15c3-4. This rule will require them 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.

#### b. MSBSPs

Rule 18a-2 prescribes the capital requirements for stand-alone MSBSPs.<sup>26</sup> Under this rule, stand-alone MSBSPs must at all times have and maintain positive tangible net worth. The term "tangible net worth" is defined to mean the stand-alone MSBSP's net worth as determined in accordance with GAAP, excluding goodwill and other intangible assets. All MSBSPs must comply with Rule 15c3-4 with respect to their security-based swap and swap activities.

### 2. Margin Requirements for Non-Cleared Security-Based Swaps

#### a. SBSBs

Rule 18a-3 prescribes margin requirements for nonbank SBSBs with respect to non-cleared security-based swaps. The rule requires a nonbank SBSB to perform two calculations with respect to each account of a counterparty as of the close of business each day: (1) The amount of current exposure in the account of the counterparty (also known as variation margin); and (2) the initial margin amount for the account of the counterparty (also known as potential future exposure or initial margin). Variation margin is calculated by

marking the position to market. Initial margin must be calculated by applying the standardized haircuts prescribed in Rule 15c3-1 or 18a-1 (as applicable). However, a nonbank SBSB may apply to the Commission for authorization to use a model (including an industry standard model) to calculate initial margin. Broker-dealer SBSBs must use the standardized haircuts (which include the option to use the more risk sensitive methodology in Rule 15c3-1a) to compute initial margin for non-cleared equity security-based swaps (even if the firm is approved to use a model to calculate initial margin). Stand-alone SBSBs (including firms registered as OTC derivatives dealers) may use a model to calculate initial margin for non-cleared equity security-based swaps (and potentially equity swaps if portfolio margining is implemented by the Commission and the CFTC), provided the account of the counterparty does not hold equity security positions other than equity security-based swaps (and potentially equity swaps).

Rule 18a-3 requires a nonbank SBSB to collect collateral from a counterparty to cover a variation and/or initial margin requirement. The rule also requires the nonbank SBSB to deliver collateral to the counterparty to cover a variation margin requirement. The collateral must be collected or delivered by the close of business on the next business day following the day of the calculation, except that the collateral can be collected or delivered by the close of business on the second business day following the day of the calculation if the counterparty is located in another

country and more than 4 time zones away. Further, collateral to meet a margin requirement must consist of cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold. The fair market value of collateral used to meet a margin requirement must be reduced by the standardized haircuts in Rule 15c3-1 or 18a-1 (as applicable), or the nonbank SBSB can elect to apply the standardized haircuts prescribed in the CFTC's margin rules. The value of the collateral must meet or exceed the margin requirement after applying the standardized haircuts. In addition, collateral being used to meet a margin requirement must meet conditions specified in the rule, including, for example, that it must have a ready market, be readily transferable, and not consist of securities issued by the nonbank SBSB or the counterparty.

There are exceptions in Rule 18a-3 to the requirements to collect initial and/or variation margin and to deliver variation margin. A nonbank SBSB need not collect variation or initial margin from (or deliver variation margin to) a counterparty that is a commercial end user, the Bank for International Settlements ("BIS"), the European Stability Mechanism, or a multilateral development bank identified in the rule. Similarly, a nonbank SBSB need not collect variation or initial margin (or deliver variation margin) with respect to a legacy account (*i.e.*, an account holding security-based swaps entered into prior to the compliance date of the rule). Further, a nonbank SBSB need not collect initial margin from a

<sup>25</sup> Stand-alone SBSBs (including firms that also are registered as OTC derivatives dealers) are subject to Rule 18a-1, which includes a

counterparty concentration charge that parallels the existing charge in Rule 15c3-1e.

<sup>26</sup> A broker-dealer MSBSP will be subject to Rule 15c3-1.

counterparty that is a financial market intermediary (*i.e.*, an SBSB, a swap dealer, a broker-dealer, a futures commission merchant (“FCM”), a bank, a foreign broker-dealer, or a foreign bank) or an affiliate. A nonbank SBSB also need not hold initial margin directly if the counterparty delivers the initial margin to an independent third-party custodian. Further, a nonbank SBSB need not collect initial margin from a counterparty that is a sovereign entity if the nonbank SBSB has determined that the counterparty has only a minimal amount of credit risk.

The rule also has a threshold exception to the initial margin

requirement. Under this exception, a nonbank SBSB need not collect initial margin to the extent that the initial margin amount when aggregated with other security-based swap and swap exposures of the nonbank SBSB and its affiliates to the counterparty and its affiliates does not exceed \$50 million. The rule also would permit a nonbank SBSB to defer collecting initial margin from a counterparty for two months after the month in which the counterparty does not qualify for the \$50 million threshold exception for the first time. Finally, the rule has a minimum transfer amount exception of \$500,000. Under this exception, if the

combined amount of margin required to be collected from or delivered to a counterparty is equal to or less than \$500,000, the nonbank SBSB need not collect or deliver the margin. If the initial and variation margin requirements collectively or individually exceed \$500,000, collateral equal to the full amount of the margin requirement must be collected or delivered.

The following table summarizes the exceptions in Rule 18a–3 from collecting initial and/or variation margin and from delivering variation margin.

Exception	Status of exception to collecting margin		Status of exception to delivering VM
	VM	IM	
Commercial End User .....	Need Not Collect .....	Need Not Collect .....	Need Not Deliver.
BIS or European Stability Mechanism .....	Need Not Collect .....	Need Not Collect .....	Need Not Deliver.
Multilateral Development Bank .....	Need Not Collect .....	Need Not Collect .....	Need Not Deliver.
Financial Market Intermediary .....	Must Collect .....	Need Not Collect .....	Must Deliver.
Affiliate .....	Must Collect .....	Need Not Collect .....	Must Deliver.
Sovereign with Minimal Credit Risk .....	Must Collect .....	Need Not Collect .....	Must Deliver.
Legacy Account .....	Need Not Collect .....	Need Not Collect .....	Need Not Deliver.
IM Below \$50 Million Threshold .....	Must Collect .....	Need Not Collect .....	Must Deliver.
Minimum Transfer Amount .....	Need Not Collect .....	Need Not Collect .....	Need Not Deliver.

Finally, nonbank SBSBs must monitor the risk of each account, and establish, maintain, and document procedures and guidelines for monitoring the risk.

#### MSBSPs

Rule 18a–3 also prescribes margin requirements for nonbank MSBSPs with respect to non-cleared security-based swaps. The rule requires a nonbank MSBSP to calculate variation margin for the account of each counterparty as of the close of each business day. The rule requires the nonbank MSBSP to collect collateral from (or deliver collateral to) a counterparty to cover a variation margin requirement. The collateral must be collected or delivered by the close of business on the next business day following the day of the calculation, except that the collateral can be collected or delivered by the close of business on the second business day following the day of the calculation if the counterparty is located in another country and more than 4 time zones away. Further, the variation margin must consist of cash, securities, money market instruments, a major foreign currency, the security of settlement of the non-cleared security-based swap, or gold. The rule has an exception pursuant to which the nonbank MSBSP need not collect variation margin if the counterparty is a commercial end user, the BIS, the European Stability Mechanism, or one of the multilateral

development banks identified in the rule (there is no exception from delivering variation margin to these types of counterparties). The rule also has an exception pursuant to which the nonbank MSBSP need not collect or deliver variation margin with respect to a legacy account. Finally, there is a \$500,000 minimum transfer amount exception to the collection and delivery requirements for nonbank MSBSPs.

#### 3. Segregation Requirements

Section 3E(b) of the Exchange Act provides that, for cleared security-based swaps, the money, securities, and property of a security-based swap customer shall be separately accounted for and shall not be commingled with the funds of the broker, dealer, or SBSB 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. However, Section 3E(c)(1) of the Exchange Act also provides, that for cleared security-based swaps, customers’ money, securities, and property may, for convenience, be commingled and deposited in the same one or more accounts with any bank, trust company, or clearing agency. Section 3E(c)(2) further provides that, notwithstanding Section 3E(b), in accordance with such terms and conditions as the Commission may

prescribe by rule, regulation, or order, any money, securities, or property of the security-based swaps customer of a broker, dealer, or security-based swap dealer described in Section 3E(b) may be commingled and deposited as provided in Section 3E with any other money, securities, or property received by the broker, dealer, or security-based swap dealer and required by the Commission to be separately accounted for and treated and dealt with as belonging to the security-based swaps customer of the broker, dealer, or security-based swap dealer.

Section 3E(f) of the Exchange Act establishes a program by which a counterparty to non-cleared security-based swaps with an SBSB or MSBSP can elect to have initial margin held at an independent third-party custodian (“individual segregation”). Section 3E(f)(4) provides that if the counterparty does not choose to require segregation of funds or other property (*i.e.*, waives segregation), the SBSB or MSBSP shall send a report to the counterparty on a quarterly basis stating that the firm’s back office procedures relating to margin and collateral requirements are in compliance with the agreement of the counterparties. The statutory provisions of Sections 3E(b) and (f) are self-executing.

The Commission is adopting segregation rules pursuant to which money, securities, and property of a

security-based swap customer relating to cleared and non-cleared security-based swaps must be segregated but can be commingled with money, securities, or property of other customers ("omnibus segregation"). The omnibus segregation requirements for stand-alone broker-dealers and broker-dealer SBSBs are codified in amendments to Rule 15c3-3. The omnibus segregation requirements for stand-alone SBSBs (including firms registered as OTC derivatives dealers) and bank SBSBs are codified in Rule 18a-4.

The omnibus segregation requirements are mandatory with respect to money, securities, or other property relating to *cleared* security-based swaps that is held by a stand-alone broker-dealer or SBSB (*i.e.*, customers cannot waive segregation). With respect to non-cleared security-based swap transactions, the omnibus segregation requirements are an alternative to the statutory provisions discussed above pursuant to which a counterparty can elect to have initial margin individually segregated or to waive segregation. However, under the final omnibus segregation rules for stand-alone broker-dealers and broker-dealer SBSBs codified in Rule 15c3-3, counterparties that are not an affiliate of the firm cannot waive segregation. Affiliated counterparties of a stand-alone broker-dealer or broker-dealer SBSB can waive segregation. Under Section 3E(f) of the Exchange Act and Rule 18a-4, all counterparties (affiliated and non-affiliated) to a non-cleared security-based swap transaction with a stand-alone or bank SBSB can waive segregation. The omnibus segregation requirements are the "default" requirement if the counterparty does not elect individual segregation or to waive segregation (in the cases where a counterparty is permitted to waive segregation). Rule 18a-4 also has exceptions pursuant to which a foreign stand-alone or bank SBSB or MSBSP need not comply with the segregation requirements (including the omnibus segregation requirements) for certain transactions.

Under the omnibus segregation requirements, an SBSB or stand-alone broker-dealer must maintain possession or control over excess securities collateral carried for the accounts of security-based swap customers. Generally, excess securities collateral means securities and money market instruments that are not being used to meet a variation margin requirement of the counterparty. In the context of security-based swap transactions, excess securities collateral means collateral delivered to the SBSB or stand-alone

broker-dealer to meet an initial margin requirement of the counterparty as well as collateral held by the SBSB or stand-alone broker-dealer in excess of any applicable initial margin requirement (and that is not being used to meet a variation margin requirement). There are two exceptions under which excess securities collateral can be held in a manner that is not in the possession or control of the SBSB or stand-alone broker-dealer: (1) It is being used to meet a margin requirement of a clearing agency resulting from a cleared security-based swap transaction of the security-based swap customer; or (2) it is being used to meet a margin requirement of an SBSB resulting from the first SBSB or stand-alone broker-dealer entering into a non-cleared security-based swap transaction with the SBSB to offset the risk of a non-cleared security-based swap transaction between the first SBSB or broker-dealer and the security-based swap customer.

Under the omnibus segregation requirements, an SBSB or stand-alone broker-dealer must maintain a security-based swap customer reserve account to segregate cash and/or qualified securities in an amount equal to the net cash owed to security-based swap customers. The SBSB or stand-alone broker-dealer must at all times maintain, through deposits into the account, cash and/or qualified securities in amounts computed weekly in accordance with the formula set forth in Rules 15c3-3b or 18a-4a. In the case of a broker-dealer SBSB or stand-alone broker-dealer, this account must be separate from the reserve accounts the firm maintains for "traditional" securities customers and other broker-dealers under pre-existing requirements of Rule 15c3-3.

The formula in Rules 15c3-3b and 18a-4a is modeled on the pre-existing reserve formula in Exhibit A to Rule 15c3-3 ("Rule 15c3-3a"). The security-based swap customer reserve formula requires the SBSB or stand-alone broker-dealer to add up various credit items (amounts owed to security-based swap customers) and debit items (amounts owed by security-based swap customers). If, under the formula, credit items exceed debit items, the SBSB or stand-alone broker-dealer must maintain cash and/or qualified securities in that net amount in the security-based swap customer reserve account. For purposes of the security-based swap reserve account requirement, qualified securities are: (1) Obligations of the United States; (2) obligations fully guaranteed as to principal and interest by the United States; and (3) subject to certain conditions and limitations, general obligations of any state or a

political subdivision of a state that are not traded flat and are not in default, are part of an initial offering of \$500 million or greater, and are issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year end.

With respect to non-cleared security-based swaps, Section 3E(f)(1)(A) of the Exchange Act provides that an SBSB and an MSBSP shall be required to notify a counterparty of the SBSB 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. SBSBs and MSBSPs must provide this notice in writing to a duly authorized individual prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the compliance date of the rule. SBSBs also must obtain subordination agreements from a counterparty that affirmatively elects to have initial margin held at a third-party custodian or that waives segregation. Finally, a stand-alone or bank SBSB will be exempt from the requirements of Rule 18a-4 if the firm meets certain conditions, including that the firm: (1) Does not clear security-based swap transactions for other persons; (2) provides notice to the counterparty regarding the right to segregate initial margin at an independent third-party custodian; (3) discloses to the counterparty in writing that any collateral received by the SBSB will not be subject to a segregation requirement; and (4) discloses to the counterparty how a claim of the counterparty for the collateral would be treated in a bankruptcy or other formal liquidation proceeding of the SBSB.

#### 4. Alternative Compliance Mechanism

The Commission is adopting an alternative compliance mechanism in Rule 18a-10 pursuant to which a stand-alone SBSB that is registered as a swap dealer and predominantly engages in a swaps business may elect to comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of complying with Rules 18a-1, 18a-3, and 18a-4. In order to qualify to operate pursuant to Rule 18a-10, the stand-alone SBSB cannot be registered as a broker-dealer or an OTC derivatives dealer. Moreover, in addition to other conditions, the aggregate gross notional amount of the firm's security-based swap positions must not exceed the lesser of a maximum fixed-dollar amount or 10% of the combined



aggregate gross notional amount of the firm's security-based swap and swap positions. The maximum fixed-dollar amount is set at a transitional level of \$250 billion for the first 3 years after the compliance date of the rule and then drops to \$50 billion thereafter unless the Commission issues an order: (1) Maintaining the \$250 billion maximum fixed-dollar amount for an additional period of time or indefinitely; or (2) lowering the maximum fixed-dollar amount to an amount between \$250 billion and \$50 billion. The final rule further provides that the Commission will consider the levels of security-based swap activity of the stand-alone SBSBs operating under the alternative compliance mechanism and provide notice before issuing such an order.

#### 5. Cross-Border Application

As adopted, the Commission is treating capital and margin requirements under Section 15F(e) of the Exchange Act and Rules 18a-1, 18a-2, and 18a-3 thereunder as entity-level requirements that are applicable to the entirety of the business of an SBSB or MSBSP. Foreign SBSBs and MSBSPs have the potential to avail themselves of substituted compliance to satisfy the capital and margin requirements under Section 15F of the Exchange Act and Rules 18a-1 and 18a-2, and 18a-3 thereunder. The segregation requirements are deemed transaction-level requirements and substituted compliance is not available for them. However, Rule 18a-4 has exceptions pursuant to which a foreign stand-alone or bank SBSB or MSBSP need not comply with the segregation requirements for certain transactions. There are no exceptions from the segregation requirements for cross-border transactions of a stand-alone broker-dealer or a broker-dealer SBSB or MSBSP.

## II. Final Rules and Rule Amendments

### A. Capital

#### 1. Introduction

The Commission is adopting capital requirements for nonbank SBSBs and MSBSPs pursuant to Sections 15 and 15F of the Exchange Act. More specifically, the Commission is adopting amendments to Rule 15c3-1 and certain of its appendices to address broker-dealer SBSBs and the security-based swap activities of stand-alone broker-dealers. In addition, the Commission is adopting Rule 18a-1, Rules 18a-1a, 18a-1b, 18a-1c and 18a-1d to establish capital requirements for stand-alone SBSBs, including for stand-alone SBSBs that are also registered as OTC

derivatives dealers. Rule 18a-1 and its related rules are structured similarly to Rule 15c3-1 and its appendices and contain many provisions that correspond to those in Rule 15c3-1 and its appendices.<sup>27</sup>

As discussed in the proposing release, Rule 15c3-1 imposes a net liquid assets test that is designed to promote liquidity within broker-dealers.<sup>28</sup> For example, paragraph (c)(2)(iv) of Rule 15c3-1 does not permit most unsecured receivables to count as allowable net capital. This aspect of the rule severely limits the ability of broker-dealers to engage in activities that generate unsecured receivables (e.g., as unsecured lending). 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 permits a broker-dealer to engage in activities that are part of conducting a securities business (e.g., taking securities positions) but in a manner that leaves the firm 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). The objective of Rule 15c3-1 is to require a broker-dealer to maintain sufficient liquid assets to meet all liabilities, including obligations to customers, counterparties, and other creditors and to have adequate additional resources to wind-down its business in an orderly manner without the need for a formal proceeding if the firm fails financially.<sup>29</sup> The business of trading securities is one in which success, both for the firms and the investing public, is strongly dependent

upon confidence, continuity, and commitment.<sup>30</sup> Generally, almost all trading-related liabilities are payable upon demand and represent a major portion of the firm's liabilities. Emphasis on liquidity helps to ensure that the liquidation of a firm will not result in excessive delay in repayment of the firm's obligations to customers, broker-dealers, and other creditors and therefore assures the continued liquidity of the securities markets. Rule 15c3-1 has been the capital standard for broker-dealers since 1975. Generally, the rule has promoted the maintenance of prudent levels of capital.<sup>31</sup>

Some commenters supported the Commission's proposal to model the nonbank SBSB capital requirements on the broker-dealer capital requirements. A commenter stated that separate standards for stand-alone broker-dealers and nonbank SBSBs would complicate the regulatory framework.<sup>32</sup> A second commenter argued that there should be no difference in the manner in which capital standards are applied to nonbank SBSBs, regardless of whether they are registered as broker-dealers or are affiliated with a bank holding company.<sup>33</sup> A third commenter expressed general support for the approach.<sup>34</sup>

Other commenters expressed concerns with regard to the proposed

<sup>30</sup> See *Net Capital Rule*, Exchange Act Release No. 27249 (Sept. 15, 1989), 54 FR 40395, 40396 (Oct. 2, 1989).

<sup>31</sup> See Securities Investor Protection Corporation ("SIPC"), *Annual Report* (2018), available at <https://www.sipc.org/media/annual-reports/2018-annual-report.pdf>. SIPC's 2018 annual report states that the annual average of new broker-dealer liquidations under the Securities Investor Protection Act of 1970 ("SIPA") for the last 10-year period was 0.8 firms per year. It also states that there have been 330 broker-dealers liquidated in a SIPA proceeding since SIPC's inception in 1970, which amounts to less than 1% of approximately 40,000 broker-dealers that have been SIPC members during that time period. Moreover, it states that over that time period the value of cash and securities of SIPA liquidated broker-dealers returned to customers totaled approximately \$139.8 billion and, of that amount, approximately \$138.9 billion came from the estates of the failed broker-dealers, and approximately \$1 billion came from the SIPC fund. It further states that, of the approximately 770,400 claims satisfied in completed or substantially completed cases as of December 31, 2018, a total of 356 were for cash and securities whose value was greater than limits of protection afforded by SIPA.

<sup>32</sup> See Letter from Dennis M. Kelleher, President and Chief Executive Officer, Better Markets, Inc. (Feb. 22, 2013) ("Better Markets 2/22/2013 Letter"); Letter from Dennis M. Kelleher, President and Chief Executive Officer, Better Markets, Inc. (July 22, 2013) ("Better Markets 7/22/2013 Letter").

<sup>33</sup> See Letter from Kurt N. Schacht, Managing Director, and Beth Kaiser, Director, CFA Institute (Feb. 22, 2013) ("CFA Institute Letter").

<sup>34</sup> See Letter from Thomas G. McCabe, Chief Operating Officer, OneChicago, LLC (Feb. 19, 2013) ("OneChicago 2/19/2013 Letter").

<sup>27</sup> Rule 18a-1a, Rule 18a-1b, Rule 18a-1c, and Rule 18a-1d correspond to the following appendices to Rule 15c3-1: Rule 15c3-1a (Options); Rule 15c3-1b (Adjustments to net worth and aggregate indebtedness for certain commodities transactions); 17 CFR 240.15c3-1c ("Rule 15c3-1c") (Consolidated computations of net capital and aggregate indebtedness for certain subsidiaries and affiliates); and Rule 15c3-1d (Satisfactory subordination agreements).

<sup>28</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70217-20.

<sup>29</sup> See *Net Capital Rule*, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474, 6475 (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.").



approach or encouraged the Commission to harmonize its final rules with those of international standard setters and domestic regulators that have finalized capital and margin requirements.<sup>35</sup> A commenter stated that the Commission's proposed approach would result in very different capital requirements for nonbank SBSBs as compared to nonbank swap dealers subject to CFTC oversight, and that this could potentially prevent entities from dually registering as nonbank SBSBs and swap dealers.<sup>36</sup> The commenter also stated that requiring a multi-registered entity—such as an entity registered as a broker-dealer, FCM, SBSB, and swap dealer—to calculate regulatory capital under the rules of both the Commission and the CFTC and adhere to the greater minimum requirement would provide a strong disincentive to seeking the operational and risk management efficiencies of a consolidated business entity, and would be anticompetitive.

Several commenters encouraged the Commission and CFTC to harmonize their proposed capital rules.<sup>37</sup> A commenter suggested that the Commission coordinate with the CFTC and, as appropriate, the prudential regulators to assure that each agency's respective capital rules are harmonized and do not have the unintended effect of impairing the ability of broker-dealers that are dually registered as FCMs to provide clearing services for security-based swaps and swaps.<sup>38</sup> Another commenter was concerned that the proposed capital requirements for nonbank SBSBs were not comparable to those proposed by other U.S. regulators

and that modeling the proposed rules on the broker-dealer capital standard was not appropriate.<sup>39</sup> This commenter argued that the bank capital standard is risk-based, whereas the broker-dealer capital standard is transaction volume-based, and that SBSBs and swap dealers operate in the same markets with the same counterparties and should be subject to comparable capital requirements. Commenters also referenced Section 15F(e)(3)(D)(ii) of the Exchange Act, which provides that the Commission, the prudential regulators, and the CFTC “shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements. . . .”<sup>40</sup> One commenter argued that divergence of bank and nonbank regulation is leading to some migration of risk to nonbank broker-dealers.<sup>41</sup> A commenter suggested that to avoid undermining the *de minimis* exception for SBSBs or inhibiting hedging activities by broker-dealers not registered as SBSBs, the Commission should limit the application of the proposed amendments to Rule 15c3–1 to broker-dealers that register as SBSBs.<sup>42</sup> Another commenter stated that a positive tangible net worth test would be more appropriate for nonbank SBSBs.<sup>43</sup>

The Commission has made two significant modifications to the final capital rules for nonbank SBSBs that should mitigate some of these concerns raised by commenters. First, as discussed below in section II.A.2.b.v. of this release, the Commission has modified Rule 18a–1 so that it no longer contains a portfolio concentration charge that is triggered when the aggregate current exposure of the stand-alone SBSB to its derivatives counterparties exceeds 50% of the firm's tentative net capital.<sup>44</sup> This means that stand-alone SBSBs that have been authorized to use models will not

be subject to this limit on applying the credit risk charges to uncollateralized current exposures related to derivatives transactions. This includes uncollateralized current exposures arising from electing not to collect variation margin for non-cleared security-based swap and swap transactions under exceptions in the margin rules of the Commission and the CFTC. The credit risk charges are based on the creditworthiness of the counterparty and can result in charges that are substantially lower than deducting 100% of the amount of the uncollateralized current exposure.<sup>45</sup> This approach to addressing credit risk arising from uncollateralized current exposures related to derivatives transactions is generally consistent with the treatment of such exposures under the capital rules for banking institutions.<sup>46</sup>

The second significant modification is an alternative compliance mechanism. As discussed below in section II.D. of this release, the alternative compliance mechanism will permit a stand-alone SBSB that is registered as a swap dealer and that predominantly engages in a swaps business to comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of complying with the Commission's capital, margin, and segregation requirements.<sup>47</sup> The CFTC's proposed capital rules for swap dealers that are FCMs would retain the existing capital framework for FCMs, which imposes a net liquid assets test similar to the existing capital requirements for stand-alone broker-dealers.<sup>48</sup> However, under the CFTC's proposed capital rules, swap dealers that are not FCMs would have the option of complying with: (1) A capital standard based on the capital rules for banks; (2) a capital standard based on the Commission's capital requirements in Rule 18a–1; or

<sup>35</sup> See Letter from Tom Quaadman, Executive Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce (Nov. 19, 2018) (“Center for Capital Markets Competitiveness, Chamber of Commerce 11/19/2018 Letter”); Citadel 11/19/2018 Letter; Letter from Walt L. Lukken, President and Chief Executive Officer, Futures Industry Association (Nov. 19, 2018) (“FIA 11/19/2018 Letter”); ICI 11/19/2018 Letter; Letter from Laura Harper Powell, Associate General Counsel, Managed Funds Association, and Adam Jacobs-Dean, Managing Director, Global Head of Markets Regulation, Alternative Investment Management Association (Nov. 19, 2018) (“MFA/ AIMA 11/19/2018 Letter”); Adam Hopkins, Managing Director, Legal Department, Mizuho Capital Markets LLC, Marcy S. Cohen, General Counsel and Managing Director, ING Capital Markets LLC, and Michael Baudo, President and CEO, ING Capital Markets LLC (Nov. 16, 2018) (“Mizuho/ING Letter”); Letter from Sebastian Crapanzano and Soo-Mi Lee, Managing Directors, Morgan Stanley (Feb. 22, 2013) (“Morgan Stanley 2/22/2013 Letter”).

<sup>36</sup> See Letter from Richard M. Whiting, Executive Director and General Counsel, The Financial Services Roundtable (Feb. 22, 2013) (“Financial Services Roundtable Letter”).

<sup>37</sup> See Citadel 11/19/18 Letter; Financial Services Roundtable Letter; FIA 11/19/2018 Letter; Morgan Stanley 11/19/2018 Letter.

<sup>38</sup> See FIA 11/19/2018 Letter.

<sup>39</sup> See Morgan Stanley 2/22/2013 Letter.

<sup>40</sup> See Letter from Robert Pickel, Chief Executive Officer, International Swaps and Derivatives Association (“ISDA”) (Feb. 5, 2014) (“ISDA 2/5/2014 Letter”); Morgan Stanley 2/22/2013 Letter.

<sup>41</sup> See Letter from Robert Rutkowski (Nov. 20, 2018) (“Rutkowski 11/20/2018 Letter”).

<sup>42</sup> See Letter from Kenneth E. Bentsen, Jr., President and CEO, Securities Industry and Financial Markets Association (Nov. 19, 2018) (“SIFMA 11/19/2018 Letter”); Morgan Stanley 11/19/2018 Letter.

<sup>43</sup> See Letter from David T. McIndoe, Alexander S. Holtan, and Cheryl I. Aaron, Counsels, Sutherland Asbill & Brennan LLP on behalf of The Commercial Energy Working Group (Feb. 14, 2013) (“Sutherland Letter”).

<sup>44</sup> See paragraph (e)(2) of Rule 18a–1, as adopted. See also *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70244 (proposing a portfolio concentration charge in Rule 18a–1 for stand-alone SBSBs).

<sup>45</sup> See paragraph (e)(2) of Rule 18a–1, as adopted.

<sup>46</sup> See *OTC Derivatives Dealers*, Exchange Act Release No. 40594 (Oct. 23, 1998), 63 FR 59362, 59384–87 (Nov. 3, 1998) (“[T]he Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the ‘U.S. Banking Agencies’) have adopted rules implementing the Capital Accord for U.S. banks and bank holding companies. Appendix F is generally consistent with the U.S. Banking Agencies’ rules, and incorporates the qualitative and quantitative conditions imposed on banking institutions.”). The use of models to compute market risk charges in lieu of the standardized haircuts (as nonbank SBSBs will be permitted to do under Rules 15c3–1 and 18a–1) also is generally consistent with the capital rules for banking institutions. *Id.* See also section VI.A.4.b. of this release (discussing bank capital regulations).

<sup>47</sup> See Rule 18a–10, as adopted.

<sup>48</sup> See *CFTC Capital Proposing Release*, 81 FR 91252.

(3) if the swap dealer is predominantly engaged in non-financial activities, a capital standard based on a tangible net worth requirement.

The Commission acknowledges that under these two modifications a stand-alone SBSB will be subject to: (1) A capital standard that is less rigid than Rule 15c3-1 in terms of imposing a net liquid assets test (in the case of firms that will comply with Rule 18a-1); or (2) a capital standard that potentially does not impose a net liquid assets test (in the case of firms that will operate under the alternative compliance mechanism and, therefore, comply with the CFTC's capital rules). This will decrease the liquidity of these firms and therefore decrease their self-sufficiency. As a result, the risk that a stand-alone SBSB may not be able to self-liquidate in an orderly manner will be increased.

However, stand-alone SBSBs will engage in a more limited business than stand-alone broker-dealers and broker-dealer SBSBs. Thus, they will be less significant participants in the overall securities markets. For example, they will not be dealers in the cash securities markets or the markets for listed options and they will not maintain custody of cash or securities for retail investors in those markets. Given their limited role, the Commission believes that it is appropriate to more closely align the requirements for stand-alone SBSBs with the requirements of the CFTC and the prudential regulators. These modifications to more closely harmonize the rules are designed to address the concerns of commenters noted above about the potential consequences of imposing different capital standards. They also take into account Section 15F(e)(3)(D)(ii) of the Exchange Act, which provides that the Commission, the prudential regulators, and the CFTC "shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements . . ."

Notwithstanding the modification to Rule 18a-1 described above, the rule continues to be modeled in large part on the broker-dealer capital rule. For example, as is the case with Rule 15c3-1, most unsecured receivables (aside from uncollateralized current exposures relating to derivatives transactions) will not count as allowable capital. Moreover, fixed assets and other illiquid assets will not count as allowable capital. Consequently, stand-alone SBSBs subject to Rule 18a-1 (*i.e.*, firms that do not operate under the alternative compliance mechanism) will remain subject to certain requirements modeled on requirements of Rule 15c3-1 that are designed to promote their liquidity.

Additionally, broker-dealer SBSBs will be subject to Rule 15c3-1 and the stricter (as compared to Rule 18a-1) net liquid assets test it imposes. For example, as discussed below in section II.A.2.b.v. of this release, Rule 15c3-1e, as amended, modifies the existing portfolio concentration charge so that it equals 10% of an ANC broker-dealer's tentative net capital (a reduction from 50% of the firm's tentative net capital).<sup>49</sup> Thus, the ability of these firms to apply the credit risk charges to uncollateralized current exposures arising from derivatives transactions will be more restricted. In addition, as discussed below, broker-dealer and stand-alone SBSBs will be subject to a 100% capital charge for initial margin they post to counterparties because, for example, the counterparty is subject to the margin rules of the CFTC or the prudential regulators.

Consequently, while the two modifications discussed above with respect to stand-alone SBSBs should mitigate commenters' concerns, there likely will be significant differences between the capital requirements for nonbank SBSBs and the capital requirements for bank SBSBs and bank and nonbank swap dealers. In this regard, the Commission has balanced the concerns raised by commenters about inconsistent requirements with the objective of promoting the liquidity of nonbank SBSBs. The Commission believes that the broker-dealer capital standard is the most appropriate alternative for nonbank SBSBs, given the nature of their business activities and the Commission's experience administering the standard with respect to broker-dealers. The objective of the broker-dealer capital standard is to protect customers and counterparties and to mitigate the consequences of a firm's failure by promoting the ability of these entities to absorb financial shocks and, if necessary, to self-liquidate in an orderly manner.

Moreover, certain operational, policy, and legal differences support the distinction between nonbank SBSBs and bank SBSBs. First, based on the Commission staff's understanding of the activities of nonbank dealers in the OTC derivatives markets, nonbank SBSBs 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, which—unlike broker-dealers—are in the business of making loans and taking deposits. Similar to stand-alone broker-dealers,

nonbank SBSBs will not be lending or deposit-taking institutions and will focus their activities on dealing in securities (*i.e.*, security-based swaps).

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. Those same differences also will exist between bank SBSBs and nonbank SBSBs. For example, in general, banks obtain much of their funding through customer deposits (a relatively inexpensive source of funding) and can obtain liquidity through the Federal Reserve's discount window. Broker-dealers do not—and nonbank SBSBs will not—have access to these sources of funding and liquidity. Consequently, in the Commission's judgment, the broker-dealer capital standard is the appropriate standard for nonbank SBSBs because it is designed to promote a firm's liquidity and self-sufficiency (in other words, to account for the lack of inexpensive funding sources that are available to banks, such as deposits and central bank support).

The rules governing ANC broker-dealers and OTC derivatives dealers currently contain provisions designed to address dealing in OTC derivatives by broker-dealers and, therefore, to some extent are tailored to address security-based swap activities of broker-dealers. However, as discussed below, the amendments to Rule 15c3-1 are designed to more specifically address the risks of security-based swaps and the potential for the increased involvement of broker-dealers in these markets.<sup>50</sup> Moreover, most stand-alone broker-dealers are not subject to Rules 15c3-1e and 15c3-1f and thus will need to take standardized haircuts in calculating their net capital. Therefore, in response to comments, the Commission believes it is appropriate for the amendments to Rule 15c3-1 to apply to broker-dealers irrespective of whether they are registered as SBSBs. This approach will establish requirements (such as standardized haircuts for security-based swaps) that are specifically tailored to security-based swap activities across all broker-dealers (*i.e.*, broker-dealer SBSBs and stand-alone broker-dealers that engage in a *de minimis* level of security-based swap activities).

The Commission disagrees with the comment that the broker-dealer capital standard is not risk-based. The ratio-

<sup>49</sup> See paragraph (c)(3) of Rule 15c3-1e, as adopted.

<sup>50</sup> See *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); *OTC Derivatives Dealers*, 63 FR 59362.

based minimum net capital requirement being adopted today is tied directly to the risk of the firm's customer exposures. Further, the standardized and model-based haircuts that will be used by nonbank SBSDs are tied directly to the market and credit risk of the firm's positions.

For these reasons, Rules 15c3–1, as amended, and 18a–1, as adopted, establish capital requirements for nonbank SBSDs that differ from the capital requirements adopted by the prudential regulators and certain of the capital requirements the CFTC proposed for nonbank swap dealers.<sup>51</sup> The Commission considered these alternative approaches in light of Section 15F(e)(3)(D)(ii) of the Exchange Act, which provides—as discussed above—that the Commission, prudential regulators, and the CFTC to the maximum extent practicable, establish and maintain comparable minimum capital requirements. However, as discussed above, the Commission believes that the capital requirements for nonbank SBSDs should take into account key differences between banks (which are lending institutions) and nonbank SBSDs (which will focus primarily on securities activities). Therefore, the Commission does not believe it would be appropriate to model the Commission's capital requirements for nonbank SBSDs on the bank capital standard.<sup>52</sup>

Further, the Commission does not believe it is necessary to apply a

tangible net worth test to nonbank SBSDs, as suggested by a commenter. The CFTC proposed a tangible net worth requirement for swap dealers that are predominately engaged in non-financial activities (e.g., agriculture or energy) because of the potential that some of these entities may need to register as swap dealers due to their use of swaps as part of their non-financial activities.<sup>53</sup> The application of a broker-dealer-based or a bank-based capital approach to entities engaged in non-financial activities could result in inappropriate capital requirements that would not be proportionate to the risk associated with these types of firms. The Commission does not believe that entities predominately engaged in non-financial activities are likely to deal in security-based swaps to an extent that would trigger registration with the Commission because, for example, the swap market is significantly larger than the security-based swap market and has many more active participants that are non-financial entities.<sup>54</sup> Moreover, a tangible net worth standard would not promote liquidity, as it treats all tangible assets equally, and therefore could incentivize a firm to hold illiquid but higher yielding assets.

Based on staff experience, it is expected that financial institutions will comprise a large segment of the security-based swap 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. Consequently, these affiliates—because their capital structures are geared towards securities trading or because they already are broker-dealers—will not face the types of practical issues that non-financial entities would face if they had to adhere to a capital standard modeled on the broker-dealer capital standard. In addition, many broker-dealers currently are affiliates of bank holding companies. Consequently, these broker-dealers are subject to Rule 15c3–1, while their parent and bank affiliates are subject to bank capital standards. For these reasons, the Commission does not believe it is necessary to adopt a different capital standard to accommodate entities that are predominately engaged in non-financial

activities as was proposed by the CFTC.<sup>55</sup>

The Commission acknowledges that not adopting the CFTC's proposed alternative-capital-standards approach could require nonbank SBSDs that are also registered with the CFTC as swap dealers to, in some cases, perform two different capital calculations. This could cause some firms to separate their nonbank SBSDs and their nonbank swap dealers into separate entities. For nonbank SBSDs that are predominately swap dealers, the alternative compliance mechanism will avoid this outcome. In addition, the modification to Rule 18a–1 more closely aligns the treatment of uncollateralized current exposures arising from derivatives transactions with the treatment of such exposures under the bank capital rules. The Commission, however, does not believe it would be appropriate to further address this potential consequence by modifying its proposed capital requirements for nonbank SBSDs to permit firms to apply a bank capital standard or tangible net worth test for the reasons discussed above.

In response to commenters' requests that the Commission and CFTC work together and harmonize their respective capital rules, as appropriate, Commission staff has consulted with the CFTC, among others, in drafting the proposals and the amendments and rules being adopted today, and as discussed further below, has sought to make the Commission's capital rule more consistent with the CFTC's proposed capital rules, as appropriate.

For these reasons, the Commission is modeling the capital requirements for nonbank SBSDs on the broker-dealer capital standard in Rule 15c3–1, as

<sup>51</sup> As noted above, the prudential regulators similarly adopted capital standards for bank SBSDs based on the capital standards for banks. See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74889. As discussed above, the CFTC has proposed different capital standards for nonbank swap dealers depending on whether the registrant is an FCM and whether the registrant is predominately engaged in non-financial activities. See *CFTC Capital Proposing Release*, 81 FR 91252.

<sup>52</sup> As discussed above and in section II.D. of this release, stand-alone SBSDs (excluding firms registered as OTC derivatives dealers) will be able to operate pursuant to the alternative compliance mechanism of Rule 18a–10 if they meet the conditions in the rule. Stand-alone SBSDs operating pursuant to this mechanism will be permitted to comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules instead of the capital, margin, and segregation requirements of Rules 18a–1, 18a–3, and 18a–4. As noted above, the CFTC's proposed capital rule for swap dealers included an option for certain firms to adhere to a bank-like capital standard. As discussed below in section II.D. of this release, the Commission believes stand-alone SBSDs that meet the conditions of Rule 18a–10 should be permitted to adhere to capital, margin, and segregation requirements of the CEA and the CFTC's rules (which, potentially, could include a bank-like capital standard) because, among other reasons, they will be predominately engaging in a swaps business and, therefore, the CFTC will have a heightened regulatory interest in these firms as compared to the Commission's regulatory interest.

<sup>53</sup> See *CFTC Capital Proposing Release*, 81 FR at 91264–65.

<sup>54</sup> See BIS, *OTC derivatives statistics at end December 2018* (May 2019). The BIS statistical releases cited in this release are available at <https://www.bis.org/list/statistics/index.htm>.

<sup>55</sup> As discussed above and in section II.D. of this release, stand-alone SBSDs (excluding firms registered as OTC derivatives dealers) will be able to adhere to the capital, margin, and segregation requirements of the CEA and the CFTC's rules instead of Rules 18a–1, 18a–3, and 18a–4 if they meet the conditions in Rule 18a–10. As noted above, the CFTC's proposed capital rule for swap dealers included an option for certain firms to adhere to a tangible net worth capital standard. As also noted above, the Commission does not expect that entities predominately engaged in non-financial activities are likely to register as SBSDs. Accordingly, it is unlikely that stand-alone SBSDs adhering to CFTC requirements in accordance with Rule 18a–10 will be subject to the CFTC's tangible net worth capital standard. To the extent that they are, however, the Commission believes stand-alone SBSDs that meet the conditions of Rule 18a–10 should be permitted to adhere to capital, margin, and segregation requirements of the CEA and the CFTC's rules (which, potentially, could include a tangible net worth capital standard) because, among other reasons, they will be predominately engaging in a swaps business and, therefore, the CFTC will have a heightened regulatory interest in these firms as compared to the Commission's regulatory interest.

proposed, but with the two significant modifications discussed above with respect to the capital requirements for stand-alone SBSBs.

The Commission is adopting a positive tangible net worth capital standard for stand-alone MSBSPs pursuant to Section 15F of the Exchange Act. As discussed in more detail below, the Commission did not receive comments that specifically objected to this standard for these entities.

## 2. Capital Rules for Nonbank SBSBs

### a. Computing Required Minimum Net Capital

Rule 15c3-1 requires a broker-dealer to maintain a minimum level of net capital (meaning highly liquid capital) at all times. Paragraph (a) of the rule requires the broker-dealer to perform two calculations: (1) A computation of the minimum amount of net capital the broker-dealer must maintain; and (2) a computation of the amount of net capital the broker-dealer is maintaining. 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 ("15-to-1 ratio") or the 2% of aggregate debit items ratio ("2% debit item ratio"). The Commission proposed that nonbank SBSBs be subject to similarly structured minimum net capital requirements that varied depending on the type of entity. More specifically, proposed Rule 18a-1 required a stand-alone SBSB not authorized to use internal models when computing net capital to maintain minimum net capital of not less than the greater of \$20 million or 8% of the firm's "risk margin amount" as that term was defined in the rule.<sup>56</sup> The risk margin amount was calculated as the sum of:

- The greater of: (1) The total margin required to be delivered by the stand-alone SBSB with respect to security-based swap transactions cleared for security-based swap customers at a clearing agency; Or (2) the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to proposed Rule 18a-1; and
- The total initial margin calculated by the stand-alone SBSB with respect to non-cleared security-based swaps pursuant to proposed Rule 18a-3.

The total of these two amounts—i.e., the risk margin amount—would be multiplied by 8% to determine the ratio-based minimum net capital requirement

("8% margin factor"). In the 2018 comment reopening, the Commission asked whether the input to the risk margin amount for cleared security-based swaps should be determined solely by the total initial margin required to be delivered by the nonbank SBSB with respect to transactions cleared for security-based swap customers at a clearing agency.<sup>57</sup>

Proposed Rule 18a-1 permitted a stand-alone SBSB to apply to the Commission to use model-based haircuts.<sup>58</sup> The rule required a stand-alone SBSB authorized to use models to maintain: (1) Minimum tentative net capital of not less than \$100 million; and (2) minimum net capital of not less than the greater of \$20 million or the 8% margin factor.<sup>59</sup> The proposed rule defined "tentative net capital" to mean, in pertinent part, the amount of net capital maintained by the nonbank SBSB before deducting haircuts (standardized or model-based) with respect to the firm's proprietary positions and, for firms authorized to use models, before deducting the credit risk charges discussed below in section II.A.2.b.v. of this release. The minimum tentative net capital requirement was designed to account for the fact that model-based haircuts, 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. It also was designed to account for the fact that models may miscalculate risks or not capture all risks (e.g., extraordinary losses or decreases in liquidity during times of stress that are not incorporated into the models).

The proposed amendments to Rule 15c3-1 established minimum net capital requirements for a broker-dealer SBSB not authorized to use model-based haircuts.<sup>60</sup> The proposed amendments required these entities to maintain minimum net capital equal of the greater of \$20 million or the sum of: (1) The 8% margin factor; and (2) the amount of the financial ratio requirement that applied to the broker-dealer under pre-existing requirements in Rule 15c3-1 (i.e., either the 15-to-1 ratio or 2% debit item ratio).

Under Rule 15c3-1e, a broker-dealer must apply to the Commission for

authorization to use the alternative net capital (ANC) computation that permits models to be used to compute haircuts and credit risk charges. Broker-dealers with that authorization—ANC broker-dealers—are subject to minimum net capital requirements specific to these entities. In particular, before today's amendments, paragraph (a)(7)(i) of Rule 15c3-1 required an ANC broker-dealer to maintain minimum tentative net capital of at least \$1 billion and minimum net capital of at least \$500 million. In addition, paragraph (a)(7)(ii) of Rule 15c3-1 required an ANC broker-dealer to provide the Commission with an "early warning" notice when its tentative net capital fell below \$5 billion.

As proposed, a broker-dealer SBSB authorized to use models was subject to the minimum net capital requirements for an ANC broker-dealer, which the Commission proposed increasing.<sup>61</sup> Consequently, under the proposed amendments to Rule 15c3-1, an ANC broker-dealer, including an ANC broker-dealer SBSB, was 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 amount of the 15-to-1 ratio or 2% debit item ratio (as applicable) plus the 8% margin factor. The Commission also proposed increasing the early warning notification requirement for ANC broker-dealers from \$5 billion to \$6 billion.

The Commission explained in the proposing release that 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 was \$5 billion.<sup>62</sup> This \$5 billion "early warning" threshold acted 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 was not to require the existing ANC broker-dealers to increase their current capital levels (as they already maintained tentative net capital in excess of \$5 billion).<sup>63</sup> Rather, the goal

<sup>57</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53009. The release also sought comment and supporting data on the potential minimum net capital amounts that would be required of nonbank SBSBs. *Id.*

<sup>58</sup> *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70226–27, 70237–40.

<sup>59</sup> 77 FR at 70221–24.

<sup>60</sup> 77 FR at 70225–26.

<sup>61</sup> 77 FR at 70227–29.

<sup>62</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70228.

<sup>63</sup> The ANC broker-dealers continue to maintain tentative net capital in excess of the proposed \$6 billion early warning level. See also section VI of this release (discussing costs and benefits of the

<sup>56</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70221–24.

was 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.

#### Comments and Final Fixed-Dollar Minimum Net Capital Requirements

Some commenters expressed support for the proposed fixed-dollar minimum tentative net capital and net capital requirements. A commenter stated that the requirements were consistent with pre-existing requirements and practices for OTC derivatives dealers and ANC broker-dealers that have not proven to produce significant disparities with other capital regimes.<sup>64</sup> A second commenter stated that the proposal to require an ANC broker-dealer to provide notification to the Commission if the firm's tentative net capital fell below \$6 billion would improve the Commission's monitoring of these key market participants.<sup>65</sup>

One commenter asked the Commission to reconsider the proposed \$100 million minimum fixed-dollar tentative net capital requirement for stand-alone SBSBs authorized to use models, particularly for a nonbank SBSB that trades only in cleared security-based swaps.<sup>66</sup> The commenter stated that dealing in cleared security-based swaps should not implicate the same concerns about the use of models that led to the establishment of a higher threshold for other Commission registrants. The Commission believes that the same risks exist with respect to the use of models whether an SBSB is trading cleared or non-cleared security-based swaps. In particular, the minimum tentative net capital requirement is designed to address the possibility that the model might miscalculate risk irrespective of the relative level of risk of the positions (e.g., cleared versus non-cleared security-based swaps) being input into the model.

For these reasons, the Commission is adopting the proposed minimum fixed-dollar tentative net capital and net

capital requirements as proposed as well as the \$6 billion early warning notification requirement as proposed.<sup>67</sup> Consequently, under the final rules: (1) A stand-alone SBSB not approved to use internal models has a \$20 million fixed-dollar minimum net capital requirement;<sup>68</sup> (2) a stand-alone SBSB authorized to use internal models (including a firm registered as an OTC derivatives dealer) has a \$100 million fixed-dollar minimum tentative net capital requirement and a \$20 million fixed-dollar minimum net capital requirement;<sup>69</sup> (3) a broker-dealer SBSB not authorized to use internal models has a \$20 million fixed-dollar minimum net capital requirement;<sup>70</sup> and (4) an ANC broker-dealer, including an ANC broker-dealer SBSB, has a \$6 billion fixed-dollar early warning notification requirement, a \$5 billion fixed-dollar minimum tentative net capital requirement, and a \$1 billion fixed-dollar minimum net capital requirement.<sup>71</sup>

#### Comments and Final Ratio-Based Minimum Net Capital Requirements

As noted above, the Commission proposed a ratio-based minimum net capital requirement that for a broker-dealer SBSB was the 15-to-1 ratio or 2% debit item ratio (as applicable) plus the proposed 8% margin factor, and for a stand-alone SBSB was only the proposed 8% margin factor.<sup>72</sup> Commenters raised concerns about the proposed 8% margin factor. One commenter suggested that the Commission require broker-dealer SBSBs to comply with a ratio that is modeled on the 2% debit item ratio in Rule 15c3-1.<sup>73</sup> Another commenter stated that a minimum capital

requirement that is scalable to the volume, size, and risk of a nonbank SBSB's activities would be consistent with the safety and soundness standards mandated by the Dodd-Frank Act and the Basel Accords and would be comparable to the requirements established by the CFTC and the prudential regulators.<sup>74</sup> The commenter, however, expressed concerns that the proposed 8% margin factor was not appropriately risk-based.<sup>75</sup>

A commenter suggested that, if the proposed 8% margin factor is adopted, the Commission should exclude security-based swaps that are portfolio margined with swaps or futures in a CFTC-supervised account.<sup>76</sup> Another commenter believed that a broker-dealer dually registered as an FCM should be subject to a single risk margin amount calculated pursuant to the CFTC's rules, since the CFTC's proposed calculation incorporates both security-based swaps and swaps.<sup>77</sup> A commenter suggested modifying the proposed definition of "risk margin amount" to reflect the lower risk associated with central clearing by ensuring that capital requirements for cleared security-based swaps are lower than the requirements for equivalent non-cleared security-based swaps.<sup>78</sup>

Commenters also addressed the modifications to the proposed rule text in the 2018 comment reopening pursuant to which the input for cleared security-based swaps in the risk margin amount would be determined solely by reference to the amount of initial margin required by clearing agencies (i.e., not be the greater of those amounts or the amount of the haircuts that would apply to the cleared security-based swap positions). Some commenters supported the potential rule language modifications.<sup>79</sup> Other commenters

increases in the capital requirements for ANC broker-dealers).

<sup>64</sup> See Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Securities Industry and Financial Markets Association (Feb. 22, 2013) ("SIFMA 2/22/2013 Letter").

<sup>65</sup> See Letter from Stuart J. Kaswell, Executive Vice President, Managing Director, and General Counsel, Managed Funds Association (Feb. 22, 2013) ("MFA 2/22/2013 Letter").

<sup>66</sup> See Letter from Stephen John Berger, Managing Director, Government & Regulatory Policy, Citadel Securities (May 15, 2017) ("Citadel 5/15/2017 Letter").

<sup>67</sup> See paragraphs (a)(7)(i) and (a)(10)(i) of Rule 15c3-1, as amended; paragraphs (a)(1) and (2) of Rule 18a-1, as adopted. In the final rule, the Commission made non-substantive amendments to the term of "tentative net capital" in Rule 18a-1, as adopted, to align the language more closely to the definition in Rule 15c3-1. See paragraph (c)(5) of Rule 18a-1, as adopted.

<sup>68</sup> See paragraph (a)(1) of Rule 18a-1, as adopted.

<sup>69</sup> See paragraph (a)(2) of Rule 18a-1, as adopted.

<sup>70</sup> See paragraph (a)(10)(i) of Rule 15c3-1, as amended.

<sup>71</sup> See paragraph (a)(7)(i) and (ii) of Rule 15c3-1, as amended.

<sup>72</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70225-26.

<sup>73</sup> See SIFMA 11/19/18 Letter. This commenter suggested that the Commission not apply the proposed 8% margin factor to full-purpose broker-dealers, and modify the customer reserve requirements to include security-based swap credits and debits, thereby covering security-based swaps in the existing 2% debit item ratio, under existing Rule 15c3-1. For stand-alone SBSBs, the commenter recommended replacing the proposed 8% margin factor with a 2% minimum capital requirement, based on a calculation consistent with the proposed risk margin amount.

<sup>74</sup> See SIFMA 2/22/2013 Letter.

<sup>75</sup> The commenter suggested two approaches: one for nonbank SBSBs authorized to use models and one for nonbank SBSBs not authorized to use models. Under the first approach, the risk margin amount would be a percent of the firm's aggregate model-based haircuts. The second approach was a credit quality adjusted version of the proposed 8% margin factor.

<sup>76</sup> See SIFMA 11/19/18 Letter.

<sup>77</sup> See Morgan Stanley 11/19/2018 Letter. This commenter also argued that a stand-alone broker-dealer should not be subject to the proposed 8% margin factor minimum ratio requirement. Stand-alone broker-dealers—other than ANC broker-dealers—do not have to incorporate the 2% margin factor into their net capital calculation under Rule 15c3-1, as amended.

<sup>78</sup> See MFA 2/22/2013 Letter. See also Letter from Thomas G. McCabe, Chief Regulatory Officer, OneChicago (Nov. 19, 2018) ("OneChicago 11/19/2018 Letter").

<sup>79</sup> See ICI 11/19/18 Letter; MFA/AIMA 11/19/2019 Letter; SIFMA 11/19/2018 Letter.

opposed them.<sup>80</sup> One commenter opposing the modifications stated that the “greater of” provision creates a backstop to protect against the possibility that varying margin requirements across clearing agencies and over time could be insufficient to reflect the true risk to a nonbank SBSB arising from its customers’ positions.<sup>81</sup> Another commenter stated that eliminating the haircut requirement may incentivize clearing agencies to compete on the basis of margin requirements.<sup>82</sup>

The Commission continues to believe a margin factor ratio is the right approach to setting a scalable minimum net capital requirement. The calculation is based on the initial margin required to be posted by an ANC broker-dealer or nonbank SBSB to a clearing agency for cleared security-based swaps and on the initial margin calculated by a nonbank SBSB for a counterparty for non-cleared security-based swaps.<sup>83</sup> Margin requirements generally are scaled to the risk of the positions, with riskier positions requiring higher levels of margin. Therefore, the amount of the ratio-based minimum net capital requirement will be linked to the volume, size, and risk of the firm’s cleared and non-cleared security-based swap transactions.

However, in response to comments raising concerns about the potential impact of the proposed 8% margin factor, the Commission believes it would be appropriate to adopt, at least initially, a lower margin factor and create a process through which the percent multiplier can potentially (but not necessarily) be increased over time (*i.e.*, starting at 2% and potentially transitioning from 2% to 8% or less over the course of at least 5 years). Initially using a 2% multiplier could provide ANC broker-dealers and nonbank SBSBs with time to adjust to the requirement if it incrementally increases. The final rule sets strict limits in terms of how quickly the multiplier can be raised and the amount by which it can be raised through the process in the rule because market participants should know when a potential increase in the multiplier using the process could first occur and how much the multiplier could be increased at that time or thereafter. The

Commission’s objective is to establish an efficient and flexible process, while providing market participants with notice about the potential timing and magnitude of an increase so that they can make informed decisions about how to structure their businesses.

Consequently, under the process set forth in the final rules, the percent multiplier will be 2% for at least 3 years after the compliance date of the rule.<sup>84</sup> After 3 years, the multiplier could increase to not more than 4% by Commission order, and after 5 years the multiplier could increase to not more than 8% by Commission order if the Commission had previously issued an order raising the multiplier to 4% or less. The process sets an upper limit for the multiplier of 8% (the day-1 multiplier under the proposed rules) and requires the issuance of two successive orders to raise the multiplier to as much as 8% (or an amount between 4% and 8%). The first order can be issued no earlier than 3 years after the compliance date of the rules, and the second order can be issued no earlier than 5 years after the compliance date.

The process in the final rules provides that, before issuing an order to raise the multiplier, the Commission will consider the capital and leverage levels of the firms subject to the ratio-based minimum net capital requirement as well as the risks of their security-based swap positions. After the rule is adopted, the Commission will gather data on how the ratio-based minimum net capital requirement using the 2% multiplier (“2% margin factor”) compares to the levels of excess net capital these firms maintain, the risks of their security-based swap positions, and the leverage they employ.<sup>85</sup> This information will assist the Commission in analyzing whether the ratio-based minimum net capital requirement is operating in practice as the Commission intends (*i.e.*, a requirement that sets a prudent level of minimum net capital given the volume, size, and risk of the firm’s security-based swap positions). In

determining whether to issue an order raising the multiplier, the Commission may also consider, for example, whether further data is necessary to analyze the appropriate level of the ratio-based minimum net capital requirement.

Finally, the process in the final rules provides that the Commission will publish notice of the potential change to the multiplier and subsequently issue an order regarding the change. The Commission intends to provide such notice sufficiently in advance of the order for the public to be aware of the potential change.

As discussed above, a commenter suggested that broker-dealer SBSBs should be subject to a ratio that is modeled on the 2% debit item ratio in Rule 15c3-1. The Commission does not believe there is a compelling reason to adopt a different standard for broker-dealer SBSBs. The standard being adopted today is based on initial margin calculations for cleared and non-cleared security-based swaps. Modeling a requirement on the 2% debit item ratio would require a calculation based on the segregation requirements for security-based swaps. This could result in firms with similar risk profiles in terms of their customers’ security-based swap positions having different minimum net capital requirements because for stand-alone SBSBs the requirement would be based on margin calculations and for ANC broker-dealers and broker-dealer SBSBs the requirement would be based on segregation requirements. The Commission believes the more prudent approach is to require all firms subject to this requirement to comply with the same standard in order to avoid the potential competitive impacts of imposing different standards, particularly when the rationale for applying the different standard advocated by the commenter is not grounded in promoting the safety and soundness of the firms.

Similarly, the Commission is not establishing two alternative methods for calculating the 2% margin factor—one for firms that use models and the other for firms that do not use models—as suggested by the commenter. To a certain extent, the 2% margin factor calculation by a nonbank SBSB authorized to use models to calculate initial margin requirements for non-cleared security-based swap transactions will be more risk sensitive than the calculation by nonbank SBSBs that will use the standardized approach to calculate initial margin (*i.e.*, the standardized haircuts). Models generally are more risk sensitive and therefore will result in lower initial

<sup>80</sup> See Letter from Americans for Financial Reform (Nov. 19, 2018) (“Americans for Financial Reform Education Fund Letter”); Better Markets 11/19/2018 Letter; Rutkowski 11/20/2018 Letter.

<sup>81</sup> See Better Markets 11/19/2018 Letter.

<sup>82</sup> See Americans for Financial Reform Education Fund Letter. See also Rutkowski 11/20/2018 Letter.

<sup>83</sup> An ANC broker-dealer will not be subject to the final margin rule for non-cleared security-based swaps if it is not also registered as an SBSB. Therefore, its calculation of the 2% margin factor will only account for cleared security-based swaps.

<sup>84</sup> As discussed below in section II.D. of this release, Rule 18a-10 contains a process through which the maximum fixed-dollar amount is set at a transitional level of \$250 billion for the first 3 years after the compliance date of the rule and then drops to \$50 billion thereafter unless the Commission issues an order: (1) Maintaining the \$250 billion maximum fixed-dollar amount for an additional period of time or indefinitely; or (2) lowering the maximum fixed-dollar amount to an amount between \$250 billion and \$50 billion.

<sup>85</sup> See section VI of this release (providing analysis of initial margin estimated for inter-dealer CDS positions, and using this to provide a range of estimates for the potential costs of complying with the 2% margin factor requirement, under certain assumptions).

margin requirements than approaches using standardized haircuts. Thus, the firms that use models to calculate initial margin for non-cleared security-based swaps generally will employ a more risk-sensitive approach when calculating the 2% margin factor than firms that do not use models. Further, the Commission believes that most nonbank SBSBs will use models to calculate initial margin to the extent permitted under the final margin rules.

Moreover, a standard based on a firm's aggregate model-based haircuts—the commenter's first suggested alternative—could result in a substantially lower minimum net capital requirement. The Commission's approach requires the firm to calculate the risk margin amount using the initial margin amount calculated for each counterparty's cleared and non-cleared security-based swap positions. The commenter's alternative of using the model-based haircut calculations would net proprietary positions resulting in a lower minimum net capital requirement. The Commission believes the more prudent approach is to base the minimum net capital requirement on the margin calculations for each counterparty's security-based swap positions. For similar reasons, the Commission believes nonbank SBSBs not authorized to use models should base the calculation of the risk margin amount on the standardized margin calculations for their counterparties (rather than the standardized haircut calculation that can be taken for proprietary positions, which permits certain netting of long and short positions). This will be simpler and more consistent with the requirements of Rule 18a–3, as adopted, than the commenter's suggested credit quality approach for nonbank SBSBs that do not use models.

Moreover, as discussed below in section II.A.2.b.v. of this release, the final capital rules for ANC broker-dealers and nonbank SBSBs broaden the application of the credit risk charges as compared to the proposed rules. This should significantly reduce the amount of net capital an ANC broker-dealer or nonbank SBSB will need to maintain with respect to its security-based swap positions (as compared to the treatment of these positions under the proposed rules).<sup>86</sup> Therefore, the Commission believes that largely retaining the proposed approaches to calculating the risk margin amount (and, therefore, the

2% margin factor) is an appropriate trade-off to reducing the application of the capital deductions in lieu of margin.

In response to comments that the Commission exclude security-based swaps that are being portfolio margined under a CFTC-supervised account, the Commission will need to coordinate with the CFTC to implement portfolio margining.<sup>87</sup> A part of any such coordination would be to resolve the question of how to incorporate accounts that are portfolio margined into the minimum net capital requirements under the capital rules of the Commission and the CFTC.

In response to comments, the Commission does not believe it would be appropriate to treat cleared security-based swaps more favorably than non-cleared security-based swaps for purposes of calculating the 2% margin factor. The 2% margin factor is consistent with an existing requirement in the CFTC's net capital rule for FCMs.<sup>88</sup> Currently, FCMs must maintain adjusted net capital in excess of 8% of the risk margin on futures, foreign futures, and cleared swaps positions carried in customer and noncustomer accounts. Moreover, the CFTC has proposed a similar requirement for swap dealers and major swap participants registered as FCMs.<sup>89</sup> The CFTC's proposed minimum capital requirement is 8% of the initial margin for non-cleared swap and security-based swap positions, and the total initial margin the firm is required to post to a clearing agency or broker-dealer for cleared swap and security-based swap positions. Thus, the CFTC's proposed rule does not treat cleared positions more favorably than non-cleared positions (both are based on initial margin calculations).

However, in response to comments, the Commission has modified the final rule so that for cleared security-based swaps the calculation of the risk margin amount is based on the initial margin required to be posted to a clearing agency rather than the greater of that amount or the haircuts that would apply to the positions (as was proposed).<sup>90</sup> Thus, for purposes of the 2% margin factor, the risk of cleared security-based swaps is measured by the amount of

initial margin the clearing agency's margin rule requires. This more closely aligns the Commission's rule with the CFTC's proposed rule (as requested by commenters).

In response to commenters who opposed this modification, the Commission recognizes that it will eliminate a component of the proposed rule that was designed to address the potential that clearing agencies might set margin requirements that were lower than the applicable haircuts that would apply to the positions. However, retaining the requirement could have created a disincentive to clear security-based swap transactions. Moreover, eliminating it will simplify the calculation and more closely align the requirement with the CFTC's proposed capital rule. The Commission has weighed these competing considerations and believes that the modification is appropriate.

The Commission does not believe further modifications to distinguish the risk of cleared security-based swaps from non-cleared security-based swaps are necessary. Cleared security-based swaps generally will be less complex than non-cleared security-based swaps. Further, cleared security-based swaps will be more liquid than non-cleared security-based swaps in terms of how long it will take to close them out. These attributes may factor into the margin calculations of the clearing agencies and, consequently, into the risk margin amount. Therefore, the potentially lower risk characteristics of cleared security-based swaps as compared to non-cleared security-based swaps could be incorporated into the 2% margin factor by virtue of relying solely on the clearing agency margin requirements.

For these reasons, the Commission is adopting the 2% margin factor with modifications to the term "risk margin amount" and the potential phase-in of the percent multiplier, as discussed above.<sup>91</sup> Stand-alone SBSBs will need to calculate the 2% margin factor to determine their ratio-based minimum net capital requirement. ANC broker-dealers and broker-dealer SBSBs will need to calculate the 2% margin factor and the 15-to-1 ratio or 2% debit item ratio (as applicable) to determine their ratio-based minimum net capital requirement.

#### b. Computing Net Capital

The Commission proposed the net liquid assets test embodied in Rule 15c3–1 as the regulatory capital

<sup>87</sup> See, e.g., *Order Granting Conditional Exemption Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps*, Exchange Act Release No. 68433 (Dec. 14, 2012), 77 FR 75211 (Dec. 19, 2012).

<sup>88</sup> See 17 CFR 1.17(a)(1)(i)(B) and (b)(8).

<sup>89</sup> See *CFTC Capital Proposing Release*, 81 FR at 91266.

<sup>90</sup> See paragraph (c)(17) of Rule 15c3–1, as amended; paragraph (c)(6) of Rule 18a–1, as adopted.

<sup>86</sup> See SIFMA 2/22/2013 Letter (raising concerns that the proposed 8% margin factor and the capital charges in lieu of margin could result in duplicative charges).

<sup>91</sup> See paragraphs (a)(7)(i) and (a)(10)(i) of Rule 15c3–1, as amended; paragraphs (a)(1) and (2) of Rule 18a–1, as adopted.



standard for all nonbank SBSDs. The standard (maintaining net liquid assets) is imposed through the computation requirements set forth in paragraph (c)(2) of Rule 15c3-1, which defines the term “net capital.” The first step in a net capital calculation is to compute the broker-dealer’s net worth under GAAP. Next, the broker-dealer must make certain adjustments to its net worth. These adjustments are designed to leave the firm in a position in which each dollar of unsubordinated liabilities is matched by more than a dollar of highly liquid assets.<sup>92</sup> There are fourteen categories of net worth adjustments, including adjustments resulting from the application of standardized or model-based haircuts.<sup>93</sup> The Commission proposed that a broker-dealer SBSD compute net capital pursuant to the pre-existing provisions in paragraph (c)(2) of Rule 15c3-1, as proposed to be amended, to account for security-based swap and swap activities, and that stand-alone SBSDs compute net capital in a similar manner pursuant to proposed Rule 18a-1.<sup>94</sup>

#### i. Deduction for Posting Initial Margin

If a stand-alone broker-dealer or nonbank SBSD delivers initial margin to a counterparty, it must take a deduction from net worth in the amount of the posted collateral.<sup>95</sup> The Commission recognizes that the imposition of this deduction could increase transaction costs for stand-alone broker-dealers and nonbank SBSDs.<sup>96</sup> Consequently, the Commission sought comment on whether it should provide a means for a firm to post initial margin to counterparties without incurring the deduction with respect to Rules 15c3-1 and 18a-1, under specified conditions. The potential conditions included that the initial margin requirement is funded by a fully executed written loan agreement with an affiliate of the firm and that the lender waives re-payment of the loan until the initial margin is returned to the firm.<sup>97</sup>

<sup>92</sup> 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).

<sup>93</sup> See paragraphs (c)(2)(i) through (xiv) of Rule 15c3-1.

<sup>94</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70230–56.

<sup>95</sup> 17 CFR 15c3-1(c)(2)(iv).

<sup>96</sup> See section VI of this release (discussing costs and benefits of the rules and amendments).

<sup>97</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53012.

Several commenters expressed support for this general approach but suggested modifications. A commenter supported requiring no deduction if the posted initial margin is: (1) Subject to an agreement that satisfies the specified conditions, or (2) maintained at a third-party custodian in accordance with the recommendations of the Basel Committee on Banking Supervision (“BCBS”) and the Board of the International Organization of Securities Commissions (“IOSCO”) made with respect to margin requirements for non-cleared derivatives (“BCBS/IOSCO Paper”).<sup>98</sup> Another commenter supported the policy behind the Commission’s approach recognizing the role of an SBSD as a subsidiary of a larger banking organization, but recommended that the Commission evaluate whether inter-company liquidity and funding arrangements and loss absorbing capacity mandated by resolution planning guidance should be recognized as a second alternative to deductions for initial margin posted away.<sup>99</sup> This commenter also encouraged the Commission to reconcile its guidance with the CFTC’s proposed capital rules, which do not require initial margin posted to a third-party custodian to be deducted from net worth in computing capital.<sup>100</sup> Finally, a commenter raised concerns regarding the potential guidance suggesting that the effect of the conditions would be to reduce the amount of capital SBSDs are required to hold, increasing risk.<sup>101</sup>

The Commission is providing the following interpretive guidance as to how a stand-alone broker-dealer or nonbank SBSD can avoid taking a deduction from net worth when it posts initial margin to a third party. Under the guidance, initial margin provided by a stand-alone broker-dealer or nonbank SBSD to a counterparty need not be deducted from net worth when computing net capital if:

- The initial margin requirement is funded by a fully executed written loan agreement with an affiliate of the stand-alone broker-dealer or nonbank SBSD;
- The loan agreement provides that the lender waives re-payment of the loan until the initial margin is returned to the stand-alone broker-dealer or nonbank SBSD; and

<sup>98</sup> See SIFMA 11/19/2018 Letter. See also BCBS and IOSCO, *Margin Requirements for Non-centrally Cleared Derivatives* (Mar. 2015), available at <http://www.bis.org/bcbs/publ/d317.pdf>.

<sup>99</sup> See Morgan Stanley 11/19/2018 Letter.

<sup>100</sup> See Morgan Stanley 11/19/2018 Letter. In the case of a dually-registered SBSD/swap dealer, the commenter encouraged the Commission to defer to the CFTC’s proposed treatment for swap initial margin.

<sup>101</sup> See Better Markets 11/19/2018 Letter.

- The liability of the stand-alone broker-dealer or the nonbank SBSD to the lender can be fully satisfied by delivering the collateral serving as initial margin to the lender.<sup>102</sup>

Stand-alone broker-dealers and nonbank SBSDs may apply this guidance to security-based swap and swap transactions.<sup>103</sup> In response to comments, the Commission does not believe this interpretive guidance will increase risk to a stand-alone broker-dealer or nonbank SBSD because the conditions require that an affiliate fund the initial margin requirement, resulting in no decrease to the capital of the broker-dealer or nonbank SBSD. In contrast, these conditions may decrease risks to a stand-alone broker-dealer or nonbank SBSD by making additional capital available to the firm for liquidity or other purposes, given that it will not need to use its own capital to fund the initial margin requirement of the counterparty. Further, the Commission does not believe that initial margin posted by a stand-alone broker-dealer or nonbank SBSD with respect to a swap transaction should be exempt from the firm’s net capital requirements, since collateral posted away from the firm would not be available for other purposes, and, therefore, the firm’s liquidity would be reduced. Finally, in response to comments, the Commission does not believe it would be appropriate at this time to permit a stand-alone broker-dealer or nonbank SBSD to look to collateral held by an affiliate as part of resolution planning as a means for the firm to avoid taking a deduction for initial margin posted to a counterparty. The collateral held by the affiliate may not be available to the stand-alone

<sup>102</sup> Although not binding, the staff of the Division of Trading and Markets issued a no-action letter (in the context of margin collateral posted by a stand-alone broker-dealer to a swap dealer or other counterparty for a non-cleared swap) that stated that the staff would not recommend enforcement action to the Commission if the stand-alone broker-dealer did not deduct from net worth when computing net capital initial margin provided to a counterparty, if certain conditions were met. See Letter from Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, Commission, to Kris Dailey, Vice President, Risk Oversight and Regulation, FINRA (Aug. 19, 2016) (“Staff Letter”). See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53012, n.38 (discussing the conditions in the Staff Letter).

<sup>103</sup> This guidance is not relevant to margin collateral posted to a clearing agency for a cleared security-based swap or a DCO for a cleared swap. Under the final capital rules, stand-alone broker-dealers and nonbank SBSDs may treat margin collateral posted to a clearing agency for cleared security-based swaps or to a DCO for cleared swaps as a “clearing deposit” and, therefore, not deduct the value of the collateral from net worth when computing net capital. See paragraph (c)(2)(iv)(E)(3) of Rule 15c3-1, as amended; paragraph (c)(1)(iii) of Rule 18a-1, as adopted.

broker-dealer or nonbank SBSB, particularly in a time of market stress when it is most needed.

ii. Deductions for not Collecting Margin

The pre-existing provisions of paragraph (c)(2)(xii) of Rule 15c3-1 require a broker-dealer to take a deduction from net worth for under-margined accounts. The Commission proposed to amend Rule 15c3-1 to require a stand-alone broker-dealer or broker-dealer SBSB to take a deduction from net worth for the amount of cash required in the account of each security-based swap customer to meet a margin requirement of a clearing agency, DEA (such as FINRA), or the Commission to which the firm was subject, after application of calls for margin, marks to the market, or other required deposits which are outstanding one business day or less.<sup>104</sup> Proposed Rule 18a-1 had an analogous provision, although it did not refer to margin requirements of DEAs because stand-alone SBSBs will not be members of self-regulatory organizations ("SROs") and therefore will not have a DEA.

These proposed under-margined account provisions required a stand-alone broker-dealer or nonbank SBSB to take a deduction from net worth when a customer or security-based swap customer did not meet a margin requirement of a clearing agency, DEA, or the Commission pursuant to a rule that applied to the stand-alone broker-dealer or nonbank SBSB after one business day from the date the margin requirement arises. The proposed deductions were designed to address the risk to stand-alone broker-dealers and nonbank SBSBs that arises from not collecting collateral to cover their exposures to counterparties. The Commission asked whether the deductions should also be extended to failing to collect margin required under margin rules for swap transactions that apply to a stand-alone broker-dealer or nonbank SBSB.<sup>105</sup>

The Commission also proposed deductions from net worth to address situations in which an account of a security-based swap customer is meeting all applicable margin requirements, but the margin requirements result in the collection of an amount of collateral that is insufficient to address the risk of the positions in the account.<sup>106</sup> The

proposals separately addressed cleared and non-cleared security-based swaps.

For cleared security-based swaps, the Commission proposed a deduction that applied if a nonbank SBSB collects margin 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 SBSB (*i.e.*, the collected margin was less than the amount of the standardized or model-based haircuts, as applicable). This proposed requirement was designed to account for the risk of the counterparty defaulting by requiring the nonbank SBSB to maintain capital in the place of collateral in an amount that is no less than required for a proprietary position. It also was designed 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. In the 2018 comment reopening, the Commission asked whether this proposed rule should be modified to include a risk-based threshold under which the deduction need not be taken, and provided modified rule text to apply the deduction to cleared swap transactions.<sup>107</sup>

For non-cleared security-based swaps, the Commission proposed requirements that imposed deductions to address 3 exceptions in the nonbank SBSB margin requirements of proposed Rule 18a-3. Under these 3 exceptions, a nonbank SBSB would not be required to collect (or, in one case, hold) variation and/or initial margin from certain types of counterparties. Consequently, the Commission proposed deductions to serve as an alternative to collecting margin.

The first proposed deduction applied when a nonbank SBSB does not collect sufficient margin under an exception in proposed Rule 18a-3 for counterparties that are commercial end users. The second proposed deduction applied when the nonbank SBSB does not hold initial margin under an exception in proposed Rule 18a-3 for counterparties requiring that the collateral be segregated pursuant to Section 3E(f) of

the Exchange Act. Section 3E(f) of the Exchange Act, among other things, provides that the collateral must be carried by an independent third-party custodian. Collateral held in this manner would not be in the physical possession or control of the nonbank SBSB, nor would it be capable of being liquidated promptly by the nonbank SBSB without the intervention of another party. Consequently, it would not meet the collateral requirements in proposed Rule 18a-3. The third proposed deduction applied when a nonbank SBSB does not collect sufficient margin under an exception in proposed Rule 18a-3 for legacy accounts (*i.e.*, accounts holding security-based swap transactions entered into prior to the effective date of the rule). The Commission also sought comment on whether there should be deductions in lieu of margin for non-cleared swaps with commercial end users and counterparties that elect to have initial margin held at a third-party custodian as well as for non-cleared swaps in legacy accounts.<sup>108</sup>

In the 2018 comment reopening, the Commission provided potential rule language that would establish deductions in lieu of margin for non-cleared security-based swaps and swaps.<sup>109</sup> The amount of the deduction for non-cleared security-based swaps would be the initial margin calculated pursuant to proposed Rule 18a-3 (*i.e.*, using the standardized haircuts in the nonbank SBSB capital rules or a margin model). The amount of the deduction for non-cleared swaps would be the standardized haircuts in the nonbank SBSB capital rules or the amount calculated using a margin model approved for purposes of proposed Rule 18a-3.

The Commission also asked in the 2018 comment reopening whether there should be an exception to taking the deduction for initial margin collateral held by an independent third-party custodian pursuant to Section 3E(f) of the Exchange Act or Section 4s(l) of the CEA under conditions that promote the SBSB's ability to promptly access the collateral if needed.<sup>110</sup> Specifically, the Commission sought comment on whether there should be such an exception under the following conditions: (1) The custodian is a bank; (2) the nonbank SBSB enters into an agreement with the custodian and the counterparty that provides the nonbank

<sup>107</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53009. More specifically, the Commission requested comment on whether the rule should provide that the deduction need not be taken if the difference between the clearing agency margin amount and the haircut is less than 1% (or some other amount) of the SBSB's tentative net capital, and less than 10% (or some other amount) of the counterparty's net worth, and the aggregate difference across all counterparties is less than 25% (or some other amount) of the counterparty's tentative net capital.

<sup>108</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70247-48.

<sup>109</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53012.

<sup>110</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53011-12.

<sup>104</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70245, 70331.

<sup>105</sup> See 77 FR at 70247.

<sup>106</sup> See 77 FR at 7045-47.

SBSD with the same control over the collateral as would be the case if the nonbank SBSD controlled the collateral directly; and (3) an opinion of counsel deems the agreement enforceable. In addition, the Commission stated it was considering providing guidance on ways a nonbank SBSD could structure the account control agreement to meet a requirement that the nonbank SBSD have the same control over the collateral as would be the case if the nonbank SBSD controlled the collateral directly.<sup>111</sup>

#### Comments and Final Requirements for Deductions for Under-Margined Accounts

As noted above, the Commission proposed a deduction from net worth for failing to collect margin required by a rule of a clearing agency, DEA, or the Commission that applied to the stand-alone broker-dealer or nonbank SBSD.<sup>112</sup> A commenter urged the Commission to permit firms a one-day grace period before the deduction would apply in the case of an under-margined account of an affiliate if the affiliate is subject to U.S. or comparable non-U.S. prudential regulation.<sup>113</sup> The commenter stated that applying an immediate deduction with respect to a security-based swap transaction with a regulated affiliate before there is operationally a means for transferring collateral to the SBSD would only serve to undermine beneficial risk management activities within a corporate group.

In response to the comment, the final margin rule being adopted today provides a nonbank SBSD or MSBSP an additional day (*i.e.*, two business days) to collect required margin from a counterparty (including variation margin due from an affiliate) if the counterparty is located in a different country and more than 4 time zones

away.<sup>114</sup> In addition, the exceptions for when nonbank SBSDs need not collect initial margin from a counterparty have been expanded.<sup>115</sup> For example, the financial market intermediary exception has been expanded so that it not only applies to counterparties that are SBSDs but also to other types of financial market intermediaries, including foreign and domestic banks and broker-dealers.<sup>116</sup> There also is an exception from collecting initial margin from affiliates.<sup>117</sup> In addition, the final margin rule includes an initial margin exception when the aggregate credit exposure of the nonbank SBSD and its affiliates to the counterparty and its affiliates is \$50 million or less.<sup>118</sup> These modifications to the final margin rule should substantially mitigate the commenter's concerns, given that in many instances there will be no requirement to collect initial margin, and the timeframe for collecting margin has been lengthened for counterparties located in other countries when they are more than 4 time zones away.

Nonetheless, when margin is required by a rule that applies to an entity, it should be collected promptly.<sup>119</sup> Margin is designed to protect the stand-alone broker-dealer or nonbank SBSD from the consequences of the counterparty defaulting on its obligations. This deduction for failing to collect required margin will serve as an incentive for stand-alone broker-dealers and nonbank SBSDs to have a well-functioning margin collection system, and the capital needed to take the deduction will protect them from the consequences of the counterparty's default.

For the foregoing reasons, the Commission is adopting the deduction for under-margined accounts with the modification to include a deduction for failing to collect required margin with

respect to swap transactions.<sup>120</sup> In addition, as discussed above, the Commission has modified Rule 18a-3 to permit an extra business day to collect margin from a counterparty that is located in another country and more than 4 time zones away. Further, it is possible that other margin requirements for security-based swaps and swaps may provide more than one business day to collect required margin.<sup>121</sup> Therefore, the final rules have been modified to provide that the deduction for uncollected margin can be reduced by calls for margin, marks to the market, or other required deposits which are outstanding *within the required time frame* to collect the margin, mark to the market, or other required deposits.<sup>122</sup> As proposed, the rules provided that the deduction could be reduced by calls for margin, marks to the market, or other required deposits which are outstanding one business day or less. Consequently, under the final rules, if the firm has sent the counterparty a margin call within the required time frame for collecting the margin, a stand-alone broker-dealer or nonbank SBSD can reduce the deduction for required margin that has not been collected from a counterparty by the amount of that call. If the counterparty does not post the margin within that time frame, the deduction must be taken.

#### Comments and Final Requirements for Deductions In Lieu of Margin for Cleared Transactions

As noted above, the Commission proposed a deduction from net worth that applied if a nonbank SBSD collects margin from a counterparty for a cleared security-based swap 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.<sup>123</sup> In the 2018 comment reopening, the Commission asked whether this proposal should be modified to include a risk-based threshold under which the proposed deduction need not be taken.<sup>124</sup>

A commenter stated that the requirement to take a deduction in lieu

<sup>111</sup> The Commission asked commenters to address whether the agreement between the nonbank SBSD, counterparty, and third party should: (1) Provide that the collateral will be released promptly and directed in accordance with the instructions of the nonbank SBSD upon the receipt of an effective notice from the nonbank SBSD; (2) provide that when the counterparty provides an effective notice to access the collateral the nonbank SBSD will have sufficient time to challenge the notice in good faith and that the collateral will not be released until a prior agreed-upon condition among the three parties has occurred; and (3) give priority to an effective notice from the nonbank SBSD over an effective notice from the counterparty, as well as priority to the nonbank SBSD's instruction about how to transfer collateral in the event the custodian terminates the account control agreement.

<sup>112</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70245.

<sup>113</sup> See SIFMA 2/22/2013 Letter.

<sup>114</sup> See paragraphs (c)(1)(iii) and (c)(2)(ii) of Rule 18a-3, as adopted. These and other provisions related to the margin rule are discussed in more detail in section II.B.2. below. In addition, a conforming change was made in paragraph (c)(1)(iii)(B) of Rule 18a-1, as adopted, to replace the phrase "one business day" with "the required time frame to collect the margin, marks to the market, or other required deposit." See paragraph (c)(1)(iii)(B) of Rule 18a-1, as adopted.

<sup>115</sup> See paragraph (c)(1)(iii) of Rule 18a-3, as adopted.

<sup>116</sup> See paragraph (c)(1)(iii)(B) of Rule 18a-3, as adopted.

<sup>117</sup> See paragraph (c)(1)(iii)(G) of Rule 18a-3, as adopted.

<sup>118</sup> See paragraph (c)(1)(iii)(H) of Rule 18a-3, as adopted.

<sup>119</sup> A stand-alone broker-dealer will not be subject to the Commission's final margin rule for non-cleared security-based swaps (Rule 18a-3). Therefore, the firm will not be required to take a capital deduction for failing to collect margin under this rule.

<sup>120</sup> See paragraph (c)(2)(xii)(B) of Rule 15c3-1, as amended; paragraph (c)(1)(viii) of Rule 18a-1, as adopted.

<sup>121</sup> See *CFTC Margin Adopting Release*, 81 FR at 649-650; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74864-65 (discussing collection of margin timing requirements, including when counterparties are located in different time zones).

<sup>122</sup> See paragraph (c)(2)(xii)(B) of Rule 15c3-1, as amended; paragraph (c)(1)(viii) of Rule 18a-1, as adopted.

<sup>123</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70245-46.

<sup>124</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53009.

of margin with respect to cleared security-based swaps would “harm customers because it would provide an incentive for the collection of margin by SBSDs beyond the amount determined by the clearing agency.”<sup>125</sup> The commenter recommended that the Commission eliminate this proposed deduction. Several commenters stated that the Commission should address any concerns regarding clearing agency minimum margin requirements directly through its regulation of clearing agencies.<sup>126</sup> One commenter stated that the deduction could drive business to firms willing to incur the deduction instead of collecting sufficient margin.<sup>127</sup> The commenter believed that this would provide an advantage to the largest clearing firms possessing the greatest amount of excess net capital, thereby exacerbating concentration in the market for clearing services. Another commenter stated that a low margin level for cleared swaps should not be viewed as a deficiency of clearing models but as an advantage of central clearing.<sup>128</sup> This commenter stated that a threshold such as the one described in the 2018 comment reopening would not address the commenter’s concerns and that the proposed deduction should be eliminated. Another commenter recommended that the Commission impose the cleared security-based swap deduction only to the extent it exceeds 1% of the SBSD’s tentative net capital, consistent with the Commission’s CDS portfolio margin exemption.<sup>129</sup> One commenter opposed the inclusion of a potential threshold in the final rule, believing it would reduce capital requirements and increase risk.<sup>130</sup> Some commenters opposed applying the proposed deduction to cleared swaps, arguing it would interfere with the CFTC’s comprehensive regulation of cleared swaps margin requirements.<sup>131</sup> A commenter noted that client clearing markets in the United States are, in their current composition, dominated by CFTC-regulated swaps and believed that integration of Commission net capital rules with CFTC net capital rules is particularly important in the case of client clearing.<sup>132</sup>

The Commission is persuaded by commenters that the proposed deduction could provide an unintended advantage to the largest clearing firms and that potential issues regarding clearing agency and DCO minimum margin requirements may be addressed through direct regulation of clearing agencies and DCOs. Therefore, the Commission is eliminating the proposed deduction from the final rules. The CFTC did not propose a similar deduction related to clearing agency margin requirements. Therefore, eliminating this deduction from the final rules may result in the two agencies having more closely aligned capital requirements.

In response to comments that elimination of the proposed deduction will decrease capital requirements and increase risk, the Commission believes that existing requirements for clearing agencies and DCOs as well as the risk management requirements for nonbank SBSDs being adopted today will address the potential risk of a counterparty defaulting on a requirement to post margin for a cleared security-based swap or swap transaction. For example, since the issuance of the proposing release in 2012, the Commission has enhanced its clearing agency standards. More specifically, in 2016, the Commission adopted final rules to establish enhanced standards for the operation and governance of registered clearing agencies that meet the definition of “covered clearing agency.”<sup>133</sup> Under these rules, a covered clearing agency that provides central clearing services must establish, implement, maintain, and enforce written policies and procedures reasonably designed to, as applicable, cover its credit exposures to its participants by establishing a risk-based margin system that meets certain minimum standards prescribed in the rule.<sup>134</sup> The CFTC also has adopted enhanced requirements for systemically important DCOs.<sup>135</sup> In addition, nonbank SBSDs must establish and maintain a risk management control system that complies with Rule 15c3–4. This rule requires that the system address various risks, including credit risk. Consequently, nonbank SBSDs will need to have risk management systems

designed to mitigate the risk of a counterparty defaulting on a requirement to post margin for a cleared security-based swap or swap transaction.

For the foregoing reasons, the Commission believes it is appropriate to eliminate from the final rules the deductions related to the margin requirements for cleared security-based swap and swap transactions.

#### Comments and Final Requirements for Deductions In Lieu of Margin for Non-Cleared Transactions

As noted above, the Commission proposed deductions from net worth in lieu of margin for non-cleared security-based swaps, and sought comment on whether these proposed deductions should be expanded to include non-cleared swaps.<sup>136</sup> In the 2018 comment reopening, the Commission provided potential rule language that would establish deductions in lieu of margin for non-cleared security-based swaps and swaps.<sup>137</sup> The amount of the deduction for non-cleared security-based swaps would be the initial margin calculated pursuant to proposed Rule 18a–3 (*i.e.*, using the standardized haircuts in the nonbank SBSD capital rules or a margin model approved for the purposes of Rule 18a–3). The amount of the deduction for non-cleared swaps would be the standardized haircuts in the nonbank SBSD capital rules or the amount calculated using a margin model approved for the purposes of proposed Rule 18a–3.

Comments on these matters generally fell into one of 3 categories: (1) Comments requesting or supporting the ability to apply credit risk charges instead of these deductions for a broader range of counterparties than only commercial end users; (2) comments objecting to the deduction when counterparties elect to have initial margin held at a third-party custodian and suggesting modifications to the potential exception to avoid the deduction; and (3) comments objecting to the deduction for legacy accounts and requesting the ability to use credit risk charges for these accounts.

As discussed in more detail below, the Commission is adopting the proposed deductions in lieu of margin for non-cleared security-based swap and swap transactions, but with two significant modifications that are designed to address the concerns raised by commenters. First, as discussed

<sup>125</sup> See SIFMA 2/22/2013 Letter.

<sup>126</sup> See Morgan Stanley 11/19/2018 Letter; OneChicago 11/19/2018 Letter; SIFMA 2/22/2013 Letter; SIFMA 11/19/2018 Letter.

<sup>127</sup> See SIFMA 11/19/2018 Letter.

<sup>128</sup> See OneChicago 11/19/2018 Letter.

<sup>129</sup> See SIFMA 11/19/2018 Letter. This commenter argued that the 25% aggregate tentative net capital threshold is unnecessary.

<sup>130</sup> See Better Markets 11/19/2018 Letter.

<sup>131</sup> See Morgan Stanley 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>132</sup> See Morgan Stanley 11/19/2018 Letter.

<sup>133</sup> See *Standards for Covered Clearing Agencies*, Exchange Act Release No. 78961 (Sept. 28, 2016), 81 FR 70786 (Oct. 13, 2016).

<sup>134</sup> 17 CFR 240.17Ad–22(e)(6).

<sup>135</sup> See *Enhanced Risk Management Standards for Systemically Important Derivatives Clearing Organizations*, 78 FR 49663 (Aug. 15, 2013); *Derivatives Clearing Organizations and International Standards*, 78 FR 72476 (Dec. 2, 2013).

<sup>136</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70246–47.

<sup>137</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53012.

below in section II.A.2.b.v. of this release, the Commission has expanded the circumstances under which a nonbank SBSB authorized to use models may apply credit risk charges instead of taking the deduction in lieu of margin.<sup>138</sup> Under the final rules, the credit risk charges may be applied when the nonbank SBSB does not collect variation or initial margin subject to any exception in Rule 18a–3 or the margin rules of the CFTC with respect to non-cleared security-based swap and swap transactions, respectively. However, an ANC broker-dealer SBSB is subject to a portfolio concentration charge with respect to uncollateralized current exposure (including current exposure resulting from not collecting variation margin) equal to 10% of the firm's tentative net capital.<sup>139</sup> A stand-alone SBSB is not subject to a portfolio concentration charge.<sup>140</sup>

Second, the Commission has added a provision in the final rule that allows a nonbank SBSB to treat initial margin with respect to a non-cleared security-based swap or swap held at a third-party custodian as if the collateral were delivered to the nonbank SBSB and, thereby, avoid taking the deduction for failing to hold the collateral directly.<sup>141</sup> This modification should help mitigate

concerns raised by commenters about the impact the deduction would have on nonbank SBSBs and their counterparties. Further, it responds to commenters who suggested that third-party custodial arrangements could be structured to provide the nonbank SBSB with sufficient control over the collateral to address the Commission's concern that the nonbank SBSB would not be able to promptly liquidate collateral in the event of the counterparty's default. As discussed in more detail below, the final rule is designed so that existing custodial agreements established pursuant to the margin rules of the CFTC and the prudential regulators should meet the conditions of the exception.

The Commission—as indicated above—has also modified the final requirements so that the deductions will apply to uncollected margin with respect to non-cleared swap transactions (in addition to non-cleared security-based swap transactions).<sup>142</sup> A commenter objected to applying the deductions in lieu of margin to non-cleared swaps transactions because, in the commenter's view, it would interfere with policy choices of the CFTC such as that agency's requirement that initial margin be held at a third-party custodian.<sup>143</sup> The commenter also objected to calculating the amount of the deduction using the standardized haircuts in the nonbank SBSB capital rules or a model approved for purposes of Rule 18a–3. The commenter recommended that the deduction be calculated using the methods for calculating initial margin prescribed in the CFTC's rules.

In response to the commenter's concerns about applying the deductions with respect to non-cleared swaps, the failure to collect sufficient margin from a counterparty with respect to a swap transaction exposes the nonbank SBSB to the same credit risk that arises from failing to collect sufficient margin with respect to a security-based swap transaction. The deduction in lieu of margin is designed to address this risk by requiring the nonbank SBSB to hold capital (instead of collateral) to protect itself from the consequences of the default of the counterparty. Applying the deduction in lieu of margin to non-cleared swap transactions is designed to promote the safety and soundness of the nonbank SBSB.<sup>144</sup> Moreover, as

discussed below, the Commission has modified the exception from taking the deduction when a counterparty's initial margin is held at a third-party custodian (including initial margin for non-cleared swap transactions) in a manner that is designed to accommodate custodial arrangements entered into pursuant to the CFTC's margin rules. In addition, as discussed below in section II.A.2.b.v. of this release, the ability to use credit risk charges has been expanded to swap transactions.

The Commission is persuaded by the commenter's second point that the amount of the deduction should be calculated using the methods for calculating initial margin prescribed in the CFTC's margin rules. Consequently, unlike the potential rule language in the 2018 comment reopening, the amount of the deduction is calculated using the methodology required by the margin rules for non-cleared swaps adopted by the CFTC. For example, if the CFTC has approved the firm's use of a margin model, the firm can use the model to calculate the amount of the deduction in lieu of margin.

Under the final rules, a nonbank SBSB must deduct from net worth when computing net capital unsecured receivables, including receivables arising from not collecting variation margin under an exception in the margin rule for non-cleared security-based swaps.<sup>145</sup> The final rules also require a nonbank SBSB to deduct the initial margin amount for non-cleared security-based swaps calculated under Rule 18a–3 with respect to a counterparty or account, less the margin value of collateral held in the account.<sup>146</sup> Consequently, if the nonbank SBSB does not collect and hold variation and/or initial margin for an account pursuant to an exception in Rule 18a–3, the nonbank SBSB will be required to take a 100% deduction for the uncollateralized amount of the exposure. For uncollected variation margin, the amount of the exposure is the mark-to-market value of the security-based swap; for initial margin, the amount of the exposure is the initial margin amount calculated pursuant to Rule 18a–3. However, as discussed below in section II.A.2.b.v. of this release, an ANC broker-dealer SBSB and stand-alone SBSB authorized to use models can apply a credit risk model to

requirements shall “help ensure the safety and soundness of” nonbank SBSBs).

<sup>145</sup> See paragraph (c)(2)(iv) of Rule 15c3–1; paragraph (c)(1)(iii) of Rule 18a–1, as adopted.

<sup>146</sup> See paragraph (c)(2)(xv)(A) of Rule 15c3–1, as amended; paragraph (c)(1)(ix)(A) of Rule 18a–1, as adopted.

<sup>138</sup> See paragraph (a)(7) of Rule 15c3–1, as amended; paragraph (a)(2) of Rule 18a–1, as adopted. See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53010–11 (soliciting comment on potential rule language that would modify the proposal in this manner).

<sup>139</sup> ANC broker-dealers that are not registered as SBSBs and other types of stand-alone broker-dealers will not be subject to the capital deductions in lieu of margin for non-cleared security-based swaps resulting from electing not to collect margin under Rule 18a–3 because they are not subject to the rule (*i.e.*, the rule only applies to nonbank SBSBs). As discussed above, they will be subject to the capital deductions for under-margined accounts with respect to margin requirements for security-based swaps and swaps that apply to them (*e.g.*, margin requirements of DEAs, clearing agencies, or DCOs). While ANC broker-dealers (*i.e.*, firms not registered as SBSBs) are not subject to Rule 18a–3 and the associated capital deductions in lieu of collecting margin under that rule, they may engage in OTC derivatives transactions that result in uncollateralized credit exposures to the counterparties. If so, they can apply credit risk charges to the exposures rather than take a 100% deduction for the exposure as discussed below in section II.A.2.b.v. of this release. However, as discussed in that section of this release, they are subject to the portfolio concentration charge.

<sup>140</sup> As discussed below in section II.A.2.b.v. of this release, proposed Rule 18a–1 would have established a portfolio concentration charge for stand-alone SBSBs equal to 50% of their tentative net capital. The final rule does not include that provision.

<sup>141</sup> See paragraph (c)(2)(xv)(C) of Rule 15c3–1, as amended; paragraph (c)(1)(ix)(C) of Rule 18a–1, as adopted. See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53011–12 (soliciting comment on potential rule language that would establish a means to avoid taking the deduction for failing to hold the collateral directly).

<sup>142</sup> See paragraph (c)(2)(xv)(B) of Rule 15c3–1, as amended; paragraph (c)(1)(ix)(B) of Rule 18a–1, as adopted.

<sup>143</sup> See SIFMA 11/19/18 Letter.

<sup>144</sup> See Section 15F(e)(3) of the Exchange Act (providing in pertinent part that the capital

these exposures instead of taking these deductions.

With respect to swaps, the final rules provide that a nonbank SBSB must deduct from net worth when computing net capital unsecured receivables, including receivables arising from not collecting variation margin under an exception in the non-cleared swaps margin rules of the CFTC.<sup>147</sup> The final rules also require a nonbank SBSB to deduct initial margin amounts calculated pursuant to the margin rules of the CFTC, less the margin value of collateral held in the account of a swap counterparty at the SBSB.<sup>148</sup> Consequently, if the nonbank SBSB does not collect and hold variation and/or initial margin for an account pursuant to an exception in the CFTC's margin rules, the nonbank SBSB will be required to take a 100% deduction for the uncollateralized amount of the exposure. For uncollected variation margin, the amount of the exposure is the mark-to-market value of the swap; for uncollected initial margin, the amount of the exposure is the initial margin amount calculated pursuant to the CFTC's margin rules. However, as discussed below in section II.A.2.b.v. of this release, an ANC broker-dealer and nonbank SBSB authorized to use models can apply a credit risk model to these exposures instead of taking these deductions.

*Deductions related to margin held at third-party custodians.* In terms of the deductions related to counterparties that elect to have initial margin held at a third-party custodian, commenters stated that it would discourage the use of third-party custodians, which security-based swap customers have a right to elect under Section 3E(f) of the Exchange Act.<sup>149</sup> They also claimed that

the deduction would result in substantial costs to the affected nonbank SBSB, which would be passed on to the security-based swap customer. A commenter noted that other regulators have finalized or proposed swap capital rules that do not include a special deduction for initial margin held at a third-party custodian.<sup>150</sup>

Various commenters stated that a nonbank SBSB will have legal "control" over collateral pledged to it and held at a third-party custodian when the parties properly structure a custodial agreement.<sup>151</sup> Some of these commenters also stated that properly structured tri-party account control agreements could address the Commission's concern about the nonbank SBSB's lack of control over initial margin held at a third-party custodian.<sup>152</sup> Some commenters argued that even though physical control is lacking under tri-party custodial arrangements, legal control of the securities collateral, under properly structured tri-party custodial arrangements, exists pursuant to Article 8 of the Uniform Commercial Code.<sup>153</sup> Commenters noted that pledgors, secured parties, and securities intermediaries typically memorialize the pledge of securities and grant "control" of the securities to the secured party through a tri-party account control agreement.<sup>154</sup> A commenter noted that courts have recognized the legitimacy of account control agreements and enforced them in accordance with their terms.<sup>155</sup> Finally, another commenter

suggested that the account control agreement should provide the nonbank SBSB with legal control over, and access to, the counterparty's initial margin in the event of enforcement of the firm's rights against such initial margin.<sup>156</sup>

As noted above, the Commission asked in the 2018 comment reopening whether there should be an exception to the deduction when collateral is held by an independent third-party custodian as initial margin pursuant to Section 3E(f) of the Exchange Act or Section 4s(l) of the CEA.<sup>157</sup> The Commission asked whether the capital charge should be avoided in these circumstances if: (1) The independent third-party custodian is a bank as defined in Section 3(a)(6) of the Exchange Act that is not affiliated with the counterparty; (2) the firm, the independent third-party custodian, and the counterparty that delivered the collateral to the custodian have executed an account control agreement governing the terms under which the custodian holds and releases collateral pledged by the counterparty as initial margin that provides the firm with the same control over the collateral as would be the case if the firm controlled the collateral directly; and (3) the firm obtains a written opinion from outside counsel that the account control agreement is legally valid, binding, and enforceable in all material respects, including in the event of bankruptcy, insolvency, or a similar proceeding.

As a preliminary matter, two commenters addressed the potential rule language in the preface to the exception that stated that it could apply with respect to collateral held by an independent third-party custodian as initial margin pursuant to Section 3E(f) of the Exchange Act or Section 4s(l) of the CEA.<sup>158</sup> One of these commenters noted that the CFTC and the prudential regulators adopted their margin rules pursuant to Section 4s(e) of the CEA and Section 15F(e) of the Exchange Act, respectively.<sup>159</sup> The commenter further noted that the margin rules of the CFTC and the prudential regulators require that initial margin be segregated at a third-party custodian. Consequently, the commenter was concerned that initial margin held at a third-party custodian pursuant to those margin rules would not qualify for the exception. The commenter also noted that foreign regulators' rules could require that

<sup>147</sup> See paragraph (c)(2)(iv) of Rule 15c3-1; paragraph (c)(1)(iii) of Rule 18a-1, as adopted. In order to further harmonize the Commission's capital rules with the CFTC's proposed capital rules, stand-alone broker-dealers and nonbank SBSBs need not deduct unsecured receivables from registered FCMs resulting from cleared swap transactions in computing net capital. See paragraph (a)(3)(iii)(C) of Rule 15c3-1b, as amended; paragraph (a)(2)(iii)(C) of Rule 18a-1b, as adopted.

<sup>148</sup> See paragraph (c)(2)(xv)(B) of Rule 15c3-1, as amended; paragraph (c)(1)(ix)(B) of Rule 18a-1, as adopted.

<sup>149</sup> See, e.g., Letter from American Benefits Council, Committee on Investment of Employee Benefit Assets, European Federation for Retirement Provision, the European Association of Paritarian Institutions, the National Coordinating Committee for Multiemployer Plans, and the Pension Investment Association of Canada (May 19, 2014) ("American Benefits Council, et al. 5/19/2014 Letter"); Letter from Karrie McMillan, General Counsel, Investment Company Institute (Feb. 4, 2013) ("ICI 2/4/2013 Letter"); Letter from David W. Blass, General Counsel, Investment Company Institute (Nov. 24, 2014) ("ICI 11/24/2014 Letter");

ICI 11/19/2018 Letter; Letter from Tim Buckley, Managing Director and Chief Investment Officer, and John Hollyer, Principal and Head of Risk Management and Strategy Analysis, Vanguard (May 27, 2014) ("Vanguard Letter").

<sup>150</sup> See Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association (May 18, 2017) ("MFA 5/18/2017 Letter").

<sup>151</sup> See Letter from Adam Jacobs, Director, Head of Markets Regulation, Alternative Investment Management Association (Mar. 17, 2014) ("AIMA 3/17/2014 Letter"); Letter from Karrie McMillan, General Counsel, Investment Company Institute (Dec. 5, 2013) ("ICI 12/5/2013 Letter"); ICI 11/19/2018 Letter; Letter from Institute of International Bankers and Securities Industry and Financial Markets Association (June 21, 2018) ("IIB/SIFMA Letter"); Letter from Stuart J. Kaswell, Executive Vice President, Managing Director, and General Counsel, Managed Funds Association (Feb. 24, 2013) ("MFA 2/24/2014 Letter").

<sup>152</sup> See ICI 12/5/2013 Letter; MFA 2/22/2013 Letter; MFA 2/24/2014 Letter.

<sup>153</sup> See American Benefits Council, et al. 5/19/2014 Letter; ICI 12/5/2013 Letter; ICI 11/19/2018 Letter; MFA 2/22/2013 Letter.

<sup>154</sup> See ICI 12/5/2013 Letter; MFA 2/22/2013 Letter; MFA 2/24/2014 Letter.

<sup>155</sup> See ICI 12/5/2013 Letter (*citing Scher Law Firm v. DB Partners I LLC*, 27 Misc.3d 1230(A), 911 N.Y.S.2d 696 (Kings County 2010) and *SIPC v. Lehman Brothers, Inc.*, 433 B.R. 127 (Bankr. S.D.N.Y. 2010)).

<sup>156</sup> See MFA/AIMA 11/19/2018 Letter.

<sup>157</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53011.

<sup>158</sup> See Morgan Stanley 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>159</sup> SIFMA 11/19/2018 Letter.

initial margin collateral be held at a third-party custodian.

The margin rules of the CFTC and the prudential regulators require initial margin to be held at a third-party custodian and prescribe specific requirements for the custodial arrangements as well as requirements to document agreements with counterparties governing the exchange of margin.<sup>160</sup> The margin rules of other jurisdictions could have similar requirements. In the specific context of this exception from taking a deduction, the reason why the collateral is held at a third-party custodian is less important than taking the necessary steps to enter into a custodial arrangement that meets the conditions discussed below for qualifying for the exception. The conditions are designed to provide the nonbank SBSB, as the secured party, with prompt access to the collateral held at the third-party custodian when the collateral is needed to protect the nonbank SBSB against the consequences of the counterparty's default. The fact that the collateral is held at the third-party custodian at the election of the counterparty or because a domestic or foreign law requires it to be held at the custodian should not be dispositive as to whether a given custodial arrangement can qualify for this exception.

Moreover, the second and third conditions discussed below are designed to ensure that the custodial agreement legally provides the nonbank SBSB with the right to promptly access the collateral if necessary. These conditions therefore will address any concerns regarding potential interference with that right. For these reasons, the Commission agrees with the commenters that the preface to the exception need not limit the legal bases for why the collateral is being held at a third-party custodian. Consequently, the final rules do not reference Section 3E(f) of the Exchange Act or Section 4s(l) of the CEA in the preface to the exception.<sup>161</sup>

Commenters addressed the first potential condition set forth in the 2018 comment reopening that the independent third-party custodian be a bank as defined in Section 3(a)(6) of the

Exchange Act that is not affiliated with the counterparty. One commenter stated that the condition that the custodian be an unaffiliated bank is reasonable and practical.<sup>162</sup> Other commenters suggested that the Commission expand the range of permissible custodians to include U.S. securities depositories and clearing agencies, foreign banks, and foreign securities depositories.<sup>163</sup> The Commission also received comments prior to the 2018 comment reopening that are relevant to this potential condition. Two commenters supported allowing the collateral to be held at an affiliate of the nonbank SBSB.<sup>164</sup> One commenter suggested that the third-party custodian must be a legal entity that is separate from both the nonbank SBSB and the counterparty (but not necessarily unaffiliated with the nonbank SBSB or counterparty).<sup>165</sup> This commenter stated that this position would appropriately recognize well established, ordinary course custody and trading practices of market participants, including registered funds.

The Commission agrees with commenters that it would be appropriate to recognize third-party custodians that are not a bank. In the U.S., clearing organizations and depositories registered with the Commission or the CFTC could serve as custodians. As these entities are subject to oversight and regulation, the Commission does not believe the rule should exclude them from serving as custodians. In addition, if foreign securities or currencies are used as collateral to meet an initial margin requirement, it may be impractical to have them held at a U.S. custodian. Accordingly, the Commission believes it would be appropriate to recognize a foreign bank, clearing organization, or depository that is supervised (*i.e.*, subject to oversight by a government authority) if the collateral consists of foreign securities or currencies and the custodian customarily maintains custody of such foreign securities or currencies. For these reasons, the final rules recognize domestic and foreign banks, custodians, and depositories, subject to the conditions discussed above.

The Commission also agrees with commenters that the final rules should permit the third-party custodian to be an affiliate of the nonbank SBSB (but not the counterparty). In particular, an

affiliate may be less likely to interfere with the legal right of the nonbank SBSB to exercise control over the collateral in the event of a default of the counterparty. Consequently, the final rules permit the custodian to be an affiliate of the nonbank SBSB but not the counterparty.<sup>166</sup>

Commenters addressed the second potential condition set forth in the 2018 comment reopening that the firm, the independent third-party custodian, and the counterparty that delivered the collateral to the custodian must have executed an account control agreement that provides the firm with the same control over the collateral as would be the case if the firm controlled the collateral directly. Commenters generally supported the view that a nonbank SBSB, as the secured party, should have prompt access to the collateral held at the third-party custodian.<sup>167</sup> However, a commenter objected to the "same control" language and argued it could be read to mean that nonbank SBSBs would be allowed to re-hypothecate and use collateral posted to a third-party custodian.<sup>168</sup> Another commenter argued that collateral covered by an agreement meeting the conditions of the exception would no longer be segregated in any meaningful sense, and may violate the plain language of the Dodd-Frank Act that initial margin be segregated for the benefit of the counterparty.<sup>169</sup> A commenter argued that this type of

<sup>166</sup> See paragraph (c)(2)(xv)(C)(1) of Rule 15c3-1, as amended; paragraph (c)(1)(ix)(C)(1) of Rule 18a-1, as adopted.

<sup>167</sup> See, *e.g.*, Letter from Carl B. Wilkerson, Vice President and Chief Counsel, American Council of Life Insurers (Feb. 22, 2013) ("American Council of Life Insurers 2/22/2013 Letter"); Letter from Adam Jacobs, Director of Markets Regulation, Alternative Investment Management Association (Feb. 22, 2013) ("AIMA 2/22/2013 Letter"); ICI 12/5/2013 Letter; Letter from Robert Pickel, Chief Executive Officer, International Swaps and Derivatives Association (Jan. 23, 2013) ("ISDA 1/23/13 Letter"); MFA 2/24/2014 Letter; SIFMA 2/22/2013 Letter.

<sup>168</sup> See ICI 11/19/2018 Letter.

<sup>169</sup> See Better Markets 11/19/2018 Letter. In response to the ICI 11/19/2018 Letter and the Better Markets 11/19/2018 Letter, the potential rule language in the 2018 comment reopening with respect to a custodial arrangement that provided the nonbank SBSB with the "same control" over the collateral was not intended to interfere with the fundamental purpose of having collateral held at a third-party custodian: To keep it segregated and bankruptcy remote from the secured party. Instead, it was designed to promote the ability of the nonbank SBSB to access the collateral if the counterparty defaulted. Consequently, it was not intended to permit the nonbank SBSB to re-hypothecate the collateral or undermine the counterparty's statutory right to elect to have initial margin held at a third-party custodian. In any event, as discussed below, the Commission is not adopting the "same control" standard and, therefore, these commenters' concerns about that standard have been addressed.

<sup>160</sup> See *CFTC Margin Adopting Release*, 81 FR at 670-73, 702-3 (adopting 17 CFR 23.157 and 17 CFR 23.158); *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74873-75, 74886-87, 74905, 74908-09.

<sup>161</sup> See paragraph (c)(2)(xv)(C) of Rule 15c3-1, as amended; paragraph (c)(1)(ix)(C) of Rule 18a-1, as adopted. The phrase "pursuant to section 3E(f) of the Act or section 4s(l) of the Commodity Exchange Act" in the preface to each paragraph included in the 2018 comment reopening is not included in the final rules.

<sup>162</sup> See MFA/AIMA 11/19/2018 Letter.

<sup>163</sup> See IIB 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>164</sup> See MFA 2/22/2013 Letter; SIFMA 2/22/2013 Letter.

<sup>165</sup> See ICI 11/24/2014 Letter.



provision would be costly, operationally burdensome, and inconsistent with current market practices for third-party custodial arrangements.<sup>170</sup>

The Commission agrees with commenters that the “same control” standard could create practical obstacles that would make it difficult to execute an account control agreement that would be sufficient to avoid the deduction when initial margin is held by a third-party custodian. Moreover, meeting the standard could have required the re-drafting of existing agreements that are in place in accordance with the third-party custodian and documentation requirements of the CFTC and the prudential regulators. Doing so would be a costly and burdensome process. At the same time, the Commission also agrees with commenters that the account control agreement should provide the nonbank SBSB, as the secured party, with the right to promptly access the collateral held at the third-party custodian if necessary.

The Commission has balanced these considerations in crafting final rules. In this regard, the Commission believes it would be appropriate to adopt final rules that align more closely with the third-party custodian requirements of the CFTC and the prudential regulators. Consequently, the final rules provide that the account control agreement must be a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency, or a similar proceeding of any of the parties to the agreement.<sup>171</sup> The rules further provide that the agreement must provide the nonbank SBSB with the right to access the collateral to satisfy the counterparty’s obligations to the nonbank arising from transactions in the account of the counterparty.<sup>172</sup> This is the fundamental purpose of the agreements and should not raise the same practical issues as the “same control” standard. At the same time, it

is designed to require an agreement that achieves this fundamental purpose and by doing so will provide the nonbank SBSB, as the secured party, with prompt access to the collateral held at the third-party custodian when the collateral is needed to protect the nonbank SBSB against the consequences of the counterparty’s default. While the provision requires an agreement, the Commission has crafted it with the objective that existing agreements with counterparties entered into for the purposes of the third-party custodian and documentation rules of the CFTC and the prudential regulators will suffice.

Commenters addressed the third potential condition set forth in the 2018 comment reopening that the firm obtain a written opinion from outside counsel that the account control agreement is legally valid, binding, and enforceable in all material respects, including in the event of bankruptcy, insolvency, or a similar proceeding. Some commenters opposed the requirement for an opinion of outside legal counsel on the basis of cost and impracticability, arguing it is inconsistent with market practice and operationally burdensome to implement.<sup>173</sup> One commenter stated that the requirement was unnecessary because existing account control agreements and laws provide substantial protections.<sup>174</sup> Another commenter suggested that the Commission consider alternatives to the requirement, such as permitting a nonbank SBSB to recognize initial margin so long as it has a well-founded basis to conclude that the collateral arrangement is enforceable.<sup>175</sup>

The Commission acknowledges that requiring a formal written legal opinion by outside counsel could be a costly burden and, on further consideration, may not be necessary. At the same time, the Commission believes the nonbank SBSB should take steps to analyze whether the custodial agreement will provide the firm, as the secured party, with the right to access the collateral to satisfy the counterparty’s obligations to the firm arising from transactions in the account of the counterparty. In other

words, the firm should analyze whether a tri-party custodial agreement intended to provide this right is a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency, or a similar proceeding of any of the parties to the agreement. The Commission’s view that this analysis should be performed is consistent with the views of the CFTC and the prudential regulators. In particular, those agencies, in explaining the requirements of their rules governing tri-party custodial agreements, stated that the secured party would need to conduct a sufficient legal review to conclude with a well-founded basis that, in the event of a legal challenge, including one resulting from the default or from the receivership, conservatorship, insolvency, liquidation, or similar proceedings of the custodian or counterparty, the relevant court or administrative authorities would find the custodial agreement to be legal, valid, binding, and enforceable under the law.<sup>176</sup>

The Commission has balanced the cost and potential practical difficulties in obtaining a written opinion of outside legal counsel with the need for the nonbank SBSB to enter into a tri-party custodial agreement that will operate as intended under the relevant laws. The Commission has concluded that a written legal opinion of outside counsel is not the only way to provide assurance that the tri-party custodial agreement will operate as intended. For example, the nonbank SBSB could perform its own legal analysis rather than pay outside counsel to provide the legal opinion or be a member of a competent industry association that makes legal analysis available to its members. Therefore, the final rules do not require the nonbank SBSB to obtain a legal opinion of outside counsel. Instead, the rules require the firm to maintain written documentation of its analysis that in the event of a legal challenge the relevant court or administrative authorities would find the account control agreement to be legal, valid, binding, and enforceable under the applicable law, including in the event of the receivership, conservatorship, insolvency, liquidation, or a similar proceeding of any of the parties to the agreement.<sup>177</sup> Among other things, the documentation could be a written

<sup>170</sup> See SIFMA 11/19/2018 Letter.

<sup>171</sup> See paragraph (c)(2)(xv)(C)(2) of Rule 15c3–1, as amended; paragraph (c)(1)(ix)(C)(2) of Rule 18a–1, as adopted. See also *CFTC Margin Adopting Release*, 81 FR at 670–71, 702–3 (adopting 17 CFR 23.157, which provides that the custodial agreement must be a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions including in the event of bankruptcy, insolvency, or a similar proceeding); *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74873–75, 74905 (adopting rules requiring that a custodial agreement must be a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency, or a similar proceeding).

<sup>172</sup> See paragraph (c)(2)(xv)(C)(2) of Rule 15c3–1, as amended; paragraph (c)(1)(ix)(C)(2) of Rule 18a–1, as adopted.

<sup>173</sup> See ICI 11/19/2018 Letter; MFA/AIMA 11/19/2018 Letter; Letter from Jason Silverstein, Esq., Managing Director, Asset Management Group & Associate General Counsel, Securities Industry and Financial Markets Association, and Andrew Ruggiero Senior Associate, Asset Management Group, Securities Industry and Financial Markets Association (Nov. 19, 2018) (“SIFMA AMG 11/19/2018 Letter”).

<sup>174</sup> See ICI 11/19/2018 Letter.

<sup>175</sup> See SIFMA 11/19/2018 Letter. This commenter also requested that the Commission clarify that industry opinions regarding classes of agreements would satisfy a potential requirement for an opinion.

<sup>176</sup> See *CFTC Margin Adopting Release*, 81 FR at 670–71; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74873–75.

<sup>177</sup> See paragraph (c)(2)(xv)(C)(3) of Rule 15c3–1, as amended; paragraph (c)(1)(ix)(C)(3) of Rule 18a–1, as adopted.

opinion of outside legal counsel, reflect the firm's own "in-house" legal research, or be the research of a competent industry association. The documentation will reflect how the firm analyzed the legality of the account control agreement.

**Legacy accounts.** In terms of the deductions related to legacy accounts, one commenter stated that "the costs of this requirement will ultimately flow back to the counterparties, penalizing all counterparties who trade with any affected [nonbank SBSB]" and that "the retroactive effect of such a requirement—which effectively requires [nonbank SBSBs] to revise the price terms of pre-effective [security-based swaps]—is contrary to the prospective nature of the rest of Dodd-Frank's Title VII."<sup>178</sup> A second commenter argued that the deduction is inconsistent with how dealers currently do business, as they do not typically collect margin from certain credit-worthy counterparties.<sup>179</sup> Commenters stated that the legacy account deduction is inconsistent with the proposed capital regimes of the CFTC and the prudential regulators.<sup>180</sup> A commenter argued that this inconsistency could result in regulatory arbitrage.<sup>181</sup> Commenters indicated that the proposed legacy account deduction would unfairly penalize nonbank SBSBs and their customers.<sup>182</sup> A commenter stated that the deduction would negatively affect the pricing and liquidity of transactions with counterparties.<sup>183</sup> Commenters also argued that the proposed deduction could lead some market participants that cannot afford the costs to exit the market or cease engaging in new security-based swaps activity.<sup>184</sup>

In response to the comment that the deduction in lieu of margin related to legacy accounts is contrary to the prospective nature of Title VII of the Dodd-Frank Act and will require re-pricing of existing security-based swaps,<sup>185</sup> the legacy account exception is designed to address the impracticality of renegotiating contracts governing security-based swap transactions that

predate the compliance date of Rule 18a–3.<sup>186</sup> Further, as discussed below in section II.A.2.b.v. of this release, the ability to apply the credit risk charges has been expanded to exposures arising from electing not to collect variation or initial margin with respect to legacy accounts. This should help to mitigate the concern of this commenter and others that the 100% deduction could cause nonbank SBSBs to pass the costs of the capital requirement to counterparties. This also should help to mitigate concerns of commenters who argued that the 100% deduction was inconsistent with the capital requirements of other regulators. As one commenter stated, applying a credit risk charge for a nonbank SBSB's legacy account positions would more closely align the Commission's capital standards with the approaches of the CFTC and the prudential regulators.<sup>187</sup>

The Commission acknowledges that, even with the modification expanding the application of the credit risk charge, the final rule will result in costs to nonbank SBSBs as well as to their security-based swap and swap counterparties. However, the Commission has sought to strike an appropriate balance between addressing the concerns of commenters and promulgating a final rule that promotes the safety and soundness of nonbank SBSBs.<sup>188</sup> The Commission believes it has achieved this objective by taking a measured approach to modifying the rule to reduce the impact of the deductions for uncollected variation and initial margin.

### iii. Standardized Haircuts

The final step in the process of computing net capital under Rule 15c3–1 is to apply the standardized or model-based haircuts to the firm's proprietary positions, thereby reducing the firm's tentative net capital amount to an amount that constitutes the firm's net capital.<sup>189</sup> Most stand-alone broker-

dealers use the standardized haircuts, which are prescribed in Rules 15c3–1, 15c3–1a, and 15c3–1b. ANC broker-dealers may apply model-based haircuts to positions for which they have been authorized to use models pursuant to Rule 15c3–1e. For all other types of positions, they must use the standardized haircuts.

The pre-existing provisions of paragraph (c)(2)(vi) of Rule 15c3–1 prescribe standardized haircuts for marketable securities and money market instruments. The amounts of the standardized haircuts 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. Broker-dealer SBSBs will be subject to these pre-existing standardized haircut provisions in paragraph (c)(2)(vi) of Rule 15c3–1. Proposed Rule 18a–1 required stand-alone SBSBs to apply the pre-existing standardized haircuts in paragraph (c)(2)(vi) of Rule 15c3–1 by cross-referencing that paragraph.<sup>190</sup> The pre-existing provisions of Rules 15c3–1a and 15c3–1b prescribe standardized haircuts for equity option positions and commodities positions, respectively. The provisions in Rule 15c3–1b incorporate deductions in the CFTC's capital rule for FCMs.<sup>191</sup> Broker-dealer SBSBs will be subject to the pre-existing standardized haircut provisions in Rules 15c3–1a and 15c3–1b. The Commission proposed Rules 18a–1a and 18a–1b to prescribe standardized haircuts for stand-alone SBSBs modeled on the pre-existing requirements in Rules 15c3–1a and 15c3–1b, respectively.<sup>192</sup>

However, the pre-existing provisions of Rule 15c3–1 and Rule 15c3–1b did not prescribe standardized haircuts tailored specifically for security-based swaps and swaps.<sup>193</sup> Consequently, the Commission proposed amending paragraph (c)(2)(vi) of Rule 15c3–1 and Rule 15c3–1b to establish standardized

market movements and other risks faced by the firms, including liquidity and operational risks.") (footnote omitted).

<sup>190</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70231, n.146.

<sup>191</sup> See 17 CFR 1.17 (prescribing standardized haircuts for commodities positions of FCMs) ("Rule 1.17").

<sup>192</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70231–37, 70248–50.

<sup>193</sup> Because there were no specific standardized haircuts for security-based swaps, a stand-alone broker-dealer was required to apply a deduction based on the existing provisions (e.g., the catchall provisions in the rule). For certain types of OTC derivatives, the deduction has been the notional amount of the derivative multiplied by the deduction that would apply to the underlying instrument referenced by the derivative. See *Net Capital Rule*, Exchange Act Release No. 32256 (May 6, 1993), 58 FR 27486, 27490 (May 10, 1993).

<sup>178</sup> See Letter from Douglas M. Hodge, Managing Director and Chief Operating Officer, Pacific Investment Management Company LLC (Feb. 21, 2013) ("PIMCO Letter").

<sup>179</sup> See Letter from Sebastian Crapanzano and Soo-Mi Lee, Managing Directors, Morgan Stanley (Oct. 29, 2014) ("Morgan Stanley 10/29/2014 Letter").

<sup>180</sup> See Morgan Stanley 2/22/13 Letter; SIFMA 2/22/2013 Letter.

<sup>181</sup> See Financial Services Roundtable Letter.

<sup>182</sup> See PIMCO Letter; SIFMA 2/22/2013 Letter.

<sup>183</sup> See Morgan Stanley 2/22/13 Letter.

<sup>184</sup> See Financial Services Roundtable Letter; Morgan Stanley 2/22/13 Letter.

<sup>185</sup> See PIMCO Letter.

<sup>186</sup> See section II.B.2.b.i. of this release (discussing the legacy account exception).

<sup>187</sup> See Morgan Stanley 10/29/14 Letter; Morgan Stanley 11/19/2018 Letter.

<sup>188</sup> See Better Markets 11/19/2018 Letter. See also section VI of this release (discussing costs and benefits of final rules).

<sup>189</sup> 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*, 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

haircuts for security-based swaps and swaps that would apply to stand-alone broker-dealers and broker-dealer SBSBs.<sup>194</sup> The Commission proposed parallel standardized deductions tailored for security-based swaps and swaps in proposed Rules 18a-1 and 18a-1b, respectively, that would apply to stand-alone SBSBs.

The proposed standardized haircut for a CDS was determined using one of two maturity grids: One for a CDS that is a security-based swap and the other for a CDS that is a swap.<sup>195</sup> The proposed grids prescribed standardized haircuts based on two variables: The length of time to maturity of the CDS and the amount of the current offered basis point spread on the CDS. The standardized haircut for an unhedged short position in a CDS (*i.e.*, selling protection) was the applicable percentage specified in the grid. The deduction for an unhedged long position in a CDS (*i.e.*, buying protection) was 50% of the applicable deduction specified in the grid. The amount of the deductions in the maturity grid for a CDS that was a swap were one-third less than the comparable deductions in the maturity grid for a CDS that was a security-based swap. The proposed rules provided for reduced grid-derived deductions based on netting positions.

For a security-based swap that is not a CDS, the proposed standardized haircuts required multiplying the notional amount of the security-based swap by the amount of the standardized haircut percent that applied to the underlying position pursuant to the pre-existing provisions of Rule 15c3-1.<sup>196</sup> For example, paragraph (c)(2)(vi)(f) of Rule 15c3-1 prescribes a standardized haircut for an exchange traded equity security equal to 15% of the mark-to-market value of the security. Consequently, the standardized haircut for a security-based swap referencing an exchange traded equity security was a deduction equal to the notional amount of the security-based swap multiplied by 15%. The same approach applied to a security-based swap (other than a CDS) referencing a debt instrument. For example, paragraph (c)(2)(vi)(F)(1)(v) of Rule 15c3-1 prescribes a 7% standardized haircut for a corporate bond that has a maturity of five years, is not traded flat or in default as to principal or interest, and has a minimal amount of credit risk. Therefore, the

proposed standardized haircut for a security-based swap referencing such a bond was a deduction equal to the notional amount of the security-based swap multiplied by 7%.

For a swap that is not a CDS or interest rate swap, the Commission proposed a similar approach that required multiplying the notional amount of the swap by a certain percent.<sup>197</sup> To determine the applicable percent, the Commission proposed a hierarchy approach. Under this approach, if the pre-existing provisions of Rule 15c3-1 prescribed a standardized haircut for the type of asset, obligation, or event underlying the swap, the percent deduction of the Rule 15c3-1 standardized haircut applied. For example, if the swap referenced an equity security index, the pre-existing standardized haircut in Rule 15c3-1 applicable to baskets of securities and equity index exchange traded funds applied. If the pre-existing provisions of Rule 15c3-1 did not prescribe a standardized haircut for the type of asset, obligation, or event underlying the swap but the pre-existing provisions in Rule 15c3-1b did, the percent deduction in the Rule 15c3-1b standardized haircut applied. This would be the case if the swap referenced a type of commodity for which CFTC Rule 1.17 prescribes a standardized haircut, and the Rule 1.17 haircut is incorporated into Rule 15c3-1b. Finally, if neither Rules 15c3-1 nor 15c3-1b prescribed a standardized haircut for the type of asset, obligation, or event underlying the swap but Rule 1.17 did, the percent deduction in the Rule 1.17 standardized deduction applied. This could be the case, for example, if the swap was a type of swap for which the CFTC had prescribed a specific standardized haircut.

For interest rate swaps, the Commission proposed a similar standardized haircut approach that required multiplying the notional amount of the swap by a certain percent.<sup>198</sup> The percent was determined by referencing the standardized haircuts in Rule 15c3-1 for U.S. government securities with comparable maturities to the swap's maturity. However, the proposed haircut for interest rate swaps had a floor of 1% (whereas U.S. government securities with a maturity of less than 9 months are subject to haircuts of  $\frac{3}{4}$  of 1%,  $\frac{1}{2}$  of 1%, or 0% depending on the time to maturity). This 1% floor was 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.

Under the proposed standardized haircuts for a security-based swap that is not a CDS, stand-alone broker-dealers and nonbank SBSBs were permitted to recognize portfolio offsets.<sup>199</sup> In particular, these entities were permitted to include an equity security-based swap in a portfolio of related equity positions (*e.g.*, long and short cash and options positions involving the same security) under the pre-existing provisions of Rule 15c3-1a, which produces a single haircut for a portfolio of equity options and related positions.<sup>200</sup> Similarly, they were permitted to treat a debt security-based swap and an interest rate swap in the same manner as debt instruments are treated in pre-existing debt-maturity grids in Rule 15c3-1 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.

#### Comments and Final Requirements for Standardized Haircuts

A commenter stated that, based on its estimates, the standardized haircuts in the proposed CDS maturity grids would be significantly greater than the capital charges that would apply to the same positions using an internal model.<sup>201</sup> The commenter stated that the Commission should conduct further review of empirical data regarding the historical market volatility and losses given default associated with CDS positions and modify the proposed standardized haircuts. This commenter argued that excessive standardized haircuts may disproportionately affect smaller and mid-size firms.<sup>202</sup> The commenter further stated that these types of firms may be limiting their security-based swaps business so they will not be required to register as a nonbank SBSB or may try to develop internal models to avoid having to use the standardized haircuts.

In response to these comments, the economic analysis performed for these

<sup>194</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70231-37, 70248-50.

<sup>195</sup> See 77 FR at 70232-34, 70248-49.

<sup>196</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70234-36.

<sup>197</sup> See 77 FR at 70249-50.

<sup>198</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70249.

<sup>199</sup> See 77 FR at 70235-36, 70249.

<sup>200</sup> Specifically, the Commission proposed amending paragraph (a)(4) of Rule 15c3-1a to include equity security-based swaps within the definition of *underlying instrument*. This would allow these positions to be included in portfolios of equity positions involving the same equity security. In addition, the Commission proposed including security futures within the definition of the term *underlying instrument* to permit these positions to be included in portfolios of positions involving the same underlying security.

<sup>201</sup> See SIFMA 2/22/2013 Letter.

<sup>202</sup> See SIFMA 11/19/2018 Letter.

final rules determined that the standardized haircuts being adopted today generally were not set at the most conservative level. As stated in the analysis, the Commission believes that, in general, haircuts are intended to strike a balance between being sufficiently conservative to cover losses in most cases, including stressed market conditions, and being sufficiently nimble to allow nonbank SBSDs to operate efficiently in all market conditions. Based on the results of the analysis, the Commission believes the standardized haircuts in the final rules take into account this tradeoff.<sup>203</sup>

Nonetheless, the Commission recognizes that the standardized haircuts for non-cleared security-based swaps are less risk-sensitive than the model-based haircuts and, therefore, in many cases will be greater than the model-based haircuts. This difference in the deductions that result from applying standardized haircuts as opposed to model-based haircuts is part of the pre-existing provisions of Rule 15c3-1. The rule has permitted ANC broker-dealers and OTC derivatives dealers to apply model-based haircuts, whereas all other broker-dealers must apply the standardized haircuts. These differences are why broker-dealers applying the model-based haircuts are subject to higher capital standards, including minimum tentative net capital requirements.<sup>204</sup> These additional and higher capital requirements account for the generally lower deductions that result from applying model-based haircuts as opposed to standardized haircuts. Because nonbank SBSDs that do not use model-based haircuts will not be subject to these additional or higher capital requirements, the Commission believes that it is an appropriate trade-off that they will employ the less risk-sensitive standardized haircuts. Further, the Commission believes that most nonbank SBSDs will seek approval to use model-based haircuts.

The standardized haircuts are designed to account for more than just market and credit risk—they also are intended to address other risks such as operational, leverage, and liquidity risks.<sup>205</sup> The standardized haircuts are

intended to account for more risks because the firms that will use them, as discussed above, are subject to lower minimum net capital requirements.

Commenters also recommended that for cleared security-based swaps, the Commission apply a standardized haircut based on the initial margin requirement of the clearing agency, similar to the treatment of futures in Rule 15c3-1b.<sup>206</sup> A commenter stated that the clearing agencies use risk-based models to calculate initial margin and, therefore, relying on their margin calculations would allow firms that do not use models to indirectly get the benefit of a more risk-sensitive approach.<sup>207</sup>

The Commission is persuaded that it would be appropriate to establish standardized haircuts for cleared security-based swaps and swaps that are determined using the margin requirements of the clearing agency or DCO where the position is cleared. Consequently, the Commission is modifying the proposed standardized haircut requirements for cleared security-based swaps and swaps to require that the amount of the deduction will be the amount of margin required by the clearing agency or DCO where the position is cleared.<sup>208</sup> This will align the treatment of these cleared products with the treatment of futures products. It also will establish standardized haircuts that potentially are more risk sensitive, as suggested by the commenter. This will benefit stand-alone broker-dealers and nonbank SBSDs that have not been authorized to

leverage, and liquidity risk, in addition to market and credit risk.”).

<sup>206</sup> See Citadel 5/15/2017 Letter; Citadel 11/19/2018 Letter; SIFMA 2/22/2013 Letter.

<sup>207</sup> See SIFMA 2/22/2013 Letter.

<sup>208</sup> See paragraph (c)(2)(vi)(O) of Rule 15c3-1, as amended; paragraph (b)(1) of Rule 15c3-1b, as amended; paragraph (c)(1)(vi)(A) of Rule 18a-1, as adopted; paragraph (b)(1) of Rule 18a-1b, as adopted. In the final rule, paragraph (c)(2)(vi)(O) of Rule 15c3-1, as proposed, is being re-designated paragraph (c)(2)(vi)(P) of Rule 15c3-1, as adopted. In addition, references to “(c)(2)(vi)(O)” have been replaced with references to “(c)(2)(vi)(P)” in paragraph (c)(2)(vi)(P) of Rule 15c3-1, as amended; the word “non-cleared” has been inserted before the term “security-based swap”; and the title has been modified to read “Non-cleared security-based swaps.” Conforming changes have been made to Appendix B to Rule 15c3-1, as amended, Rule 18a-1, as adopted, and Rule 18a-1b, as adopted. Paragraph (c)(2)(vi)(O) of Rule 15c3-1, as amended, will state: “Cleared security-based swaps. In the case of a cleared security-based swap held in a proprietary account of the broker or dealer, deducting the amount of the applicable margin requirement of the clearing agency or, if the security-based swap references an equity security, the broker or dealer may take a deduction using the method specified in § 240.15c3-1a.” Conforming rule text modifications were made to Appendix B to Rule 15c3-1, as amended, Rule 18a-1, as adopted, and Rule 18a-1b, as adopted.

use models to determine market risk charges for their security-based swap and swap positions.

A commenter supported the Commission’s proposal to allow standardized haircuts for portfolios of equity security-based swaps and related equity positions using the methodology in Rule 15c3-1a.<sup>209</sup> The commenter believed this would allow stand-alone broker-dealers and nonbank SBSDs to employ a more risk-sensitive approach to computing net capital than if a position were treated in isolation. The Commission agrees with the commenter’s reasoning and continues to believe that cleared equity security-based swaps should be permitted to be included in the portfolios of equity positions for purposes of Rules 15c3-1a and 18a-1a and that this treatment should be extended to cleared equity-based swaps. Therefore, the Commission is modifying the requirement to permit equity-based swaps (in addition to equity security-based swaps) to be included as related or underlying instruments for purposes of Rules 15c3-1a and 18a-1a.<sup>210</sup> Further, as discussed above, the standardized haircut for cleared security-based swaps and swaps being adopted today is determined using the margin requirements of the clearing agency or DCO where the position is cleared. However, as an alternative to that standardized haircut, a stand-alone broker-dealer and nonbank SBSD can use the methodology prescribed in Rules 15c3-1a and 18a-1a to derive a portfolio-based standardized haircut for cleared security-based swaps that reference an equity security or narrow-based equity index and swaps that reference a broad-based equity index.<sup>211</sup>

A commenter opposed the 1% minimum standardized haircut for interest rate swaps as being too severe.<sup>212</sup> Based on its analysis of sample positions, this commenter believed that the proposed standardized haircut calculations that include the 1% minimum haircut would result in market risk charges that are nearly 35 times higher than charges without the 1% minimum.<sup>213</sup> The Commission is persuaded that the proposed 1% minimum haircut was too conservative,

<sup>209</sup> See SIFMA 2/22/2013 Letter.

<sup>210</sup> See paragraphs (a)(3) and (4) of Rule 15c3-1a, as amended; paragraphs (a)(3) and (4) of Rule 18a-1a, as adopted.

<sup>211</sup> See paragraph (c)(2)(vi)(O) of Rule 15c3-1, as amended; paragraph (b)(1) of Rule 15c3-1b, as amended; paragraph (c)(1)(vi)(A) of Rule 18a-1, as adopted; paragraph (b)(1) of Rule 18a-1b, as adopted.

<sup>212</sup> See SIFMA 2/22/2013 Letter.

<sup>213</sup> See SIFMA 11/19/2018 Letter.

<sup>203</sup> See section VI of this release.

<sup>204</sup> See *OTC Derivatives Dealers*, 63 FR at 5938; *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, 69 FR at 34431.

<sup>205</sup> See *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, 69 FR at 34431 (“The current haircut structure [use of the standardized haircuts] seeks to ensure that broker-dealers maintain a sufficient capital base to account for operational,

particularly when applied to tightly hedged positions such as those in the commenter's examples. As discussed above, the standardized haircut for cleared swaps, including interest rate swaps, being adopted today is determined by the margin required by the DCO where the position is cleared. Therefore, the 1% minimum standardized haircut for cleared security-based swaps is being eliminated.

However, the Commission continues to believe that a minimum haircut should be applied to non-cleared interest rate swaps. Under the final rules being adopted today, the standardized haircuts for non-cleared interest rate swaps are determined using the maturity grid for U.S. government securities in paragraph (c)(2)(vi)(A) of Rule 15c3-1.<sup>214</sup> Moreover, the standardized haircuts for non-cleared security-based swaps and swaps (other than CDS) being adopted today permit a stand-alone broker-dealer and nonbank SBSD to reduce the deduction by an amount equal to any reduction recognized for a comparable long or short position in the reference security under the standardized haircuts in Rule 15c3-1.<sup>215</sup> The standardized haircuts in paragraph (c)(2)(vi)(A) of Rule 15c3-1 permit a stand-alone broker-dealer to take a capital charge on the net long or short position in U.S. government securities that are in the same maturity categories in the rule. This treatment will apply to interest rate swaps. Therefore, if a stand-alone broker-dealer or nonbank SBSD has long and short positions in interest rate swaps, the amount of the standardized haircut applied to these positions could be greatly reduced and could potentially be 0% for positions that are tightly hedged. This could permit the firm to substantially leverage its interest rate swaps and hold little or no capital against them. Further, potential differences between the movement of interest rates on U.S. government securities and interest rates upon which swap payments are based could impose a level of additional risk even to tightly hedged interest rate positions.

For these reasons, the Commission believes that a minimum standardized haircut for non-cleared interest rate swaps is appropriate. However, the Commission is persuaded by the

commenter that the proposed 1% minimum haircut was too conservative. Therefore, the Commission is modifying the standardized haircut for non-cleared interest rate swaps so that it can be no less than  $\frac{1}{8}$  of 1% of a long position that is netted against a short position in the case of a non-cleared swap with a maturity of 3 months or more.<sup>216</sup> The standardized haircuts in paragraph (c)(2)(vi)(A) of Rule 15c3-1 require a 0% haircut for the unhedged amount of U.S. government securities that have a maturity of less than 3 months. Therefore, the standardized haircuts for interest rate swaps will treat hedged and unhedged positions with maturities of less than 3 months identically in that there will be no haircut required to be applied to the positions.

The next lowest standardized haircut in paragraph (c)(2)(vi)(A) of Rule 15c3-1 applies to unhedged positions with a maturity of 3 months but less than 6 months. For these positions, the haircut is  $\frac{1}{2}$  of 1%. Therefore, the minimum standardized haircut for hedged interest rate swaps with a maturity of 3 months or more (*i.e.*,  $\frac{1}{8}$  of 1%) will be one-quarter of the standardized haircut for unhedged positions with a maturity 3 months but less than 6 months. The Commission believes this modified minimum haircut for interest rate swaps strikes an appropriate balance in terms of addressing commenters' concerns that the 1% minimum was too conservative and the prudential concern with permitting a stand-alone broker-dealer or nonbank SBSD to substantially leverage its non-cleared interest rate swaps positions.

Another commenter stated that the Commission appears to have proposed different and substantially higher haircuts for cleared swaps regulated by the CFTC, such as cleared interest rate swaps and cleared index CDS, than those proposed under the CFTC's rules.<sup>217</sup> This commenter stated that dual registrants should not be subject to conflicting requirements for the same instrument and urged the Commission to work with the CFTC to harmonize applicable requirements for cleared swaps that are regulated by the CFTC. The commenter also noted that increasing harmonization will promote the portfolio margining of cleared security-based swaps and swaps. The CFTC has not finalized its capital rules under Title VII of the Dodd-Frank Act; however, as discussed above, the Commission has modified the

standardized haircuts for cleared CDS and interest rate swaps so that the deduction equals the margin requirement of the clearing agency or DCO where the positions are cleared. This should alleviate the commenter's concerns about the magnitude of the standardized haircuts for cleared swaps. In terms of harmonizing the Commission's standardized haircuts with the CFTC's standardized haircuts, the Commission intends to continue coordinating with the CFTC as that agency finalizes its capital requirements under Title VII of the Dodd-Frank Act.

For the foregoing reasons, the Commission is adopting the standardized haircuts for security-based swaps and swaps with the modifications discussed above and with certain non-substantive modifications to conform the final rule text in Rule 15c3-1, as amended, and Rule 18a-1, as adopted.<sup>218</sup>

#### iv. Model-Based Haircuts

The Commission proposed to allow nonbank SBSDs to apply model-based haircuts.<sup>219</sup> Broker-dealer SBSDs that were not already ANC broker-dealers needed Commission authorization to use model-based haircuts and were subject to the requirements governing the use of models by ANC broker-dealers (*i.e.*, they would need to operate as an ANC broker-dealer SBSD). Stand-alone SBSDs similarly needed Commission authorization to apply model-based haircuts and were subject to requirements governing the use of them modeled on the requirements for ANC broker-dealers.

Under the proposals, nonbank SBSDs seeking authorization to use model-based haircuts needed to submit an application to the Commission ("ANC application").<sup>220</sup> The pre-existing provisions of paragraphs (a)(1) through (a)(3) of Rule 15c3-1e set forth in detail the information that must be submitted

<sup>214</sup> See paragraph (b)(2)(ii)(A)(3) of Rule 15c3-1b, as amended; paragraph (b)(2)(ii)(A)(3) of Rule 18a-1b, as adopted.

<sup>215</sup> See paragraph (c)(2)(vi)(P)(2) of Rule 15c3-1, as amended; paragraph (b)(2)(ii)(B) of Rule 15c3-1b, as amended; paragraph (c)(1)(vi)(B)(2) of Rule 18a-1, as adopted; paragraph (b)(2)(ii)(B) of Rule 18a-1b, as adopted.

<sup>216</sup> See paragraph (b)(2)(ii)(A)(3) of Rule 15c3-1b, as amended; paragraph (b)(2)(ii)(A)(3) of Rule 18a-1b, as adopted.

<sup>217</sup> See Citadel 5/15/2017 Letter.

<sup>218</sup> See paragraphs (c)(2)(vi)(O) and (P) of Rule 15c3-1, as amended; Rule 15c3-1a, as amended; Rule 15c3-1b as amended; paragraph (c)(1)(vi) of Rule 18a-1, as adopted; Rule 18a-1a, as adopted; Rule 18a-1b, as adopted. In addition to the changes discussed above, the Commission has made some non-substantive modifications to the final rule text for the standardized haircuts for non-cleared CDS that are security-based swaps or swaps in order to conform the final rule text in Rule 18a-1, as adopted, and Rule 18a-1b, as adopted, with the final rule text in Rule 15c3-1, as amended, and Rule 15c3-1b, as amended. The standardized haircuts for these positions were designed to be consistent in both rules. See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70233-34. In the proposing release, however, there were some inadvertent differences in the proposed rule texts which have been corrected in the final rules.

<sup>219</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70237-40.

<sup>220</sup> See 77 FR at 70237-39.

by a stand-alone broker-dealer in an ANC application. The pre-existing provisions of paragraph (a)(4) provide that the Commission may request that the applicant supplement the ANC application with other information. The pre-existing provisions of paragraph (a)(5) prescribe when an ANC application is deemed filed with the Commission and provides that the application and all submissions in connection with it are accorded confidential treatment to the extent permitted by law. The pre-existing provisions of paragraph (a)(6) provide that if any information in an ANC application is found to be or becomes inaccurate before the Commission approves the application, the stand-alone 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. The pre-existing provisions of paragraph (a)(7) provide that 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. A broker-dealer SBSB seeking authorization to use internal models would be subject to these pre-existing application requirements in paragraph (a) of Rule 15c3–1e. A stand-alone SBSB seeking authorization to use internal models would be subject to similar application requirements in proposed Rule 18a–1.

As part of the ANC application approval process, the Commission staff reviews the operation of the stand-alone broker-dealer's model, including a review of associated risk management controls and the use of stress tests, scenario analyses, and back-testing. As part of this process, the applicant provides information designed to demonstrate to the Commission staff that the model reliably accounts for the risks that are specific to the types of positions the firm intends to include in the model computations. During the review, the Commission staff assesses the quality, rigor, and adequacy of the technical components of the model and of related governance processes around the use of the model as well as the firm's risk management policies, procedures, and controls. Under the proposals, nonbank SBSBs seeking authorization to use internal models would be subject to

similar reviews during the application process.<sup>221</sup>

The pre-existing provisions of paragraph (a)(8) of Rule 15c3–1e require an ANC broker-dealer to amend its ANC application and submit it to the Commission for approval before materially changing its model or its internal risk management control system. Further, the pre-existing provisions of paragraph (a)(10) require an ANC broker-dealer to notify the Commission 45 days before the firm ceases to use internal models to compute net capital. Finally, the pre-existing provisions of paragraph (a)(11) provide that the Commission, by order, can revoke an ANC broker-dealer's exemption that allows it to use internal models if the Commission finds that the ANC broker-dealer's use of models is no longer necessary or appropriate in the public interest or for the protection of investors. In this case, the firm would need to revert to applying the standardized haircuts for all positions. Under the proposal, an ANC broker-dealer SBSB would be subject to these pre-existing application requirements in paragraph (a) of Rule 15c3–1e. A stand-alone SBSB authorized to use internal models would have been subject to similar application requirements in proposed Rule 18a–1.<sup>222</sup>

The pre-existing provisions of paragraph (d)(1) of Rule 15c3–1e require an ANC broker-dealer to comply with qualitative requirements that specify among other things that: (1) The model must be integrated into the ANC broker-dealer's daily internal risk management system; (2) the model must be reviewed periodically by the firm's internal audit staff, and annually by an independent public accounting firm; and (3) the measure computed by the model must be multiplied by a factor of at least 3 but potentially a greater amount based on the number of exceptions to the measure resulting from quarterly back-testing exercises.<sup>223</sup> The pre-existing provisions of paragraph (d)(2) prescribe quantitative requirements that specify that the model must, among other things: (1) Use a 99%, one-tailed confidence level with price changes equivalent to a 10-business-day movement in rates and prices;<sup>224</sup> (2) use

an effective historical observation period of at least one year; (3) use historical data sets that are updated at least monthly and are reassessed whenever market prices or volatilities change significantly; 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. An ANC broker-dealer SBSB would be subject to these pre-existing qualitative and quantitative requirements in paragraph (d) of Rule 15c3–1e. A stand-alone SBSB authorized to use internal models would have been subject to similar qualitative and quantitative requirements in proposed Rule 18a–1.<sup>225</sup>

The pre-existing provisions of paragraph (b) of Rule 15c3–1e prescribe the model-based haircuts an ANC broker-dealer must deduct from tentative net capital in lieu of the standardized haircuts. This deduction is an amount equal to the sum of four charges: (1) A portfolio market risk charge for all positions that are included in the ANC broker-dealer's models (*i.e.*, the amount measured by the model multiplied by a factor of at least 3);<sup>226</sup> (2) a "specific risk" charge for positions where specific risk was not captured in the model;<sup>227</sup> (3) a charge for positions not included in the model where the ANC broker-dealer is approved to use scenario analysis; and (4) a charge for all other positions that is determined using the standardized haircuts. An ANC broker-dealer SBSB would be subject to these pre-existing model-based haircut requirements in paragraph (b) of Rule 15c3–1e. A stand-alone SBSB authorized to use internal models would have been subject to similar requirements in proposed Rule 18a–1.<sup>228</sup>

Finally, ANC broker-dealers are subject to ongoing supervision with respect to their internal risk management, including their use of models. In this regard, the Commission staff meets regularly with senior risk managers at each ANC broker-dealer to

<sup>221</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70239.

<sup>222</sup> *Id.*

<sup>223</sup> A back-testing exception occurs when the ANC broker-dealer's actual one-day loss exceeds the amount estimated by its model.

<sup>224</sup> This means the potential loss measure produced by the model is a loss that the portfolio could experience if it were held for 10 trading days and that this potential loss amount would be exceeded only once every 100 trading days.

<sup>225</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70239.

<sup>226</sup> This 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.

<sup>227</sup> This 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.

<sup>228</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70239–40.

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 (scheduled and *ad hoc*) focused on financial results, the management of the firm's balance sheet, and, in particular, the liquidity of the firm's balance sheet.<sup>229</sup> The Commission staff also monitors the performance of the ANC broker-dealer's internal models through regular submissions of reported model changes by the firms and quarterly discussions with the firm's quantitative modeling personnel. Material changes to the internal models used to determine regulatory capital require advance notification, Commission staff review, and pre-approval before implementation. Stand-alone SBSDs authorized to use model-based haircuts would be subject to similar monitoring and reviews.

#### *Comments and Final Requirements for Model-Based Haircuts*

A commenter expressed support for the Commission's proposal that nonbank SBSDs be authorized to use model-based haircuts for proprietary securities positions, including security-based swap positions, in lieu of standardized haircuts, subject to application to, and approval by, the Commission and satisfaction of the qualitative and quantitative requirements set forth in Rule 15c3-1e.<sup>230</sup> However, other commenters raised concerns about permitting nonbank SBSDs to use model-based haircuts. A commenter stated that model-based haircuts should be "floored" at a level set by a standardized approach.<sup>231</sup> This commenter also stated that the Commission's continued reliance on model-based haircuts would represent a step away from the evolving practice of prudential regulators. This commenter and others also generally argued that the failure by significant market participants to accurately measure risk using models in the run-up to and

during the 2008 financial crisis demonstrated that such models do not successfully measure risk and do not enable firms to make optimal judgments about risk.<sup>232</sup> One of these commenters argued that the firms using models are the most systemically risky and have a financial incentive to keep the measures low.<sup>233</sup> Other commenters argued that models can be manipulated and create perverse incentives for risk management staff to minimize capital charges.<sup>234</sup> A commenter indicated that it will be difficult for Commission staff to examine, duplicate, and back-test model estimates.<sup>235</sup> A second commenter believed models tend to fail during volatile market conditions particularly during a crisis.<sup>236</sup> Another commenter, in light of various reforms by banking regulators, urged the Commission to place more limitations on ANC broker-dealers because they use internal models to determine capital charges.<sup>237</sup>

Commenters also argued that *allowing* the use of models for capital purposes can create competitive advantages for larger firms that are able to reduce their capital requirements through internal modeling relative to smaller firms that are engaged in similar activities but are subject to different capital requirements.<sup>238</sup> A commenter stated that allowing the use of models will incentivize firms to organize themselves in ways that reduce their capital requirements and increase their leverage in order to enhance return on capital.<sup>239</sup> This commenter also stated that capital requirements should be the same regardless of firms' activities and that the only reason for different treatment should be the aggregate exposures taken by individual firms.

The Commission continues to believe that the capital rules for ANC broker-dealers and nonbank SBSDs should permit these entities to use model-based haircuts. Models are used by financial institutions to manage risk and, therefore, permitting their use will allow firms to integrate their risk

management processes with their capital computations.

The Commission, however, acknowledges the concerns raised by commenters about the efficacy of models, particularly in times of market stress. In response to these concerns and the comment that ANC broker-dealers should be subject to more limitations, ANC broker-dealers and nonbank SBSDs using models will be subject to higher minimum capital requirements as well as the Commission's ongoing monitoring of their use of models. In particular, the minimum tentative net capital requirements that apply to ANC broker-dealers (which are being substantially increased by today's amendments) and stand-alone SBSDs authorized to use model-based haircuts are designed to address the concerns raised by commenters that the models may fail to accurately measure risk, firms may calibrate the models to keep values low, firms might manipulate models, and models may fail during volatile market conditions. More specifically, tentative net capital is the amount of a firm's net capital *before* applying the haircuts.

Today's amendments and new rules will require ANC broker-dealers (including ANC broker-dealer SBSDs) to maintain at least \$5 billion in tentative net capital and subject them to a minimum fixed-dollar net capital requirement of \$1 billion. Stand-alone SBSDs authorized to use models will be required to maintain at least \$100 million in tentative net capital and will be subject to a minimum fixed-dollar net capital requirement of \$20 million. Consequently, for each type of nonbank SBSD, the fixed-dollar minimum tentative net capital requirement is five times the fixed-dollar minimum net capital requirement. Thus, nonbank SBSDs that use models will need to maintain minimum tentative net capital in an amount that far exceeds their minimum fixed-dollar net capital requirement. The larger tentative net capital requirement is designed to address the risk associated with using model-based haircuts. To the extent a nonbank SBSD's model fails to accurately calculate the risk of its positions, the tentative net capital requirement will serve as a buffer to account for the difference between the calculated haircut amount and the actual risk of the positions. Further, the Commission's ongoing supervision of the firms' use of models as well as the qualitative and quantitative requirements governing the use of models (e.g., backtesting) provide additional checks on the use of models that are designed to address the risks

<sup>229</sup> 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.

<sup>230</sup> See SIFMA 2/22/2013 Letter.

<sup>231</sup> See Letter from Americans for Financial Reform (Feb. 22, 2013) ("Americans for Financial Reform Letter").

<sup>232</sup> See Americans for Financial Reform Letter; Better Markets 7/22/2013 Letter; CFA Institute Letter; Letter from Sheila C. Bair, Systemic Risk Council (Jan. 24, 2013) ("Systemic Risk Council Letter"). See also Letter from Lisa A. Rutherford (Jan. 22, 2013) ("Rutherford Letter").

<sup>233</sup> See Better Markets 7/22/2013 Letter.

<sup>234</sup> See CFA Institute Letter; Systemic Risk Council Letter.

<sup>235</sup> See Better Markets 7/22/2013 Letter.

<sup>236</sup> See Letter from Matthew Shaw (Feb. 22, 2013) ("Shaw Letter").

<sup>237</sup> See Americans for Financial Reform Education Fund Letter.

<sup>238</sup> See CFA Institute Letter; Systemic Risk Council Letter.

<sup>239</sup> See CFA Institute Letter.



identified by the commenters. Finally, ANC broker-dealers and nonbank SBSDs are subject to Rule 15c3–4, which requires them 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.

Although one commenter stated that the Commission's continued reliance on internal models would represent a step away from the evolving practice of prudential regulators, this has not been the case. Financial supervisors and regulators, in the United States and elsewhere, have continued to permit the use of internal models as a component of establishing and measuring capital requirements for financial market participants, including with respect to bank SBSDs and bank swap dealers. Similarly, the CFTC has proposed to allow nonbank swap dealers to use models. The Commission's final rules and amendments will promote consistency with these other rules. For these reasons, the Commission is adopting the provisions relating to the use of model-based haircuts substantially as proposed.<sup>240</sup>

Finally, a commenter recommended that the Commission adopt an expedited review and approval process for models that have been approved and are subject to periodic assessment by the Federal Reserve or a qualifying foreign regulator.<sup>241</sup> This commenter suggested that if the Commission has previously approved a model for use by one registrant, the Commission should automatically approve the use of that model by an affiliate subject to the same risk management program as the affiliate whose model was previously approved. Other commenters recommended that the Commission permit a nonbank SBSD to use internal credit risk models approved by other regulators, and that the Commission generally defer to the other regulator's ongoing oversight of the model (including model governance).<sup>242</sup> Another commenter

supported a provisional approval process for internal capital models.<sup>243</sup>

In response to these comments, the Commission encourages prospective registrants to reach out to the Commission staff as early as possible in advance of the registration compliance date to begin the model approval process. The staff will work diligently to review the models before the firm must register as an SBSD. However, the Commission acknowledges the possibility that it may not be able to make a determination regarding a firm's model before it is required to register as an SBSD. Consequently, the Commission is modifying Rule 15c3–1e and Rule 18a–1 to provide that the Commission may approve, subject to any condition or limitations that the Commission may require, the temporary use of a provisional model by an ANC broker-dealer, including an ANC broker-dealer SBSD, or a stand-alone SBSD for the purposes of computing net capital if the model had been approved by certain other supervisors.<sup>244</sup> Further, as discussed below in section II.B.2.a.i. of this release, the Commission also may approve, subject to any condition or limitations that the Commission may require, the temporary use of a provisional model by a nonbank SBSD for the purposes of calculating initial margin pursuant to the requirements of Rule 18a–3, as adopted.

To qualify, the firm must have a complete application pending for approval to use a model.<sup>245</sup> The requirement that a complete application be pending is designed to limit the amount of time that the firm uses the provisional model and incentivize firms to promptly file applications for model approval.

In addition, to be approved by the Commission, the use of the provisional model must have been approved by a prudential regulator, the CFTC, a CFTC-registered futures association, a foreign financial regulatory authority that administers capital and/or margin requirements that the Commission has found are eligible for substituted compliance, or any other foreign supervisory authority that the Commission finds has approved and monitored the use of the provisional

model through a process comparable to the process set forth in the final rules.<sup>246</sup> This condition is designed to ensure that the provisional model has been approved by a financial regulator that is administering a program for approving and monitoring the use of models that is consistent with the Commission's program, including with respect to the qualitative and quantitative requirements for models in the final rules being adopted today.

#### v. Credit Risk Models

The pre-existing provisions of paragraph (a)(7) of Rule 15c3–1 and paragraph (c) of Rule 15c3–1e permit an ANC broker-dealer to treat uncollateralized current exposure to a counterparty arising from derivatives transactions as part of its tentative net capital instead of deducting 100% of the value of the unsecured receivable (as is required with respect to most unsecured receivables under Rule 15c3–1).<sup>247</sup> These provisions further require the ANC broker-dealer to take a credit risk charge to tentative net capital (along with the market risk charges—the model-based haircuts—discussed above in section II.A.2.b.iv. of this release) to compute its net capital. The credit risk charge typically will be significantly less than the 100% deduction to net worth that would have otherwise applied to the unsecured receivable since the credit risk charge is a percentage of the amount of the receivable. The pre-existing provisions of paragraph (c) of Rule 15c3–1e prescribe the method for calculating credit risk charges (“ANC credit risk model”). In particular, the credit risk charge is the sum of 3 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 the aggregate current exposure to all counterparties exceeds 50% of the firm's tentative net capital.

The capital rules governing OTC derivatives dealers similarly permit them to include uncollateralized current exposures to a counterparty arising from derivatives transactions in their tentative net capital, and require them to take a credit risk charge to tentative net capital with respect to these exposures to compute net capital.<sup>248</sup>

<sup>240</sup> See paragraph (a)(7) of Rule 15c3–1, as amended; paragraph (a) of Rule 15c3–1e, as amended; paragraphs (a)(2), (d), and (e)(1) of Rule 18a–1, as adopted. The Commission also is modifying the credit risk charges in the final rule in paragraph (a)(7) of Rule 15c3–1, as amended and paragraph (a)(2) of Rule 18a–1, as adopted. These changes are discussed in the next section. The Commission also is making some non-substantive changes in paragraph (d)(9)(iii) of Rule 18a–1, as adopted.

<sup>241</sup> See SIFMA 2/22/2013 Letter; SIFMA 11/19/2018 Letter.

<sup>242</sup> See ING/Mizuho Letter; IIB 11/19/2018 Letter.

<sup>243</sup> See Citadel 5/15/2017 Letter.

<sup>244</sup> See paragraph (a)(7)(ii) of Rule 15c3–1e, as amended; paragraph (d)(5)(ii) of Rule 18a–1, as adopted. As a result of this modification, paragraph (a)(7) of Rule 15c3–1e has been re-designated paragraph (a)(7)(i) of Rule 15c3–1e, as amended, and paragraph (d)(5) of Rule 18a–1, as proposed, has been re-designated paragraph (d)(5)(i) of Rule 18a–1, as adopted.

<sup>245</sup> See paragraph (a)(7)(ii)(A) of Rule 15c3–1e, as amended; paragraph (d)(5)(ii)(A) of Rule 18a–1, as adopted.

<sup>246</sup> See paragraph (a)(7)(ii)(B) of Rule 15c3–1e, as amended; paragraph (d)(5)(ii)(B) of Rule 18a–1, as adopted.

<sup>247</sup> See paragraph (c)(15) of Rule 15c3–1 (defining the term “tentative net capital”).

<sup>248</sup> See paragraphs (a)(5) and (c)(15) of Rule 15c3–1; 17 CFR 240.15c3–1f (“Rule 15c3–1f”).

Paragraph (d) of Rule 15c3–1f prescribes the method for computing the credit risk charges for OTC derivatives dealers (“OTCDD credit risk model”). The OTCDD credit risk model is similar to the ANC credit risk model except that the former does not include a portfolio concentration charge.<sup>249</sup>

Commission staff reviews an ANC broker-dealer’s use of the ANC credit risk model as part of the overall review of the firm’s ANC application and monitors the firm’s use of the model thereafter. Moreover, the process is subject to the pre-existing provisions of paragraphs (a)(8), (a)(10), and (a)(11) of Rule 15c3–1e, which provide, respectively, that: (1) An ANC broker-dealer must amend and submit to the Commission for approval its ANC application before materially changing its ANC credit risk model; (2) an ANC broker-dealer must notify the Commission 45 days before it ceases using its ANC credit risk model; and (3) the Commission, by order, can revoke an ANC broker-dealer’s ability to use the ANC credit risk model. Commission staff also reviews and monitors an OTC derivatives dealer’s use of its OTCDD credit risk model.<sup>250</sup>

Under the pre-existing provisions of Rule 15c3–1e, an ANC broker-dealer approved to use an ANC credit risk model can apply the model to unsecured receivables arising from OTC derivatives instruments from all types of counterparties. The Commission proposed to narrow this treatment so that ANC broker-dealers could apply the ANC credit risk model to unsecured receivables arising exclusively from security-based swap transactions with commercial end users (*i.e.*, unsecured receivables arising from other types of derivative transactions were subject to the 100% deduction from net worth).<sup>251</sup>

The Commission proposed that stand-alone SBSBs authorized to use models also could apply a credit risk model to unsecured receivables arising from security-based swap transactions with commercial end users.<sup>252</sup> The proposed credit risk model for stand-alone SBSBs was modeled on the ANC credit risk model (as opposed to the OTCDD credit risk model). Consequently, the credit risk model for stand-alone SBSBs included a portfolio concentration charge if aggregate current exposures to all counterparties exceeded 50% of the firm’s tentative net capital.

In the 2018 comment reopening, the Commission asked whether the final rules should cap the ability of ANC broker-dealers and stand-alone SBSBs authorized to use models to apply the credit risk models to uncollateralized *current exposures* arising from security-based swap and swap transactions with commercial end users. The Commission asked whether this cap should equal 10% of the firm’s tentative net capital.<sup>253</sup> In addition, the Commission asked whether the use of the credit risk models by ANC broker-dealers and stand-alone SBSBs should be expanded to apply to uncollateralized *potential exposures* to counterparties arising from electing not to collect initial margin for non-cleared security-based swap and swap transactions pursuant to exceptions in the margin rules of the Commission and the CFTC. This treatment would be an alternative to taking the 100% deduction to net worth in lieu of collecting initial margin.

#### Comments and Final Requirements for Using Credit Risk Models

A commenter urged the Commission not to limit the circumstances in which the credit risk models could be used.<sup>254</sup> The commenter stated that uncollateralized receivables arising from a counterparty failing to post margin typically result from operational issues that are temporary in nature (*i.e.*, that are addressed in a matter of days) and are liquidated if they last for longer periods of time. The commenter stated that a credit risk charge adequately addresses the risks of under-collateralized positions during the interim period before margin is posted and that “a punitive 100% deduction is unnecessary.” The commenter also stated that requiring a nonbank SBSB to hold additional capital for each dollar of margin it did not collect from a non-financial entity for a swap would effectively undermine an exception proposed by the CFTC, which the commenter indicated would deter the dual registration of nonbank SBSBs as swap dealers. The commenter also requested that the Commission permit ANC broker-dealers and stand-alone SBSBs authorized to use models to apply a counterparty credit risk charge in lieu of a 100% deduction for security-based swaps and swaps with sovereigns, central banks, supranational institutions, and affiliates to the extent that an exception to applicable margin requirements applies. Similarly, another commenter recommended that the

Commission calibrate the capital charges so that they do not make compliance with other regulators’ margin rules punitive.<sup>255</sup>

A commenter stated that ANC broker-dealers and stand-alone SBSBs should be permitted to apply the credit risk models to uncollateralized exposures to multilateral development banks in which the U.S. is a member.<sup>256</sup> This commenter stated that the Commission’s proposal to limit use of the models to commercial end users is unwarranted, on either risk-based or policy grounds. A commenter stated that requiring a 100% deduction for unsecured receivables from commercial end users with respect to swap transactions (as compared to security-based swap transactions for which the credit risk models would apply) will make it difficult, if not impossible, to maintain a dually-registered nonbank SBSB and swap dealer.<sup>257</sup> Another commenter urged the Commission to modify its proposal to avoid the pass-through of costs to commercial end users that the commenter argued would result if SBSBs are required to hold capital to cover unsecured credit exposures to them.<sup>258</sup> This commenter also recommended that the Commission allow nonbank SBSBs and nonbank MSBSPs that are not approved to use internal models to take the credit risk charge (*i.e.*, not limit its use to ANC broker-dealers and stand-alone SBSBs authorized to use models). One commenter suggested that the Commission substitute a credit risk charge or a credit concentration charge in place of the 100% charge for legacy accounts, with an exception permitting SBSBs to exclude any currently non-cleared positions for which a clearing agency has made an application to the Commission to accept for clearing.<sup>259</sup>

In response to the 2018 comment reopening, a commenter expressed support for expanding the use of credit risk models to uncollected initial margin from legacy accounts.<sup>260</sup> This commenter argued that this would be comparable to capital rules for bank SBSBs. Similarly, a commenter supported expanding the use of credit

<sup>255</sup> See Memorandum from Richard Gabbert, Counsel to Commissioner Hester M. Peirce, regarding an April 24, 2018 meeting with representatives of Citigroup (April 26, 2018) (“Citigroup 4/24/2018 Meeting”).

<sup>256</sup> See Letter from Anne-Marie Leroy, Senior Vice President and Group General Counsel, and David Harris, Acting Vice President and General Counsel, The World Bank (Feb. 21, 2013) (“World Bank Letter”).

<sup>257</sup> See Financial Services Roundtable Letter.

<sup>258</sup> See Sutherland Letter.

<sup>259</sup> See SIFMA 2/22/2013 Letter.

<sup>260</sup> See Morgan Stanley 11/19/2018 Letter.

<sup>249</sup> See paragraph (d) of Rule 15c3–1f.

<sup>250</sup> See paragraph (a) of Rule 15c3–1f.

<sup>251</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70240–44.

<sup>252</sup> See 77 FR at 70240–44.

<sup>253</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53010–11.

<sup>254</sup> See SIFMA 2/22/2013 Letter.

risk models, noting that it would be consistent with the Basel capital standards as well as the manner in which the current net capital rule applies to ANC broker-dealers.<sup>261</sup> Conversely, a commenter opposed expanding the use of credit risk models.<sup>262</sup>

Finally, a commenter raised concerns about the potential rule language in the 2018 comment reopening because it narrowed the ability to use credit risk models for transactions in security-based swaps and swaps.<sup>263</sup> The commenter noted that the current capital rules permit ANC broker-dealers to use the ANC credit risk models with respect to derivatives instruments, which encompass—among other things—OTC options that are not security-based swaps or swaps.

In response to these comments, the Commission is persuaded that the ability to apply the credit risk models should not be narrowed as proposed in 2012 (*i.e.*, to exposures arising from uncollected variation and initial margin from commercial end users). The Commission believes the better approach is to maintain the existing provision in Rule 15c3–1 that permits an ANC broker-dealer to apply the ANC credit risk model to credit exposures arising from all derivatives transactions. The Commission further believes that Rule 18a–1 should permit stand-alone SBSBs authorized to use models to similarly apply the credit risk model. Consequently, under the final rules, the credit risk models can be applied to uncollateralized current exposures to counterparties arising from all derivatives instruments, including such exposures arising from not collecting variation margin from counterparties pursuant to exceptions in the margin rules of the Commission and the CFTC.<sup>264</sup>

The final rules also permit use of the credit risk models instead of taking the 100% deductions to net worth for electing not to collect initial margin for non-cleared security-based swaps and swaps pursuant to exceptions in the margin rules of the Commission and the CFTC, respectively. This broader application of the credit risk models with respect to security-based swap and swap transactions—which will reduce the amount of the capital charges—should mitigate concerns raised by commenters about the impact that the

100% deductions to net worth would have on nonbank SBSBs and their counterparties. It also responds to commenters who requested that the ability to use the credit risk models be expanded to a broader range of transactions. In addition, the broader application of credit risk models should mitigate the concerns raised by commenters that applying the 100% deduction to net worth with respect to swap transactions would make it difficult, if not impossible, to maintain an entity dually-registered as a nonbank SBSB and swap dealer.

As noted above, the 2018 comment reopening described a potential cap equal to 10% of the firm's tentative net capital that would limit the firm's ability to apply the credit risk models to uncollateralized current exposures arising from electing not to collect variation margin.<sup>265</sup> Under this potential threshold, a firm would need to take a capital charge equal to the aggregate amount of uncollateralized current exposures that exceeded 10% of the firm's tentative net capital.

Commenters addressed this potential cap. One commenter recommended that rather than an aggregate cap, the Commission adopt a counterparty-by-counterparty threshold equal to 1% of the firm's tentative net capital.<sup>266</sup> In the alternative, this commenter suggested using a 20% cap, if the Commission deemed it necessary to impose an aggregate limit. Another commenter suggested that the Commission not adopt the 10% cap and instead rely on the existing portfolio concentration charge in Rule 15c3–1e that is part of the credit risk model used to calculate the credit risk charges.<sup>267</sup>

In response to the comments, the 10% cap was designed to limit the amount of a firm's capital base that is comprised of unsecured receivables. These assets generally are illiquid and cannot be readily converted to cash, particularly in a time of market stress. Permitting additional unsecured receivables to be allowable assets for capital purposes (in the form of either a higher aggregate cap or alternative thresholds) could substantially impair the firm's liquidity and ability to withstand a financial shock. Moreover, as discussed above, the Commission is broadening the application of the credit risk models to all types of counterparties and transactions that are subject to exceptions in the margin rules for non-

cleared security-based swaps and swaps.

For these reasons, the Commission believes it is an appropriate and prudent measure to adopt the 10% cap for ANC broker-dealers, including ANC broker-dealer SBSBs. These firms engage in a wide range of securities activities beyond dealing in security-based swaps, including maintaining custody of securities and cash for retail customers. They are significant participants in the securities markets and, accordingly, the Commission believes it is appropriate to adopt rules that promote their safety and soundness by limiting the amount of unsecured receivables that can be part of their regulatory capital. Thus, the Commission does not believe increasing the 10% cap to a 20% cap would be appropriate.

Consequently, under the final rule, these firms are subject to a portfolio concentration charge equal to 100% of the amount of the firm's aggregate *current exposure* to all counterparties in excess of 10% of the firm's tentative net capital.<sup>268</sup> Thus, unsecured receivables arising from electing not to collect variation margin are included in the portfolio concentration charge. The charge does not include *potential future exposure* arising from electing not to collect initial margin.

In response to comments, the Commission has reconsidered the proposed portfolio concentration charge for stand-alone SBSBs (including stand-alone SBSBs registered as OTC derivatives dealers).<sup>269</sup> These firms will engage in a much more limited securities business as compared to ANC broker-dealers, including ANC broker-dealer SBSBs. Consequently, they will be a less significant participant in the broader securities market. Moreover, under existing requirements, OTC derivatives dealers are not subject to a portfolio concentration charge.<sup>270</sup> Therefore, not including a portfolio concentration charge for stand-alone SBSBs will more closely align the credit risk model for these firms with the OTCCDD credit risk model. The Commission believes this is appropriate as both types of entities are limited in the activities they can engage in as compared to ANC broker-dealers. Further, as discussed above in section II.A.4. of this release, a stand-alone SBSB that also is registered as an OTC derivatives dealer will be subject to

<sup>268</sup> See paragraph (c)(3) of Rule 15c3–1e, as amended.

<sup>269</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70244 (proposing a portfolio concentration charge in Rule 18a–1 for stand-alone SBSBs).

<sup>270</sup> See paragraph (c) of Rule 15c3–1f.

<sup>261</sup> See SIFMA 11/19/2018 Letter.

<sup>262</sup> See Better Markets 11/19/2018 Letter.

<sup>263</sup> See Morgan Stanley 11/19/2018 Letter.

<sup>264</sup> See paragraph (a)(7) of Rule 15c3–1, as amended; paragraph (a)(2) of Rule 18a–1, as adopted.

<sup>265</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53010.

<sup>266</sup> See Morgan Stanley 11/19/2018 Letter.

<sup>267</sup> See SIFMA 11/19/2018 Letter.

Rules 18a–1, 18a–1a, 18a–1b, 18a–1c and 18a–1d rather than Rule 15c3–1 and its appendices (and, in particular, Rule 15c3–1f). Consequently, not including a portfolio concentration charge in Rule 18a–1 will avoid having two different standards: one for OTC derivatives dealers that also are SBSDs and the other for OTC derivatives dealers that are not SBSDs. For these reasons, the credit risk model for stand-alone SBSDs in Rule 18a–1 has been modified from the proposal to eliminate the portfolio concentration charge.<sup>271</sup>

In addition to the foregoing modifications to the credit risk models for ANC broker-dealers and stand-alone SBSDs, the Commission is making an additional modification to the term “collateral” as defined in the rules for purposes of the models.<sup>272</sup> In particular, the existing definition in Rule 15c3–1e and the proposed definition in Rule 18a–1 provided that in applying the credit risk model the fair market value of collateral pledged by the counterparty could be taken into account if, among other conditions, the firm maintains possession or control of the collateral.<sup>273</sup> Consequently, under the existing and proposed rules, collateral held at a third-party custodian could not be taken into account because it was not in the possession or control of the firm.

As discussed above in section II.A.2.b.ii. of this release, the Commission believes it would be appropriate to recognize a broader range of custodians for purposes of the exception to taking the deduction to net worth when initial margin is held at a third-party custodian. Consequently, the Commission modified that provision so that, for purposes of the exception, a stand-alone broker-dealer or nonbank SBSB could recognize collateral held at a bank as defined in Section 3(a)(6) of the Exchange Act or a registered U.S. clearing organization or depository that is not affiliated with the counterparty or, if the collateral consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that is not affiliated with the counterparty and that customarily maintains custody of such foreign securities or currencies.<sup>274</sup> The Commission believes the same types of custodians should be recognized for purposes of the credit risk models and

accordingly is modifying the definitions of “collateral” in Rules 15c3–1e, as amended, and 18a–1, as adopted, to permit an ANC broker-dealer or nonbank SBSB to take into account collateral held at a third-party custodian that is one of these entities, subject to the same conditions with respect to foreign securities and currencies.<sup>275</sup>

A commenter urged the Commission to modify the proposed application of the credit risk models to avoid the pass-through of costs to commercial end users that the commenter argued would result if nonbank SBSBs are required to hold capital to cover unsecured credit exposures to these counterparties.<sup>276</sup> The commenter recommended that the Commission allow nonbank SBSBs not authorized to compute model-based haircuts to use the credit risk models (*i.e.*, not limit the use of credit risk models to ANC broker-dealers and stand-alone SBSBs authorized to use models). Another commenter suggested that nonbank SBSBs that have not been approved to use models for capital purposes also be allowed to compute credit risk charges for uncollected initial margin by multiplying the exposure by 8% and a credit-risk-weight factor.<sup>277</sup>

In response, the Commission does not believe it would be appropriate to permit stand-alone SBSBs that are not authorized to use models to apply model-derived credit risk charges. First, the credit risk models used by ANC broker-dealers and nonbank SBSBs require a calculation of maximum potential exposure to the counterparty multiplied by a back-testing-determined factor.<sup>278</sup> The maximum potential exposure amount is a charge to address potential future exposure and is calculated using the firm’s market risk model (*i.e.*, the model to calculate model-based haircuts) 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. Second, ANC broker-dealers and stand-alone SBSBs authorized to use models are subject to higher minimum tentative net capital and net capital requirements. These enhanced minimum capital requirements are designed to account for the lower deductions that result from using models. Nonbank SBSBs that have not been authorized to use models will not be subject to these additional requirements. Moreover, as a practical matter, the Commission expects that most nonbank SBSBs will apply to use models.

A commenter argued that adopting an exception from collecting initial margin from another SBSB for a non-cleared security-based swap transaction without imposing a deduction from net worth would be inappropriate.<sup>279</sup> The commenter argued that these counterparties could default, which, in turn, could increase systemic risk. In response, as discussed above in section II.A.2.b.ii. of this release, the final rules require a nonbank SBSB to take a deduction in lieu of margin when it does not collect initial margin from a counterparty, including an SBSB. The capital charge is designed to achieve the same objective as collecting margin (*i.e.*, protect the nonbank SBSB from the consequences of the counterparty’s default). Moreover, a nonbank SBSB will be required to collect variation margin from other financial market intermediaries such as SBSBs.

A commenter stated that uncollateralized receivables arising from a counterparty failing to post margin typically result from operational issues that are temporary in nature (*i.e.*, that are addressed in a matter of days) and are liquidated if they last for longer periods of time.<sup>280</sup> Consequently, the commenter requested that the Commission expand the use of credit risk models to instances when the nonbank SBSB does not collect *required* margin (*i.e.*, as distinct from when the SBSB elects not collect margin pursuant to an exception in the margin rules). As discussed above in section II.A.2.b.ii. of this release with respect to under-margined accounts, when margin is required it should be collected promptly, as it is designed to protect the nonbank SBSB from the consequences of the counterparty defaulting on its obligations. The 100% deduction from net worth for failing to collect required margin will serve as an incentive for nonbank SBSBs to have a well-

<sup>275</sup> See paragraph (c)(4)(v)(B)(2) of Rule 15c3–1e, as amended; paragraph (e)(2)(iii)(E)(2) of Rule 18a–1, as adopted. As part of this modification, paragraph (c)(4)(v)(B) was re-designated paragraph (c)(4)(v)(B)(1) and the phrase “and may be liquidated promptly by the firm without intervention by any other party” was added before the semicolon. This rule text was moved from paragraph (c)(4)(v)(D) of Rule 15c3–1e, because this provision is not applicable to the third-party custodial provisions in paragraph (c)(4)(v)(B)(2). As a result, paragraph (c)(4)(v)(D) of Rule 15c3–1e was deleted and the remaining subparagraphs re-numbered. Conforming changes also were made to paragraph (e)(2)(iii) of Rule 18a–1, as amended.

<sup>276</sup> See Sutherland Letter.

<sup>277</sup> See SIFMA 11/19/2018 Letter.

<sup>278</sup> See paragraph (c)(4)(i) and Rule 15c3–1e, as amended; paragraph (e)(2)(iii)(A) of Rule 18a–1, as adopted.

<sup>279</sup> See OneChicago 2/19/2013 Letter.

<sup>280</sup> See SIFMA 2/22/2013 Letter.

<sup>271</sup> See paragraph (e)(2) of Rule 18a–1, as adopted.

<sup>272</sup> See paragraph (c)(4)(v) of Rule 15c3–1e, as amended; paragraph (e)(2)(iii)(E) of Rule 18a–1, as adopted.

<sup>273</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70243.

<sup>274</sup> See paragraph (c)(2)(xv)(C)(1) of Rule 15c3–1, as amended; paragraph (c)(1)(ix)(C)(1) of Rule 18a–1, as adopted.

functioning margin collection system and the capital needed to take the deduction will protect the nonbank SBSD from the consequences of the counterparty's default. However, the final margin rule being adopted today provides a nonbank SBSD or MSBSP an additional day to collect required margin from a counterparty (including variation margin due from an affiliate) if the counterparty is located in a different country and is more than 4 time zones away.<sup>281</sup> This should mitigate the commenter's concern about having to take a deduction when required margin is not collected in a timely manner.

Finally, a commenter requested that the Commission permit a nonbank SBSD to substitute the credit risk charge that would apply to a transaction with a counterparty with the credit risk charge that would apply to a transaction with a different counterparty that hedges the transaction with the first counterparty, as permitted under bank capital rules under certain conditions.<sup>282</sup> The commenter cited a bank regulation that permits this shifting of credit risk charges.<sup>283</sup> The bank regulation cited in support of this comment is integrated into the broader set of bank capital regulations. The commenter did not describe why such a provision would be appropriate for a nonbank or which bank regulations would need to be codified into the ANC broker-dealer and nonbank SBSD capital rules to prudently and effectively implement it. Consequently, the Commission is not incorporating such a provision into the ANC broker-dealer and nonbank SBSD capital rules.<sup>284</sup>

For the foregoing reasons, the Commission is adopting final rules that permit ANC broker-dealers and stand-alone SBSDs authorized to use credit risk models to apply the credit risk charges with the modifications discussed above.<sup>285</sup> The Commission also is adopting final rules regarding the operation of the credit risk models with the modifications discussed above.<sup>286</sup>

<sup>281</sup> See paragraphs (c)(1)(iii) and (c)(2)(ii) of Rule 18a-3, as adopted. These and other provisions related to the margin rule are discussed in more detail in section II.B.2. of this release.

<sup>282</sup> See SIFMA 11/19/2018 Letter.

<sup>283</sup> 12 CFR 217.36.

<sup>284</sup> See also section II.A.1. of this release (discussing why the Commission does not believe it would be appropriate to apply a bank capital standard to a nonbank SBSD).

<sup>285</sup> See paragraph (a)(7) of Rule 15c3-1, as amended; paragraph (a)(2) of Rule 18a-1, as adopted.

<sup>286</sup> See paragraph (c) of Rule 15c3-1e, as amended; paragraph (e)(2) to Rule 18a-1, as adopted. The following non-substantive changes are being made. First, “%” is replaced with “percent” in paragraph (e)(2) of Rule 18a-1, as adopted, to improve internal consistency in the rule. Second,

## c. Risk Management

ANC broker-dealers and OTC derivatives dealers are subject to a risk management rule.<sup>287</sup> Rule 15c3-4 requires these firms to, among other things, 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. The Commission proposed that nonbank SBSDs be required to comply with Rule 15c3-4 to promote the establishment of effective risk management control systems by these firms.<sup>288</sup>

Commenters expressed support for the Commission's proposal.<sup>289</sup> A commenter stated that requiring nonbank SBSDs to comply with Rule 15c3-4 “will better enable nonbank SBSDs to identify and mitigate and manage the risks they are facing.”<sup>290</sup> A second commenter stated that Rule 15c3-4 should already contemplate the unique needs of a dealer in derivatives.<sup>291</sup> The Commission is adopting, as proposed, the requirement that nonbank SBSDs comply with Rule 15c3-4.<sup>292</sup>

## d. Other Rule 15c3-1 Provisions Incorporated Into Rule 18a-1

### i. Debt-Equity Ratio Requirements

Paragraph (d) of Rule 15c3-1 sets limits on the amount of a stand-alone broker-dealer's outstanding subordinated loans. The debt-to-equity limits are designed to ensure that a stand-alone broker-dealer has a base of permanent capital in addition to any

“paragraphs (c)(1)(iv), (vi), and (vii) of this section” are replaced with “paragraphs (c)(1)(iv), (vi), and (vii) of this section, and § 240.18a-1b,” in paragraph (d)(1) of Rule 18a-1, as adopted. Third, “ten business day” is replaced with “ten-business day” in paragraph (d)(9)(i)(C)(5)(i) of Rule 18a-1, as adopted. Fourth, “paragraphs (c)(1)(iii), (iv), (vii), or (viii)” is replaced with “paragraphs (c)(1)(iii), (iv), (vi), (vii),” in paragraph (d)(9)(iii) of Rule 18a-1, as adopted.

<sup>287</sup> See 17 CFR 240.15c3-4 (“Rule 15c3-4”); paragraph (a)(7)(iii) of Rule 15c3-1.

<sup>288</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70250–70251.

<sup>289</sup> See Letter from Chris Barnard (Dec. 4, 2012) (“Barnard Letter”); Financial Services Roundtable Letter.

<sup>290</sup> See Barnard Letter.

<sup>291</sup> See Financial Services Roundtable Letter.

<sup>292</sup> See paragraph (a)(10)(ii) of Rule 15c3-1, as amended (which applies Rule 15c3-4 to broker-dealer SBSDs not authorized to use model-based haircuts); paragraph (f) of Rule 18a-1, as adopted (which applies Rule 15c3-4 to stand-alone SBSDs). In the final rule, paragraph (g) of Rule 18a-1, as proposed to be adopted, was re-designated paragraph (f). See paragraph (f) of Rule 18a-1, as adopted. See also paragraph (a)(7)(iii) of Rule 15c3-1 (which applies Rule 15c3-4 to ANC broker-dealers, including ANC broker-dealer SBSDs).

subordinated loans, which—as discussed above—are permitted to be added back to net worth when computing net capital. Paragraph (h) of proposed Rule 18a-1 contained parallel debt-to-equity limits.<sup>293</sup> The Commission did not receive comments concerning the debt-to-equity limits in proposed Rule 18a-1 and for the reasons discussed in the proposing release is adopting them as proposed.<sup>294</sup>

### ii. Capital Withdrawal Requirements

Paragraph (e)(1) of Rule 15c3-1 requires that a stand-alone broker-dealer provide notice when it seeks to withdraw capital in an amount that exceeds certain thresholds. Paragraph (e)(2) of Rule 15c3-1 permits the Commission to issue an order temporarily restricting a stand-alone broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain circumstances. The Commission proposed parallel requirements for stand-alone SBSDs.<sup>295</sup> The Commission did not receive comments concerning the proposed capital withdrawal requirements for stand-alone SBSDs and for the reasons discussed in the proposing release is adopting them as proposed.<sup>296</sup>

### iii. Appendix C

Appendix C to Rule 15c3-1 requires a stand-alone 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.<sup>297</sup> 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 stand-alone broker-dealer may also be consolidated. Subject to certain conditions in Appendix C to Rule 15c3-1, a stand-alone broker-dealer may receive flow-through net capital benefits because the consolidation may serve to increase the firm's net capital and thereby assist it in

<sup>293</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70254–55.

<sup>294</sup> See paragraph (g) of Rule 18a-1, as adopted. The debt-equity ratio requirements were set forth in re-designated paragraph (g) of Rule 18a-1, as adopted, and conforming changes were made to applicable cross-references in the rule.

<sup>295</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70254–55.

<sup>296</sup> See paragraph (h) of Rule 18a-1, as adopted. The capital withdrawal requirements were set forth in re-designated paragraph (h) of Rule 18a-1, as adopted, and conforming changes were made to applicable cross-references in the rule.

<sup>297</sup> See Rule 15c3-1c.

meeting the minimum requirements of Rule 15c3-1. However, based on Commission staff experience and information from an SRO, very few stand-alone broker-dealers consolidate subsidiaries or affiliates to obtain the flow-through capital benefits permitted under Appendix C to Rule 15c3-1.

Consequently, the Commission proposed a parallel requirement for a stand-alone SBSB to include in its net capital computation all liabilities or obligations of a subsidiary or affiliate of the stand-alone SBSB that the SBSB guarantees, endorses, or assumes either directly or indirectly, but the Commission did not propose parallel provisions permitting flow-through capital benefits.<sup>298</sup> The Commission did not receive comments on this proposed consolidation requirement and for the reasons discussed in the proposing release is adopting it as proposed.<sup>299</sup>

#### iv. Appendix D

Paragraph (c)(2)(ii) of Rule 15c3-1 permits a stand-alone broker-dealer when computing net capital to exclude liabilities that are subordinated to the claims of creditors pursuant to a satisfactory subordination agreement. Excluding these liabilities has the effect of increasing the firm's net capital. Appendix D to Rule 15c3-1 (Rule 15c3-1d) sets forth minimum and non-exclusive requirements for satisfactory subordination agreements.<sup>300</sup> There are two types of subordination agreements under Rule 15c3-1d: (1) A subordinated loan agreement, which is used when a third party lends cash to a stand-alone broker-dealer;<sup>301</sup> and (2) a secured demand note agreement, which is a promissory note in which a third party agrees to give cash to a stand-alone broker-dealer on demand during the term of the note and provides cash or securities to the broker-dealer as collateral.<sup>302</sup> Based on Commission staff experience, stand-alone broker-dealers infrequently utilize secured demand notes as a source of capital, and the amounts of these notes are relatively small in size.

Certain of the provisions in Rule 15c3-1d are tied to the minimum net capital requirements of stand-alone broker-dealers. Consequently, the Commission proposed amendments to the rule to reflect the proposed minimum net capital requirements of broker-dealer SBSBs so that they could

realize the net capital benefits of qualified subordination agreements.<sup>303</sup> The Commission also included parallel provisions in proposed Rules 18a-1 and 18a-1d so that stand-alone SBSBs could realize the net capital benefits of qualified subordination agreements.<sup>304</sup> However, because stand-alone broker-dealers rarely use secured demand notes, the proposed provisions for stand-alone SBSBs did not include this option for entering into a qualified subordinated agreement. The Commission did not receive comments on the proposed amendments to Rule 15c3-1d or the proposed parallel provisions for stand-alone SBSBs and for the reasons discussed in the proposing release is adopting them with certain non-substantive modifications.<sup>305</sup>

#### v. Capital Charge for Unresolved Securities Differences

Paragraph (c)(2)(v) of Rule 15c3-1 requires a stand-alone broker-dealer to take a capital charge for short securities differences that are unresolved for seven days or longer and for long securities differences where the securities have been sold before they are adequately resolved. These capital charges were inadvertently omitted from the text of Rule 18a-1 when it was proposed and, consequently, the Commission proposed to include them in the rule when proposing the recordkeeping and reporting rules for SBSBs and MSBSPs.<sup>306</sup> The Commission received

<sup>303</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70256, n. 460.

<sup>304</sup> See 77 FR at 70255-70256.

<sup>305</sup> See Rule 15c3-1d, as amended; paragraph (c)(1)(ii) of Rule 18a-1, as adopted; Rule 18a-1d, as adopted. The final rules are modified in the following non-substantive ways. The proposed rule text in Rule 15c3-1d is modified to refer generically to minimum capital requirements, rather than specific numbers and percentages, to account for the additional financial ratios that broker-dealer SBSBs are subject to under Rule 15c3-1. The term “%” is replaced with “percent” to improve internal consistency in paragraphs (b)(7), (b)(8)(i), (b)(10)(ii)(B), and (c)(5)(B) of Rule 15c3-1d, as amended, and in paragraphs (b)(6), (b)(7), (b)(9)(ii)(A), (c)(2), and (c)(4) of Rule 18a-1, as adopted. The headers “(i)” and “(ii)” are removed in paragraph (b)(1) of Rule 18a-1d, as adopted. The semicolon at the end of paragraph is replaced with a period in paragraph (c)(2) of Rule 15c3-1d, as amended, and paragraph (b)(5) of Rule 18a-1d, as adopted. The phrase “§ 240.18a-1 and § 240.18a-1d” is replaced with “§§ 18a-1 and 18a-1d” in paragraphs (b)(8)(i) and (c)(1) of Rule 18a-1d, as adopted. Semicolons are added at the end of paragraphs (b)(9)(D) and (D)(1) of Rule 18a-1d, as adopted. The phrase “[C]ause (i) of paragraph (b)(8)” is replaced with “paragraph (b)(8)(i) of this section” in paragraph (b)(9)(ii)(D) of Rule 18a-1d, as adopted.

<sup>306</sup> See *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers*, 79 FR at 25254.

one comment, which addressed concerns regarding short sale buy-in requirements that are beyond the scope of this rulemaking.<sup>307</sup> For the reasons discussed in the proposing release, the Commission is adopting the capital charges as proposed with minor non-substantive changes.<sup>308</sup>

#### 3. Capital Rules for Nonbank MSBSPs

The Commission proposed Rule 18a-2 to establish capital requirements for nonbank MSBSPs.<sup>309</sup> Under the proposal, nonbank MSBSPs were required at all times to have and maintain positive tangible net worth. The Commission proposed a tangible net worth standard, 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 stand-alone broker-dealers or SBSBs. As proposed, the term “tangible net worth” was defined to mean the nonbank MSBSP's net worth as determined in accordance with GAAP, excluding goodwill and other intangible assets. Consequently, the definition of “tangible net worth” allowed nonbank MSBSPs to include as regulatory capital assets that 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.

The Commission also proposed that nonbank MSBSPs must comply with Rule 15c3-4 with respect to their security-based swap and swap activities. Requiring nonbank MSBSPs to be subject to Rule 15c3-4 was intended to promote sound risk management practices with respect to the risks associated with OTC derivatives.

Commenters expressed support for the Commission's proposed requirements for nonbank MSBSPs.<sup>310</sup> A commenter stated that the positive tangible net worth test is more appropriate than the net liquid assets test particularly for entities that have never been prudentially regulated before.<sup>311</sup> Another commenter supported “the proposed requirement

<sup>307</sup> See Shatto Letter.

<sup>308</sup> See paragraph (c)(1)(x)(A) through (C) of Rule 18a-1, as adopted. In the final rule, the Commission replaced the phrase “broker or dealer” with “security-based swap dealer” in paragraph (c)(1)(x)(B) and the term “designated examining authority for a broker or dealer” with “Commission” in paragraph (c)(1)(x)(C).

<sup>309</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70256-57.

<sup>310</sup> See Barnard Letter; Sutherland Letter.

<sup>311</sup> See Sutherland Letter.

<sup>298</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70255.

<sup>299</sup> See Rule 18a-1c, as adopted.

<sup>300</sup> See 17 CFR 240.15c3-1d (“Rule 15c3-1d”).

<sup>301</sup> See paragraph (a)(2)(ii) of Rule 15c3-1d.

<sup>302</sup> See paragraph (a)(2)(v)(A) of Rule 15c3-1d.

that MSBSPs maintain a positive tangible net worth.”<sup>312</sup> However, the commenter also stated that the proposed rule “should recognize and respect state insurance regulators’ role in ensuring the capital adequacy of financial guaranty insurers, and should accordingly recognize that, in the case of a financial guaranty insurer, any positive tangible net worth requirement should be satisfied if an insurer maintains the minimum statutory capital and complies with the investment requirements under applicable insurance law.”<sup>313</sup> This commenter also stated that, to the extent that financial guaranty insurers use affiliates to write CDS that they in turn insure, and insofar as such affiliates are designated as MSBSPs, the positive tangible net worth test should refer back to the financial guaranty insurer itself, as that is the entity that the CDS counterparties look to for paying the affiliates’ obligations under the insured CDS.

With respect to the Commission’s proposal that nonbank MSBSPs comply with Rule 15c3–4, the commenter stated that it recognized the need for nonbank MSBSPs to maintain strong internal risk controls, but cautioned the Commission against imposing unnecessarily burdensome, duplicative, and costly risk management controls on financial guaranty insurers. This commenter also stated that financial guaranty insurers that are determined to be MSBSPs should be able to establish compliance with Rule 15c3–4 by virtue of compliance with the New York Department of Financial Services Circular Letter No. 14, which calls for the establishment of comprehensive internal risk management controls.

The Commission has considered the comments on its proposed requirements for nonbank MSBSPs and is adopting the requirements substantially as proposed.<sup>314</sup> The requirement that nonbank MSBSPs at all times have and maintain positive tangible net worth is intended to be a less rigorous requirement than the net liquid assets test applicable to stand-alone broker-dealers and nonbank SBSDs. It will provide a workable standard for entities

that engage in a diverse range of business activities that differ from, and are broader than, the securities activities conducted by stand-alone broker-dealers or SBSDs.

In response to the comment that the rule should recognize and respect existing state insurance law capital adequacy standards, the commenter supported the proposed tangible net worth requirement for nonbank MSBSPs.<sup>315</sup> The final rule imposes a relatively simple capital standard—the requirement to maintain positive tangible net worth (*i.e.*, positive net worth after deducting intangible assets). This should not impose a significant burden on nonbank MSBSPs, including firms that also are subject to capital requirements under state insurance laws. If it is possible that a nonbank MSBSP’s capital position could drop below a positive tangible net worth but at the same time still comply with a state insurance law capital requirement, the Commission believes the rule’s positive tangible net worth standard should be the binding constraint with respect to the nonbank MSBSP’s activities as an MSBSP. The Commission does not believe it would be appropriate to permit a nonbank MSBSP to continue to operate as an MSBSP if it cannot meet the capital requirement of the positive tangible net worth test. In such a case, the firm’s precarious capital position would pose a significant risk to its security-based swap counterparties.

In response to the comment about nonbank MSBSPs with CDS insured by an affiliate, the commenter did not identify an alternative capital standard that should apply to such nonbank MSBSPs. If the commenter was suggesting that these nonbank MSBSPs should be subject to a lesser requirement than the positive tangible net worth standard, the Commission disagrees. As discussed above, the Commission believes this standard will not impose a substantial burden on nonbank MSBSPs. Further, to the extent the affiliate insuring the CDS fails, the nonbank MSBSP will need to rely on its own financial resources.

The Commission also is adopting, as proposed, the requirement that MSBSPs comply with Rule 15c3–4.<sup>316</sup> Although a commenter cautioned the Commission against imposing unnecessarily burdensome, duplicative, and costly risk management controls on financial guaranty insurers, the Commission

believes that establishing and maintaining a strong risk management control system that complies with Rule 15c3–4 is necessary for entities engaged in a security-based swaps business. Participants in the securities markets are exposed to various risks, including market, credit, leverage, liquidity, legal, and operational risk. Risk management controls promote the stability of the firm and, consequently, the stability of the marketplace. A firm that adopts and follows appropriate risk management controls reduces 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. Moreover, to the extent an entity, such as a financial guaranty insurer, complies with existing risk management requirements applicable to its business, the entity will likely have in place some, if not many, of the required risk management controls. Thus, the incremental burdens and costs associated with complying with Rule 15c3–4 should not be great.

#### 4. OTC Derivatives Dealers

OTC derivatives dealers are limited purpose broker-dealers that are authorized to trade in OTC derivatives (including a broader range of derivatives than security-based swaps) and to use models to calculate net capital. They are required to maintain minimum tentative net capital of \$100 million and minimum net capital of \$20 million.<sup>317</sup> OTC derivatives dealers also are subject to Rule 15c3–4.

A commenter stated that OTC derivatives dealers will register as nonbank SBSDs in order to conduct an integrated equity derivatives business (*i.e.*, trade in equity security-based swaps and equity OTC options).<sup>318</sup> The commenter requested that the Commission modify its framework for OTC derivatives dealers to allow them to register as nonbank SBSDs. The commenter further stated that the Commission should permit an OTC derivatives dealer that is dually registered as a nonbank SBSD to deal in OTC options and qualifying forward contracts, subject to the rules applicable to the nonbank SBSD.

The Commission agrees with the commenter that entities may seek to deal in a broader range of OTC derivatives that are securities other than dealing in just security-based swaps. In order to engage in this broader securities activity, the entity would need to register as a broker-dealer. The capital

<sup>312</sup> See Letter from Bruce E. Stern, Chairman, Association of Financial Guaranty Insurers (Feb. 15, 2013) (“AFGI 2/15/2013 Letter”). See also Letter from Bruce E. Stern, Chairman, Association of Financial Guaranty Insurers (July 22, 2013) (“AFGI 7/22/2013 Letter”).

<sup>313</sup> See AFGI 2/15/2013 Letter.

<sup>314</sup> See Rule 18a–2, as adopted. The Commission modified paragraph (a) of the rule to provide that the tangible net worth requirement does not apply to a broker-dealer MSBSP. However, a broker-dealer MSBSP will be required to comply with Rule 15c3–4. See paragraph (c) of Rule 18a–2, as adopted.

<sup>315</sup> See AFGI 2/15/2013 Letter (“We support the proposed requirement that MSBSPs maintain a positive tangible net worth.”).

<sup>316</sup> See paragraph (c) of Rule 18a–2, as adopted.

<sup>317</sup> See paragraph (a)(5) of Rule 15c3–1, as amended.

<sup>318</sup> See SIFMA 2/22/2013 Letter.



rules the Commission is adopting today address entities that will register as broker-dealer SBSDs. In response to the comments, the Commission believes it would be appropriate to also adopt final rules to address OTC derivatives dealers that will register as nonbank SBSDs. Accordingly, the final rules provide that an OTC derivatives dealer that is registered as a nonbank SBSD must comply with Rule 18a–1, as adopted, and Rules 18a–1a, 18a–1b, 18a–1c and 18a–1d instead of Rule 15c3–1 and its appendices.<sup>319</sup> This will simplify the capital rules for such an entity by requiring the firm to comply with a single set of requirements.

Moreover, the provisions of Rule 18a–1 and related rules are similar to the provisions of Rule 15c3–1 and its appendices. For example, the minimum fixed-dollar capital requirements in both sets of rules are \$100 million in tentative net capital and \$20 million in net capital. Both sets of rules permit the firms to compute net capital using models. In addition, as discussed above in section II.A.2.b.v. of this release, the methodology for computing the credit risk charges in Rule 18a–1 does not include the proposed portfolio concentration charge. As a result of this modification, both sets of rules are consistent in that they do not require this charge. Stand-alone SBSDs and OTC derivatives dealers also are both subject to Rule 15c3–4. For these reasons, the Commission believes a stand-alone SBSD should be able to efficiently incorporate its activities as an OTC derivatives dealer into its capital and risk management requirements under Rule 18a–1, as adopted.

## B. Margin

### 1. Introduction

The Commission is adopting Rule 18a–3 pursuant to Section 15F of the Exchange Act to establish margin requirements for nonbank SBSDs and MSBSPs with respect to non-cleared security-based swaps. The Commission modeled Rule 18a–3 on the margin rules applicable to stand-alone broker-dealers (the “broker-dealer margin rules”).<sup>320</sup> A commenter supported the Commission’s decision to base its proposal on the existing margin rules for stand-alone broker-dealers, noting that it is critically important that the Commission

maintain a level playing field for similar financial instruments.<sup>321</sup>

A number of commenters raised concerns about the Commission’s decision to model proposed Rule 18a–3 on the broker-dealer margin rules to the extent that doing so resulted in inconsistencies with the margin rules of the CFTC and the prudential regulators as well as with the recommendations in the BCBS/IOSCO Paper.<sup>322</sup> A commenter argued that the broker-dealer margin rules are not consistent with the restrictions on re-hypothecation recommended by the BCBS/IOSCO Paper.<sup>323</sup> This commenter stated that the Commission needed to tailor its margin requirements to the realities of the security-based swap and swap markets.

Another commenter appreciated that the Commission largely modeled its proposed margin rules on the broker-dealer margin rules in an effort to promote consistency with existing rules, but suggested that the Commission more closely conform its final rules to the recommendations in the final BCBS/IOSCO Paper to promote the comparability of margin requirements among jurisdictions.<sup>324</sup> A second commenter noted that material differences and inconsistencies between the proposal and domestic and international standards could cause a need for separate documentation and tri-party arrangements for security-based swaps and swaps, which could lead to separate margin calls and different netting sets.<sup>325</sup>

A commenter suggested that the Commission coordinate its margin rules with the CFTC and the prudential regulators and raised a concern that the cumulative effects of multiple regulations potentially could tie up significant amounts of financial resources.<sup>326</sup> Other commenters recommended re-proposing the margin rule after publication of the final recommendations of the BCBS/IOSCO Paper, as well as coordinating and harmonizing with the margin rules of the CFTC and other foreign and

domestic regulators.<sup>327</sup> A commenter argued that inconsistent rules potentially could be incompatible in practice and that international adoption of the recommended standards in the BCBS/IOSCO Paper will prevent regulatory arbitrage and lead to a more level playing field between competitors in different jurisdictions.<sup>328</sup> Other commenters argued that the Commission should more closely align its margin requirements to the recommended standards in the BCBS/IOSCO Paper to promote more comparable margin requirements across jurisdictions.<sup>329</sup> One commenter argued that several components of the proposed margin rules differ from the recommended framework in the BCBS/IOSCO Paper and would generally make nonbank SBSDs uncompetitive with bank SBSDs and foreign SBSDs.<sup>330</sup> The commenter argued that the Commission could best address these differences by permitting OTC derivatives dealers and stand-alone SBSDs to collect and maintain margin in a manner consistent with the recommendations in the BCBS/IOSCO Paper.

Section 15F(e)(3)(D) of the Exchange Act requires that, to the maximum extent practicable, the Commission, the CFTC, and the prudential regulators shall establish and maintain comparable minimum initial and variation margin requirements for SBSDs and MSBSPs. In response to the comments above, the Commission has modified the proposal to more closely align the final rule with the margin rules of the CFTC and the prudential regulators and, in doing so,

<sup>327</sup> See, e.g., Letter from William J. Harrington (Nov. 19, 2018) (“Harrington 11/19/2018 Letter”); ICI 1/23/2013 Letter; ICI 11/19/2018 Letter; ISDA 1/23/13 Letter; Morgan Stanley 10/29/2014 Letter; PIMCO Letter; SIFMA AMG 11/19/2018 Letter. The CFTC and the prudential regulators re-proposed their margin rules after publication of the BCBS/IOSCO Paper. See *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 79 FR 59898 (Oct. 3, 2014); *Margin and Capital Requirements for Covered Swap Entities*, 79 FR 57348 (Sept. 24, 2014). As noted above, these agencies incorporated the recommendations of the BCBS/IOSCO Paper into their final margin rules. The Commission reopened the comment period for the proposed capital, margin, and segregation requirements in October 2018—well after the final recommendations of the BCBS/IOSCO Paper. In reopening the comment period, the Commission asked specific questions about potential rule language that would modify rule text in the proposed margin rule. See *Capital, Margin, and Segregation Comment Reopening*.

<sup>328</sup> See ISDA 2/5/2014 Letter.

<sup>329</sup> See American Council of Life Insurers 2/22/2013 Letter; American Council of Life Insurers 11/19/2018 Letter; Letter from Dan Waters, Managing Director, ICI Global (Nov. 24, 2014) (“ICI Global 11/24/2014 Letter”); MFA 2/22/2013 Letter; Letter from Christopher A. Klem, Leigh R. Fraser, and Molly Moore, Ropes & Gray LLP (Jan. 22, 2013) (“Ropes & Gray Letter”); SIFMA 11/19/2018 Letter.

<sup>330</sup> See SIFMA 11/19/2018 Letter.

<sup>321</sup> See OneChicago 2/19/2013 Letter.

<sup>322</sup> The CFTC and the prudential regulators incorporated the recommendations in the BCBS/IOSCO Paper into their final margin rules for non-cleared security-based swaps and/or swaps. See *CFTC Margin Adopting Release*, 81 FR 636; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR 74840.

<sup>323</sup> See Letter from Paul Schott Stevens, President and CEO, Investment Company Institute (May 11, 2015) (“ICI 5/11/2015 Letter”).

<sup>324</sup> See MFA 2/22/2013 Letter.

<sup>325</sup> See SIFMA AMG 11/19/2018 Letter.

<sup>326</sup> See Financial Services Roundtable Letter.

<sup>319</sup> See paragraph (a)(5)(ii) of Rule 15c3–1, as amended; undesignated introductory paragraph to Rule 18a–1, as adopted (stating that the rule applies to stand-alone SBSDs registered as OTC derivatives dealers).

<sup>320</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70259.

the recommendations in the IOSCO/BCBS Paper. As discussed in more detail below, these modifications to harmonize the final rule include:

- An extra day to collect margin in the event a counterparty is located in a different country and more than 4 time zones away;
- A requirement that SBSBs post variation margin to most counterparties;
- An exception pursuant to which a nonbank SBSB need not collect initial margin to the extent that the initial margin amount when aggregated with other security-based swap and swap exposures of the nonbank SBSB and its affiliates to the counterparty and its affiliates does not exceed a fixed-dollar \$50 million threshold;
- An exception pursuant to which a nonbank SBSB need not collect initial margin from a counterparty that is an affiliate of the nonbank SBSB;
- An exception pursuant to which a nonbank SBSB need not collect variation or initial margin from a counterparty that is the BIS, the European Stability Mechanism, or certain multilateral development banks;
- An exception pursuant to which a nonbank SBSB need not collect initial margin from a counterparty that is a sovereign entity with minimal credit risk;
- An option for nonbank SBSBs to use models to calculate initial margin that are different from the models they use to calculate capital charges;
- An option for nonbank SBSBs to use models developed by third parties (which will permit the use of an industry standard model such as ISDA's SIMM™ model);<sup>331</sup>
- An option for stand-alone SBSBs to use a model to calculate initial margin for equity security-based swaps subject to certain conditions;
- An option for nonbank SBSBs to collect and deliver collateral that is eligible under the CFTC's margin rules; and
- An option for nonbank SBSBs to use the standardized haircuts prescribed in the CFTC's margin rule to determine deductions for collateral received or delivered as margin.

While differences remain, the Commission believes the final nonbank SBSB margin rule for non-cleared security-based swaps is largely comparable to the margin rules of the CFTC and the prudential regulators. The main differences are that the Commission's rule:

- Does not require (but permits) nonbank SBSBs to collect initial margin

from counterparties that are financial market intermediaries such as SBSBs, swap dealers, FCMs, and domestic and foreign broker-dealers and banks;

- Does not require (but permits) nonbank SBSBs to post initial margin to a counterparty;
- Does not contain the exceptions from the requirement to collect margin for counterparties such as financial end users that do not have material exposures to security-based swaps and swaps; and
- Does not require (but permits) initial margin to be held at a third-party custodian.

These differences between the Commission's final rule and the margin rules of the CFTC and the prudential regulators reflect the Commission's judgment of how "to help ensure the safety and soundness" of nonbank SBSBs and MSBSPs as required by Section 15F(e)(3)(i) of the Exchange Act. The Commission has sought to strike an appropriate balance between addressing the concerns of commenters and promulgating a final margin rule that promotes the safety and soundness of nonbank SBSBs.<sup>332</sup> For these reasons, the Commission is adopting a final rule—Rule 18a–3—that is modeled on the broker-dealer margin rule but with the significant modifications noted above. These modifications further harmonize the rule with the final margin rules of the CFTC and the prudential regulators. In particular, and as discussed in more detail below, these changes are intended, in part, to permit firms that are registered as SBSBs and swap dealers to collect initial margin and collect and deliver variation margin in a manner consistent with current practices under the CFTC's margin rules, which should in turn reduce operational burdens that would arise due to differences in these requirements.<sup>333</sup> Moreover, while paragraphs (c)(4) and (5) of Rule 18a–3, as adopted, respectively require netting and collateral agreements to be in place,<sup>334</sup> the rule does not impose a

specific margin documentation requirement as do the margin rules of the CFTC and the prudential regulators.<sup>335</sup> Consequently, an existing netting or collateral agreement with a counterparty that was entered into by the nonbank SBSB in order to comply with the margin documentation requirements of the CFTC or the prudential regulators will suffice for the purposes of Rule 18a–3, as adopted, if the agreement meets the requirements of paragraph (c)(4) or (5), as applicable.

## 2. Margin Requirements for Nonbank SBSBs and Nonbank MSBSPs

### a. Daily Calculations

#### i. Nonbank SBSBs

Proposed Rule 18a–3 required a nonbank SBSB to perform two calculations for the account of each counterparty: (1) The amount of equity in the account (variation margin); and (2) the initial margin amount for the account.<sup>336</sup> The term "equity" was 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 meeting the requirements of the rule. As indicated by the definition, the Commission proposed that the nonbank SBSB could offset payables and receivables relating to derivatives in the account by applying a qualifying netting agreement with the counterparty. Proposed Rule 18a–3 set forth the requirements for a netting agreement to qualify for this treatment. The equity in the account was the amount that resulted after

take into account the fair market value of collateral delivered by a counterparty, provided the collateral is subject to an agreement between the SBSB or the MSBSP and the counterparty that is legally enforceable by the SBSB or MSBSP against the counterparty and any other parties to the agreement; paragraph (c)(5) of Rule 18a–3, as adopted (prescribing requirements for qualified netting agreements).

<sup>335</sup> See 17 CFR 23.159 (CFTC rule requiring that margin documentation: (1) Specify the methods, procedures, rules, inputs, and data sources to be used for determining the value of non-cleared swaps for purposes of calculating variation margin; (2) describe the methods, procedures, rules, inputs, and data sources to be used to calculate initial margin for non-cleared swaps entered into between the covered swap entity and the counterparty; and (3) specify the procedures by which any disputes concerning the valuation of non-cleared swaps, or the valuation of assets collected or posted as initial margin or variation margin may be resolved); see also *CFTC Margin Adopting Release*, 81 FR at 672–73, 702–3; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74886–87, 74908–909.

<sup>336</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70260–62.

<sup>331</sup> Information about ISDA's SIMM™ model is available at <https://www.isda.org/category/margin/isda-simm/>.

<sup>332</sup> See Section VI of this release (discussing benefits and costs of the final margin requirements).

<sup>333</sup> Furthermore, although Rule 18a–3 does not mandate that SBSBs deliver initial margin to their counterparties (or to deliver or collect initial margin from financial market intermediaries) as the CFTC's margin rules do, nothing in Rule 18a–3 prohibits nonbank SBSBs from delivering initial margin to these counterparties or collecting initial margin from or posting initial margin to financial market intermediaries. In addition, as above in section II.A.2.b.i. of this release, the Commission is providing guidance that would permit nonbank SBSBs to post initial margin to counterparties without taking a capital charge pursuant to certain conditions.

<sup>334</sup> See paragraph (c)(4) of Rule 18a–3, as adopted (providing that a nonbank SBSB or MSBSP may

marking-to-market the securities positions and adding the credit balance or subtracting the debit balance (including giving effect to qualifying netting agreements). An account with negative equity was subject to a variation margin requirement unless an exception from collecting collateral to cover the negative equity (*i.e.*, the nonbank SBSB's current exposure) applied.

The proposed rule set forth a standardized and a model-based approach for calculating initial margin.<sup>337</sup> The rule divided security-based swaps into two classes for purposes of the standardized approach: (1) CDS; and (2) all other security-based swaps. In both cases, the initial margin amount was to be calculated using the standardized haircuts in the proposed capital rules for nonbank SBSBs.

Proposed Rule 18a-3 provided that, if the nonbank SBSB was authorized to use model-based haircuts, the firm could use them to calculate initial margin for security-based swaps for which the firm had been approved to apply such haircuts.<sup>338</sup> However, model-based haircuts could not be used to calculate initial margin for equity security-based swaps. Initial margin for equity security-based swaps needed to be calculated using standardized haircuts in order to be consistent with SRO margin rules for cash equity positions. Consequently, a nonbank SBSB authorized to use model-based haircuts for certain types of debt security-based swaps could use these haircuts to calculate initial margin for the same types of positions. For all other positions, a nonbank SBSB needed to use the standardized haircuts. Nonbank SBSBs not authorized to use model-based haircuts needed to use the standardized haircuts to calculate initial margin for all types of positions.

Finally, proposed Rule 18a-3 required a nonbank SBSB to increase the frequency of the variation and initial margin calculations (*i.e.*, perform intra-day calculations) during periods of extreme volatility and for accounts with concentrated positions.<sup>339</sup>

#### Comments and Final Requirements To Calculate Variation Margin

A commenter sought clarification as to whether the mark-to-market value of security-based swap positions would only be counted in the definition of "equity" as part of the credit balance or the debit balance, as appropriate.<sup>340</sup> This commenter believed the absence of credit and debit balance definitions created a potential issue that the mark-to-market value of non-cleared security-based swap positions would be double counted in the calculation of the equity in a counterparty's account. In response, a nonbank SBSB should only include the mark-to-market value of a security-based swap once when calculating equity in determining the variation margin requirement.

Another commenter stated that counterparties should be permitted to reference third parties for dispute resolution, valuations, and inputs in relation to their account equity variation margin calculations.<sup>341</sup> In response, the Commission agrees that price and valuation information from third parties can be useful in validating the nonbank SBSB's variation margin calculations and in the dispute resolution process.

The Commission is adopting the requirement to calculate variation margin for the account of a counterparty on a daily basis, with certain non-substantive modifications to the rule, in response to comments and to use terms that are more commonly used in the security-based swap market.<sup>342</sup> In the final rule, the Commission has deleted the term "equity" and the definitions of "positive equity" and "negative equity" and has included the phrase "current exposure" without defining it.<sup>343</sup> The

phrase "current exposure" is used more commonly in the non-cleared security-based swap market when describing uncollateralized mark-to-market gains or losses.

#### Comments and Final Requirements To Calculate Initial Margin Using the Standardized Approach

Commenters argued that the standardized approach to calculating initial margin was too conservative and not sufficiently risk sensitive.<sup>344</sup> A commenter stated that the standardized approach would result in excessive margin requirements because the standardized haircuts in the capital rules were applied to gross notional amounts and only permitted limited netting.<sup>345</sup> This commenter also argued that it was unclear how the proposed grids applied to more complex products.

In response to these concerns, nonbank SBSBs may seek authorization to calculate initial margin using the model-based approach. Based on staff experience and the ongoing implementation of margin rules for non-cleared security-based swaps and swaps by other regulators and market participants, the Commission believes that most nonbank SBSBs will seek authorization to use a model. The availability of an initial margin model and the widespread use of initial margin models by industry participants should alleviate commenters' concerns that using standardized haircuts to calculate initial margin will lead to excessive initial margin requirements. While the Commission agrees that standardized haircuts likely will lead to more conservative requirements in contrast to the model-based initial margin calculations, the Commission does not believe these requirements will be excessive. The standardized haircuts have been used by stand-alone broker-dealers for many years. Moreover, as discussed below, the Commission is modifying the proposal to add a threshold under which initial margin need not be collected. This should mitigate the concern raised by the commenter with regard to using the standardized haircuts to calculate initial margin. Finally, the ability to use the simpler standardized haircuts for initial margin calculations may be preferable for nonbank SBSBs that occasionally trade in non-cleared security-based swaps but not in a substantial enough

<sup>340</sup> See SIFMA 2/22/13 Letter.

<sup>341</sup> See Letter from Kevin Gould, President, Markit (Feb. 22, 2013) ("Markit Letter").

<sup>342</sup> See paragraph (c)(1)(i)(A) of Rule 18a-3, as adopted.

<sup>343</sup> See paragraph (c)(1)(i)(A) of Rule 18a-3, as adopted. The Commission also proposed to define the term "positive equity" to mean equity of greater than \$0 and "negative equity" to mean equity of less than \$0. The Commission received no comments on these proposed definitions. However, the Commission is deleting them in the final rule because the term equity is no longer being defined. In addition, paragraph (b)(1) of proposed Rule 18a-3 defined the term "account" for purposes of the daily calculations of variation and initial margin to mean an account carried by a nonbank SBSB or MSBSP for a counterparty that holds non-cleared security-based swaps. The Commission did not receive any comments on this definition. However, the Commission is modifying the definition to move the clause "for a counterparty" to the end of the definition to clarify that the nonbank SBSB holds non-cleared security-based swaps for a counterparty, and to add the term "one or more" before the phrase "non-cleared security-based swaps." Furthermore, paragraph (b)(3) of proposed Rule 18a-3 defined the term "counterparty" to

mean a person with whom the nonbank SBSB or MSBSP has entered into a non-cleared security-based swap transaction. The Commission received no comments on this definition and is adopting it as proposed.

<sup>344</sup> See ISDA 1/23/2013 Letter; Markit Letter.

<sup>345</sup> See ISDA 1/23/2013 Letter.

<sup>337</sup> See 77 FR at 70261.

<sup>338</sup> In the 2018 comment reopening, the Commission also sought comment on whether the margin rule should permit nonbank SBSBs to apply to use models other than proprietary capital models to compute initial margin, including applying to use an industry standard model. *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53013.

<sup>339</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70260.

volume to justify the initial and ongoing systems and personnel costs that may be associated with the implementation and operation of an initial margin model.

Commenters argued that nonbank SBSBs should be permitted to use approaches other than the standardized approach to calculate initial margin for equity security-based swaps.<sup>346</sup> One commenter stated that the standardized haircuts in the capital rules that would be used to calculate initial margin for equity security-based swaps—including the more risk sensitive standardized haircut approach in Rule 15c3–1a and proposed Rule 18a–1a (“Appendix A methodology”)—are inadequate and inefficient for a proper initial margin calculation and do not sufficiently recognize portfolio margining. This commenter argued that the Appendix A methodology does not incorporate critical factors such as volatility, and, as a result, initial margin on equity security-based swaps would likely be insufficient in times of market stress (in contrast to a model-based approach). Finally, this commenter stated that requiring the Appendix A methodology for non-cleared equity security-based swaps would place U.S.-based nonbank SBSBs at a competitive disadvantage in the market because no other jurisdiction (or other U.S. regulator) has proposed to prohibit the use of models for specific asset classes.<sup>347</sup> Another commenter similarly raised concerns that applying the Appendix A methodology (as compared to a model) would result in initial margin requirements that are substantially less sensitive to the economic risks of a security-based swap portfolio, and suggested that the Commission permit a nonbank SBSB to use a model to calculate initial margin for equity security-based swaps.<sup>348</sup> Several other commenters endorsed the use of models to compute initial margin for equity security-based swaps.<sup>349</sup>

The Commission continues to believe it is important to maintain parity between the margin requirements in the cash equity markets and the margin requirements for equity security-based

swaps. The only method currently available to portfolio margin positions in the cash equity markets is the Appendix A methodology.<sup>350</sup> Consequently, the Commission is adopting the requirement to use the standardized approach to calculate initial margin for non-cleared equity security-based swaps, but with a modification to address commenters’ concerns.<sup>351</sup> In particular, the Commission is modifying the margin rule to permit a stand-alone SBSB to use a model to calculate initial margin for non-cleared equity security-based swaps, provided the account does not hold equity security positions other than equity security-based swaps and equity swaps (*e.g.*, the account cannot hold long and short positions, options, or single stock futures).<sup>352</sup> The Commission believes permitting the model-based approach under these limited circumstances strikes an appropriate balance in terms of addressing commenters’ concerns and maintaining regulatory parity between the cash equity market and the equity security-based swap market. Moreover, a nonbank stand-alone SBSB could seek authorization to use a model to portfolio margin equity security-based swaps with equity swaps. Similarly, as discussed above in relation to the standardized haircuts, the Commission modified the Appendix A methodology from the proposal to permit equity swaps to be included in a portfolio of equity products. The ability to use the model-based approach for equity

security-based swaps (and potentially equity swaps) and the modification to the Appendix A methodology will facilitate portfolio margining of equity security-based swaps and equity swaps, though the Commission and the CFTC will need to coordinate further to implement this type of portfolio margining.<sup>353</sup>

#### Comments and Final Requirements To Calculate Initial Margin Using the Model-Based Approach

Comments addressing the model-based approach to calculating initial margin generally fell into one of two broad categories: (1) Comments raising concerns about the risks of using models; and (2) comments supporting the use of models but suggesting modifications to the proposal or seeking clarifications as to how the proposal would work in practice.

In terms of concerns about the risks of models, one commenter argued that using models for capital and margin calculations likely will make capital and margin more pro-cyclical because market data used in the models will show less risk during strong periods of the economic cycle and more risk during downturns.<sup>354</sup> This commenter recommended, among other things, that if internal models continue to be used, they should be “floored” at the level set by standardized approaches (*e.g.*, those used in bank capital regimes), and that the Commission should continue with a review of the implications of the use of internal models. Another commenter stated that netting derivatives exposures (a component of model-based initial margin calculations) when calculating potential losses is an unsound risk management practice.<sup>355</sup> According to the commenter, even if two positions appear to offset one another, liquidity conditions, replacement costs, and counterparty credit risk may vary considerably.

The Commission acknowledges the concerns expressed by commenters about the efficacy of models, particularly in times of market stress. The Commission nonetheless believes it is appropriate to permit firms to employ a model to calculate initial margin. The Commission’s supervision of the firms’ use of models as well as the conditions that will be imposed governing their use will provide checks that are designed to address the risks identified by the

<sup>350</sup> See FINRA Rule 4210(g).

<sup>351</sup> See paragraph (d)(1) of Rule 18a–3, as adopted. In the final rule, the Commission replaced the term “margin” with the term “initial margin amount” and replaced the phrase “of positive equity in an account of a counterparty” with the phrase “calculated pursuant to paragraph (d) of this section.” See paragraph (b)(4) of Rule 18a–3, as adopted. These are non-substantive changes to conform the rule text to changes made to other paragraphs of the final rule. In addition, in the final rule the Commission deleted the phrase “calculated pursuant to paragraph (d)(2) of this section” from paragraph (c)(1)(i)(B) of the rule, because the phrase, as modified, was moved to paragraph (b)(4) of the rule to define the term “initial margin amount.”

<sup>352</sup> See paragraph (d)(2)(ii) of Rule 18a–3, as adopted. See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53015–16. In the reopening, the potential modifications to the rule contained the phrase “provided, however, the account of the counterparty subject to the requirements of this paragraph may not hold equity securities or listed options.” 83 FR at 53016. The final rule contains the phrase “provided, however, the account of the counterparty subject to the requirements of this paragraph may not hold equity security positions other than equity security-based swaps and equity swaps.” The final rule clarifies that the account of a counterparty utilizing this paragraph may not hold equity security positions other than equity security-based swaps and equity swaps.

<sup>346</sup> See ISDA 1/23/2013 Letter; SIFMA 2/22/2013 Letter; SIFMA 11/19/2018 Letter.

<sup>347</sup> See ISDA 1/23/2013 Letter.

<sup>348</sup> See SIFMA 2/22/2013 Letter.

<sup>349</sup> See Center for Capital Markets Competitiveness, Chamber of Commerce 11/19/2018 Letter; Letter from Scott O’Malia, Chief Executive Officer, International Swaps and Derivatives Association (Nov. 19, 2018) (“ISDA 11/19/2018”); OneChicago 11/19/2018 Letter; SIFMA AMG 2/22/2013 Letter; SIFMA 11/19/2018 Letter. One commenter suggested that the Commission permit stand-alone SBSBs and SBSBs dually-registered as OTC derivatives dealers to calculate initial margin for equity security-based swaps using an industry standard model such as SIMM™. See SIFMA 11/19/2018 Letter.

<sup>353</sup> See, *e.g.*, *Order Granting Conditional Exemption Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps*, 77 FR 75211.

<sup>354</sup> See *Americans for Financial Reform Letter*.

<sup>355</sup> See *Better Markets 1/22/2013 Letter*; *Better Markets 7/22/2013 Letter*.

commenters, such as the potential for firms to manipulate their collateral needs. In addition, the CFTC, the prudential regulators, and foreign financial regulators permit the use of internal models to calculate initial margin. Permitting nonbank SBSDs to use models for this purpose will further harmonize the Commission's margin rule with the rules of domestic and foreign regulators and, therefore, minimize potential competitive impacts of imposing different requirements.

Commenters supporting the use of models commented on the proposed requirement that the initial margin model needed to be the same model used by the nonbank SBSD to calculate haircuts for purposes of the proposed capital rules. These commenters supported the Commission's potential modification to permit nonbank SBSDs to use models other than proprietary capital models to compute initial margin, including an industry standard model.<sup>356</sup> A commenter stated that the rule should provide a nonbank SBSD with the option to choose between internal and third-party models to avoid an uneven playing field among counterparties, noting that not all entities have sufficient resources to develop internal models.<sup>357</sup> This commenter argued that permitting a nonbank SBSD to use a third-party model would reduce the time and resources needed for the Commission to authorize the use of the model. A second commenter requested that nonbank SBSDs be permitted to use an industry standard model to compute initial margin and argued that such a model would result in efficiency, transparency, and consistency in the marketplace.<sup>358</sup> Other commenters generally supported the use of an industry standard model to compute initial margin.<sup>359</sup>

Making a similar point about the benefits of model transparency, a commenter suggested that internal models should be available to counterparties upon request.<sup>360</sup> Similarly, commenters suggested that the ability of a counterparty to replicate a firm's initial margin model should be a condition of the Commission's approval of the model, or that the

calculation of initial margin should be independently verifiable.<sup>361</sup> A commenter argued that external models, in some cases, are preferable to internal models because there is less potential for firms to manipulate their collateral needs.<sup>362</sup> The commenter also supported the use of pre-approved clearing agency and DCO models as one input in the calculation of initial margin for non-cleared positions, but cautioned that additional inputs should be required. The commenter opposed the use of vendor-supplied models for the calculation of margin due to concerns that vendors may develop models that would help firms minimize required margin.

Commenters also addressed the potential offsets that could be permitted with respect to the model-based initial margin calculations. A commenter argued that netting should be limited to exactly offsetting positions and that positions that are potentially correlated due to, for example, long and short positions in the same broad industry should not be permitted to be offset.<sup>363</sup> On the other hand, another commenter requested that counterparties be permitted to use a broader product set to calculate initial margin than the set required by each counterparty's applicable regulation.<sup>364</sup> The commenter stated that this broader product set potentially could include a wide set of bilaterally traded products, even if such products are not swaps or derivatives. Other commenters asked the Commission to clarify whether cleared and non-cleared security-based swaps could be offset.<sup>365</sup> A commenter stated that if U.S. registrants must structure their activities so as to margin non-centrally cleared security-based swaps and swaps separately from other non-centrally cleared derivatives, they would be at a significant competitive

disadvantage to foreign competitors.<sup>366</sup> Another commenter encouraged the Commission to consider allowing participants to calculate the risk of positions within broad asset classes and then sum the risk calculations for each asset class.<sup>367</sup> A commenter also stated that it is essential that national supervisors provide consistent and more comprehensive guidance regarding model inputs (including baseline stress scenarios) and the adjustment of model inputs.<sup>368</sup> Commenters supported the cross-margining of security-based swaps with other products under a single cross-product netting agreement, as well as the portfolio margining of cleared security-based swaps and swaps.<sup>369</sup>

Commenters also requested that the Commission facilitate portfolio margining.<sup>370</sup> A commenter supported the Commission's proposal to allow portfolio margining between cash market securities and security-based swaps, and encouraged the Commission to work with other regulators to make such an approach as expansive as possible.<sup>371</sup> Other commenters encouraged the Commission to permit a nonbank SBSD (including a broker-dealer SBSD) to portfolio margin non-cleared security-based swaps with non-cleared swaps in accordance with the CFTC's margin and segregation rules, subject to appropriate conditions (including appropriately calibrated capital charges and waiver of customer protection rules).<sup>372</sup> Another commenter argued that the CFTC, in turn, should expand its existing relief allowing a swap dealer to collect and post margin on a portfolio basis for swaps and security-based swaps under the CFTC's margin rules by reciprocally allowing a dually registered swap dealer and nonbank SBSD to portfolio margin security-based swaps and swaps under the Commission's margin rules.<sup>373</sup> One commenter suggested that the Commission clarify that the portfolio margining of cleared and non-cleared

<sup>356</sup> See Center for Capital Markets Competitiveness, Chamber of Commerce 11/19/2018 Letter; ISDA 11/19/2018 Letter; MFA/AIMA 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>357</sup> See Markit Letter.

<sup>358</sup> See SIFMA 3/12/2014 Letter; SIFMA 11/19/2018 Letter.

<sup>359</sup> See Center for Capital Markets Competitiveness, Chamber of Commerce 11/19/2018 Letter; MFA/AIMA 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>360</sup> See Sutherland Letter.

<sup>361</sup> See MFA 2/22/2013 Letter; MFA/AIMA 11/19/2018 Letter; Letter from Timothy W. Cameron, Managing Director, and Matthew J. Nevins, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association Asset Management Group (Feb. 22, 2013) ("SIFMA AMG 2/22/2013 Letter").

<sup>362</sup> See CFA Institute Letter.

<sup>363</sup> See Americans for Financial Reform Letter.

<sup>364</sup> See Letter from Mary P. Johannes, Senior Director and Head of ISDA WGMR Initiative, International Swaps and Derivatives Association (May 15, 2015) ("ISDA 5/15/2015 Letter").

<sup>365</sup> See, e.g., AIMA 2/22/2013 Letter; Letter from American Benefits Council, Committee on Investment of Employee Benefit Assets, European Federation for Retirement Provision, the European Association of Paritarian Institutions, the National Coordinating Committee for Multiemployer Plans, and the Pension Investment Association of Canada (Jan. 29, 2013) ("American Benefits Council, et al. 1/29/2013 Letter"); ISDA 2/5/2014 Letter; MFA 2/22/2013 Letter; Ropes & Gray Letter; SIFMA 2/22/2013 Letter.

<sup>366</sup> See Letter from Kenneth E. Bentsen, Jr., President and Chief Executive Officer, Securities Industry and Financial Markets Association (Mar. 12, 2014) ("SIFMA 3/12/2014 Letter").

<sup>367</sup> See ISDA 2/5/2014 Letter.

<sup>368</sup> See SIFMA 3/12/14 Letter.

<sup>369</sup> See FIA 11/19/2018 Letter; MFA/AIMA 11/19/2018 Letter; OneChicago 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>370</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53014–16. See also Center for Capital Markets Competitiveness, Chamber of Commerce 11/19/2018 Letter; ICI 11/19/2018 Letter; ISDA 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>371</sup> See Financial Services Roundtable Letter.

<sup>372</sup> See Citigroup 4/24/2018 Meeting; IIB/SIFMA Letter.

<sup>373</sup> See IIB/SIFMA Letter; see also CFTC Letter 16–71 (Aug. 23, 2016).

security-based swaps and swaps should be permitted and encouraged the Commission to coordinate with the CFTC to determine appropriate conditions for enhanced portfolio margining.<sup>374</sup>

To expedite the approval process, some commenters suggested that the Commission permit the use of initial margin models approved by other domestic and foreign regulators, or a model already approved for a firm's parent company.<sup>375</sup> One commenter suggested that the Commission provisionally approve proprietary models used by nonbank SBSBs when the margin rules first become effective subject to further Commission review.<sup>376</sup> The commenter argued that such a process would prevent those firms whose models were reviewed earlier from having an unfair market advantage over those firms that are positioned later in the Commission's review schedule.

Other commenters argued that the Commission should restrict the use of portfolio margining to ensure greater security for market participants, or stated that the Commission did not provide an explanation as to how the Commission would oversee portfolio margin models.<sup>377</sup>

In response to comments, the Commission made the following modifications to the proposed model-based approach to calculating initial margin: (1) Nonbank SBSBs may use a model other than their capital model; (2) the final rule provides more clarity as to the offsets permitted of an initial margin model; (3) the final rule permits stand-alone SBSBs to use a model to portfolio margin equity security-based swaps and will permit these entities to include equity swaps in the portfolio, subject to further coordination with the CFTC; and (4) as discussed above in section II.A.2.b.iv. of this release, the final capital rule provides that the Commission may approve the temporary use of a provisional model by a nonbank SBSB for the purposes of calculating initial margin if the model had been approved by certain other supervisors.

As indicated, the final rule does not limit a nonbank SBSB to using its capital model to calculate initial

margin.<sup>378</sup> For example, after the Commission proposed Rule 18a-3, the CFTC and the prudential regulators adopted final margin rules permitting the use of a model to calculate initial margin subject to the approval of the CFTC or a firm's prudential regulator.<sup>379</sup> The first compliance date for these rules for both variation and initial margin was September 1, 2016 for the largest firms.<sup>380</sup> The Commission understands that the firms subject to these final rules have widely adopted the use of an industry standard model to compute initial margin.<sup>381</sup> Based on these developments, the Commission believes that most nonbank SBSBs likely will apply to the Commission to use the industry standard model to compute initial margin. The final rule permits the use of such a model, subject to approval by the Commission.

The Commission believes that the ability to use an initial margin model (other than the firm's capital model)—including the industry standard model that has been widely adopted by market participants—will mitigate many of the concerns raised by commenters. Counterparties will be better able to replicate the initial margin calculations of the nonbank SBSBs with whom they transact. Giving counterparties the ability to meaningfully estimate potential future initial margin calls will allow them to prepare for contingencies and minimize the risk of their failure to meet a margin call. This increased transparency will benefit the nonbank SBSB and the counterparty. Consequently, widespread use of an industry standard model to calculate initial margin may increase transparency and decrease margin disputes. This should mitigate commenters' concerns regarding the transparency of a nonbank SBSB's proprietary model used to calculate initial margin, as the Commission believes that most nonbank SBSBs

likely will apply to the Commission to use the industry standard model to compute initial margin.

The Commission acknowledges that some nonbank SBSBs may choose to use models other than the industry standard model. However, the anticipated widespread use of the industry standard model will provide counterparties with the option of taking their business to nonbank SBSBs that use this model to the extent they are concerned about a lack of transparency with respect to other models used by nonbank SBSBs. Moreover, this could incentivize firms that use other models to make them more transparent to market participants.

The final rule also provides that the initial margin model must use a 99%, one-tailed confidence level with price changes equivalent to a 10 business-day movement in rates and prices, and must use risk factors sufficient to cover all the material price risks inherent in the positions for which the initial margin amount is being calculated, including foreign exchange or interest rate risk, credit risk, equity risk, and commodity risk, as appropriate.<sup>382</sup> Several commenters opposed a 10 business-day movement in rates and prices as part of the quantitative requirements for using a model and recommended that the Commission reduce the close-out period to 3 or 5 days.<sup>383</sup> One of these commenters argued that a 10-day period substantially overstates the risk of many non-cleared security-based swaps and will create unnecessarily high initial margin requirements.<sup>384</sup> Other commenters recommended that the Commission establish a more flexible, risk-specific approach to determine and adjust the appropriate liquidation time horizon by product type or asset class.<sup>385</sup>

The Commission believes the prudent approach is to retain the proposed 10 business-day period in the final requirements governing the use of models to calculate initial margin.<sup>386</sup> The 10-day standard has been part of the quantitative requirements for broker-dealers in calculating model-based haircuts under the net capital rule since

<sup>378</sup> See paragraph (d)(2) of Rule 18a-3, as adopted. See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53012-13 (soliciting comment on potential rule language that would modify the proposal in this manner).

<sup>379</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74876; *CFTC Margin Adopting Release*, 81 FR at 654.

<sup>380</sup> See, e.g., *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74849-74851; *CFTC Margin Adopting Release*, 81 FR at 674-677. Variation margin requirements have been implemented pursuant to these rules, while initial margin requirements are being phased in through September 1, 2020.

<sup>381</sup> See, e.g., ISDA, *ISDA SIMM™ Deployed Today; New Industry Standard for Calculating Initial Margin Widely Adopted by Market Participants* (Sept. 1, 2016), available at <https://www.isda.org/2016/09/01/isda-simm-deployed-today-new-industry-standard-for-calculating-initial-margin-widely-adopted-by-market-participants/>.

<sup>382</sup> See paragraph (d)(2) of Rule 18a-3, as adopted. This approach is consistent with the final margin rules of the CFTC and the prudential regulators. See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74906; *CFTC Margin Adopting Release*, 81 FR at 699.

<sup>383</sup> See American Benefits Council, et al. 1/29/2013 Letter; MFA 2/22/2013 Letter; PIMCO Letter; SIFMA AMG 2/22/2013 Letter.

<sup>384</sup> See American Benefits Council, et al. 1/29/2013 Letter.

<sup>385</sup> See MFA 2/22/2013 Letter; MFA/AIMA 11/19/2018 Letter.

<sup>386</sup> See paragraph (d)(2) of Rule 18a-3, as adopted.

<sup>374</sup> See MFA/AIMA 11/19/2018 Letter.

<sup>375</sup> See IIB 11/19/2018 Letter; ISDA 1/23/2013 Letter; SIFMA 3/12/2014 Letter.

<sup>376</sup> See ISDA 1/23/2013 Letter.

<sup>377</sup> See Americans for Financial Reform Education Fund Letter; Better Markets 11/19/2018 Letter; Rutkowski 11/20/2018 Letter. Another commenter opposed the portfolio margining of swaps with flip clauses, walkaway clauses, or similar provisions. See Harrington 11/19/2018 Letter.

the rule permitted the use of models. The Commission does not believe it would be appropriate to have a less conservative standard for calculating initial margin (which is designed to account for the risk of the counterparty's positions) than for calculating model-based haircuts under Rule 15c3-1e, as amended, and Rule 18a-1, as adopted (which is designed to account for the risk of the nonbank SBSB's own positions). Further, the Commission does not believe that a period of less than 10 business days—such as the 3 to 5 business-day period typically used by clearing agencies and DCOs—would be appropriate given that non-cleared security-based swaps may be, in some cases, less liquid than cleared security-based swaps in terms of how long it would take to close them out. Moreover, the initial margin model requirements of the CFTC and the prudential regulators mandate a 10-day standard and, therefore, the Commission's rule is harmonized with their rules.<sup>387</sup>

The final rule provides more clarity as to the offsets permitted in calculating initial margin using a model. In particular, it provides that an initial margin model must use risk factors sufficient to cover all the material price risks inherent in the positions for which the initial margin is being calculated, including foreign exchange or interest rate risk, credit risk, equity risk, and commodity risk, as appropriate.<sup>388</sup> The final rule also provides that empirical correlations may be recognized by the model within each broad risk category, but not across broad risk categories. This means that each non-cleared security-based swap and related position must be assigned to a single risk category for purposes of calculating initial margin. Thus, the initial margin calculation can offset cleared and non-cleared security-based swaps (in answer to the question raised by some commenters) to the extent they are within the same asset class.<sup>389</sup>

The presence of any common risks or risk factors across asset classes (e.g., credit, commodity, and interest rate risks) cannot be recognized for initial margin purposes. This approach is

designed to help ensure a conservative and robust margin regime that potentially reduces counterparty exposures to offset the greater risk to the nonbank SBSB and the financial system arising from the use of non-cleared security-based swaps.<sup>390</sup> Margin calculations that limit correlations to asset classes generally will result in more conservative initial margin amounts than calculations that permit offsets across different asset classes. Finally, this approach is consistent with the final margin rules adopted by the CFTC and the prudential regulators, and with the industry standard model being used today to comply with the margin rules of the CFTC and the prudential regulators.<sup>391</sup>

The final rule permits stand-alone SBSBs to use a model to calculate initial margin for equity security-based swaps and will permit these entities to include equity swaps in the portfolio, subject to further coordination with the CFTC.<sup>392</sup> Under the final rule, these entities are not required to use the standardized approach to calculate initial margin for equity security-based swaps. However, the account of a counterparty for which the stand-alone SBSB provides model-based portfolio margining may not hold equity security positions other than equity security-based swaps and equity swaps. Therefore, cash market positions such as long and short equity positions, listed options positions, and single stock futures positions cannot be held in the accounts or otherwise included in the portfolio margin calculations. This is designed to ensure that a stand-alone SBSB cannot provide more favorable treatment for these types of equity positions than a stand-alone or ANC broker-dealer that is subject to the margin requirements of the Federal Reserve's Regulation T and the margin rules of the SROs.

A commenter requested that qualified netting agreements be permitted in calculating initial margin.<sup>393</sup> Other

commenters argued that effective netting agreements lower systemic risk by reducing both the aggregate requirement to deliver margin and trading costs for market participants.<sup>394</sup> A commenter stated that netting, among other things, is an important tool for the reduction of counterparty credit risk.<sup>395</sup> Another commenter supported the Commission's proposal to permit certain netting under a qualified netting agreement to determine margin requirements, stating that netting obligations under derivatives and other trading positions reduces counterparty credit risk and allows market participants to make the most efficient use of their capital.<sup>396</sup> Finally, a commenter stated that differences in the security-based swap and swap margin rules may fragment the market by causing firms to engage only in a security-based swaps business through a Commission-regulated nonbank SBSB.<sup>397</sup> The commenter stated that, upon the insolvency of a nonbank SBSB and an affiliated swap dealer, a counterparty would likely be unable to close out and net security-based swaps entered into with the nonbank SBSB with swaps entered into with the swap dealer because the entities are not the same. This commenter also believed that the Commission's proposals may undermine the mutuality of obligations for close-out netting, stating that the Commission appeared to treat a nonbank SBSB as an agent of the counterparty rather than a direct counterparty, which may cause a bankruptcy court to reject attempts by a counterparty to close out derivatives positions with the debtor.

In response, the Commission has modified the rule to clarify that qualified netting agreements may be used in the calculation of initial margin (in addition to variation margin).<sup>398</sup> Generally, industry practice is to use netting in variation and initial margin calculations. Further, the Commission believes that in most cases a counterparty entering into a non-cleared security-based swap transaction with a nonbank SBSB will be a direct counterparty of the nonbank SBSB. In response to the comment regarding potential fragmentation of the market

<sup>390</sup> See Section 15F(e)(3)(A) of the Exchange Act.

<sup>391</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74876 ("Each derivative contract must be assigned to a single asset class in accordance with the classifications in the final rule (i.e., foreign exchange or interest rate, commodity, credit, and equity)"); *CFTC Margin Adopting Release*, 81 FR at 657-58 ("The final rule does not permit an initial margin model to reflect offsetting exposures, diversification, or other hedging benefits across broad risk categories. Hence, the margin calculations for derivatives in distinct product-based asset classes, such as equity and credit, must be performed separately without regard to derivatives contracts in other asset classes. Each derivatives contract must be assigned to a single asset class. . ."). See also BCBS/IOSCO Paper at 12-13.

<sup>392</sup> See paragraph (d)(2) of Rule 18a-3, as adopted.

<sup>393</sup> See MFA 2/22/2013 Letter.

<sup>394</sup> See AIMA 2/22/2013 Letter; MFA 2/22/2013 Letter.

<sup>395</sup> See MFA 2/22/2013 Letter.

<sup>396</sup> See Sutherland Letter.

<sup>397</sup> See ICI 11/19/2018 Letter.

<sup>398</sup> Specifically, the Commission has modified paragraph (c)(5) in the final rule to delete the "(A)" from the reference to paragraph (c)(1)(i)(A) (as a result, paragraph (c)(5), governing the use of netting agreements, now refers to the variation and initiation margin calculations as opposed to just the variation margin calculation).

<sup>387</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74875; *CFTC Margin Adopting Release*, 81 FR at 653. See also BCBS/IOSCO Paper at 12.

<sup>388</sup> See paragraph (d)(2) of Rule 18a-3, as adopted. Although the final rule uses the term "risk factors," the approach of assigning each non-cleared security-based swap to a specific risk factor category is sometimes referred to by market participants as the "asset class approach."

<sup>389</sup> However, the clearing agency's margin requirement for the cleared security-based swaps in a portfolio likely will permit offsets only for positions it clears.



and the proposed rule's effects on close-out netting, as discussed above, the Commission believes the final margin rule for non-cleared security-based swaps is largely comparable to the final margin rules of the CFTC and the prudential regulators.<sup>399</sup> In addition, as discussed above, the Commission has modified the final rules to facilitate the portfolio margining of security-based swaps and swaps, subject to further coordination with the CFTC.<sup>400</sup> For example, the Commission modified Rules 15c3-1a and 18a-1a to permit swaps to be included in the Appendix A methodology, which can be used by broker-dealer SBSBs to calculate initial margin.<sup>401</sup> Moreover, the Commission modified paragraph (d)(2) of Rule 18a-3 to permit stand-alone SBSBs to use a model to portfolio margin equity security-based swaps with equity swaps, subject to certain conditions. The Commission believes that these modifications will provide a means for market participants to conduct security-based swap and swap activity in the same legal entity without incurring significant additional operational or compliance costs.

A commenter stated that the Commission's potential modification of the proposed rules to permit the use of an industry standard model provides too little information concerning the parameters that would be required for such models and the process for nonbank SBSBs to approve, establish, maintain, review, and validate margin models.<sup>402</sup> In response, the final rule provides that a nonbank SBSB seeking approval to use a model (including an industry standard model) to calculate initial margin will be subject to the application process in Rule 15c3-1e, as amended, or paragraph (d) of Rule 18a-1, as adopted, as applicable, governing the use of model-based haircuts.<sup>403</sup> As part of the application process, the Commission staff will review whether

the model meets the qualitative and quantitative requirements of Rule 18a-3. Therefore, a nonbank SBSB will need to submit sufficient information to allow the Commission to make a determination regarding the performance of the nonbank SBSB's initial margin model. The use of internal models, industry standard models, or other models to calculate initial margin by nonbank SBSBs will be subject to the same application and approval process under the final rule. The application process and any condition imposed in connection with Commission approval of the use of the model should mitigate the risk that nonbank SBSBs will compete by implementing lower initial margin levels and should also help ensure that initial margin levels are set at sufficiently prudent levels to reduce risk to the firm and, more generally, systemic risk.

If an industry standard model is widely used by nonbank SBSBs, concerns about competing through lower margin requirements should be further mitigated. However, the Commission reiterates that each nonbank SBSB individually must receive approval from the Commission to use an initial margin model, including an industry standard model, because, among other things, each firm must submit a comprehensive description of its internal risk management control system and how that system satisfies the requirements set forth in Rule 15c3-4. Thus, any approval by the Commission for a particular nonbank SBSB to use a specific model to calculate initial margin will not be deemed approval for another nonbank SBSB to use the same model.

As noted above, some commenters made suggestions about how to expedite the model approval process.<sup>404</sup> In response to these comments, the Commission recognizes that the timing of such approvals could raise competitive issues if one nonbank SBSB is authorized to use a model before one or more other firms. Timing issues may also arise with respect to the review and approval process if multiple firms simultaneously apply to the Commission for approval to use a model. The Commission is sensitive to these issues and, similar to the capital model approval process, encourages all firms that intend to register as nonbank SBSBs and seek model approval to begin working with the staff as far in advance of their targeted registration date as is feasible. However, as

discussed above with respect to capital models, the Commission acknowledges the possibility that it may not be able to make a determination regarding a firm's margin model before it is required to register as an SBSB. Consequently, the Commission is modifying Rule 15c3-1e and Rule 18a-1 to provide that the Commission may approve the temporary use of a provisional model by a nonbank SBSB for the purposes of calculating initial margin if the model had been approved by certain other supervisors.

Two commenters suggested the Commission allow market participants to delegate the duty to run a model to a counterparty or third party noting that it is an accepted market practice for a counterparty to agree that a dealer will make determinations for a security-based swap in the dealer's capacity as calculation agent.<sup>405</sup> In response to this comment, a nonbank SBSB could enter into a commercial arrangement to serve as a third-party calculation agent for entities that are not required to calculate initial margin pursuant to Rule 18a-3, as adopted. In addition, a nonbank SBSB's model can use third-party inputs (e.g., price calculations). However, a nonbank SBSB retains responsibility for the model-based initial margin calculations required by Rule 18a-3, as adopted. As discussed above, paragraph (c)(1)(i) of Rule 18a-3, as adopted, requires a nonbank SBSB to calculate an initial margin amount for each counterparty as of the close of each business day. Under paragraph (d) of Rule 18a-3, the nonbank SBSB must use the standardized or model-based approach, as applicable, to calculate the initial margin amount. The fact that a nonbank SBSB uses a model to perform the calculation and that the model uses third-party inputs does not eliminate or diminish the firm's underlying obligation under the rule to calculate an initial margin amount for each counterparty as of the close of each business day. In light of the comment and the Commission's response that third-party inputs may be used, the Commission believes it would be appropriate to make explicit in the rule that the nonbank SBSB retains responsibility for model-based initial margin calculations. Accordingly, the Commission is modifying the proposed rule text to make this clear.<sup>406</sup>

In summary, the Commission is adopting the model-based approach to calculating initial margin, with the

<sup>399</sup> See section II.B.1. of this release (summarizing similarities and differences between the Commission's final margin rules for non-cleared security-based swaps and the final margin rules of the CFTC and the prudential regulators).

<sup>400</sup> See also *Order Granting Conditional Exemption Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps*, 77 FR 75211.

<sup>401</sup> See also section II.A.2.b.iii. of this release (discussing adding swaps to the Appendix A methodology for purposes of the standardized haircuts).

<sup>402</sup> See Better Markets 11/19/2018 Letter.

<sup>403</sup> If a nonbank SBSB's model is approved for use to compute initial margin under paragraph (d) of Rule 18a-3, the performance of the model would be subject to ongoing regulatory supervision, and the nonbank SBSB will need to submit an amendment to the Commission for approval before materially changing its model. See, e.g., Rule 15c3-1e, as amended; paragraph (d) of Rule 18a-1, as adopted.

<sup>404</sup> See IIB11/19/2018 Letter; ISDA 1/23/2013 Letter; SIFMA 3/12/2014 Letter.

<sup>405</sup> See ISDA 2/5/2014 Letter; Markit Letter.

<sup>406</sup> See paragraph (d)(2)(i) of Rule 18a-3, as adopted. In the final rule, the Commission inserted the phrase "and be responsible for" after the phrase "authorization to use."

modifications discussed above. The final rule will require a nonbank SBSB to calculate with respect to each account of a counterparty as of the close of each business day: (1) The amount of the current exposure in the account; and (2) the initial margin amount for the account.<sup>407</sup> As discussed above, in response to comments, the Commission modified paragraph (d) of Rule 18a-3 to establish a margin model authorization process that is distinct from the net capital rule model authorization process. This modification will provide flexibility to allow nonbank SBSBs that do not use a model for purposes of the net capital rule to seek authorization to use a model for purposes of the margin rule.<sup>408</sup> It also will permit firms to use an industry standard model such as the model currently being used to comply with the margin rules of the CFTC and the prudential regulators.

#### Comments and Final Requirements To Increase the Frequency of the Calculations

Two commenters supported the proposed requirement to perform more frequent calculations under specified conditions.<sup>409</sup> Another commenter requested that the Commission clarify that the requirement for a nonbank SBSB to perform calculations more frequently in specified circumstances does not give rise to a regulatory requirement for the nonbank SBSB to collect intra-day margin from its counterparties.<sup>410</sup> The commenter argued that requiring a nonbank SBSB to collect margin more frequently than daily would be operationally difficult and contrary to current market practice.

The Commission is adopting the requirement to increase the frequency of the required calculations during periods of extreme volatility and for accounts with concentrated positions, as proposed, with some non-substantive modifications.<sup>411</sup> In response to the comment about collecting margin intra-day, the Commission clarifies that the rule does not require a nonbank SBSB to collect intra-day margin, although it may choose to do so (such as through a house margin requirement). In addition, more frequent calculations are only required during periods of extreme

volatility and for accounts with concentrated positions. However, nonbank SBSBs are subject to Rule 15c3-4, which requires, among other things, that they have a system of internal controls to assist in managing the risks associated with their business activities, including credit risk. In designing a system of internal controls pursuant to Rule 15c3-4, a nonbank SBSB generally should consider whether there are circumstances where the collection of intra-day margin in times of volatility and for accounts with concentrated positions would be necessary to effectively manage credit risk. In addition, a nonbank SBSB generally should consider these factors in its risk monitoring procedures required under paragraph (e)(7) of Rule 18a-3, as adopted, which is discussed below.

#### ii. Nonbank MSBSPs

As proposed, Rule 18a-3 required 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.<sup>412</sup> Consequently, a nonbank MSBSP needed to calculate as of the close of business each day the amount of equity in each account of a counterparty. Consistent with the proposal for nonbank SBSBs, a nonbank MSBSP was required to increase the frequency of its calculations during periods of extreme volatility and for accounts with concentrated positions.

A commenter stated that it believed that nonbank MSBSPs should be required to calculate initial margin for each counterparty and collect or post initial margin because doing so would allow nonbank MSBSPs to better measure and understand their aggregate counterparty risk.<sup>413</sup> The commenter believed that nonbank MSBSPs should have the personnel necessary to operate daily initial margin programs. Another commenter, who supported bilateral margining for both variation and initial margin, stated that not requiring the bilateral exchange of initial margin is inconsistent with the BCBS/IOSCO Paper and the re-proposals of the CFTC and the prudential regulators.<sup>414</sup> A commenter supported the proposal that nonbank MSBSPs should not have to collect initial margin.<sup>415</sup> Another commenter stated that MSBSPs should be provided flexibility as to whether

and to what extent they should be required to pledge initial margin to financial firms.<sup>416</sup>

In response to comments that nonbank MSBSPs should calculate and collect and post initial margin, the margin requirements for nonbank MSBSPs are designed to “neutralize” the credit risk between a nonbank MSBSP and its counterparty. This requirement is intended to account for the fact that nonbank MSBSPs will be subject to less stringent capital requirements than nonbank SBSBs. Consequently, in the case of a nonbank MSBSP, the Commission believes it is more prudent to not require the firm to collect initial margin from counterparties, as doing so would increase the counterparties’ exposures to the nonbank MSBSP. Therefore, the Commission is not adopting requirements for nonbank MSBSPs to calculate and post or deliver initial margin.

The Commission acknowledges that the final rule, in this case, is not consistent with the final margin rules of the CFTC and the prudential regulators, which generally require nonbank major swap participants, bank MSBSPs, and bank major swap participants to collect and post initial margin from and to specified counterparties.<sup>417</sup> However, the Commission believes that minimizing a counterparty exposure to a nonbank MSBSP by not requiring it to deliver initial margin is prudent, as these firms will not be subject to as robust a capital framework as SBSBs or bank MSBSPs. Similarly, the Commission believes it is prudent to limit the exposure of the nonbank MSBSP to the counterparty by not requiring it to post initial margin, as the counterparty may not be subject to any capital requirement. While the final rule does not impose a requirement to post or deliver initial margin, nonbank MSBSPs and their counterparties are permitted to agree to the exchange of initial margin. For these reasons, the Commission is adopting paragraph (c)(2)(i) of Rule 18a-3 substantially as proposed.<sup>418</sup>

<sup>416</sup> See American Council of Life Insurers 2/22/2013 Letter.

<sup>417</sup> See also BCBS/IOSCO Paper at 5 (“All financial firms and systemically important non-financial entities (“covered entities”) that engage in non-centrally cleared derivatives must exchange initial and variation margin as appropriate to the counterparty risks posed by such transactions.”).

<sup>418</sup> See paragraph (c)(2)(i) of Rule 18a-3, as adopted. In the final rule, the Commission made several non-substantive modifications. The word “equity” was replaced with the phrase “the current exposure.” The phrase “with respect to each account of a counterparty” was inserted before the word “calculate” and the word “the” replaced the

<sup>407</sup> See paragraph (c)(1)(i) to Rule 18a-3, as adopted.

<sup>408</sup> See paragraph (d)(2) of Rule 18a-3, as adopted.

<sup>409</sup> See Better Markets 7/22/2013 Letter; Markit Letter.

<sup>410</sup> See SIFMA AMG 2/22/2013 Letter.

<sup>411</sup> See paragraph (c)(6) to Rule 18a-3, as adopted. Paragraph (c)(7) of Rule 18a-3, as proposed to be adopted, was re-designated paragraph (c)(6) in the final rule due to non-substantive amendments made to the minimum transfer amount language.

<sup>412</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70262-63.

<sup>413</sup> See CFA Institute Letter.

<sup>414</sup> See ICI 5/11/2015 Letter.

<sup>415</sup> See Financial Services Roundtable Letter.

## b. Account Equity Requirements

## i. Nonbank SBSDBs

As discussed above, a nonbank SBSDB must calculate variation and initial margin amounts with respect to the account of a counterparty as of the close of each business day. Proposed Rule 18a-3: (1) Required a nonbank SBSDB to collect margin from the counterparty unless an exception applied; (2) set forth the time frame for when that collateral needed to be collected; (3) prescribed the types of assets that could serve as eligible collateral; (4) prescribed additional requirements for the collateral; (5) prescribed when collateral must be liquidated; and (6) set forth certain exceptions to collecting the collateral.<sup>419</sup>

More specifically, proposed Rule 18a-3 required that a nonbank SBSDB collect from the counterparty by noon of the following business day cash, securities, and/or money market instruments in an amount at least equal to the “negative equity” (current exposure) in the account plus the initial margin amount unless an exception applied. Assets other than cash, securities, and/or money market instruments were not eligible collateral. The proposed rule further provided that the fair market value of securities and money market instruments (“securities collateral”) held in the account of a counterparty needed to be reduced by the amount of the standardized haircuts the nonbank SBSDB would apply to the positions pursuant to the proposed capital rules for the purpose of determining whether the level of equity in the account met the minimum margin requirements. Securities collateral with no “ready market” or that could not be publicly offered or sold because of statutory, regulatory, or contractual arrangements or other restrictions effectively could not serve as collateral because it would be subject to a 100% deduction pursuant to the standardized haircuts in the proposed capital rules, which were to be used to take the collateral deductions for the purposes of proposed Rule 18a-3.

In addition, proposed Rule 18a-3 contained certain additional requirements for cash and securities to be eligible as collateral. These requirements were designed to ensure that the collateral was of stable and predictable value, not linked to the value of the transaction in any way, and capable of being sold quickly and easily

if the need arose. The requirements included that the collateral was: (1) Subject to the physical possession or control of the nonbank SBSDB; (2) liquid and transferable; (3) capable of being liquidated promptly without the intervention of a third party; (4) subject to a legally enforceable collateral agreement; (5) not securities issued by the counterparty or a party related to the counterparty or the nonbank SBSDB; and (6) a type of financial instrument for which the nonbank SBSDB could apply model-based haircuts if the nonbank SBSDB was authorized to use such haircuts. Proposed Rule 18a-3 also required a nonbank SBSDB to take prompt steps to liquidate collateral consisting of securities collateral to the extent necessary to eliminate the account equity deficiency.

The Commission proposed five exceptions to the account equity requirements. The first applied to counterparties that were commercial end users. The second applied to counterparties that were nonbank SBSDBs. The third applied to counterparties that were not commercial end users and that required their collateral to be segregated pursuant to Section 3E(f) of the Exchange Act. The fourth proposed exception applied to accounts of counterparties that were not commercial end users and that held legacy non-cleared security-based swaps. The fifth provided for a \$100,000 minimum transfer amount with respect to a particular counterparty.

#### Comments and Final Requirements Regarding the Collection and Posting of Margin

As noted above, proposed Rule 18a-3 required a nonbank SBSDB to collect margin from the counterparty by noon of the next business day unless an exception applied.<sup>420</sup> Generally, the comments on this aspect of the proposal fell into two categories: (1) Comments requesting that nonbank SBSDBs be required to deliver margin (in addition to collecting it); and (2) comments requesting that the required time frame for collecting margin be lengthened.

In terms of requiring nonbank SBSDBs to deliver margin, commenters stated that doing so would promote consistency with the recommendations in the BCBS/IOSCO Paper.<sup>421</sup> Commenters also argued that bilateral margining would help to reduce systemic risk.<sup>422</sup> A commenter argued

that not requiring a nonbank SBSDB to post margin could create an incentive to avoid clearing security-based swaps counter to the Dodd-Frank Act’s objective of promoting central clearing.<sup>423</sup> One commenter stated that the Commission did not adequately consider the potential for one-way margining to harm investors and the security-based swap market.<sup>424</sup> This commenter argued that making two-way margining mandatory would provide important risk mitigation benefits to the markets, and protect counterparties of all sizes, not just those large enough to negotiate for two-way margining.<sup>425</sup> Some commenters suggested that the rule should permit the counterparty to require the nonbank SBSDB to deliver margin at the counterparty’s discretion.<sup>426</sup> Another commenter stated that nonbank SBSDBs and financial end users should have the flexibility to determine whether nonbank SBSDBs should be required to post initial margin to financial end users.<sup>427</sup>

In response to these comments, the Commission is persuaded that requiring nonbank SBSDBs to deliver variation margin to counterparties would provide an important protection to the counterparties by reducing their uncollateralized current exposure to SBSDBs. The Commission also believes it would be appropriate to require nonbank SBSDBs to deliver variation margin to counterparties in order to further harmonize Rule 18a-3 with the margin rules of the CFTC and the prudential regulators.<sup>428</sup> For these reasons, the Commission has modified the final rule to require a nonbank SBSDB to deliver variation margin to a counterparty unless an exception applies. However, as discussed below, the nonbank SBSDB is not required to collect or deliver variation or collect initial margin from a commercial end user, a security-based swap legacy account, or a counterparty that is the BIS, the European Stability Mechanism, or one of the multilateral development banks identified in the rule.<sup>429</sup>

Letter; ICI 11/19/2018 Letter; SIFMA AMG 11/19/2018 Letter.

<sup>423</sup> See PIMCO Letter.

<sup>424</sup> See ICI 11/19/2018 Letter.

<sup>425</sup> See ICI 11/19/2018 Letter.

<sup>426</sup> See PIMCO Letter; SIFMA AMG 2/22/2013 Letter.

<sup>427</sup> See American Council of Life Insurers 2/22/2013 Letter; American Council of Life Insurers 11/19/2018 Letter.

<sup>428</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74903; *CFTC Margin Adopting Release*, 80 FR at 698.

<sup>429</sup> See paragraphs (c)(1)(ii)(A)(2) and (c)(1)(iii) of Rule 18a-3, as adopted. The Commission also made some non-substantive changes to paragraph (c)(1)(ii)

Continued

word “each” to conform the language in the paragraph more closely with the language in paragraph (c)(1)(i) of the final rule.

<sup>419</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70263-69.

<sup>420</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70264.

<sup>421</sup> See AIMA 2/22/2013 Letter; ICI 2/4/2013 Letter.

<sup>422</sup> See American Council of Life Insurers 11/19/2018 Letter; ICI 2/4/2013 Letter; ICI 5/11/2015

The Commission does not believe it would be appropriate to require nonbank SBSBs to deliver initial margin and, therefore, the final rule does not require it. Requiring nonbank SBSBs to deliver initial margin could impact the liquidity of these firms. Delivering initial margin would prevent this capital of the nonbank SBSB from being immediately available to the firm to meet liquidity needs. If the delivering SBSB is undergoing financial stress or the markets more generally are in a period of financial turmoil, a nonbank SBSB may need to liquidate assets to raise funds and reduce its leverage. Assets in the control of a counterparty would not be available for this purpose. For these reasons, under the net capital rule, most unsecured receivables must be deducted from net worth when the nonbank SBSB computes net capital. The final rule, however, does not prohibit a nonbank SBSB from delivering initial margin. For example, a nonbank SBSB and its counterparty can agree to commercial terms pursuant to which the nonbank SBSB will post initial margin to the counterparty.

In terms of lengthening the time frame for collecting margin, a commenter requested flexibility for nonbank SBSBs to collect initial margin on a different schedule and frequency than variation margin.<sup>430</sup> A second commenter sought clarification concerning how often initial margin needed to be collected and noted that the overall initial margin amount for a portfolio could change even if no new transactions occur because existing transactions may mature or significant market moves may impact values.<sup>431</sup> A third commenter suggested that the Commission require nonbank SBSBs to begin collecting initial margin on a weekly basis and phase in more frequent collections.<sup>432</sup> Another commenter recommended that consistent with the CFTC's and prudential regulators' margin rules, the Commission should require an SBSB to collect margin by the end of the business day following the day of execution and at the end of each business day thereafter, with appropriate adjustments to address operational difficulties associated with parties located in different time zones.<sup>433</sup>

to accommodate the new requirement. In the final rule, paragraph (c)(1)(ii)(A) of Rule 18a-3, as proposed to be adopted, was re-designated paragraph (c)(1)(ii)(A)(1).

<sup>430</sup> See ISDA 1/23/2013 Letter; ISDA 2/5/2014 Letter.

<sup>431</sup> See Markit Letter.

<sup>432</sup> See SIFMA 3/12/2014 Letter.

<sup>433</sup> See SIFMA 11/19/2018 Letter.

Other commenters recommended a longer time period than one business day to collect margin, citing cross-border transactions as possibly requiring more time.<sup>434</sup> One commenter stated that the time zone differences between the United States and certain jurisdictions will cause major operational challenges, and could lead to delayed payments, disputes, and broadly greater operational risk.<sup>435</sup> Another commenter noted that the settlement and delivery periods for securities to be posted as collateral are longer than the time period for collection under the proposed rule, particularly in a cross-border context.<sup>436</sup> A commenter stated that the proposed one business-day requirement did not reflect the operational realities of security-based swap trading, payment, and collateral transfer processes.<sup>437</sup> The commenter argued that the need for additional time was especially critical with respect to transactions with counterparties in countries such as Japan and Australia.

The Commission recognizes that it will take time for nonbank SBSBs to implement processes to collect variation and initial margin on a daily basis if the entity is not currently collecting margin at this frequency. The Commission, therefore, is establishing compliance and effective dates discussed below in section III.B. of this release designed to give nonbank SBSBs and their counterparties a reasonable period of time to implement the operational, legal, and other changes necessary to come into compliance with requirements to collect and deliver margin on a daily basis.

In terms of lengthening the period to collect or deliver margin beyond one business day, promptly obtaining collateral to cover credit risk exposures is vitally important to promoting the financial responsibility of nonbank SBSBs and protecting their counterparties. Collateral protects the nonbank SBSB from consequences of the counterparty's default and the counterparty from the consequences of

the nonbank SBSB's default. However, the Commission is modifying the next-day collection requirement in two ways that should mitigate the concerns of commenters. First, the Commission is lengthening time for nonbank SBSBs and MSBSPs to collect or post required margin from noon to the close of business on the next business day.<sup>438</sup> Second, the Commission is lengthening from one to two business days the time frame in which the nonbank SBSB or MSBSP must collect or deliver required margin if the counterparty is located in another country and more than 4 time zones away. These changes should mitigate the concerns of commenters about cross-border transactions.

For the foregoing reasons, the Commission is adopting the proposed requirements to collect variation and initial margin with the modifications discussed above and with certain other non-substantive modifications.<sup>439</sup>

#### Comments and Final Requirements for Collateral and Taking Deductions on Collateral

As noted above, proposed Rule 18a-3 permitted cash, securities, and money market instruments to serve as collateral to meet variation and initial margin requirements and, if securities or money market instruments were used, required the nonbank SBSB to apply the standardized haircuts in the capital rules to the collateral when computing the equity in the account.<sup>440</sup> Generally, comments addressing these requirements fell into two categories: (1) Comments requesting that the scope of assets qualifying as collateral be broadened, or modified to conform with requirements of the prudential regulators, the CFTC, or the recommendations in the BCBS/IOSCO Paper; and (2) comments requesting that the deductions to securities or money market instruments serving as collateral be calculated using methods other than

<sup>438</sup> See paragraphs (c)(1)(ii) and (c)(2)(ii) of Rule 18a-3, as adopted.

<sup>439</sup> See paragraphs (c)(1)(ii) and (c)(1)(iii) of Rule 18a-3, as adopted. References to cash, securities and/or money market instruments were deleted throughout the rule text and replaced with the term "collateral" as a result of other modifications to the rule to expand the types of collateral permitted under the rule. The defined term "non-cleared security-based swap" in paragraph (b)(5) of Rule 18a-3, as adopted, is modified to add the phrase "submitted to and" before the word "cleared," and to add the phrase "or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to section 17A of the Act (15 U.S.C. 78q-1)" before the "...". The language regarding exemption from registration was added to the final rule to align the definition more closely with the definitions used in the margin rules of the CFTC and prudential regulators.

<sup>440</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70264.

<sup>434</sup> See American Benefits Council, et al. 1/29/2013 Letter; Letter from Angus D.W. Martowardojo, Governor of Bank Indonesia and Chairman of the Executives Meeting of East Asia-Pacific Central Banks (Aug. 31, 2016) ("EMEAP Letter"); Letter from Mary P. Johannes, Senior Director and Head of ISDA WGMR Initiative, International Swaps and Derivatives Association (Aug. 7, 2015) ("ISDA 8/7/2015 Letter"); Letter from Mary P. Johannes, Senior Director and Head of ISDA WGMR Initiative, International Swaps and Derivatives Association (Sept. 24, 2015) ("ISDA 9/24/2015 Letter"); SIFMA AMG 2/22/2013 Letter.

<sup>435</sup> See EMEAP Letter.

<sup>436</sup> See ISDA 8/7/2015 Letter.

<sup>437</sup> See SIFMA AMG 2/22/2013 Letter.

the standardized haircuts in the capital rules.

In terms of the scope of eligible collateral, commenters supported the broad categories of securities and money market instruments that qualified under the proposal, but asked that the final rule be more consistent with the recommendations in the BCBS/IOSCO Paper or the rules of the CFTC and the prudential regulators.<sup>441</sup> A commenter stated that the Commission should define the term “eligible collateral,” preferably by adopting the CFTC’s “forms of margin” approach.<sup>442</sup> A second commenter recommended that the Commission carefully parallel the collateral approach recommended in the BCBS/IOSCO Paper.<sup>443</sup> This commenter noted that the examples of collateral listed in the BCBS/IOSCO Paper were not exhaustive. Another commenter suggested that regulators and market participants develop a set of consistent definitions for the categories of eligible collateral.<sup>444</sup>

In response to these comments, the BCBS/IOSCO Paper recommends that national supervisors develop their own list of collateral assets, taking into account the conditions of their own markets, and based on the key principle that assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress.<sup>445</sup> The examples of collateral in the BCBS/IOSCO Paper are: (1) Cash; (2) high-quality government and central bank securities; (3) high-quality corporate bonds; (4) high-quality covered bonds; (5) equities included in major stock indices; and (6) gold.<sup>446</sup> Eligible securities collateral under the margin rules of the CFTC and the prudential regulators includes: (1) U.S. Treasury securities; (2) certain securities guaranteed by the U.S.; (3) certain securities issued or guaranteed by the European Central Bank, a sovereign entity, or the BIS; (4) certain corporate debt securities; (5) certain equity securities contained in major indices; and (6) certain redeemable government bond funds.<sup>447</sup> Under the Commission’s

proposed margin rule, these types of securities would be permitted as collateral if they had a ready market. The margin rules of the CFTC and the prudential regulators also permit major foreign currencies, the currency of settlement for the security-based swap, and gold to serve as collateral. The Commission’s proposed rule permitted “cash” but did not permit foreign currencies to serve as collateral, and the proposed rule did not permit gold to serve as collateral.

The Commission is modifying proposed Rule 18a–3 in response to commenters’ concerns about the rule excluding collateral types that are permitted by the CFTC and the prudential regulators. Consequently, the final rule permits cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold to serve as eligible collateral.<sup>448</sup> This will avoid the operational burdens of having different sets of collateral that may be used with respect to a counterparty depending on whether the nonbank SBSD is entering into a security-based swap (subject to the Commission’s rule) or a swap (subject to the CFTC’s rule) with the counterparty. It also will avoid potential unintended competitive effects of having different sets of collateral for non-cleared security-based swaps under the margin rules for nonbank SBSDs and bank SBSDs. Finally, by giving the option of aligning with the requirements of the CFTC and the prudential regulators, the final rule should avoid the necessity of amending existing collateral agreements that may specifically reference the forms of margin permitted by those requirements.

Commenters requested that certain types of assets be permitted to serve as collateral when dealing with commercial end users and special purpose vehicles.<sup>449</sup> One commenter requested that the Commission expand the collateral permitted under the rule to include shares of affiliated registered funds or clarify that a fund of funds could post shares of an affiliated registered fund to meet a margin requirement under the rule.<sup>450</sup> Another commenter requested that the Commission adopt a definition of collateral that includes U.S. government

money market funds.<sup>451</sup> In response to these comments, the final rule does not specifically exclude any type of security provided it has a ready market, is readily transferable, and does not consist of securities and/or money market instruments issued by the counterparty or a party related to the nonbank SBSD or MSBSP, or the counterparty.<sup>452</sup> Generally, U.S. government money market funds should be able to serve as collateral under these conditions.

In terms of applying the standardized haircuts in the nonbank SBSD capital rules to securities and money market instruments serving as collateral, a commenter advocated aligning with the prudential regulators’ proposed rules for ease of application and consistency of treatment across instruments, as well as to minimize the opportunity for regulatory arbitrage.<sup>453</sup> Comments received after the CFTC and the prudential regulators adopted their final margin rules supported aligning the haircuts in the Commission’s margin rule with the standardized haircuts adopted by the CFTC and the prudential regulators.<sup>454</sup>

The haircuts in proposed Rule 18a–3 (*i.e.*, the standardized haircuts in the proposed nonbank SBSD capital rules) and the haircuts in the margin rules of the CFTC and the prudential regulators (which are based on the recommended standardized haircuts in the BCBS/IOSCO Paper) are largely comparable.<sup>455</sup> However, the Commission also recognizes that there are differences. For example, the Commission’s standardized haircuts in some cases are more risk sensitive than those required by final margin rules of the CFTC and the prudential regulators.<sup>456</sup>

<sup>451</sup> See Letter from Lee A. Pickard, Esq., Pickard, Djinis and Pisarri, on behalf of Federated Investors, Inc. (Nov. 15, 2018) (“Federated 11/15/2018 Letter”).

<sup>452</sup> See paragraph (c)(4) of Rule 18a–3, as adopted.

<sup>453</sup> See PIMCO Letter.

<sup>454</sup> See American Council of Life Insurers 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>455</sup> See, *e.g.*, paragraph (c)(2)(vi)(I) of Rule 15c3–1, as amended (prescribing a haircut of 15% for equity securities), and BCBS/IOSCO Paper, Appendix B, at 27 (prescribing a haircut of 15% for equities included in major stock indices). See also paragraph (c)(2)(vi)(A)(1) of Rule 15c3–1, as amended (prescribing a haircut of 0.5% for securities issued or guaranteed by the United States or any agency thereof with 3 months but less than 6 months to maturity), and BCBS/IOSCO Paper, Appendix B, at 27 (prescribing a haircut of 0.5% for high quality government and central bank securities: Residual maturity less than one year).

<sup>456</sup> See, *e.g.*, paragraph (c)(2)(vi)(A)(1) of Rule 15c3–1, as amended (prescribing a range of four haircuts of 0% to 1% for securities issued or guaranteed by the United States or any agency thereof with less than 12 months to maturity), and

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<sup>441</sup> See American Council of Life Insurers 2/22/2013 Letter; American Council of Life Insurers 11/19/2018 Letter; CFA Institute Letter; MFA 2/22/2013 Letter; SIFMA AMG 11/19/2018; SIFMA 3/12/2014 Letter; SIFMA 11/19/2019 Letter.

<sup>442</sup> See MFA 2/22/2013 Letter.

<sup>443</sup> See American Council of Life Insurers 2/22/2013 Letter; American Council of Life Insurers 11/19/2018 Letter.

<sup>444</sup> See SIFMA 3/12/2014 Letter.

<sup>445</sup> See BCBS/IOSCO Paper at 16.

<sup>446</sup> *Id.* at 17–18.

<sup>447</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74870; *CFTC Margin Adopting Release*, 81 FR at 701–2.

<sup>448</sup> See paragraph (c)(4)(i)(C) of Rule 18a–3, as adopted. The additional collateral requirements in the final rule are discussed below.

<sup>449</sup> See Financial Services Roundtable Letter; MFA 2/22/2013 Letter; Sutherland Letter.

<sup>450</sup> See ICI 11/19/2018 Letter.

At the same time, the Commission believes it would be appropriate to provide nonbank SBSBs the option either to use the standardized haircuts in the nonbank SBSB capital rules as proposed or to use the collateral haircuts in the CFTC's margin rules. Consequently, the final margin rule provides nonbank SBSBs with the option of choosing to use the standardized haircuts in the capital rules or the standardized haircuts in the CFTC's margin rules.<sup>457</sup> The final rule further provides that if the nonbank SBSB uses the CFTC's standardized haircuts it must apply them consistently with respect to the counterparty.<sup>458</sup> This requirement is designed to prevent a nonbank SBSB from "cherry picking" either the nonbank SBSB capital haircuts or the CFTC haircuts at different points in time depending on which set provides the more advantageous haircut.

Similar to aligning the sets of eligible collateral, giving the option of aligning the collateral haircuts with the CFTC's collateral haircuts will allow a firm to avoid the operational burdens of having different haircut requirements with respect to a counterparty depending on whether the nonbank SBSB is entering into a security-based swap (subject to the Commission's rule) or a swap (subject to the CFTC's rule) with the counterparty. This option also will avoid potential unintended competitive effects of having different sets of collateral for non-cleared security-based swaps under the margin rules for nonbank SBSBs and bank SBSBs. Finally, by aligning with the requirements of the CFTC and the

prudential regulators, the final rule should reduce the likelihood that SBSBs will seek to amend existing collateral agreements that may specifically reference the haircuts in the margin rules of the CFTC or prudential regulators.<sup>459</sup>

With respect to the proposed collateral haircuts, a commenter suggested that the deductions applicable to high-grade corporate debt or liquid structured credit instruments be calculated using the option-adjusted spread ("OAS").<sup>460</sup> A second commenter noted that the BCBS/IOSCO Paper provides that the haircuts can be determined by a model that is approved by a regulator, in addition to a standardized schedule set forth in the BCBS/IOSCO Paper.<sup>461</sup> In response to these comments, the Commission believes that the simpler and more transparent approach of using the standardized haircuts will establish appropriately conservative discounts on eligible collateral. Moreover, using models to determine haircuts on collateral would not be consistent with the final rules of the CFTC and the prudential regulators.<sup>462</sup>

Finally, a commenter recommended that the Commission apply a 100% haircut to a structured product, asset-backed security, re-packaged note, combination security, and any other complex instrument.<sup>463</sup> In response, the final margin rule requires margin collateral to have a ready market.<sup>464</sup> This is designed to exclude collateral that cannot be promptly liquidated.

A nonbank SBSB must apply the collateral haircuts to collateral used to meet a variation margin requirement and an initial margin requirement as was proposed.<sup>465</sup> However, the

Commission is making a conforming modification to require a nonbank SBSB to apply the deductions prescribed in paragraph (c)(3)(i) or (ii) of Rule 18a-3 to variation margin that the firm delivers to a counterparty to meet a variation margin requirement. As discussed above, the final rule now requires nonbank SBSBs to deliver variation margin to counterparties, and applying the haircuts to collateral used for this purpose will serve the same purpose of determining whether the level of equity in the account met the minimum margin requirements, as applying them to collateral collected by the nonbank SBSB. In addition, applying a haircut to collateral delivered by the nonbank SBSB to a counterparty is consistent with the requirements of the CFTC and the prudential regulators.

#### Comments and Final Requirements Regarding Additional Collateral and Liquidation Requirements

As noted above, proposed Rule 18a-3 prescribed additional requirements for collateral (e.g., it must be liquid and transferable) and required the prompt liquidation of the collateral to eliminate a margin deficiency.<sup>466</sup> A commenter requested that only "excess securities collateral" as defined in proposed Rule 18a-4 for purposes of the segregation requirements be subject to the possession or control requirement in proposed Rule 18a-3.<sup>467</sup> The commenter noted that the proposed segregation requirements only required excess securities collateral to be in the SBSB's possession or control. Thus, the commenter argued that imposing a

collateral haircut schedule, in the final rule, the Commission inserted the word "standardized" before the word "deductions" and deleted the phrase "determining whether the level of equity in the account meets the requirements of" to clarify that only the use of standardized haircuts is permitted and to make a conforming change as a result of changes made to the definitions in paragraph (b) of the final rule. In the final rule, the Commission also deleted the phrase "securities and money market instruments held in the account of" and replaced it with "collateral delivered by" to clarify that the collateral in the account was delivered by a counterparty to the nonbank SBSB. Further, in the final rule, the title of the paragraphs reads: "Deductions for collateral" as a conforming change. In addition, the phrase "securities and money market instruments" has been replaced with the term "collateral" to conform to changes made to other parts of the rule. Finally, the phrase "or security-based swap dealer" is being added after the phrase "collateral delivered by a counterparty." These changes conform the modification to the final rule requiring nonbank SBSBs to apply the standardized haircuts to collateral they deliver to counterparties to meet a variation margin requirement.

<sup>466</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 7064-65.

<sup>467</sup> See SIFMA 2/22/2013 Letter.

BCBS/IOSCO Paper, Appendix B, at 27 (prescribing a haircut of 0.5% for high-quality and central bank securities; Residual maturity less than one year); see also paragraph (c)(2)(vi)(F)(1) of Rule 15c3-1, as amended (prescribing a range of three haircuts of 3% to 6% for nonconvertible debt securities that mature in more than one year but less than five years), and BCBS/IOSCO Paper, Appendix B, at 27 (prescribing a haircut of 4% for high-quality corporate/covered bonds; Residual maturity greater than one year and less than five years). The prudential regulators' and CFTC's final margin rules each prescribe a collateral haircut schedule that is generally consistent with the BCBS/IOSCO Paper. See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74910; *CFTC Margin Adopting Release*, 81 FR at 702.

<sup>457</sup> See paragraph (c)(3) of Rule 18a-3, as adopted.

<sup>458</sup> See paragraph (c)(3)(ii) of Rule 18a-3, as adopted. In the final rule, paragraph (c)(3) of Rule 18a-3, as proposed, is re-designated paragraph (c)(3)(i) of Rule 18a-3, as adopted, and a new subparagraph (c)(3)(ii) is added to read: "(ii) Notwithstanding paragraph (c)(3)(i) of this section, the fair market value of assets delivered as collateral by a counterparty or the security-based swap dealer may be reduced by the amount of the standardized deductions prescribed in 17 CFR 23.156 if the security-based swap dealer applies these standardized deductions consistently with respect to the particular counterparty."

<sup>459</sup> As discussed above in section II.B.1. of this release, while paragraphs (c)(4) and (5) of Rule 18a-3, as adopted, respectively require netting and collateral agreements to be in place, the rule does not impose a specific margin documentation requirement as do the margin rules of the CFTC and the prudential regulators.

<sup>460</sup> See PIMCO Letter. The commenter stated that OAS generally measures a debt instrument's risk premium over benchmark rates covering a variety of risks and net of any embedded options in the instrument. See *id.* (citing Frank J. Fabozzi, *The Handbook of Fixed Income Securities*, at 908-909 (7th ed. 2005)).

<sup>461</sup> See ISDA 1/23/2013 Letter; ISDA 2/5/2014 Letter. See also BCBS/IOSCO Paper at 17-19, Appendix B.

<sup>462</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74872; *CFTC Margin Adopting Release*, 81 FR at 702.

<sup>463</sup> See Letter from William J. Harrington (Nov. 19, 2018) ("Harrington 11/19/2018 Letter").

<sup>464</sup> See paragraph (c)(4)(i)(A) of Rule 18a-3, as adopted.

<sup>465</sup> See paragraph (c)(3) of Rule 18a-3, as adopted. In addition to the changes to the final rule described above to permit the use of the CFTC

possession or control requirement on a broader range of collateral could impose “serious” funding costs on SBSBs by requiring them to fund initial and variation margin payments for offsetting transactions through their own resources rather than through the collateral posted by security-based swap customers in accordance with proposed Rule 18a–3. Another commenter requested that the Commission amend paragraph (c)(4)(i) of proposed Rule 18a–3 to recognize initial margin collateral that is held at an independent third-party custodian as being in the control of the nonbank SBSB.<sup>468</sup>

The Commission did not intend the possession or control requirement in proposed Rule 18a–3 to conflict with the proposed possession or control requirement in Rule 18a–4. More specifically, under Rule 18a–4, as proposed, a nonbank SBSB could re-hypothecate collateral received as initial margin pursuant to Rule 18a–3 in limited circumstances and subject to certain conditions. The Commission clarifies that under Rule 18a–3, as adopted, initial margin that is held at a clearing agency to meet a margin requirement of the customer is in the control of the nonbank SBSB for purposes of the rule. Additionally, as discussed above in sections II.A.2.b.ii. and II.A.2.b.v. of this release, the Commission has adopted final capital rules for stand-alone broker-dealers and nonbank SBSBs that permit them to recognize collateral held at a third-party custodian for purposes of: (1) The exception from taking the capital charge when initial margin is held at a third-party custodian;<sup>469</sup> and (2) computing credit risk charges.<sup>470</sup> In each case, the collateral can be recognized if the custodian is a bank as defined in Section 3(a)(6) of the Exchange Act or a registered U.S. clearing organization or depository that is not affiliated with the counterparty or, if the collateral consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that is not affiliated with the counterparty and that customarily maintains custody of such foreign securities or currencies.

The Commission believes collateral held at a third-party custodian also should be recognized for the purposes of determining the account equity requirements in Rule 18a–3. Consequently, the Commission is

modifying paragraph (c)(4) in the final rule to provide that the collateral must be either: (1) Subject to the physical possession or control of the nonbank SBSB or MSBSP and may be liquidated promptly by the firm without intervention by any other party (as was proposed); or (2) carried by an independent third-party custodian that is a bank as defined in Section 3(a)(6) of the Exchange Act or a registered U.S. clearing organization or depository that is not affiliated with the counterparty or, if the collateral consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that is not affiliated with the counterparty and that customarily maintains custody of such foreign securities or currencies.<sup>471</sup> This will address the second commenter’s concern about recognizing collateral that is held at a third-party custodian.

As discussed above, the Commission has modified proposed Rule 18a–3 to provide a nonbank SBSB with the option to use the collateral haircuts required by the CFTC’s rules.<sup>472</sup> In light of this modification, the Commission is modifying the final margin rule to explicitly require that the collateral have a ready market.<sup>473</sup> The requirement that the collateral have a ready market was incorporated into the proposed rule because, as discussed above, the nonbank SBSB was required to use the standardized haircuts in the proposed capital rules for purposes of the collateral deductions. The proposed nonbank SBSB capital rules required the firm to take a 100% deduction for a security or money market instrument that does not have a ready market (as do the final capital rules). Consequently, by incorporating those standardized haircuts into proposed Rule 18a–3, a nonbank SBSB would need to deduct 100% of the value of a security or money market instrument it received as margin if the security or money market instrument did not have a ready market. In other words, the security or money market instrument would have no collateral value for purposes of meeting the account equity requirements in proposed Rule 18a–3. The Commission’s modification will retain

the proposed requirement that collateral without a ready market has no collateral value and, in particular, will apply that requirement when the standardized haircuts of the CFTC are used, as they do not explicitly impose a ready market test. However, the CFTC, in describing its requirements for collateral, stated that margin assets should share the following fundamental characteristics: They “should be liquid and, with haircuts, hold their value in times of financial stress.”<sup>474</sup> The CFTC further stated in describing collateral permitted under its rule that it consists of “assets for which there are deep and liquid markets and, therefore, assets that can be readily valued and easily liquidated.” The Commission believes that modifying the final rule to make explicit that the ready market test applies when the CFTC’s standardized haircuts are used is consistent with these statements by the CFTC about collateral permitted under its margin rule.

For the foregoing reasons, the Commission is adopting the proposed collateral requirements with the modifications discussed above and certain additional non-substantive modifications.<sup>475</sup>

<sup>474</sup> See *CFTC Margin Adopting Release*, 81 FR at 665.

<sup>475</sup> See paragraph (c)(4) of Rule 18a–3, as adopted. As a consequence of the modifications discussed above, paragraph (c)(4)(i) is re-designated paragraph (c)(4)(i)(A) through (E), paragraph (c)(4)(ii) is re-designated paragraph (c)(4)(ii)(A) and (B), and paragraphs (c)(4)(iii), (iv), and (v) are deleted. The Commission made the following additional non-substantive modifications to paragraph (c)(4) of Rule 18a–3, as adopted: (1) The phrase “A security-based swap dealer and” in the preface of the paragraph (c)(4) is changed to “A security-based swap dealer or”; (2) the phrases “cash and,” “securities and money market instruments,” and “delivered as collateral” in the preface to paragraph (c)(4) are deleted and replaced with the phrase “collateral delivered”; (3) the phrase “The collateral is subject to the physical possession or control of the security-based swap dealer or the major security-based swap participant” is deleted from paragraph (c)(4)(i) and replaced with the phrase “The collateral;” and the phrase “Subject to the physical possession or control of the security-based swap dealer or the major security-based swap participant” is added to re-designated paragraph (c)(4)(ii)(A); (4) the phrase “The collateral does not consist of securities and/or money market instruments issued by the counterparty or a party related to the security-based swap dealer, the major security-based swap participant, or to the counterparty.” is deleted along in paragraph (c)(4)(v) and the phrase “Does not consist of securities and/or money market instruments issued by the counterparty or a party related to the security-based swap dealer, the major security-based swap participant, or the counterparty; and” is added to new paragraph (c)(4)(i)(D); (5) the phrase “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”

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<sup>468</sup> See SIFMA 11/19/2018 Letter.

<sup>469</sup> See paragraph (c)(2)(xv)(C)(1) of Rule 15c3–1, as amended; paragraph (c)(1)(ix)(C)(1) of Rule 18a–1, as adopted.

<sup>470</sup> See paragraph (c)(4)(v)(B) of Rule 15c3–1e, as amended; paragraph (e)(2)(iii)(E)(2) of Rule 18a–1, as adopted.

<sup>471</sup> See paragraph (c)(4)(ii)(A) and (B) of Rule 18a–3, as adopted.

<sup>472</sup> See paragraph (c)(4)(i)(C) of Rule 18a–3, as adopted.

<sup>473</sup> See paragraph (c)(4)(i)(A) of Rule 18a–3, as adopted. The modification replaces paragraph (4)(i) of proposed Rule 18a–3 (which provided that “The collateral is liquid and transferable”) with paragraph (4)(i)(A) of Rule 18a–3, as adopted (which provides that the collateral “Has a ready market”) and paragraph (4)(i)(B) of Rule 18a–3, as adopted (which provides that the collateral “Is readily transferable”).



Finally, the Commission did not receive any comments addressing the prompt liquidation requirement and is adopting it with several non-substantive modifications.<sup>476</sup>

#### Comments and Final Requirements Regarding Exceptions to Collecting Margin

**Commercial End Users.** As noted above, the Commission proposed five exceptions to the account equity requirements, and the first exception applied to counterparties that are commercial end users.<sup>477</sup> This exception provided that a nonbank SBSB need not collect variation or initial margin from a counterparty that was a commercial end user. A commenter opposed any exceptions in the rule, stating that failing to collect and deliver margin contributed significantly to the 2008 financial crisis.<sup>478</sup> Another commenter argued that commercial end users carry market risk and can default on their obligations to the nonbank SBSB, which may then be faced with liquidity challenges.<sup>479</sup> This commenter stated that the lack of margin from these market participants can be a source of systemic risk that can “ripple through the financial market ecosystem.”

against the counterparty and any other parties to the agreement; and” is deleted in paragraph (c)(4)(iv) and the phrase “Is subject to an agreement between the security-based swap dealer or the major security-based swap participant and the counterparty that 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; and” is added to re-designated paragraph (c)(4)(i)(E); (6) the phrase “The collateral is liquid and transferable” is deleted from paragraph (c)(4)(ii) and replaced with the phrase “The collateral is either”; and (7) the phrase “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”; is deleted from paragraph (c)(4)(iii) and the phrase “and may be liquidated promptly by the security-based swap dealer or the major security-based swap participant without intervention by any other party; or” is added to re-designated paragraph (c)(4)(ii)(A) after the phrase “Subject to the physical possession or control of the security-based swap dealer or the major security-based swap participant.”

<sup>476</sup> See paragraph (c)(7) of Rule 18a–3, as adopted. This paragraph was re-numbered in the final rule as a result of changes made to other paragraphs in the rule. In the final rule, the word “and” was replaced with “or” between the phrase “A security-based swap dealer” and the phrase “major security-based swap participant”; the phrase “securities and money market instruments” was replaced with the word “positions”; and the phrase “account equity” was replaced with the word “margin” in two places. These changes to the rule were non-substantive amendments to conform the final rule text with changes made to other parts of the rule.

<sup>477</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70265–66.

<sup>478</sup> See CFA Institute Letter.

<sup>479</sup> See OneChicago 2/19/2013 Letter.

After Rule 18a–3 was proposed, the Terrorism Risk Insurance Program Reauthorization Act of 2015 (“TRIPRA”) was enacted.<sup>480</sup> Title III of TRIPRA amended Section 15F(e) of the Exchange Act to provide that the requirements of Section 15F(e)(2)(B)(ii) (which requires the Commission to adopt margin requirements for nonbank SBSBs with respect to non-cleared security-based swaps) shall not apply to a security-based swap in which a counterparty qualifies for an exception under Section 3C(g)(1) of the Exchange Act or that satisfies the criteria in Section 3C(g)(4) of the Exchange Act (the exceptions from mandatory clearing for commercial end users). Consequently, Congress mandated an exception for commercial end users from the Commission’s margin rules for non-cleared security-based swaps.<sup>481</sup> While the statutory provision establishes a commercial end user exception, defining the term “commercial end user” will serve an important purpose. In particular, the definition will implement the statutory provision and serve as a cross-reference for the term “commercial end user,” which is referenced in other parts of the Commission’s rules. Consequently, the Commission is adopting the exception and related definition with modifications to conform the definition to the statutory text.<sup>482</sup> In the final rule, the term “commercial end user” is defined to mean a counterparty that qualifies for an exception from clearing under section 3C(g)(1) of the Exchange Act and implementing regulations or satisfies the criteria in Section 3C(g)(4) of the Exchange Act and implementing regulations.<sup>483</sup>

In response to the concerns raised by the commenters regarding the exception, a nonbank SBSB will be required to take a capital deduction in lieu of margin or credit risk charge if it does not collect margin from a

commercial end user counterparty. The capital deduction or charge is intended to require a nonbank SBSB to set aside net capital to address the risks that would be mitigated through the collection of initial margin.<sup>484</sup> The set-aside net capital will serve as an alternative to obtaining collateral for this purpose. Consequently, the final capital rules and amendments work in tandem with the margin rules to require capital deductions or credit risk charges that will require nonbank SBSBs to allocate capital against the market and credit exposures resulting from transactions with commercial end users, which may not be fully collateralized.

In addition, as discussed below, a nonbank SBSB will be required to establish, maintain, and document procedures and guidelines for monitoring the risk of accounts holding non-cleared security-based swaps. Among other things, a nonbank SBSB will 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.<sup>485</sup> Consequently, nonbank SBSBs that do not collect variation and/or initial margin from a commercial end user will need to establish a credit limit for the end user and periodically review the credit limit in accordance with their risk monitoring guidelines.<sup>486</sup> The final rule also does not prohibit a nonbank SBSB from requiring a commercial end user to post variation and initial margin under its own house margin requirements.

**Financial Market Intermediaries.** The second exception to collecting margin applied when the counterparty was another SBSB.<sup>487</sup> More specifically, the Commission proposed two alternatives with respect to SBSB counterparties. Under the first alternative, a nonbank SBSB would need to collect variation margin but not initial margin from the other SBSB (“Alternative A”). Under the second alternative, a nonbank SBSB would be required to collect variation and initial margin from the other SBSB

<sup>484</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70245.

<sup>485</sup> See paragraph (e)(2) of Rule 18a–3, as adopted.

<sup>486</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74848–49 (“Finally, the Agencies note that the exception or exemption of a transaction from the margin requirements in no way prohibits a covered swap entity from requiring initial and/or variation margin on such transactions but does not impose initial or variation margin requirements as a regulatory matter.”); see also *CFTC Margin Adopting Release*, 81 FR at 648 (“The Commission has other requirements [17 CFR 23.600 (Risk Management Program for swap dealers and major swap participants)] that should address the monitoring of risk exposures for those entities”).

<sup>487</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70267–68.

<sup>480</sup> See Public Law 114–1, 129 Stat. 3 (2015).

<sup>481</sup> Section 3C(g) of the Exchange Act provides that the Commission shall consider whether to exempt small banks, savings associations, Farm Credit System institutions, and credit unions with total assets of \$10 billion or less. 15 U.S.C. 78c–3(g)(3)(B). If the Commission implements an exclusion for such entities from clearing, those entities would be encompassed within the definition of *commercial end user* under the rule. See *End-User Exception to Mandatory Clearing of Security-Based Swaps; Proposed Rule*, Exchange Act Release No. 63556 (Dec. 15, 2010), 75 FR 79992 (Dec. 21, 2010).

<sup>482</sup> See paragraphs (b)(2) and (c)(1)(iii)(A) of Rule 18a–3, as adopted.

<sup>483</sup> See paragraph (b)(2) of Rule 18a–3, as adopted. This language is consistent with the final rule adopted by the prudential regulators to implement Title III of TRIPRA and the CFTC’s final margin rule. See *Margin and Capital Requirements for Covered Swap Entities*, 81 FR 50605 (Aug. 2, 2016); *CFTC Margin Adopting Release*, 81 FR at 677–79.

and the initial margin needed to be held at a third-party custodian ("Alternative B").<sup>488</sup>

Some commenters supported Alternative A. One of these commenters argued that the requirement to collect initial margin from other SBSDs under Alternative B would severely curtail the use of non-cleared security-based swaps for hedging.<sup>489</sup> The commenter argued that this result would disrupt key financial services, such as those that facilitate the availability of home loans and corporate finance. The commenter argued that the requirement to collect initial margin from another SBSD would have detrimental pro-cyclical effects because it would increase collateral demands in times of market stress. A second commenter believed that Alternative B could limit credit availability, be destabilizing, and have undesirable pro-cyclical effects.<sup>490</sup> While generally supporting harmonization of the Commission's margin rules with the recommendations of the BCBS/IOSCO Paper, this commenter supported Alternative A. The commenter stated that harmonization in this case is not appropriate because it would put stress on the funding models of U.S. nonbank SBSDs if they were required to post initial margin to other SBSDs.<sup>491</sup> A third commenter argued that the proposal to require the exchange of large amounts of liquid initial margin come at a time when other regulators and regulations are also focusing on and imposing new requirements with respect to liquidity in the financial sector.<sup>492</sup> This commenter urged the Commission to evaluate initial margin requirements in light of the changing financial regulatory environment and to establish regulations that will support capital growth and customer protection while minimizing systemic risk. Some commenters also supported expanding the Alternative A approach so that nonbank SBSDs would not be required to collect initial margin from swap dealers, stand-alone broker-dealers,

banks, foreign banks, and foreign broker-dealers.<sup>493</sup>

Other commenters supported Alternative B, arguing that it was more consistent with the intent of the Dodd-Frank Act and that Alternative A would permit an inappropriate build-up of systemic risk within the financial system.<sup>494</sup> One commenter argued that the Commission should not be swayed by claims that Alternative B would make it difficult for nonbank SBSDs to hedge transactions, or that it would shrink the size of the global security-based swap market.<sup>495</sup> Another commenter argued that it would be inappropriate to allow a nonbank SBSD to have non-cleared security-based swap exposure to another SBSD without any requirement to collect initial margin or to take a capital charge to address the risk of the non-cleared security-based swap.<sup>496</sup> Some commenters noted that the CFTC and the prudential regulators require the exchange of initial margin between SBSDs and swap dealers, and the Commission should do so as well in order to harmonize its rules with the rules of the CFTC and the prudential regulators.<sup>497</sup> One commenter argued that a lack of harmonization would reduce the likelihood of achieving substituted compliance determinations.<sup>498</sup> Finally, a commenter responding to the 2018 comment reopening argued that the proposed rule text modifications were made despite the fact that insufficient margin and capital were two of the triggers of the financial crisis.<sup>499</sup>

In the Commission's judgment, Alternative A is the prudent approach because it will promote the liquidity of nonbank SBSDs by not requiring them to deliver initial margin to other SBSDs. As discussed above, delivering initial margin would prevent this capital of the nonbank SBSD from being immediately available to be used by the firm. If the delivering SBSD is undergoing financial stress or the markets more generally are in a period of financial turmoil, a nonbank SBSD may need to liquidate assets to raise funds and reduce its leverage. However, if assets are in the

control of another SBSD, they would not be available for this purpose. For these reasons, the nonbank SBSD capital rule treats most unsecured receivables as assets that must be deducted from net worth when the firm computes net capital.

In addition, the Commission believes that nonbank SBSDs serve an important function in the non-cleared security-based swap market by providing liquidity to market participants and by performing important market making functions. Thus, the Commission believes its margin rule for non-cleared security-based swaps should promote the liquidity of these entities, which, in turn, will help ensure their safety and soundness. Further, the Commission believes these considerations support expanding the exception beyond SBSD counterparties to include other financial market intermediary counterparties such as swap dealers, FCMs, stand-alone broker-dealers, banks, foreign banks, and foreign broker-dealers.<sup>500</sup> The Commission believes it is appropriate to expand the list given their importance to the securities markets, the liquidity impact on these entities if they are required to post initial margin, and the fact that these entities will be subject to a regulatory capital standard that would incentivize them to collateralize exposures to their security-based swap counterparties.

A nonbank SBSD will be required to take a capital deduction in lieu of margin or credit risk charge if it does not collect initial margin from a counterparty that is a financial market intermediary. As discussed above, the capital deduction or credit risk charge is intended to require a nonbank SBSD to set aside net capital to address the risks that are mitigated through the collection of initial margin. Furthermore, the nonbank SBSD will be required to establish, maintain, and document procedures and guidelines for monitoring the risk of accounts holding non-cleared security-based swaps.<sup>501</sup> These include procedures for determining, approving, and periodically reviewing credit limits for each counterparty. Consequently, a nonbank SBSD will need to establish credit limits for each counterparty to a non-cleared security-based swap, including counterparties that are financial market intermediaries.

While Alternative A is not consistent with the final rules of the CFTC and the

<sup>488</sup> Alternative B would not be an exception to the account equity requirements in Rule 18a–3 because it would require the nonbank SBSD to collect variation and initial margin from another SBSD. However, the proposed exception related to how the collateral must be held—at an independent third-party custodian on behalf of the counterparty—and, therefore, not in the possession or control of the nonbank SBSD.

<sup>489</sup> See ISDA 1/23/2013 Letter.

<sup>490</sup> See SIFMA 2/22/2013 Letter.

<sup>491</sup> See SIFMA Letter 11/19/2018. See also ISDA 11/19/2018 Letter.

<sup>492</sup> See Financial Services Roundtable Letter. See also Letter from Robert Rozell (Nov. 8, 2018) ("Rozell Letter").

<sup>493</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR 53013–14; SIFMA 11/19/2018 Letter.

<sup>494</sup> See Americans for Financial Reform Education Fund Letter; Barnard Letter; Citadel 11/19/2018 Letter; Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors (Nov. 8, 2018) ("Council of Institutional Investors Letter").

<sup>495</sup> See Americans for Financial Reform Letter.

<sup>496</sup> See OneChicago 2/19/2013 Letter.

<sup>497</sup> See Americans for Financial Reform Education Fund Letter; Citadel 11/19/2018 Letter; Rutkowski Letter.

<sup>498</sup> See Citadel 11/19/2018 Letter.

<sup>499</sup> See Better Markets 11/19/2018 Letter.

<sup>500</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53013–14 (soliciting comment on whether the dealer to dealer initial margin exception should be expanded to other types of financial market intermediaries).

<sup>501</sup> See paragraph (e) of Rule 18a–3, as adopted.

prudential regulators, the rule does not prohibit nonbank SBSBs from collecting initial margin from another financial intermediary as a house margin requirement or by agreement. In addition, the adoption of Alternative A as one requirement in the margin rule should not negatively affect potential substituted compliance determinations because the Commission expects regulators will focus on regulatory outcomes as a whole rather than on requirement-by-requirement similarity.<sup>502</sup> Finally, the adoption of Alternative A with modifications discussed above should alleviate commenters' concerns that imposing initial margin requirements would severely curtail the use of non-cleared security-based swaps for hedging.

For these reasons, the Commission is adopting Alternative A with the modifications discussed above.<sup>503</sup>

**Counterparties that Use Third-Party Custodians.** The third proposed exception applied to counterparties that are not commercial end users and that elect to have their initial margin segregated pursuant to Section 3E(f) of the Exchange Act.<sup>504</sup> Among other things, Section 3E(f) provides that a counterparty may elect to have its initial margin segregated in an account carried by an independent third-party custodian. Under the proposed exception, the nonbank SBSB did not need to directly hold the initial margin required from the counterparty. This accommodated the counterparty's right under Section 3E(f) to elect to have the third-party custodian hold the initial margin. The Commission did not receive any comments specifically addressing this provision but is modifying it to remove the reference to Section 3E(f) to address the potential that the initial margin might be held at a third-party custodian pursuant to other provisions. For the foregoing reasons, the Commission is adopting this exception with the modification described above and certain non-substantive modifications.<sup>505</sup>

<sup>502</sup> See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR at 30078–30079.

<sup>503</sup> See paragraph (c)(1)(iii)(B) of Rule 18a–3, as adopted. The text of the final rule is modified to add swap dealers, broker-dealers, FCMs, banks, foreign banks, and foreign broker-dealers to the list of counterparties covered by the exception.

<sup>504</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70268–69.

<sup>505</sup> In the final rule, this exception is contained in paragraph (c)(1)(iii)(C) of Rule 18a–3, as adopted. This paragraph states “The requirements of paragraph (c)(1)(ii)(B) of this section do not apply to an account of a counterparty that delivers the collateral to meet the initial margin amount to an independent third-party custodian.”

**Legacy Accounts.** The fourth proposed exception applied to accounts of counterparties that are not commercial end users and that hold legacy non-cleared security-based swaps.<sup>506</sup> Under this proposed exception, the nonbank SBSB did not need to collect variation or initial margin from the counterparty.

Some commenters expressed support for this exception. One of these commenters suggested that the Commission except legacy transactions, unless both counterparties agree that margin should be exchanged.<sup>507</sup> A second commenter suggested that legacy trades be excepted unless the nonbank SBSB includes them in a netting set with new transactions.<sup>508</sup> Some commenters also provided suggestions as to what should be deemed a legacy transaction, citing novated contracts and existing legacy security-based swaps that have been modified for loss mitigation purposes, or contracts that have been amended to replace references to the London Inter-bank Offered Rate (“LIBOR”).<sup>509</sup> Commenters also requested clarification as to whether the legacy account exception for nonbank SBSBs applies to both variation and initial margin or to initial margin only.<sup>510</sup> A commenter argued that initial margin requirements should not apply to legacy security-based swaps, but that the exception should only apply until the legacy contracts expire or are revised.<sup>511</sup> This commenter further argued that the exception should not apply to variation margin because, without this type of protection, counterparties are exposed to potential losses as a consequence of the default of trading partners.

The Commission is adopting the proposed exception for accounts holding legacy security-based swaps<sup>512</sup>

<sup>506</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70269.

<sup>507</sup> See PIMCO Letter.

<sup>508</sup> See SIFMA 3/12/2014 Letter.

<sup>509</sup> See Letter from the Alternative Reference Rates Committee (Jul. 12, 2018) (“ARRC Letter”); AFIG 2/15/2013 Letter; SIFMA 2/22/2013 Letter.

<sup>510</sup> See Financial Services Roundtable Letter; ISDA 1/23/2013 Letter.

<sup>511</sup> See CFA Institute Letter.

<sup>512</sup> See paragraph (c)(1)(iii)(D) of Rule 18a–3, as adopted. In the final rule, the Commission modified the defined term “security-based swap legacy account” by replacing the word “effective” in two places with the word “compliance.” See paragraph (b)(6) of Rule 18a–3, as adopted. The Commission made these modifications to link the legacy account exception to the compliance date of Rule 18a–3 (i.e., the date when nonbank SBSBs must begin complying with the rules) as opposed to the effective date, which will occur before these entities are required to register as SBSBs and comply with the rule. The term *security-based swap legacy account* was re-designated subparagraph (b)(6) of the rule due to non-substantive changes made to

with a modification to make explicit that the exception applies to variation and initial margin in response to comments seeking clarification on that point.<sup>513</sup> Under the final rule, nonbank SBSBs can collect variation or initial margin with respect to legacy transactions pursuant to house requirements or agreement.

With regard to the comment that counterparties should be required to post variation margin since they may be exposed to potential losses, a nonbank SBSB will be required to take a capital deduction in lieu of margin or credit risk charge if it does not collect variation and/or initial margin with respect to a legacy account. Furthermore, the nonbank SBSB will be required to establish, maintain, and document procedures and guidelines for monitoring the risk of legacy accounts. With respect to the comment about the effect of the replacement of references to LIBOR in security-based swap contracts, the Commission intends to consult and coordinate with other regulators on this question.

**Minimum Transfer Amount.** The fifth exception established a minimum transfer amount.<sup>514</sup> Under this provision, a nonbank SBSB was not required to collect margin if the total amount of the requirement was equal to or less than \$100,000. If this amount was exceeded, the nonbank SBSB needed to collect margin to cover the entire amount of the requirement, not just the amount that exceeded \$100,000.

Several commenters supported this exception, or supported increasing it to amounts that ranged from \$250,000 to

other parts of the rule. Finally, the phrase “one or more” was inserted after the phrase “is used to hold.”

<sup>513</sup> See paragraph (c)(1)(iii)(D) of Rule 18a–3, as adopted. See also *Capital, Margin, and Segregation Proposing Release*, 77 FR 70269. The Commission's intent was to propose an exception that applied to both variation and initial margin. See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70269 (“Under the fourth exception to the account *equity* requirements in proposed Rule 18a–3, a nonbank SBSB 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.”). The proposed rule text, however, inadvertently limited the exception to the collection of initial margin. In the final rule, the Commission also deleted the phrase “of a counterparty that is not a commercial end user” from this subsection because it is redundant, as commercial end users are subject to an exception from the rule under paragraph (c)(1)(iii)(A) of Rule 18a–3. Finally, the word “legacy” was moved to before the word “account” to conform the language with the definition of security-based swap legacy account in paragraph (b)(6) of the rule. See paragraph (c)(1)(iii)(D) of Rule 18a–3, as adopted.

<sup>514</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70272.

\$500,000.<sup>515</sup> Commenters also asked the Commission to clarify whether the proposed minimum transfer amount applies to both initial and variation margin, and recommended that different jurisdictions use the same currency to designate thresholds.<sup>516</sup> A commenter also supported consistent minimum transfer amounts across domestic regulators.<sup>517</sup> The CFTC and the prudential regulators adopted a minimum transfer amount of \$500,000.<sup>518</sup> One commenter opposed a minimum transfer amount for variation margin.<sup>519</sup>

The Commission agrees with commenters that the minimum transfer amount should be increased to \$500,000. This will reduce operational burdens for nonbank SBSBs and their counterparties by not requiring them to transfer small amounts of collateral on a daily basis. It also will align the rule with the minimum transfer amount adopted by the CFTC and the prudential regulators and, thereby, reduce potential operational burdens and competitive impacts that could result from inconsistent requirements.

In response to the commenter concerned about applying the minimum transfer amount to variation margin, a nonbank SBSB will be required to take a capital deduction in lieu of margin or credit risk charge if it does not collect variation and/or initial margin pursuant to the minimum transfer amount exception.

For these reasons, the Commission is adopting the minimum transfer amount exception with an increase to \$500,000, and with minor modifications.<sup>520</sup>

<sup>515</sup> See American Council of Life Insurers 2/22/2013 Letter; American Council of Life Insurers, et al. 1/29/2013 Letter; ICI 11/19/2018 Letter; ISDA 11/19/2018 Letter; Markit Letter; SIFMA AMG 2/22/2013 Letter; SIFMA AMG 11/19/2018 Letter; SIFMA 3/12/14 Letter; SIFMA 11/19/2018 Letter.

<sup>516</sup> See ISDA 2/5/2014 Letter; SIFMA 3/12/14 Letter.

<sup>517</sup> See American Council of Life Insurers 2/22/2013 Letter.

<sup>518</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74903; *CFTC Margin Adopting Release*, 81 FR at 697. See also BCBS/IOSCO Paper at 10 (recommending a minimum transfer amount of €500,000).

<sup>519</sup> See Harrington 11/19/2018 Letter.

<sup>520</sup> See paragraph (c)(1)(iii)(I) and (c)(2)(iii)(D) of Rule 18a–3, as adopted. In the final rule the minimum transfer amount paragraph was moved to the exceptions section of the rule as a non-substantive change to facilitate cross-references to the capital rules related to capital charges in lieu of margin and credit risk charges. This modification also will improve the overall consistency and structure of the margin rule. Therefore, the exception appears twice in the final rule text, rather than once, as proposed, with references to both nonbank SBSBs and MSBSPs. See paragraph (c)(1)(iii)(I) and (c)(2)(iii)(D) of Rule 18a–3, as adopted. Finally, the phrase “cash, securities, and money market instruments” has been replaced with

The Commission also clarifies that the minimum transfer amount applies to both initial and variation margin. Thus, required initial and variation margin need not be collected if the combined requirements are below \$500,000. However, if the \$500,000 level is exceeded, the entire amount must be collected (*i.e.*, not the just amount that exceeds \$500,000). Finally, in response to a comment, nonbank SBSBs may negotiate a lower “house” minimum transfer amount with their counterparties.

*Initial Margin Threshold.* The CFTC and the prudential regulators have adopted a fixed-dollar \$50 million threshold under which initial margin need not be collected.<sup>521</sup> The CFTC defines its initial margin threshold amount to mean an aggregate credit exposure of \$50 million resulting from all non-cleared swaps of a swap dealer and its affiliates with a counterparty and its affiliates.<sup>522</sup> The prudential regulators adopted a similar threshold, except that it covers aggregate credit exposure resulting from all non-cleared security-based swaps and swaps.<sup>523</sup>

Some commenters requested that the Commission adopt a threshold consistent with the thresholds adopted by the CFTC and the prudential regulators, and with the recommendations in the BCBS/IOSCO Paper.<sup>524</sup> A commenter stated that initial margin thresholds can be a useful means for reducing the aggregate liquidity impact of mandatory initial margin requirements while still protecting an SBSB from large uncollateralized potential future exposures to counterparties.<sup>525</sup> Another commenter suggested that if pension plans are subject to initial margin requirements, then dealers should be able to set initial margin thresholds for them on a case-by-case basis.<sup>526</sup> A third commenter suggested that low-risk financial end users should be allowed an uncollateralized threshold of \$100 million.<sup>527</sup> Other commenters raised concerns about the consequences of

the term “collateral” as a result of changes made to other paragraphs of the rule.

<sup>521</sup> See *CFTC Margin Adopting Release*, 81 FR at 652; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74863; see also BCBS/IOSCO Paper, principle 2.1 (providing that covered entities must exchange initial margin with a threshold not to exceed €50 million).

<sup>522</sup> See *CFTC Margin Adopting Release*, 81 FR at 697.

<sup>523</sup> *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74901.

<sup>524</sup> See, *e.g.*, ICI 5/11/2015 Letter; Ropes & Gray Letter; SIFMA 3/12/2014 Letter.

<sup>525</sup> See SIFMA 2/22/2013 Letter.

<sup>526</sup> See American Benefits Council Letter, et al., 1/29/2013 Letter.

<sup>527</sup> See PIMCO Letter.

breaching the threshold and noted that doing so would trigger the need to execute agreements to address the posting of initial margin.<sup>528</sup>

In the 2018 comment reopening, the Commission asked whether it would be appropriate to establish a risk-based threshold where, for example, a nonbank SBSB would not be required to collect initial margin to the extent the amount does not exceed the lesser of: (1) 1% of the SBSB’s tentative net capital; or (2) 10% of the net worth of the counterparty.<sup>529</sup> The Commission stated that the purpose would be to establish a threshold that is scalable and has a more direct relation to the risk to the nonbank SBSB arising from its security-based swap activities. The Commission also stated that a fixed-dollar threshold, depending on the size and activities of the nonbank SBSB, could either be too large and, therefore, not adequately address the risk, or too small and, therefore, overcompensate for the risk.

In response to the potential risk-based threshold discussed in the comment period reopening, most commenters argued that the Commission should adopt a fixed-dollar \$50 million threshold consistent with the final margin rules of the CFTC and the prudential regulators.<sup>530</sup> A commenter suggested that this would result in benefits such as predictability and transparency.<sup>531</sup> This commenter also argued that a threshold harmonized with that of other regulators would prevent opportunities for counterparties to engage in regulatory arbitrage, and recommended that any drawbacks (such as the threshold being too large in relation to a nonbank SBSB’s net capital) be addressed through additional capital charges.<sup>532</sup> A commenter raised concerns that a different threshold

<sup>528</sup> See Letter from Scott O’Malia, Chief Executive Officer, International Swaps and Derivatives Association, Kenneth E. Bentsen, Jr., President & CEO, Securities Industry and Financial Markets Association, Ananda Radhakrishnan, Vice President, Center for Bank Derivatives Policy, American Bankers Association, James Kemp, Managing Director, Global Foreign Exchange Division, CFMA, and Briget Polichene, Chief Executive Officer, Institute of International Bankers (Sept. 12, 2018) (“ISDA, SIFMA, ABA, et al. 9/12/18 Letter”).

<sup>529</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53013.

<sup>530</sup> See Center for Capital Markets Competitiveness, Chamber of Commerce 11/19/2018 Letter; ICI 11/19/2018 Letter; ISDA 11/19/2018 Letter.

<sup>531</sup> See SIFMA 11/19/2018 Letter. This commenter recommended that the Commission adopt a \$50 million initial margin threshold, but recommended that the drawbacks of the fixed-dollar threshold could be addressed through additional capital charges, such as credit concentration capital charges.

<sup>532</sup> See SIFMA 11/19/2018 Letter.

would result in significant compliance challenges if trading desks that trade both security-based swaps and swaps were required to apply different standards to the same counterparty.<sup>533</sup> Another commenter believed that a scalable threshold would cause significant operational challenges and inefficiencies by subjecting individual SBSDs to different thresholds for the collection of initial margin.<sup>534</sup>

Several commenters argued against including an initial margin threshold in the final rule. Two stated that there is no threshold in the margin rules for cleared security-based swaps, and establishing one for non-cleared security-based swaps would increase systemic risk.<sup>535</sup> One commenter argued that the Commission did not explain its views on why a counterparty specific threshold (e.g., \$50 million) should be rejected in favor of a measure that would be tied to a percentage of the nonbank SBSB's tentative net capital.<sup>536</sup>

In response to comments, the Commission believes that it would be appropriate to establish a threshold that is more consistent with the thresholds adopted by the CFTC and the prudential regulators. This will eliminate potential competitive disparities and address operational concerns raised by commenters. For these reasons, the Commission is adopting a fixed-dollar \$50 million initial margin threshold below which initial margin need not be collected.<sup>537</sup> As discussed below, the threshold in the Commission's final margin rule is consistent with the threshold in the prudential regulators' margin rules.

Pursuant to the threshold, an SBSB need not collect the calculated amount of initial margin to the extent that the sum of that amount plus all other credit exposures resulting from non-cleared security-based swaps and swaps of the nonbank SBSB and its affiliates with the counterparty and its affiliates does not exceed \$50 million. The threshold will be calculated across all non-cleared security-based swaps and swaps of the nonbank SBSB and its affiliates with the counterparty and its affiliates, with the exception that non-cleared security-based swap transactions with commercial end users and non-cleared swap transactions that are exempted under Section 4s(e)(4) of the CEA need not be included in the calculation. The margin rules of the CFTC and the

prudential regulators similarly exclude transactions with commercial end users from their respective fixed-dollar \$50 million thresholds. Moreover, as discussed above, the TRIPRA statute precludes the Commission from adopting margin requirements for commercial end users.

The Commission's fixed-dollar \$50 million threshold is consistent with the threshold established by the prudential regulators in that the calculation includes both non-cleared security-based swaps and swaps (in contrast to the CFTC's threshold, which includes only swaps in the calculation). Including both non-cleared security-based swaps and swaps in the calculation will result in a more prudent requirement that takes into account a broader range of exposures. Further, because bank SBSBs can deal in security-based swaps, aligning the nonbank SBSB threshold with the bank threshold will eliminate a potential competitive disparity between the two types of U.S. entities that deal in security-based swaps. Also, if the calculation of the Commission's threshold were limited to security-based swaps, SBSBs and counterparties potentially would need to make 3 threshold calculations: One for the Commission's rule (security-based swaps only), one for the CFTC's rule (swaps only), and one for the prudential regulators' rule (security-based swaps and swaps). By conforming to the prudential regulator's rule, SBSBs and counterparties need only make two calculations (the Commission/prudential regulator threshold and the CFTC threshold). Further, a counterparty that breaches the Commission's fixed-dollar \$50 million threshold will not necessarily breach the CFTC's fixed-dollar \$50 million threshold exception given that the former calculation includes security-based swap and swap exposures and the latter includes only swap exposures.

The Commission recognizes that a fixed-dollar threshold (as opposed to a scalable threshold) does not necessarily bear a relation to the financial condition of the nonbank SBSB and its counterparty. To address this issue, as discussed above, and as suggested by a commenter, a nonbank SBSB will be required to take a capital deduction in lieu of margin or a credit risk charge if it does not collect initial margin pursuant to the fixed-dollar \$50 million threshold exception. Furthermore, the nonbank SBSB will be required to establish, maintain, and document procedures and guidelines for monitoring counterparty risk. Consequently, the Commission does not

believe the fixed-dollar \$50 million threshold exception will unduly increase systemic risk as suggested by a commenter. For these reasons, the Commission believes it is appropriate to adopt the exception to promote greater consistency with the margin requirements of the prudential regulators.

Finally, commenters raised concerns about the consequences of breaching a fixed-dollar \$50 million threshold and noted that doing so would trigger the need to execute agreements to address the posting of initial margin.<sup>538</sup> The Commission recognizes that after a breach counterparties may need time to execute agreements, establish processes for exchanging initial margin, and take other steps to comply with the initial margin requirement.<sup>539</sup> Therefore, the Commission is modifying the final rule to permit a nonbank SBSB to defer collecting the initial margin amount for up to two months following the month in which a counterparty no longer qualifies for the fixed-dollar \$50 million threshold exception for the first time.<sup>540</sup> This is designed to provide the counterparty with sufficient time to take the steps necessary to begin posting initial margin pursuant to the final rule.

*Affiliates.* The margin rules of the CFTC and the prudential regulators have exceptions for counterparties that are affiliates.<sup>541</sup> Some commenters requested that the Commission also adopt exceptions for affiliates.<sup>542</sup> One

<sup>538</sup> See ISDA, SIFMA, American Bankers Association, et al 9/12/2018 Letter.

<sup>539</sup> As discussed above in section II.B.1. of this release, while paragraphs (c)(4) and (5) of Rule 18a-3, as adopted, respectively require netting and collateral agreements to be in place, the rule does not impose a specific margin documentation requirement as do the margin rules of the CFTC and the prudential regulators.

<sup>540</sup> See paragraph (c)(1)(iii)(H)(2) of Rule 18a-4, as adopted. Paragraph (c)(1)(iii)(H)(2) of the final rule states "Notwithstanding paragraph (c)(1)(iii)(H)(1) of this section, a security-based swap dealer may defer collecting the amount required under paragraph (c)(1)(ii)(B) of this section for up to two months following the month in which a counterparty no longer qualifies for this threshold exception for the first time."

<sup>541</sup> See *CFTC Margin Adopting Release*, 81 FR at 673-674; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74887-90.

<sup>542</sup> See Letter from Representative Ted Budd, Representative Patrick McHenry et. al. (May 14, 2019); Letter from John Court, Managing Director and Senior Associate General Counsel, The Clearing House, Cecelia A. Calaby, Executive Director and General Counsel, American Bankers Association Securities Association, and Jason Shafer, Vice President, American Bankers Association (Nov. 24, 2014) ("Clearing House 11/24/14 Letter"); Letter from John Court, Managing Director/Deputy General Counsel, The Clearing House, Cecelia A. Calaby, Senior Vice President, Office of Regulatory Policy, American Bankers Association and Executive Director and General Counsel, American Bankers Association Securities Association, and Kyle

<sup>533</sup> See ICI 11/19/2018 Letter.

<sup>534</sup> See ISDA 11/29/2018 Letter.

<sup>535</sup> See Better Markets 11/19/2018 Letter; OneChicago 11/19/2018 Letter.

<sup>536</sup> See Better Markets 11/19/2018 Letter.

<sup>537</sup> See paragraph (c)(1)(iii)(H)(1) of Rule 18a-3, as adopted.

commenter stated that inter-affiliate transactions do not increase the overall risk profile or leverage of the SBSB.<sup>543</sup> Another commenter noted that some affiliates enter into security-based swap transactions with their nonbank SBSB affiliates, either for individual hedging purposes or as part of the consolidated group's broader risk strategy.<sup>544</sup>

Other commenters opposed an exception for affiliates.<sup>545</sup> One of these commenters urged the Commission to impose strong margin requirements for security-based swaps between bank affiliates and other entities under the Commission's authority.<sup>546</sup>

The Commission is persuaded that there should be an exception for affiliates in order to reduce potential competitive disparities, and to promote consistency with the margin requirements of the CFTC. Therefore, the Commission is modifying the final rule to establish an initial margin exception when the counterparty is an affiliate of the SBSB.<sup>547</sup>

Although they will not be required to collect initial margin from affiliates, a nonbank SBSB must collect variation margin from them. In addition, as discussed above, a nonbank SBSB will be required to take a capital deduction in lieu of margin or credit risk charge if

it does not collect initial margin from an affiliate. The nonbank SBSB also will be required to establish, maintain, and document procedures and guidelines for monitoring the risk of affiliates. Moreover, the final rule does not prohibit a nonbank SBSB from requiring an affiliate to post initial margin under its own house margin requirements.

*The BIS, European Stability Mechanism, Multilateral Development Banks, and Sovereigns.* The margin rules of the CFTC and the prudential regulators have exceptions for counterparties that are not a financial end user as that term is defined in their rules.<sup>548</sup> Their definitions of financial end user exclude the BIS, multilateral development banks, and sovereign entities.<sup>549</sup>

Some commenters requested that the Commission adopt exceptions for these types of entities to be consistent with the margin rules of the CFTC and the prudential regulators, and with the recommendations in the BCBS/IOSCO Paper.<sup>550</sup> One of these commenters argued that international consistency among covered entities subject to margin requirements, including the definition of public sector entities, is critical to competitive parity and comity.<sup>551</sup> Another commenter argued that the approach to margin for foreign sovereign governments, central banks, and multilateral lending or development organizations should be determined through international consensus.<sup>552</sup> A commenter recommended that the Commission adopt a definition of "financial end user" consistent with the margin rules of the CFTC and the prudential regulators, which—as noted above—results in exceptions for sovereign entities, multilateral development banks, and the BIS.<sup>553</sup> The commenter argued that different treatment of these entities will create unnecessary competitive disparities.

The Commission is persuaded that there should be some exceptions for these types of entities in order to reduce potential competitive disparities.

However, the Commission also believes that the exception for sovereign entities should be more limited, given the wide range of potential counterparties that would be within this category and their differing levels of creditworthiness. Limiting the exception for sovereign entities will help ensure the safety and soundness of nonbank SBSBs.

For these reasons, the Commission is adopting an exception from collecting variation and initial margin if the counterparty is the BIS, the European Stability Mechanism, or one of a number of multilateral development banks identified in the rule.<sup>554</sup> These multilateral development banks are the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral development bank that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member. These specific counterparties also are not required to collect and/or post variation margin under the final margin rules of the CFTC and/or the prudential regulators.<sup>555</sup> The Commission believes these counterparties pose minimal credit risk and, therefore, it is an appropriate trade-off to exempt them from the margin requirements (which are designed to protect the nonbank SBSB from counterparty risk) in order to eliminate the potential competitive disparities and operational burdens of treating them differently than under the rules of the CFTC and the prudential regulators.<sup>556</sup>

The exception for sovereign entities is more limited. Specifically, the final rule excepts a nonbank SBSB from collecting initial margin from a counterparty that is a sovereign entity if the nonbank SBSB has determined that the

Brandon, Managing Director, Director of Research, SIFMA (June 1, 2015) ("Clearing House 6/1/15 Letter"); Letter from Coalition for Derivatives End-Users (Feb. 22, 2013) ("Coalition for Derivatives End-Users 2/22/2013 Letter"); Financial Services Roundtable Letter; ISDA 1/23/2013 Letter; ISDA 2/5/2014 Letter; ISDA 11/19/2018 Letter; SIFMA 2/22/2013 Letter; SIFMA 3/12/2014 Letter; SIFMA 11/19/2019 Letter. The Clearing House proposed two alternatives for initial margin: A requirement that a nonbank SBSB collect initial margin from less regulated affiliates and segregate it, and not collect (or post) initial margin from highly regulated affiliates. Variation margin would still be collected under this proposal. In lieu of these proposals, The Clearing House also proposed a pooled segregated collateral account held at the parent company level. See Clearing House 6/1/15 Letter. One commenter recommended that variation margin requirements apply to an inter-affiliate transaction only when an SBSB is transacting with an unregulated/non-prudentially supervised affiliate. See SIFMA 2/22/2013 Letter. This commenter also recommended that the Commission should not require nonbank SBSBs to collect initial margin from affiliates that are subject to the same centralized risk management program as the nonbank SBSB. See SIFMA 11/19/2018 Letter.

<sup>543</sup> See ISDA 11/19/2018 Letter.

<sup>544</sup> See SIFMA 11/19/2018 Letter.

<sup>545</sup> See CFA Institute Letter; Letter from Elijah E. Cummings, Ranking Member, Committee on Oversight and Government Reform and Elizabeth Warren, Ranking Member, Subcommittee on Economic Policy (Nov. 10, 2015) ("Cummings and Warren Letter").

<sup>546</sup> See Cummings and Warren Letter.

<sup>547</sup> See paragraph (c)(1)(iii)(G) of Rule 18a–3, as adopted. This paragraph in the final rule will read: [t]he requirements of paragraph (c)(1)(ii)(B) of this section do not apply to an account of a counterparty that is an affiliate of the security-based swap dealer.

<sup>548</sup> See *CFTC Margin Adopting Release*, 81 FR at 642; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74855.

<sup>549</sup> See *CFTC Margin Adopting Release*, 81 FR at 642; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74855. See also BCBS/IOSCO Paper, paragraph 2(c) (recommending that margin standards should not be applied in such a way that would require sovereigns, central banks, multilateral development banks, or the BIS to either collect or post margin).

<sup>550</sup> See Financial Services Roundtable Letter; SIFMA 2/22/2013 Letter; SIFMA 3/12/2014 Letter; SIFMA 11/19/2018 Letter.

<sup>551</sup> See SIFMA 3/12/2014 Letter.

<sup>552</sup> See Financial Services Roundtable Letter.

<sup>553</sup> See SIFMA 11/19/2018 Letter.

<sup>554</sup> See paragraph (c)(1)(iii)(E) of Rule 18a–3, as adopted.

<sup>555</sup> See *CFTC Margin Adopting Release*, 81 FR at 642; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74855. See also BCBS/IOSCO Paper at 10. The CFTC's approach generally treats the European Stability Mechanism consistent with the treatment of a multilateral development bank for purposes of the CFTC margin rule. See CFTC Letter No. 17–34 (Jul. 24, 2017).

<sup>556</sup> See *CFTC Margin Adopting Release*, 81 FR at 642; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74855.

counterparty has only a minimal amount of credit risk pursuant to policies and procedures or credit risk models established under applicable net capital rules for nonbank SBSDs.<sup>557</sup> The final capital rules for nonbank SBSDs require these entities to have policies and procedures for assessing the creditworthiness of certain types of securities or money market instruments for purposes of applying standardized haircuts.<sup>558</sup> The rules also require firms authorized to use models to compute haircuts to have a model for determining credit risk charges. The firms will need to use these policies and procedures or models (as applicable) to determine whether a sovereign entity has a minimal amount of credit risk in order to apply this exception. A sovereign entity that the nonbank SBSD has determined has a minimal amount of credit risk for purposes of the nonbank capital rules would qualify for the initial margin exception in Rule 18a–3.

Nonbank SBSDs must collect variation margin from and deliver variation margin to counterparties that are sovereign entities under the final rule. In contrast, the final margin rules of the CFTC and the prudential regulators do not require an SBSD or swap dealer to exchange variation margin with a counterparty that is a sovereign entity.<sup>559</sup> Collecting variation margin from sovereign entity counterparties is an important means of managing credit exposure to these entities and limiting the amount of unsecured receivables that comprise the firm's capital. As discussed above, in contrast to the multilateral development banks identified in the rule, the Commission believes that the exception for sovereign entities should be more limited given the wide range of potential counterparties in this category and their differing levels of creditworthiness. Limiting the exception for sovereign entities and requiring that these counterparties post variation margin will help ensure the

safety and soundness of nonbank SBSDs. Therefore, the Commission does not believe it is appropriate to except such counterparties from the variation margin requirements of the final rule.

#### Requests for Other Exceptions

Commenters suggested that the Commission except other counterparties from the margin requirements in Rule 18a–3. The proposed exceptions included: Pension plans;<sup>560</sup> securitization and similar special purpose vehicles;<sup>561</sup> state and municipal government entities;<sup>562</sup> low risk financial end users;<sup>563</sup> financial end users such as captive financial affiliates and mutual life insurance companies;<sup>564</sup> emerging market counterparties that constitute only a certain percentage of a nonbank SBSD's volume;<sup>565</sup> and counterparties trading non-cleared derivatives below a certain notional amount (e.g., financial end users without material swaps exposure).<sup>566</sup> Other commenters suggested that the Commission adopt exceptions to the margin requirements recommended in the BCBS/IOSCO Paper, including for entities that have less than a specified gross notional amount of outstanding non-centrally cleared swaps.<sup>567</sup>

A commenter opposed any exceptions, arguing that exceptions for certain market participants were a significant contributor to the systemic risk disruptions during the 2008 financial crisis.<sup>568</sup> A commenter specifically opposed exceptions for asset-backed security issuers.<sup>569</sup>

<sup>560</sup> See American Benefits Council, et al. 1/29/2013 Letter.

<sup>561</sup> See Financial Services Roundtable Letter; ISDA 1/23/2013 Letter; ISDA 2/5/2014 Letter; SIFMA 2/22/2013 Letter; SIFMA 3/12/2014 Letter.

<sup>562</sup> See Financial Services Roundtable Letter; ISDA 1/23/2013 Letter.

<sup>563</sup> See SIFMA AMG 2/22/2013 Letter.

<sup>564</sup> See Coalition for Derivatives End-Users 2/22/2013 Letter.

<sup>565</sup> See SIFMA 3/12/2014 Letter.

<sup>566</sup> See ICI 11/19/2018 Letter; ISDA 11/19/2018 Letter; ISDA, SIFMA, American Bankers Association, et al. 9/12/18 Letter; SIFMA 11/19/2018 Letter; SIFMA AMG 11/19/2018 Letter. These commenters generally supported that the Commission only require counterparties with "material swaps exposure" to post initial margin.

<sup>567</sup> See Financial Services Roundtable Letter; ISDA 2/5/2014 Letter; Letter from Lutz-Christian Funke, Senior Vice President, and Frank Czichowski, Senior Vice President and Treasurer, KfW Bankengruppe (Dec. 19, 2012) ("KfW Bankengruppe Letter"); SIFMA 2/22/2013 Letter; SIFMA 3/12/2014 Letter; World Bank Letter.

<sup>568</sup> See CFA Institute Letter. This commenter specifically opposed exceptions for small banks, savings associations, farm credit system institutions, credit unions and foreign governments.

<sup>569</sup> See Letter from William J. Harrington (May 12, 2015) ("Harrington 5/12/2015 Letter").

The Commission does not believe it is necessary or prudent to establish special exceptions for these specific types of counterparties. The Commission acknowledges that not establishing special exceptions for some of these types of counterparties may lead to different margin requirements across both foreign and domestic regulators. On balance, however, the Commission believes that, given the funding profiles of nonbank SBSDs and the role of margin in promoting liquidity and self-sufficiency and managing credit exposure, the expansion of the exceptions in the manner suggested by commenters would not be prudent. The addition of the fixed-dollar \$50 million threshold exception should provide relief to many of these counterparties from the requirement to deliver initial margin. Moreover, as discussed above, the Commission is providing SBSDs with a deferral period that should provide sufficient time for them and their counterparties to implement any documentation, custodial, or operational arrangements that they deem necessary to comply with Rule 18a–3.<sup>570</sup>

#### ii. Nonbank MSBSPs

As discussed earlier, proposed Rule 18a–3 required a nonbank MSBSP 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.<sup>571</sup> By noon of the next business day, the nonbank MSBSP was 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.<sup>572</sup> In other words, the nonbank MSBSP was required to either collect or deliver variation margin but not required to collect or deliver initial margin. The proposed rule did not require the nonbank MSBSP to apply the

<sup>570</sup> As discussed above, while paragraphs (c)(4) and (5) of Rule 18a–3, as adopted, respectively require netting and collateral agreements to be in place, the rule does not impose a specific margin documentation requirement as do the margin rules of the CFTC and the prudential regulators. Consequently, an existing netting or collateral agreement with a counterparty that was entered into by the nonbank SBSD in order to comply with the margin documentation requirements of the CFTC or the prudential regulators will suffice for the purposes of Rule 18a 3, as adopted, if the agreement meets the requirements of paragraph (c)(4) or (5), as applicable.

<sup>571</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70270–71.

<sup>572</sup> The nonbank MSBSP would need to deliver cash, securities, and/or money market instruments and, consequently, under the proposal, other types of assets would not be eligible as collateral.

<sup>557</sup> See paragraph (c)(1)(iii)(F) of Rule 18a–3, as adopted. The exception applies to a counterparty that is a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government if the security-based swap dealer has determined that the counterparty has only a minimal amount of credit risk pursuant to policies and procedures established pursuant to Rule 15c3–1 or 18a–1 (as applicable).

<sup>558</sup> See *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Exchange Act Release No. 71194 (Dec. 27, 2013), 79 FR 1522 (Jan. 8, 2014) (discussing the "minimal amount of credit risk" standard). See also paragraph (c)(2)(vi)(I) of Rule 15c3–1.

<sup>559</sup> See *CFTC Margin Adopting Release*, 81 FR at 642; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74855.



standardized haircuts to securities or money market instruments when calculating the variation margin requirement for an account because the proposed capital rule for these entities did not use standardized haircuts (or model-based haircuts).

Under the proposal, a nonbank MSBSP was subject to certain of the account equity requirements that applied to nonbank SBSBs and were discussed above. First, the types of assets that could be used to meet the nonbank MSBSP's obligation to either collect or deliver variation margin were limited to cash, securities, or money market instruments. Second, the nonbank MSBSP was subject to the additional collateral requirements designed to ensure that the collateral was of stable and predictable value, not linked to the value of the transaction in any way, and capable of being sold quickly and easily if the need arises. Third, the nonbank MSBSP was subject to the requirement to take prompt steps to liquidate collateral consisting of securities or money market instruments to the extent necessary to eliminate an account equity deficiency (though the measure of a deficiency related solely to required variation margin, as these entities were not required to collect initial margin).

Proposed Rule 18a-3 also provided exceptions under which a nonbank MSBSP was not required to collect and, in some cases, deliver variation margin. The first exception applied to counterparties that were commercial end users. Under this exception, the nonbank MSBSP was not required to collect variation margin from the commercial end user. The second exception applied to counterparties that were SBSBs. Under this exception, the nonbank MSBSP was not required to collect variation margin from the SBSB. However, under proposed Rule 18a-3, a nonbank SBSB was required to collect variation and initial margin from an MSBSP. The third exception applied to legacy accounts. Under this exception, the nonbank MSBSP was not required to collect or deliver variation margin with respect to positions in a legacy account. The fourth exception was the \$100,000 minimum transfer amount provision. Under this exception, the nonbank MSBSP was not required to collect or deliver variation margin if the margin requirement was less than \$100,000.

#### Comments and Final Account Equity Requirements for Nonbank MSBSPs

A commenter stated that nonbank MSBSPs should be required to apply haircuts to the value of securities and money market instruments when

determining whether the level of equity in the account meets the minimum requirement.<sup>573</sup> Under the final rules being adopted today, nonbank MSBSPs are not subject to a capital standard that uses standardized or model based haircuts. Consequently, the Commission believes it would not be appropriate to require these firms to apply the standardized haircuts to the variation margin they receive from counterparties.

The Commission did not receive any specific comments on the commercial end user exception and is adopting it as proposed, with a non-substantive modification.<sup>574</sup> As discussed above, however, the Commission modified the definition of "commercial end user" as a result of amendments to Section 15F(e) of the Exchange Act.

The Commission did not receive any specific comments on the exception for SBSB counterparties. The Commission, however, is removing this exception from the final rule because it is unnecessary. The final rule requires nonbank SBSBs to collect and post variation margin with respect to most counterparties including nonbank MSBSPs, and, consequently, a specific exception from collecting variation margin from nonbank SBSBs would be inconsistent with the requirement that they deliver variation margin to counterparties, including nonbank MSBSPs.

Several commenters supported the Commission's proposed legacy account exception for nonbank MSBSPs.<sup>575</sup> Commenters stated that applying the new rules to legacy accounts would be highly disruptive as the underlying agreements were negotiated based on the law in effect at the time of execution, and that, specifically, financial guarantee insurers are subject to extensive regulation by state insurance companies, and their security-based swap guarantees reflect the restrictions and obligations imposed by those regimes.<sup>576</sup> The Commission is adopting the legacy account exception for nonbank MSBSPs substantially as proposed.<sup>577</sup>

<sup>573</sup> See CFA Institute Letter.

<sup>574</sup> See paragraph (c)(2)(iii)(A) of Rule 18a-3, as adopted. In the final rule, the phrase "an account of" was inserted before the phrase "a counterparty" to more closely align the text with paragraph (c)(1)(iii)(A) of the final rule.

<sup>575</sup> See AFGI 2/15/2013 Letter; AFGI 7/22/2013 Letter.

<sup>576</sup> See AFGI 2/15/2013 Letter; AFGI 7/22/2013 Letter.

<sup>577</sup> See paragraph (c)(2)(iii)(B) of Rule 18a-3, as adopted. In the final rule, the Commission deleted the phrase "of a counterparty that is not a commercial end user" from this paragraph because the phrase is redundant, as an exception for commercial end users is contained in paragraph

The Commission is making several conforming modifications to the account equity requirements for nonbank MSBSPs in light of modifications made to the account equity requirements for nonbank SBSBs discussed above in section II.B.2.i. of this release. First, the final rule provides that the nonbank MSBSP must collect or deliver variation margin by the close of business on the next business day following the day of the calculation, except that the collateral can be collected or delivered by the close of business on the second business day following the day of the calculation if the counterparty is located in another country and more than four time zones away.<sup>578</sup> Second, the modifications to the collateral requirements in paragraph (c)(4) of Rule 18a-3, as adopted, apply to nonbank MSBSPs, including that the collateral to meet a margin requirement must consist of cash, securities, money market instruments, a major foreign currency, the security of settlement of the non-cleared security-based swap, or gold.<sup>579</sup> Third, the final rule includes an exception from collecting variation margin if the counterparty is the BIS, the European Stability Mechanism, or one of the multilateral development banks identified in the rule (there is no exception from delivering variation margin to these types of counterparties).<sup>580</sup> Fourth, the Commission is making the minimum transfer amount a specific exception to the account equity requirements for nonbank MSBSPs and raising the amount from \$100,000 to \$500,000.<sup>581</sup>

Finally, a commenter stated that commercial end users do not normally operate under the fiduciary obligations applicable to financial firms for the safekeeping of client funds and, therefore, are unequipped to handle collateral while a contract is open.<sup>582</sup> Therefore, the commenter suggested that margin that a nonbank MSBSP is required to deliver to a commercial end user be held at a third-party custodian. In response, the final rules do not

(c)(2)(iii)(A) of Rule 18a-3, as adopted. The exception for legacy accounts has been re-designated paragraph (c)(2)(iii)(B) of Rule 18a-3, as adopted, since the exception for SBSBs was deleted from the final rule. Finally, the word "legacy" was moved to before the word "account" to align the phrase with the definition in paragraph (b)(6) of Rule 18a-3, as adopted.

<sup>578</sup> See paragraph (c)(2)(ii) of Rule 18a-3, as adopted.

<sup>579</sup> See paragraph (c)(4) of Rule 18a-3, as adopted (applying its provisions to nonbank SBSBs and MSBSPs).

<sup>580</sup> See paragraph (c)(2)(iii)(C) of Rule 18a-3, as adopted.

<sup>581</sup> See paragraph (c)(2)(iii)(D) of Rule 18a-3, as adopted.

<sup>582</sup> See CFA Institute Letter.

prevent a nonbank MSBSP from entering into an agreement with a commercial end user under which variation margin required to be delivered to the commercial end user is held at a third-party custodian.

For the foregoing reasons, the Commission is adopting the proposed account equity requirements for nonbank MSBSPs with the modifications discussed above.<sup>583</sup>

#### c. Risk Monitoring and Procedures

Under proposed Rule 18a–3, a nonbank SBSD was required to monitor the risk of the positions in the account of each counterparty to a non-cleared security-based swap and establish, maintain, and document procedures and guidelines for monitoring those risks.<sup>584</sup> The nonbank SBSD also was also 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. The Commission did not receive any comments on these proposed requirements and for the reasons discussed in the proposing release is adopting them as proposed.<sup>585</sup>

#### C. Segregation

##### 1. Background

The Commission is adopting security-based swap segregation requirements for SBSDs and stand-alone broker-dealers pursuant to Sections 3E and 15(c)(3) of the Exchange Act.<sup>586</sup> Section 3E(b) of the Exchange Act provides that, for cleared security-based swaps, the money, securities, and property of a security-based swap customer 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. However, Section 3E(c)(1) of the Exchange Act also provides that, for cleared security-based swaps, customers' money, securities, and property may, for convenience, be commingled and deposited in the same

one or more accounts with any bank, trust company, or clearing agency. Section 3E(c)(2) further provides that, notwithstanding Section 3E(b), in accordance with such terms and conditions as the Commission may prescribe by rule, regulation, or order, any money, securities, or property of the security-based swaps customer of a broker, dealer, or SBSD described in Section 3E(b) may be commingled and deposited as provided in Section 3E with any other money, securities, or 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 swaps customer of the broker, dealer, or SBSD.

Section 3E(f) of the Exchange Act establishes a program by which a counterparty to non-cleared security-based swaps with an SBSD or MSBSP can elect to have initial margin held at an independent third-party custodian (individual segregation). Section 3E(f)(4) provides that if the counterparty does not choose to require segregation of funds or other property (*i.e.*, waives segregation), the SBSD or MSBSP shall send a report to the counterparty on a quarterly basis stating that the firm's back office procedures relating to margin and collateral requirements are in compliance with the agreement of the counterparties. The statutory provisions of Sections 3E(b) and (f) are self-executing.

Finally, Section 15(c)(3)(A) of the Exchange Act provides, in pertinent part, that no broker-dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security (except a government security) or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers-dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances. The statute further provides, in pertinent part, that the rules and regulations shall require the maintenance of reserves with respect to customers' deposits or credit balances. The Commission adopted Rule 15c3–3

pursuant to this authority in Section 15(c)(3)(A) of the Exchange Act.<sup>587</sup>

The Commission is adopting omnibus segregation requirements pursuant to which money, securities, and property of a security-based swap customer relating to cleared and non-cleared security-based swaps must be segregated but can be commingled with money, securities, or property of other customers. The omnibus segregation requirements for stand-alone SBSDs (including firms registered as OTC derivatives dealers) and bank SBSDs are codified in Rules 18a–4 and 18a–4a.<sup>588</sup> The omnibus segregation requirements for stand-alone broker-dealers and broker-dealer SBSDs are codified in amendments to Rules 15c3–3 and 15c3–3b.<sup>589</sup>

The omnibus segregation requirements are mandatory with respect to money, securities, or other property relating to cleared security-based swaps that is held by a stand-alone broker-dealer or SBSD (*i.e.*, customers cannot waive segregation). With respect to non-cleared security-based swap transactions, the omnibus segregation requirements are an alternative to the statutory provisions discussed above pursuant to which a counterparty can elect to have initial margin individually segregated or to waive segregation. However, under the final omnibus segregation rules for stand-alone broker-dealers and broker-dealer SBSDs in Rule 15c3–3, counterparties that are not an affiliate of the firm cannot waive segregation. Affiliated counterparties of a stand-alone broker-dealer or broker-dealer SBSD can waive segregation. Under Section 3E(f) of the Exchange Act and Rule 18a–4, all counterparties (affiliated and non-affiliated) to a non-cleared security-based swap transaction with a stand-alone or bank SBSD can waive segregation. The omnibus segregation requirements are the “default” requirement if the counterparty does not elect individual segregation or to waive segregation (in the cases where a counterparty is permitted to waive segregation). As discussed below in section II.E.2. of this release, Rule 18a–4 also has exceptions pursuant to which a foreign stand-alone or bank SBSD or MSBSP need not comply with the

<sup>583</sup> See paragraphs (c)(2)(ii) and (iii) of Rule 18a–3, as adopted.

<sup>584</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70272–70273.

<sup>585</sup> See paragraph (e) of Rule 18a–3, as adopted.

<sup>586</sup> 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 market 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.

<sup>587</sup> See *Broker-Dealers; Maintenance of Certain Basic Reserves*, Exchange Act Release No. 9856 (Nov. 29, 1972), 37 FR 25224, 25226 (Nov. 29, 1972).

<sup>588</sup> See Rule 18a–4, as adopted; Rule 18a–4a, as adopted. See also undesignated introductory paragraph to Rule 18a–4, as adopted (stating that the rule applies to stand-alone SBSDs registered as OTC derivatives dealers).

<sup>589</sup> See paragraph (p) of Rule 15c3–3, as amended; Rule 15c3–3b, as adopted.

segregation requirements (including the omnibus segregation requirements) for certain transactions.

The omnibus segregation requirements do not apply to MSBSPs.<sup>590</sup> However, if an MSBSP requires initial margin from a counterparty with respect to non-cleared security-based swaps, the counterparty can request that the collateral be held at a third-party custodian pursuant to Section 3E(f) of the Exchange Act.<sup>591</sup>

As proposed, the segregation requirements for all types of SBSDs would have been codified in Rules 18a–4 and 18a–4a. However, a commenter requested that Rule 15c3–3 be amended so that initial margin delivered to a stand-alone broker-dealer by a counterparty to a cleared security-based swap and which the stand-alone broker-dealer in turn delivers to a clearing agency could be treated under the proposed omnibus segregation requirements.<sup>592</sup> In the 2018 comment reopening, the Commission asked whether omnibus segregation requirements parallel to those in proposed Rule 18a–4 should be codified in Rule 15c3–3, in which case they would apply to stand-alone broker-dealers and broker-dealer SBSDs.<sup>593</sup> One commenter argued that the Commission should apply the omnibus segregation requirements of Rule 15c3–3 to a broker-dealer SBSD, but recommended a single possession or control requirement for all positions, including those that are portfolio margined.<sup>594</sup> Another commenter supported the integration of security-based swap segregation requirements for stand-alone broker-dealers into Rule 15c3–3, including the express recognition in Rule 15c3–3 of margin posted by a stand-alone broker-dealer to a clearing agency.<sup>595</sup> Other commenters stated that the Commission should consider raising segregation requirements to achieve regulatory consistency, or harmonize rules with other regulators to avoid operational issues that could fragment the security-based swap market.<sup>596</sup>

The Commission believes it is appropriate to codify the omnibus segregation requirements for stand-alone broker-dealers and broker-dealer SBSDs in Rules 15c3–3 and 15c3–3b. Absent this modification, a stand-alone broker-dealer that engages in security-based swap activity would continue to be subject to the segregation requirements of Rules 15c3–3 and 15c3–3a as they existed prior to today's amendments. However, as discussed in more detail below, these pre-existing requirements are not tailored to security-based swaps in the way that the omnibus segregation requirements are tailored. Consequently, by codifying the omnibus segregation requirements in Rules 15c3–3 and 15c3–3b, stand-alone broker-dealers also will be subject to the tailored requirements and will meet their pre-existing segregation obligations through them. Furthermore, Section 3E(b) of the Exchange Act imposes self-executing segregation requirements on stand-alone broker-dealers (as well as SBSDs) that would place strict restrictions on, and not permit the commingling of, collateral for a cleared security-based swap unless the Commission, pursuant to Section 3E(c), permits it by rule, regulation, or order. The omnibus segregation requirements being adopted in Rules 15c3–3 and 15c3–3b will permit stand-alone broker-dealers to commingle this collateral and take other actions with respect to it that otherwise would have been prohibited. Thus, the Commission believes that stand-alone broker-dealers will benefit by being subject to more tailored and flexible segregation requirements.

As discussed above, non-affiliated customers of a stand-alone broker-dealer or broker-dealer SBSD will not be permitted to waive segregation. Section 15(c)(3) of the Exchange Act does not have a provision that is analogous to Section 3E(f)(4), which provides that if the counterparty does not choose to require segregation of funds or other property with respect to non-cleared swaps, the SBSD or MSBSP shall send a report to the counterparty on a quarterly basis stating that the firm's back office procedures relating to margin and collateral requirements are in compliance with the agreement of the counterparties. Under Section 15(c)(3) of the Exchange Act and Rule 15c3–3 thereunder, persons—other than affiliates—are not permitted to waive segregation. This reflects the important protection that segregation provides to customers. It also serves to promote the safety and soundness of stand-alone broker-dealers. Segregating securities and cash of customers makes these

assets readily available to be returned to the customers and therefore makes it more likely that a stand-alone broker-dealer (and a broker-dealer SBSD) can meet its obligations to the customers. Thus, segregation protects customers and supports the liquidity of stand-alone broker-dealers (and will have the same effect on broker-dealer SBSDs). Moreover, segregation reduces the risk that customers will “run” on a stand-alone broker-dealer when it is experiencing financial difficulty or the securities markets are in turmoil (and will have the same effect on broker-dealer SBSDs). Customers whose assets are being segregated know that the assets are being protected. Conversely, persons whose assets are not being segregated may act precipitously to withdraw them from a firm if they perceive that the firm is experiencing financial difficulty or the markets are in turmoil. This could put severe liquidity pressure on the firm, particularly since the assets these persons are seeking to withdraw may not be readily available to the firm (e.g., they may be re-hypothecated or serving as collateral for loans to the broker-dealer). Affiliates are less likely to create this “run” risk as they will have more information about the financial condition of the firm and their shared parent holding company.

In addition, as discussed below, a number of commenters have raised questions about how claims would be handled in the liquidation of a broker-dealer SBSD. In addition, one commenter argued that stand-alone broker-dealers and broker-dealer SBSDs should be subject to a single set of omnibus segregation requirements for security-based swaps and related cash and all other types of securities and related cash.<sup>597</sup> This commenter argued that separating security-based swap positions from all other security positions for purposes of the possession or control and reserve account requirements of the omnibus segregation rule could foster legal uncertainty in a SIPA liquidation. As discussed below in sections II.C.3.a. and II.C.3.b. of this release, the Commission does not believe at this time that security-based swaps should be combined with other types of securities positions for the purposes of the possession or control and reserve account calculations.<sup>598</sup>

<sup>597</sup> SIFMA 11/19/2018 Letter.

<sup>598</sup> Combining security-based swap transactions, particularly non-cleared security-based swap transactions, with other securities positions for purposes of the reserve account calculation would mean that credit items owed to retail customers could be used to fund debits relating to non-cleared security-based swap transactions. The Commission

<sup>590</sup> A broker-dealer dually registered as an MSBSP will be subject to the omnibus segregation requirements in Rule 15c3–3 by virtue of being a broker-dealer.

<sup>591</sup> See 15 U.S.C. 78c–5(f).

<sup>592</sup> See Letter from Kathleen M. Cronin, Senior Managing Director, General Counsel, CME Group Inc. (Feb. 22, 2013) (“CME Letter”).

<sup>593</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53016.

<sup>594</sup> See SIFMA 11/19/2018 Letter.

<sup>595</sup> See FIA 11/19/2018 Letter.

<sup>596</sup> See Better Markets 11/19/2018 Letter; ISDA 11/19/2018 Letter.

However, the Commission does share the commenter's concern about taking steps to avoid legal uncertainty. In this regard, customers could be harmed in cases where a stand-alone broker-dealer or broker-dealer SBSB that holds cash and securities for persons who waived segregation with respect to their non-cleared security-based transactions, but did not (because they could not) waive segregation with respect to cash and securities that are not related to non-cleared security-based swap transactions. More specifically, there could be questions about the status of a particular person's claim in a liquidation proceeding and potentially result in the amount of cash and securities that were segregated by the stand-alone broker-dealer or broker-dealer SBSB being insufficient to satisfy the claims of all persons who a court ultimately determines are customers under SIPA and are entitled to a *pro rata* share of customer property.

For these reasons, the omnibus segregation requirements are being codified in Rule 15c3-3 to apply to stand-alone broker-dealers and broker-dealer SBSBs with a limitation that non-affiliates cannot waive segregation with respect to non-cleared security-based swap transactions (in addition to not being able to waive segregation with respect to all other securities transactions). In order to implement this limitation, the Commission is modifying the subordination provisions in the final rule to provide that only an affiliate of the stand-alone broker-dealer or broker-dealer SBSB can waive segregation with respect to non-cleared security-based swap transactions. In particular, the Commission is modifying the definition of "security-based swap customer" to provide that, with respect to persons who subordinate their claims, the term excludes an affiliate of the stand-alone broker-dealer or broker-dealer SBSB.<sup>599</sup> Thus, a person who is not an affiliate will be a "security-based swap customer" (regardless of whether the person attempts to subordinate) and therefore cash and securities of the customer related to non-cleared security-based swaps will be subject to the omnibus segregation requirements. The Commission is making a conforming amendment to the requirement that the stand-alone broker-dealer or broker-dealer SBSB obtain a subordination agreement from a person who waives segregation with respect to non-cleared security-based swaps to

provide that the provision applies to *affiliates* that waive segregation because persons who are not affiliates cannot waive segregation.<sup>600</sup>

Commenters sought clarification on how customer collateral held by an SBSB as initial margin to secure a security-based swap would be treated in the event of the SBSB's insolvency.<sup>601</sup> A commenter requested clarification on how counterparties to an entity that is both an SBSB and CFTC-regulated swap dealer would be treated in the event of the insolvency of the firm.<sup>602</sup> The same commenter stated that it is unclear how claims of a security-based swap customer of a broker-dealer SBSB would be treated relative to the claims of other types of customers of the firm, including whether security-based swaps would be subject to SIPA protections.

In response to commenters' requests for clarification, Section 3E(g) of the Exchange Act applies the customer protection elements of the stockbroker liquidation provisions to cleared security-based swaps and related collateral, and to collateral delivered as margin for non-cleared security-based swaps if collateral is subject to a customer protection requirement under Section 15(c)(3) of the Exchange Act or a segregation requirement. The Dodd-Frank Act also amended the U.S. Bankruptcy Code, and the CFTC has promulgated rules to implement that amendment, to provide the protections of Subchapter IV of Chapter 7 of the Bankruptcy Code and CFTC Regulation Part 190 to collateral associated with cleared swaps.<sup>603</sup> Finally, SIPA protects customers of SIPC-member broker-dealers. SIPA defines a "customer" as any person (including any person with whom the broker-dealer deals as principal or agent) who has a claim on account of securities received, acquired, or held by the broker-dealer in the ordinary course of its business as a broker-dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral, security, or for purposes of effecting transfer.<sup>604</sup>

The omnibus segregation requirements will apply to stand-alone broker-dealers and broker-dealer SBSBs

pursuant to new paragraph (p) of Rule 15c3-3, as discussed above. They also will apply to stand-alone and bank SBSBs if they elect to clear security-based swap transactions for other persons or otherwise do not meet the conditions of the exemption discussed below in section II.C.2. of this release. In this regard, Section 3E of the Exchange Act authorizes the Commission to promulgate segregation rules for all types of SBSBs. In contrast, Section 15F of the Exchange Act authorizes the prudential regulators to promulgate capital and margin rules for bank SBSBs. Further, the requirements of the prudential regulators with respect to segregating initial margin apply to non-cleared security-based swaps (*i.e.*, they do not address cleared security-based swaps). As discussed above, with respect to cleared security-based swaps, Section 3E(b) of the Exchange Act imposes self-executing segregation requirements on stand-alone broker-dealers and SBSBs that place strict restrictions on, and do not permit the commingling of, collateral for a cleared security-based swap unless the Commission, pursuant to Section 3E(c), permits it by rule, regulation, or order. Therefore, the Commission believes the statute itself imposes strict segregation requirements on bank SBSBs with respect to cleared security-based swaps in the absence of Commission rulemaking. The Commission's omnibus segregation requirements implement Section 3E(c) in a manner that is designed to protect security-based swap customers, but in a tailored way that will permit stand-alone broker-dealers and SBSBs to commingle collateral with respect to cleared security-based swaps and take other actions with respect to the collateral that otherwise would have been prohibited. Consequently, bank SBSBs (along with nonbank SBSBs and stand-alone broker-dealers) will benefit from the flexibility offered by the omnibus segregation requirements to the extent they elect to clear security-based swap transactions for other persons. However, as noted above and discussed below in section II.C.2. of this release, stand-alone and bank SBSBs will be exempt from the omnibus segregation requirements of Rule 18a-4 under certain conditions, including that they do not clear security-based swaps for other persons.<sup>605</sup> The Commission expects that bank SBSBs will operate under this exemption, because in order to clear swaps for other persons they would need to be registered as an FCM, which would subject them to CFTC capital requirements in addition to the

does not believe that retail customers should be subject to this risk.

<sup>599</sup> See paragraph (p)(1)(vi) of Rule 15c3-3, as amended.

<sup>600</sup> See paragraph (p)(4)(ii)(B) of Rule 15c3-3, as amended.

<sup>601</sup> See, e.g., Letter from Angie Karna, Managing Director, Legal, Nomura Global Financial Products, Inc. (Sept. 10, 2014) ("Nomura Letter"); SIFMA AMG 2/22/2013 Letter.

<sup>602</sup> See SIFMA AMG 2/22/2013 Letter.

<sup>603</sup> See *Protection of Cleared Swaps Customer Contracts and Collateral; Commodity Broker Bankruptcy Provisions*, 77 FR 6336 (Feb. 7, 2012).

<sup>604</sup> See 15 U.S.C. 7811l(2).

<sup>605</sup> See paragraph (f) of Rule 18a-4, as adopted.

capital requirements imposed by their prudential regulator.

Commenters recommended that the Commission adopt individual segregation requirements for cleared security-based swaps. A commenter stated that the European Commission has finalized regulations mandating that central counterparties allow customers to choose between omnibus segregation and individual segregation for their cleared derivatives assets and positions.<sup>606</sup> A second commenter stated that if the stand-alone broker-dealer or SBSB defaults, any cleared security-based swap customer collateral that is individually segregated would likely be outside the estate of the stand-alone broker-dealer or SBSB for bankruptcy purposes, thereby facilitating customers' retrieval of their collateral.<sup>607</sup> This commenter also indicated that cleared security-based swap customers registered with the Commission under the Investment Company Act of 1940 may be precluded from having their collateral held at an SBSB that is not a bank. A third commenter argued that collateral posted as margin should be segregated by client, rather than on an omnibus basis.<sup>608</sup> A number of these commenters advocated that the Commission modify its proposal for cleared security-based swaps to allow for the approach adopted by the CFTC, known as legal separation with operational comingling ("LSOC").<sup>609</sup> Under the CFTC's LSOC rules, the collateral of multiple cleared swap customers can be commingled in one account.<sup>610</sup>

Implementing an individual segregation regime for cleared security-based swaps, including an LSOC-like approach, would require implementing new rules governing the treatment of collateral held by clearing agencies. For example, under the CFTC's rules, the DCO and the FCM that is a member of the DCO must take certain steps to ensure that the collateral attributable to non-defaulting swap customers is not used to pay for obligations arising from other defaulting swap customers. Implementing such rules would be outside the scope of this rulemaking, which involves segregation

requirements for SBSBs (not clearing agencies).

A commenter requested clarification as to how property remaining in a portfolio margin account of a security-based swap customer should be treated when all the security-based swap positions in the account are temporarily closed out or expire before the customer enters into a new security-based swap transaction.<sup>611</sup> As noted above, this commenter also argued that the Commission should apply the omnibus segregation requirements of Rule 15c3-3 to a broker-dealer SBSB, but recommended a single possession or control requirement for all positions, including those that are portfolio margined.<sup>612</sup> As stated above, implementing portfolio margining will require further coordination with the CFTC. If the entity is a broker-dealer, the security-based swap customer could request that cash and securities in the security-based swap account be transferred to a traditional securities account, in which case it would be subject to the segregation requirements of Rules 15c3-3 and 15c3-3a that existed prior to today's amendments.<sup>613</sup> A commenter argued that swaps should be permitted to be held in a security-based swap account to facilitate portfolio margining for related or offsetting positions in the account.<sup>614</sup> As discussed above with respect to Rule 18a-3, the Commission has modified the rule to accommodate portfolio margining of security-based swaps and swaps.

A commenter stated that if MSBSPs are not required to comply with the proposed omnibus segregation requirements, many firms will apply to register as MSBSPs as a way to circumvent them.<sup>615</sup> The Commission does not agree. First, Section 3E(a) of the Exchange Act makes it unlawful for a person to accept any money, securities, or property (or to extend credit in lieu thereof) from, for, or on behalf of a security-based swap customer to margin, guarantee, or secure a cleared security-based swap unless the person is registered as a broker-dealer or an SBSB. This prohibition severely limits the activities a stand-alone MSBSP can engage in with respect to effecting transactions for cleared security-based swap customers (as compared to the activities permitted of broker-dealers and SBSBs). Second, the

omnibus segregation requirements as applied to non-cleared security-based swaps are designed to provide a third segregation option to security-based swap customers in addition to the statutory options of individual segregation or waiving segregation altogether. The Commission believes that SBSBs will favor having the ability to utilize this third option. Third, a firm with security-based swap activity exceeding the *de minimis* threshold must register as an SBSB.<sup>616</sup> A firm that does not want to comply with the omnibus segregation requirements by virtue of being an SBSB will need to restrict its activities to stay below the *de minimis* threshold. For these reasons, the Commission does not believe firms will seek to register as MSBSPs to avoid the omnibus segregation requirements.

Moreover, MSBSPs will be subject to the self-executing segregation provisions in Section 3E(f) of the Exchange Act for collateral relating to non-cleared security-based swap transactions, and, consequently, their customers can request individual segregation. Therefore, an MSBSP will be subject to a rigorous statutory segregation requirement. Finally, the omnibus segregation requirements may not be practical for stand-alone MSBSPs, given the potentially wide range of business models under which they may operate, and the uncertain impact that requirements designed for broker-dealers could have on these commercial entities.

For the reasons discussed above, the Commission is adopting the omnibus segregation requirements for SBSBs modeled on the segregation requirements for broker-dealers but, as discussed below, with an exemption for stand-alone and bank SBSBs if they meet the conditions in the final rule, including that they do not clear security-based swaps transactions for other persons.

## 2. Exemption

In the 2018 comment reopening, the Commission asked whether there are aspects of the proposed omnibus segregation requirements where greater clarity regarding the operation of the rule would be helpful.<sup>617</sup> One commenter supported the use of third-party custodians to avoid the omnibus

<sup>606</sup> See MFA 2/22/2013 Letter (citing Regulation (EU) No. 648/2012 of the European Parliament of the Council on OTC derivative transactions, central counterparties and trade repositories (July 4, 2012)).

<sup>607</sup> See ICI 2/4/2013 Letter.

<sup>608</sup> See CFA Institute Letter.

<sup>609</sup> See AIMA 2/22/2013 Letter; MFA 2/22/2013 Letter; SIFMA AMG 2/22/2013 Letter; Vanguard Letter.

<sup>610</sup> See *Protection of Cleared Swaps Customer Contracts and Collateral; Commodity Broker Bankruptcy Provisions*, 77 FR 6336.

<sup>611</sup> See SIFMA 2/22/2013 Letter.

<sup>612</sup> See SIFMA 11/19/2018 Letter.

<sup>613</sup> See paragraphs (a) and (o) of Rule 15c3-3; Rule 15c3-3a.

<sup>614</sup> See CFA Institute Letter.

<sup>615</sup> See CFA Institute Letter.

<sup>616</sup> See Section 3(a)(71) of the Exchange Act (defining the term "security-based swap dealer"); *Entity Definitions Adopting Release*, 77 FR 30596; *Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 80 FR 48964.

<sup>617</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53016.

segregation requirements.<sup>618</sup> Several commenters recommended that the Commission modify its final segregation requirements based on entity type and whether or not the entity offered counterparty clearing.<sup>619</sup> More specifically, one commenter recommended that no customer protection and segregation requirements should apply to a stand-alone broker-dealer if it does not clear security-based swap transactions.<sup>620</sup> Instead, the firm should be required to provide certain notices to customers: (1) Regarding their right to request that initial margin related to non-cleared security-based swaps be held at a third-party custodian; and (2) disclosing that the customer has no customer claim in the event of the SBSB's insolvency.<sup>621</sup> Another commenter recommended that the Commission not impose the omnibus segregation requirements on bank SBSBs, foreign SBSBs, and stand-alone SBSBs.<sup>622</sup> This commenter argued that the proposed omnibus segregation requirements could conflict with bank liquidation or resolution schemes, could cause jurisdictional disputes, and would not be consistent with the Exchange Act. In addition, this commenter argued that the omnibus segregation requirements would impair hedging and funding activities for stand-alone SBSBs. Another commenter was concerned about the application of omnibus segregation requirements to foreign SBSBs that are not registered broker-dealers.<sup>623</sup> With respect to non-cleared security-based swaps, this commenter suggested that the proposed omnibus segregation requirements not apply at all.

These comments echoed comments the Commission previously received opposing the application of the omnibus segregation requirements to a bank. Commenters argued that imposing the omnibus segregation requirements on banks was unnecessary because rules of the prudential regulators require initial margin for non-cleared security-based swaps to be segregated at a third-party

custodian.<sup>624</sup> One of these commenters recommended that the Commission adopt an approach similar to that of the Department of Treasury, which exempts government securities dealers from customer protection requirements if the entity is a bank that meets certain conditions.<sup>625</sup>

The Commission is persuaded that it would be appropriate to exempt from the omnibus segregation requirements stand-alone and bank SBSBs that do not clear security-based swaps for other persons. As discussed above, the omnibus segregation requirements implement the provisions of Section 3E of the Exchange Act that require Commission rulemaking to permit SBSBs to commingle their customers' cleared security-based swaps. If the stand-alone or bank SBSB does not clear security-based swaps for other persons then there is no need for the omnibus segregation requirements with respect to those positions. Moreover, as discussed above, with respect to non-cleared security-based swaps, the omnibus segregation requirements provide an alternative to the statutory options available to counterparties to request individual segregation or to waive segregation. Thus, counterparties will have the option of protecting their initial margin for non-cleared security-based swaps by exercising their statutory right to individual segregation.

This modification from the proposed rule is designed to mitigate commenters' concerns that the proposed omnibus segregation requirements may conflict with bank liquidation or resolution schemes. In addition, as discussed above, Section 3E(g) of the Exchange Act applies the customer protection elements of the stockbroker liquidation provisions to cleared security-based swaps and related collateral, and to collateral delivered as initial margin for non-cleared security-based swaps if the collateral is subject to a customer protection requirement under Section 15(c)(3) of the Exchange Act or a segregation requirement. Consequently, a stand-alone SBSB that does not have cleared security-based swap customers and is not subject to a segregation requirement with respect to collateral for non-cleared security-based swaps will not implicate the stockbroker liquidation provisions.

For the foregoing reasons, the final rule exempts stand-alone and bank SBSBs from the requirements of Rule 18a-4 if the SBSB meets certain conditions, including that the SBSB

does not clear security-based swap transactions for other persons, provides notice to the counterparty regarding the right to segregate initial margin at an independent third-party custodian, and discloses in writing that any collateral received by the SBSB for non-cleared security-based swaps will not be subject to a segregation requirement and regarding how a claim of the counterparty for the collateral would be treated in a bankruptcy or other formal liquidation proceeding of the SBSB.<sup>626</sup>

Under the first condition, the stand-alone or bank SBSB must not: (1) Effect transactions in cleared security-based swaps for or on behalf of another person; (2) have any open transactions in cleared security-based swaps executed for or on behalf of another person; and (3) hold or control any money, securities, or other property to margin, guarantee, or secure a cleared security-based swap transaction executed for or on behalf of another person (including money, securities, or other property accruing to another person as a result of a cleared security-based swap transaction).<sup>627</sup> For the reasons discussed above, this condition will ensure that the exemption is only available to stand-alone SBSBs or bank SBSBs that do not clear security-swaps for other persons.

Under the second condition, the stand-alone or bank SBSB must provide the notice required pursuant to Section 3E(f)(1)(A) of the Exchange Act in writing to a duly authorized individual prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the compliance date of the rule.<sup>628</sup> Section 3E(f)(1)(A) of the Exchange Act provides that an SBSB 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.<sup>629</sup> This condition will require a stand-alone or bank SBSB 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 compliance date.<sup>630</sup> Consequently, the stand-alone or bank SBSB must give the notice in writing before the counterparty is required to

<sup>618</sup> See American Council of Life Insurers 11/19/2018 Letter.

<sup>619</sup> See Morgan Stanley 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>620</sup> See Morgan Stanley 11/19/2018 Letter.

<sup>621</sup> This commenter also recommended that if the Commission wants to ensure that non-cleared security-based swap counterparties can have their collateral protected at a Commission registrant, a more appropriate way to do so would be to permit a stand-alone SBSB to provide non-cleared security-based swap clients with the option of placing initial margin at a full-purpose broker-dealer affiliate. See Morgan Stanley 11/19/2018 Letter.

<sup>622</sup> See SIFMA 11/19/2018 Letter.

<sup>623</sup> See IIB 11/19/2018 Letter.

<sup>624</sup> See Financial Services Roundtable Letter; SIFMA AMG 2/22/2013 Letter.

<sup>625</sup> See SIFMA 2/22/2013 Letter.

<sup>626</sup> See paragraph (f) of Rule 18a-4, as adopted.

<sup>627</sup> See paragraph (f)(1) of Rule 18a-4, as adopted.

<sup>628</sup> See paragraph (f)(2) of Rule 18a-4, as adopted.

<sup>629</sup> See 15 U.S.C. 78c-5(f)(1)(A).

<sup>630</sup> Compare paragraph (d)(1) of Rule 18a-4, as adopted.

deliver margin to the SBSB. This will give the counterparty an opportunity to determine whether to elect individual segregation or to waive segregation.

Under the third condition, the stand-alone or bank SBSB must disclose in writing to a counterparty before engaging in the first non-cleared security-based swap transaction with the counterparty that any margin collateral received and held by the SBSB will not be subject to a segregation requirement and how a claim of the counterparty for the collateral would be treated in a bankruptcy or other formal liquidation proceeding of the SBSB.<sup>631</sup> This condition is designed to provide the counterparty with additional information to determine whether to elect individual segregation or to waive segregation by describing the potential consequences of waiving segregation.

### 3. Segregation Requirements for Security-Based Swaps

#### a. Possession or Control of Excess Securities Collateral

##### i. Requirement To Obtain Possession or Control

Paragraph (b)(1) of Rule 15c3-3, as it existed before today's amendments, requires a stand-alone broker-dealer that carries customer securities and cash ("carrying broker-dealer") to promptly obtain and thereafter maintain physical possession or control of all customer fully paid and excess margin securities. Fully paid and excess margin securities, as defined in paragraphs (a)(3) and (a)(5) of the rule, respectively, generally are securities the carrying broker-dealer is carrying for customers that are not being used as collateral arising from margin loans to the customer or to facilitate a customer's short sale of a security. Physical possession or control as used in paragraph (b)(1) of Rule 15c3-3 under these pre-existing requirements means the carrying broker-dealer cannot lend or hypothecate securities and must hold them itself or, as is more common, at a satisfactory control location.

As part of the omnibus segregation requirements, the Commission proposed that SBSBs be required to promptly obtain and thereafter maintain physical possession or control of all excess securities collateral carried for the accounts of security-based swap customers.<sup>632</sup> The Commission modeled these proposed requirements for SBSBs on the pre-existing requirements in paragraph (b)(1) of Rule 15c3-3 and

intended that physical possession or control have the same meaning in terms of prohibiting the SBSB from lending or hypothecating the excess securities collateral and requiring the SBSB to hold the collateral itself or in a satisfactory control location.

The term "security-based swap customer" was defined to mean any person from whom or on whose behalf the SBSB 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 proposed definition excluded 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 SBSB or is subordinated to all claims of security-based swap customers of the SBSB. The term "excess securities collateral" was defined to mean securities and money market instruments ("securities collateral") carried for the account of a security-based swap customer that have a market value in excess of the current exposure of the SBSB to the customer. Thus, securities collateral held by the SBSB that was not being used to meet a variation margin requirement of the customer needed to be protected by maintaining physical possession or control of it. This would be the case with respect to securities collateral held by the SBSB to meet the customer's initial margin requirement or that had a value in excess of the initial margin requirement.

The definition of excess securities collateral had two exclusions that permitted an SBSB to use, under certain narrowly prescribed circumstances, securities collateral of a security-based swap customer not being held to meet a variation margin requirement of the customer. Under the first exclusion, the SBSB could use the securities collateral to meet a margin requirement of a clearing agency resulting from a security-based swap transaction of the customer. This exclusion was designed to accommodate the margin requirements of clearing agencies, which will require SBSBs to deliver collateral to cover exposures arising from cleared security-based swaps of the SBSB's security-based swap customers. The exclusion required that the securities collateral be held in a qualified clearing agency account. The term "qualified clearing agency account" was defined to mean an account of the SBSB at a clearing agency that met certain conditions designed to ensure that the securities collateral was isolated from the proprietary assets of

the SBSB and identified as property of the firm's security-based swap customers. Excluding the securities collateral from the definition of excess securities collateral meant it was not subject to the physical possession or control requirement. This allowed the clearing agency to hold the securities collateral against obligations of the SBSB's customers without the SBSB violating the physical possession or control requirement.<sup>633</sup>

Under the second exclusion from the definition of "excess securities collateral," the SBSB could use securities collateral to meet a margin requirement of a second SBSB resulting from the first SBSB entering into a non-cleared security-based swap transaction with the second SBSB. However, the transaction with the second SBSB needed to be for the purpose of offsetting the risk of the non-cleared security-based swap transaction between the first SBSB and the security-based swap customer. This exclusion was 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.

The exclusion required that the securities collateral be held in a qualified registered security-based swap dealer account. The term "qualified registered security-based swap dealer account" was defined to mean an account at a second unaffiliated SBSB that met certain conditions designed to ensure that the securities collateral provided to the second SBSB was isolated from the proprietary assets of the first SBSB and identified as property of the firm's 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 was designed to ensure that if the second SBSB fails, the first SBSB would be treated as a security-based swap customer in a liquidation proceeding and, therefore, accorded applicable protections under the bankruptcy laws. Thus, because the account was at a second SBSB, the second SBSB needed to treat the first SBSB as a customer and the first SBSB's account was subject to the proposed omnibus segregation requirements. Excluding the securities collateral from

<sup>633</sup> As discussed below, under the proposed omnibus segregation requirements, the values of these security-based swap customer securities and money market instruments held by the clearing agency needed to be included in the reserve formula calculations.

<sup>631</sup> See paragraph (f)(3) of Rule 18a-4, as adopted.

<sup>632</sup> See *Capital, Margin, and Segregation* Proposing Release, 77 FR at 70278-82.



the definition of “excess securities collateral” meant that the first SBSB did not have to hold them in accordance with the physical possession or control requirement. This allowed the first SBSB to finance customer transactions in non-cleared security-based swaps by using the customer’s securities collateral to secure an offsetting transaction with a second SBSB.

#### Comments and Final Physical Possession or Control Requirements

A commenter stated that the proposed use of market value rather than haircut value for the securities collateral posted in connection with non-cleared security-based swaps would require that an SBSB use its own resources to fund margin requirements.<sup>634</sup> The Commission did not intend this result and is modifying the definition of “excess securities collateral” so that stand-alone broker-dealers or SBSBs may use securities collateral for non-cleared security-based swaps in an amount that equals the regulatory margin requirement of the SBSB with whom they are entering into a hedging transaction taking into account haircuts required by that regulatory requirement.<sup>635</sup> For purposes of this modification, the Commission clarifies that “regulatory margin requirement” means the amount of initial margin the SBSB-hedging counterparty is required to collect from the stand-alone broker-dealer or SBSB and not any greater “house” margin amount the SBSB-hedging counterparty may require as a supplement to the regulatory requirement. If the SBSB-hedging counterparty imposes a supplemental “house” margin requirement, the stand-alone broker-dealer or SBSB cannot use the customer’s securities collateral to meet the additional requirement. Securities collateral used in this manner will not be excluded from the definition of “excess securities collateral” and therefore must be in the physical possession or control of the stand-alone broker-dealer or SBSB. Thus, the stand-alone broker-dealer or SBSB would need to fund the supplemental “house” margin requirement of the SBSB-hedging counterparty using proprietary cash or securities.

In the 2018 comment reopening, the Commission asked whether it should modify the definition of “excess securities collateral” to account for the fact that the prudential regulators require initial margin to be held at a

third-party custodian.<sup>636</sup> As discussed above, the proposed second exclusion from the definition of “excess securities collateral” required that the securities collateral be held in a qualified registered security-based swap dealer account (*i.e.*, an account at a second SBSB). Thus, the proposed definition of “qualified registered security-based swap dealer account” did not contemplate holding the securities collateral at a third-party custodian. Absent modification, the proposed rule would have created the unintended consequence of preventing an SBSB from posting a customer’s securities collateral to a third-party custodian in accordance with the requirements of the prudential regulators. Thus, the SBSB would have been required to use proprietary securities or cash to enter into a hedging transaction with a bank SBSB.

Consequently, in the 2018 comment reopening, the Commission asked whether the definition of “excess securities collateral” should exclude securities collateral held in a third-party custodial account, subject to the same limitations and conditions as apply to securities collateral re-hypothecated directly to a second SBSB. The Commission asked whether the term “third-party custodial account” should be defined to mean an account carried by an independent third-party custodian that meets the following conditions:

- It is established for the purposes of meeting regulatory margin requirements of another SBSB;
- The account is carried by a bank under Section 3(a)(6) of the Exchange Act;
- The account is designated for and on behalf of the SBSB for the benefit of its security-based swap customers and the account is subject to a written acknowledgement by the bank provided to and retained by the SBSB 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 SBSB and are being kept separate from any other accounts maintained by the SBSB with the bank; and
- The account is subject to a written contract between the SBSB 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 SBSB 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.

The conditions in the definition of “third-party custodial account” in the 2018 comment reopening were designed to ensure that securities collateral posted to the custodian is isolated from the proprietary assets of the SBSB and identified as property of its security-based swap customers.<sup>637</sup> The objective was to facilitate the prompt return of the securities collateral to the customers if the SBSB fails.

As discussed above, commenters suggested that the Commission recognize a broader range of custodians for purposes of the provisions in the final capital rules that permit stand-alone broker-dealers and nonbank SBSBs to avoid taking a capital charge when initial margin is held at a third-party custodian.<sup>638</sup> These same commenters similarly suggested that the definition of “third-party custodial account” for purposes of the segregation rules include a broader range of custodians. One of these commenters suggested that the definition of “third-party custodial account” for purposes of the segregation rules be modified to include domestic clearing agencies and depositories.<sup>639</sup> The second commenter suggested that the definition include foreign banks.<sup>640</sup>

For the reasons discussed above, the final segregation rules being adopted today modify the proposed definition of “excess securities collateral” to exclude securities collateral held in a “third-party custodial account” as that term is defined in the rules.<sup>641</sup> The final segregation rules also incorporate the definition of “third-party custodial account” that was included in the 2018 comment reopening but with the modifications suggested by the commenters to broaden the definition to include domestic clearing organizations and depositories and foreign supervised banks, clearing organizations, and depositories.<sup>642</sup> As a result of these modifications, the definition of “third-party custodial account” in the final segregation rules means, among other

<sup>637</sup> *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53016–17.

<sup>638</sup> See IIB 11/19/2018 Letter; SIFMA 11/19/2018 Letter. The provisions in the final capital rules that permit broker-dealers and nonbank SBSBs to avoid taking a capital charge when initial margin is held at a third-party custodian are discussed above in section II.A.2. of this release.

<sup>639</sup> See SIFMA 11/19/2018 Letter.

<sup>640</sup> See IIB 11/19/2018 Letter.

<sup>641</sup> See paragraph (p)(1)(ii)(B) of Rule 15c3–3, as amended; paragraph (a)(2)(ii) of Rule 18a–4, as adopted.

<sup>642</sup> See paragraph (p)(1)(viii) of Rule 15c3–3, as amended; paragraph (a)(10) of Rule 18a–4, as adopted.

<sup>634</sup> See SIFMA 2/22/2013 Letter.

<sup>635</sup> See paragraph (p)(1)(ii)(B) of Rule 15c3–3, as amended; paragraph (a)(2)(ii) of Rule 18a–4, as adopted.

<sup>636</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53016–17.

conditions, an account carried by a bank as defined in Section 3(a)(6) of the Exchange Act or a registered U.S. clearing organization or depository or, if the collateral to be held in the account consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that customarily maintains custody of such foreign securities or currencies. Thus, the definition includes the same types of custodians as are permitted by the final capital rules for purposes of the exception from taking the capital charge when initial margin is held at a third-party custodian<sup>643</sup> and computing credit risk charges.<sup>644</sup> These same types of custodians also are permitted by Rule 18a-3 for the purposes of calculating the account equity requirements.<sup>645</sup>

In addition to these modifications, the Commission believes it is appropriate to modify the proposed definition of “qualified registered security-based swap dealer account” to remove the limitation that the account be held at an unaffiliated SBSB. This limitation would have had the unintended consequence of impeding a financial institution from centralizing its risk management of security-based swaps in a central booking entity through affiliate transactions or of transferring risk from one affiliate to another to manage the risk of the position in the jurisdiction where the underlying security is traded, for example. Therefore, the Commission is not adopting the affiliate limitation in the final rule.<sup>646</sup>

For the foregoing reasons, the Commission is adopting the proposed physical possession or control requirements with the modifications discussed above and certain other non-substantive modifications.<sup>647</sup>

<sup>643</sup> See paragraph (c)(2)(xv)(C)(1) of Rule 15c3-1, as amended; paragraph (c)(1)(ix)(C)(1) of Rule 18a-1, as adopted. The exception is discussed above in section II.A.2.b.ii. of this release.

<sup>644</sup> See paragraph (c)(4)(v)(B) of Rule 15c3-1e, as amended; paragraph (e)(2)(iii)(E)(2) of Rule 18a-1, as adopted. The computation is discussed in section II.A.2.b.v. of this release.

<sup>645</sup> See paragraph (c)(4)(ii)(A) and (B) of Rule 18a-3, as adopted. This provision is discussed in section II.B.2.b.i. of this release.

<sup>646</sup> See paragraph (p)(1)(iv) of Rule 15c3-3, as amended; paragraph (a)(6) of Rule 18a-4, as adopted.

<sup>647</sup> See paragraph (p)(2)(i) of Rule 15c3-3, as amended; paragraph (b)(1) of Rule 18a-4, as adopted. Conforming changes are made to reflect the phrase “special account for the exclusive benefit of security-based swap dealer customers” in the definition of qualified registered security-based swap dealer account is changed to “special reserve account for the exclusive benefit of security-based swap customers.” See paragraphs (c)(2)(iv)(E)(1), (p)(1)(iv), (p)(1)(vii), (p)(1)(vii)(A), (p)(3), (p)(3)(i), (p)(3)(i)(B), (p)(3)(i)(C), (p)(3)(iii), and (p)(3)(iv) of Rule 15c3-3, as amended, paragraph (c)(1)(iii)(D) of Rule 18a-1, as adopted, and paragraphs (c), (c)(1), (c)(1)(ii), (c)(1)(iii), (c)(3), (c)(4), and (e)(1)(i) of Rule

18a-4, as adopted. In addition, the definition of qualified clearing agency account in the two rules is modified to align them more closely with the language used in Section 3E(b) of the Exchange Act, which addresses the segregation of cleared security-based swaps. The revised language replaces the phrase “established to hold funds and other property in order to purchase, margin, guarantee, secure, adjust, or settle clear security based swaps” with the phrase “that holds funds and other property in order to margin, guarantee, or secure cleared security-based swap transactions.”

A commenter urged the Commission to conform its proposal to the recommendations in the BCBS/IOSCO Paper with respect to re-hypothecation of collateral for non-cleared security-based swaps, by limiting re-hypothecation of securities collateral to circumstances that facilitate hedging of derivatives transactions entered into with customers.<sup>648</sup> The Commission agrees that securities collateral with respect to non-cleared security-based swaps should be re-hypothecated only in order to hedge a transaction with a security-based swap customer. Consequently, as discussed above, the final rules permit re-hypothecation only for this purpose.

A commenter questioned whether it was necessary for the Commission to promulgate a possession or control requirement for security-based swap customers that is separate from and in addition to the requirement for traditional securities customers under Rules 15c3-3 given the common insolvency treatment of securities and security-based swap customers.<sup>649</sup> The commenter argued that requiring separate calculations could increase operational risk. In response, the possession or control requirement is tailored to security-based swaps activity. For example, the definition of excess securities collateral, which is tied to the security-based swap possession or control requirement, is different than the definitions of “fully paid” and excess margin securities, which are tied to the existing possession or control requirement in Rule 15c3-3. The Commission believes it is appropriate to have separate requirements to help ensure that stand-alone and broker-dealer SBSBs appropriately account for excess securities collateral in the context of security-based swap activities and fully paid and excess margin securities in the context of traditional securities activities.

Commenters asked the Commission to permit re-hypothecation of securities collateral for non-cleared security-based swap transactions to entities other than

other SBSBs.<sup>650</sup> One of these commenters noted that SBSBs may use products such as cleared and non-cleared swaps, cleared security-based swaps, and futures to hedge security-based swap transactions.<sup>651</sup> Conversely, another commenter opposed the re-hypothecation of initial margin.<sup>652</sup>

In response, the exemption from Rule 18a-4 being adopted today will permit SBSBs that operate under the exemption to re-hypothecate initial margin collateral received from counterparties for non-cleared security-based swaps unless the counterparty elects to have the initial margin held at a third-party custodian. The Commission anticipates that most stand-alone and bank SBSBs will operate under this exemption because, for example, to clear swaps for others the firms would need to register with the CFTC as an FCM and be subject to the specific rules governing FCMs.

If a stand-alone or bank SBSB does not operate under the exemption because it clears security-based swaps for others, the Commission believes the strict limits on re-hypothecation should apply. This type of firm will receive and hold initial margin for both cleared and non-cleared security-based swaps. Securities and cash collateral held directly by the firm would be fungible and, therefore, the Commission believes it should be subject to the strict limitations of the omnibus segregation requirements in order to facilitate the prompt return of the collateral to cleared and non-cleared security-based swap customers of the SBSB.

The Commission designed the hedging exception for non-cleared security-based swap collateral to accommodate a limited scenario: The industry practice of dealers in OTC derivatives maintaining “matched books” of transactions.<sup>653</sup> The Commission does not believe it would be appropriate at this time to either broaden the exception to permit the securities collateral to be used in connection with other types of products, or to prohibit the re-hypothecation of initial margin. The second SBSB must treat the securities collateral it receives in the hedging transaction in accordance with the omnibus segregation requirements being adopted today for security-based swaps. This is designed to ensure that the securities collateral posted by the first SBSB to the second

<sup>650</sup> See ISDA 1/23/13 Letter; SIFMA 2/22/2013 Letter.

<sup>651</sup> See SIFMA 2/22/2013 Letter.

<sup>652</sup> See SIFMA AMG 11/19/2018 Letter.

<sup>653</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70279.

SBSD remains within the omnibus segregation program.

## ii. Good Control Locations

As discussed above, paragraph (b) of Rule 15c3-3, as it existed before today's amendments, requires a carrying broker-dealer to promptly obtain and thereafter maintain physical possession or control of a customer's fully paid and excess margin securities. The pre-existing provisions of paragraph (c) of the rule identify locations that are deemed to be under the control of the carrying broker-dealer. As part of the omnibus segregation requirements, the Commission proposed five locations where an SBSB could hold excess securities collateral and be deemed in control of it.<sup>654</sup> The Commission modeled these proposed requirements for SBSBs on the pre-existing requirements in paragraph (c) of Rule 15c3-3. The identification of these satisfactory control locations was designed to limit where the SBSB could hold excess securities collateral. The identified locations were places from which securities collateral can promptly be retrieved and returned to security-based swap customers. The Commission did not receive any comments addressing these specific provisions and for the reasons discussed in the proposing release is adopting them as substantially as proposed.<sup>655</sup>

## iii. Steps To Obtain Possession or Control

Paragraph (d) of Rule 15c3-3, as it existed before today's amendments, requires a carrying broker-dealer to determine each business day the quantity of fully paid and excess margin securities it has in its physical possession or control based on its books and records and the quantity of such securities it does not have in its possession or control. If a quantity of fully paid and excess margin securities is not in the carrying broker-dealer's physical possession or control, the firm must initiate steps to bring them within its physical possession or control.

As a component of the omnibus segregation requirements, the

Commission proposed to require that each business day an SBSB must determine from its books and records the quantity of excess securities collateral that the firm had in its physical possession or control as of the close of the previous business day and the quantity of excess securities collateral the firm did not have in its physical possession or control on that day.<sup>656</sup> The SBSB also needed to take steps to retrieve excess securities collateral from certain specifically identified non-control locations if securities collateral of the same issue and class are at the locations. The Commission modeled these proposed requirements for SBSBs on the pre-existing requirements in paragraph (d) of Rule 15c3-3. The Commission did not receive any comments addressing these specific provisions and for the reasons discussed in the proposing release is adopting them with the certain amendments.<sup>657</sup>

## b. Security-Based Swap Customer Reserve Account

Paragraph (e) of Rule 15c3-3, as it existed before today's amendments, requires a carrying broker-dealer to maintain a reserve of cash or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers, including cash obtained from the use of customer securities. The account must be titled "Special Reserve Bank Account for the Exclusive Benefit of Customers." The amount of net cash owed to customers is computed pursuant to a formula set forth in Rule 15c3-3a. Under this

formula, the carrying broker-dealer adds up customer credit items (e.g., cash in customer securities accounts and cash obtained through the use of customer margin securities) and then subtracts from that amount customer debit items (e.g., margin loans). If credit items exceed debit items, the net amount must be on deposit in the customer reserve account in the form of cash and/or qualified securities. The carrying 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. The carrying broker-dealer must make a deposit into the customer reserve account if the computation shows an increase in the reserve requirement.

As a component of the omnibus segregation requirements, the Commission proposed reserve account requirements for SBSBs that were modeled on the pre-existing requirements of paragraph (e) of Rule 15c3-3 and Rule 15c3-3a.<sup>658</sup> More specifically, proposed Rule 18a-4 required an SBSB to maintain a special account for the exclusive benefit of security-based swap customers separate from any other bank account of the SBSB. The term "special account for the exclusive benefit of security-based swap customers" ("SBS Customer Reserve Account") was defined to mean an account at a bank that is not the SBSB or an affiliate of the SBSB and that met certain conditions designed to ensure that cash and qualified securities deposited into the account were isolated from the proprietary assets of the SBSB and identified as property of the security-based swap customers.

The proposed rule provided that the SBSB must at all times maintain in an SBS Customer Reserve Account, through deposits into the account, cash and/or qualified securities in amounts computed daily in accordance with the formula set forth in proposed Rule 18a-4a. This formula required the SBSB to add up credit items and debit items. If, under the formula, the credit items exceeded the debit items, the SBSB would be required to maintain cash and/or qualified securities in that net amount in an SBS Customer Reserve Account. The credit and debit items identified in the proposed formula included the same credit and debit items in the Rule 15c3-3a formula. Further, the proposed formula identified two additional debit items: (1) Margin related to cleared security-based swap transactions in accounts carried for

<sup>656</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70281-82.

<sup>657</sup> For clarity, the phrase "security-based swap" is being inserted before "customer securities" in paragraph (b)(2)(v) of Rule 18a-4, as adopted. The text of paragraph (b)(3)(vii) of Rule 18a-4, as adopted, is modified to align it with existing broker-dealer possession or control requirements with respect to the allocation of a customers' fully paid and excess margin securities to short positions. See paragraph (d)(5) of Rule 15c3-3, as amended; *Financial Responsibility Rules for Broker-Dealers*, Exchange Act Release No. 70072 (July 30, 2013), 78 FR 51823, 51835-51836 (Aug. 21, 2013) (explaining non-substantive amendments to the final rule with respect to the allocation of customers' fully paid and excess margin securities to short positions). In addition to the modifications discussed above, the Commission is adopting the following non-substantive changes to paragraph (b)(3)(vii) of Rule 18a-4: (1) The phrase "security-based swap dealer's" is added before "books or records"; (2) the phrase "that allocate to a short position" is added before "of the security-based swap dealer"; (3) the phrase "as a proprietary short position or as" is replaced with "or"; (4) the phrase "more than 10 days business (or)" is replaced with "for"; and (5) the phrase "days if the security based swap dealer is a market maker in the securities" is removed. The text of the parallel paragraphs of Rule 15c3-3, as amended, reflects these modifications to the proposed text in Rule 18a-4.

<sup>654</sup> See 77 FR at 70280-82.

<sup>655</sup> See paragraph (p)(2)(ii) of Rule 15c3-3, as amended; paragraph (b)(2) of Rule 18a-4, as adopted. For clarity, the phrase "security-based swap" is inserted before the phrase "customer securities" in paragraph (b)(2)(v) of Rule 18a-4. The text of the parallel paragraph in Rule 15c3-3, as amended, reflects this modification. In the final rule, the phrase "security-based swap" was inserted before the word "accounts" in paragraph (b)(1) of the rule to clarify that the possession or control requirements apply only to security-based swap accounts. See also paragraph (p)(2)(i) of Rule 15c3-3, as amended.

<sup>658</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70282-86.

security-based swap customers required and on deposit in a qualified clearing agency account at a clearing agency; and (2) margin related to non-cleared security-based swap transactions in accounts carried for security-based swap customers held in a qualified registered SBSB account at another SBSB. These items were designed to accommodate the two exclusions from the definition of “excess securities collateral” discussed above pursuant to which an SBSB could deliver a customer’s collateral to a clearing agency to meet a margin requirement of the clearing agency or to a second SBSB to meet a regulatory margin requirement of the second SBSB. They also accommodated customer cash collateral delivered for this purpose. In either case, the debit items would offset related credit items in the formula.

As proposed, if the total credits exceeded the total debits, the SBSB needed to maintain that net amount on deposit in a SBS Customer Reserve Account in the form of funds and/or qualified securities. The term “qualified security” as defined in proposed Rule 18a–4 meant: (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 a 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. The proposed conditions for obligations of a State or subdivision of a State (“municipal securities”) were 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 were used for this purpose.

As discussed above, an SBSB was required to add up credit and debit items pursuant to the formula in proposed Rule 18a–4a. If, under the formula, the credit items exceeded the debit items, the SBSB was required to maintain cash and/or qualified securities in that net amount in the SBS Customer Reserve Account. Under the proposal, an SBSB was required to take certain deductions for purposes of this requirement. The amount of cash and/or qualified securities in the SBS Customer Reserve Account needed to equal or exceed the amount required pursuant to the formula in proposed Rule 18a–4a after applying the deductions.

First, under the proposal, if municipal securities were held in the account, the

SBSB was required to apply the standardized haircut specified in Rule 15c3–1 to the value of the municipal securities. Second, if municipal securities were held in the account, the SBSB needed to deduct the aggregate value of the municipal securities of a single issuer to the extent that value exceeded 2% of the amount required to be maintained in the SBS Customer Reserve Account. Third, if municipal securities were held in the account, the SBSB needed to deduct the aggregate value of all municipal securities to the extent that amount exceeded 10% of the amount required to be maintained in the SBS Customer Reserve Account. Fourth, the proposal required that the SBSB deduct the amount of funds held in an SBS Customer Reserve Account at a single bank to the extent that amount exceeded 10% of the equity capital of the bank as reported on its most recent Consolidated Report of Condition and Income (“Call Report”). This proposal was consistent with the proposed 2007 amendments to Rule 15c3–3 that were pending at the time.<sup>659</sup>

The proposed rule also provided that it would be unlawful for an SBSB to accept or use credits identified in the items of the formula in proposed Rule 18a–4a except to establish debits for the specified purposes in the items of the formula. This provision would prohibit the SBSB from using customer cash and cash realized from the use of customer securities for purposes other than those identified in the debit items in the proposed formula. Thus, the SBSB would be prohibited from using customer cash to, for example, pay expenses.

The proposed rule also provided that the computations necessary to determine the amount required to be maintained in the SBS 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. Further, the SBSB could make a withdrawal from the SBS Customer Reserve Account only if the amount remaining in the account after the withdrawal equaled or exceeded the amount required to be maintained in the account.

Finally, the proposed rule required an SBSB to promptly deposit funds or qualified securities into an SBS

Customer Reserve Account if the amount of funds and/or qualified securities held in one or more SBS Customer Reserve Accounts falls below the amount required to be maintained by the rule.

#### Comments and Final Reserve Account Requirements

A commenter argued that a separate calculation for the SBS Customer Reserve Account is not necessary given the common insolvency treatment of securities customers and security-based swap customers.<sup>660</sup> However, similar to the daily possession or control requirement calculation, the Commission believes it is appropriate as an initial matter to require separate reserve computations. First, broker-dealers historically have not engaged in significant amounts of security-based swap activities. Given the customer protection objectives of the reserve account requirements, the Commission believes the prudent approach is to require two reserve account calculations and accounts. Second, the SBS Customer Reserve Account requirements are tailored to security-based swap activities. For example, the SBS Customer Reserve Account formula has debit items relating to margin delivered to security-based swap clearing agencies and other SBSBs. The Commission believes it is appropriate to have separate requirements to help ensure that stand-alone and broker-dealer SBSBs appropriately account for debits and credits in the context of their security-based swap activities and in their traditional securities activities. Third, the definition of qualified securities for purposes of the SBS Customer Reserve Account requirement includes certain municipal securities; whereas the definition of qualified securities for purposes of the traditional securities reserve account requirement is limited to government securities.

A commenter objected to the application of the SBS Customer Reserve Account requirements to bank SBSBs due to the existing customer protection requirements applicable to banks.<sup>661</sup> The commenter argued that the SBS Customer Reserve Account calculation would be operationally intensive. In response, bank SBSBs are exempt from the final omnibus segregation requirements if they meet the conditions of the exemption, including not clearing security-based swap transactions for others.<sup>662</sup> If a bank

<sup>659</sup> See *Amendments to Financial Responsibility Rules for Broker-Dealers*, Exchange Act Release No. 55431 (Mar. 9, 2007), 72 FR 12862 (Mar. 19, 2007). See also *Financial Responsibility Rules for Broker-Dealers*, 78 FR at 51832–35.

<sup>660</sup> See SIFMA 2/22/2013 Letter.

<sup>661</sup> See SIFMA 2/22/2013 Letter.

<sup>662</sup> See paragraph (f) to Rule 18a–4, as adopted.

SBSD is appropriately operating pursuant to the exemption, it will not be required to perform the SBS Customer Reserve Account calculation. To the extent a bank SBSB does not take advantage of the exemption, the Commission believes that the computation a bank SBSB will be required to perform will be less operationally complex because generally it should only involve cleared security-based swaps. The prudential regulators' margin rules for non-cleared security-based swaps applicable to banks require that initial margin be held at a third-party custodian. Therefore, initial margin arising from non-cleared security-based swaps generally should not be a factor in the SBS Customer Reserve Account formula for these entities.

A commenter requested that the Commission require a weekly SBS Customer Reserve Account computation rather than a daily computation.<sup>663</sup> The commenter stated that calculating the reserve account formula is an onerous process that is operationally intensive and requires a significant commitment of resources. The commenter further stated that the Commission can achieve its objective of decreasing liquidity pressures on SBSBs while limiting operational burdens by requiring weekly computations and permitting daily computations. The Commission acknowledges that a daily reserve calculation will increase operational burdens as compared to a weekly computation. Therefore, in response to comments, the Commission is modifying the final rules to require a weekly SBS Customer Reserve Account computation.<sup>664</sup> The final rules further provide that stand-alone broker-dealers or SBSBs may perform daily computations if they choose to do so.<sup>665</sup> These modifications to the final rules align with the existing reserve account computation requirements in paragraph (e) of Rule 15c3-3.

Another commenter asked the Commission to prohibit an SBSB from using funds in the SBS Customer Reserve Account held for one customer to extend credit to another customer.<sup>666</sup> The SBS Customer Reserve Account deposit will equal or exceed the net monies owed to security-based swap customers as calculated using the formula in Rules 15c3-3b and 18a-4a,

as adopted. The logic behind the formula is that credits (monies owed to customers) are offset by debits (monies owed by customers) and, if there is a net amount of credits in excess of debits, that amount is reserved in the form of cash or qualified securities. Consequently, implementing the commenter's suggestion would not be consistent with the omnibus segregation requirements, which are designed to permit the commingling of customer assets in a safe manner.

A commenter requested that the Commission modify the definition of "qualified security" in Rule 18a-4 to include U.S. government money market funds.<sup>667</sup> In the proposal, the Commission sought to align the definition of qualified security in Rule 18a-4 with the existing definition of qualified security in Rule 15c3-3 with one exception: Namely, the Commission proposed that the Rule 18a-4 definition include certain municipal securities because Section 3E(d) of the Exchange Act provides that municipal securities are a "permitted investment" for purposes of the segregation requirements for cleared security-based swaps. There is no corresponding statutory requirement to permit municipal securities to be a "permitted investment" for purposes of the segregation requirements and implementing regulations under Section 15(c)(3) of the Exchange Act applicable to stand-alone broker-dealers. While Section 3E(d) of the Exchange Act authorizes the Commission to expand the list of permitted investments for purposes of the omnibus segregation requirements for security-based swaps, the Commission believes the definitions in the two rules should be consistent and the types of securities permitted to be deposited into the customer reserve accounts required by each rule limited to the safest and most liquid securities.

In addition, the commenter stated that limiting instruments to be utilized by SBSBs under financial responsibility requirements will create pressure on regulated entities in search of those limited instruments to buy and sell on a continuous basis in their reserve accounts.<sup>668</sup> The Commission disagrees. As discussed above, the final rule contains an exemption for stand-alone SBSBs from the omnibus segregation requirements of Rule 18a-4, as adopted, if certain conditions are met.<sup>669</sup> This modification to the final rule will

reduce the number of SBSBs subject to the omnibus segregation requirements in the final rules and reduce the amounts that will need to be deposited into these accounts. This modification as well as the availability of municipal securities as qualified securities under Rule 18a-4, as adopted, should mitigate the commenter's concerns regarding the availability of qualified securities. For these reasons, the Commission is not modifying the proposal to permit U.S. government money market funds to serve as qualified securities as suggested by the commenter.

A commenter urged the Commission to reconsider the provision in the proposed rule requiring the SBS Customer Reserve Accounts to be maintained at a bank that is not affiliated with the SBSB.<sup>670</sup> The primary concern with permitting an affiliated bank to carry the SBS Customer Reserve Account is that the SBSB or stand-alone broker-dealer may not exercise due diligence with the same degree of impartiality and care when assessing the financial soundness of an affiliated bank as it would with an unaffiliated bank.<sup>671</sup> The decision of the SBSB or stand-alone broker-dealer to hold cash in a reserve account at an affiliated bank may be driven in part by profit or for reasons based on the affiliation, regardless of any due diligence it may conduct or the overall safety and soundness of the bank.<sup>672</sup> However, this concern largely pertains to cash deposits because they become part of the assets of the bank and can be used by the bank for any of its business activities.<sup>673</sup> As discussed below, the concern about cash deposits is being addressed through a 100% deduction of cash held in an SBS Customer Reserve Account at an affiliated bank.<sup>674</sup> Unlike cash, qualified securities deposited with a bank are held in a custodial capacity and, absent

<sup>670</sup> See SIFMA 2/22/2013 Letter.

<sup>671</sup> See *Financial Responsibility Rules for Broker-Dealers*, 78 FR at 51833.

<sup>672</sup> See *id.*

<sup>673</sup> See Federal Reserve, Division of Banking Supervision and Regulation, *Commercial Bank Examination Manual, Section 3000.1, Deposit Accounts* (stating that deposits are the primary funding source for most banks and that banks use deposits in a variety of ways, primarily to fund loans and investments), available at <http://www.federalreserve.gov/boarddocs/supmanual/cbem/3000.pdf>. See also OCC Banking Circular (BC-196), *Securities Lending* (May 7, 1985) (stating securities should be lent only pursuant to a written agreement between the lender institution and the owner of the securities specifically authorizing the institution to offer the securities for loan), available at <http://www.occ.gov/static/news-issuances/bulletins/pre-1994/banking-circulars/bc-1985-196.pdf>.

<sup>674</sup> See paragraph (p)(3)(i)(E) of Rule 15c3-3, as amended; paragraph (c)(1)(i)(E) of Rule 18a-4, adopted.

<sup>663</sup> See SIFMA 2/22/2013 Letter.

<sup>664</sup> See paragraphs (p)(3)(A) and (B) of Rule 15c3-3, as amended; paragraphs (c)(3)(i) and (ii) of Rule 18a-4, as adopted.

<sup>665</sup> See paragraph (p)(3)(B) of Rule 15c3-3, as amended; paragraph (c)(3)(ii) of Rule 18a-4, as adopted.

<sup>666</sup> See ICI 2/4/2013 Letter.

<sup>667</sup> See Federated 11/15/2018 Letter; Letter from Lee A. Pickard, Esq., Pickard, Djinis and Pisarri, on behalf of Federated Investors, Inc. (Dec. 7, 2018) ("Federated 12/7/2018 Letter").

<sup>668</sup> See Federated 11/15/2018 Letter.

<sup>669</sup> See paragraph (f) of Rule 18a-4, as adopted.

an agreement between the bank and the depositor, cannot be used by the bank. Consequently, in response to the comment, the Commission is modifying the final rule from the proposal so that it no longer requires the SBS Customer Reserve Account to be maintained at an unaffiliated bank.<sup>675</sup>

The Commission also is modifying the final rules to require an SBSB to deduct 100% of the amount of cash held at an affiliated bank and to increase the deduction threshold for cash held at a non-affiliated bank from 10% to 15% of the bank's equity capital.<sup>676</sup> These modifications more closely align the SBS Customer Reserve Account requirements with the pre-existing customer reserve account requirements for traditional securities.<sup>677</sup> However, the Commission is adding an exception to the 15% deduction to accommodate bank SBSBs that choose to maintain the SBS Customer Reserve Account themselves rather than at an affiliated or non-affiliated bank.<sup>678</sup> Under the exception, they would not need to take the 15% deduction.

One commenter argued that these changes would lead to undue risk for

SBSBs and their customers.<sup>679</sup> The Commission does not agree. Increasing the deduction threshold from 10% to 15% aligns the threshold with the threshold in the pre-existing requirements for traditional securities under existing Rule 15c3-3. Further, the exemption from the requirements of Rule 18a-4 likely will appreciably reduce the amounts that will need to be deposited into the SBS Customer Reserve Accounts.<sup>680</sup> For example, the Commission expects that the omnibus segregation requirements largely will apply to cleared security-based swaps transactions where a substantial portion of the initial margin received by the stand-alone broker-dealer or SBSB will be passed on to the clearing agency. Consequently, it will not need to be locked up in SBS Customer Reserve Accounts. Moreover, the Commission does not believe that increasing the threshold from 10% to 15% will unduly undermine the objective of addressing the risk that arises when a bank's deposit base is overly reliant on a single depositor. Finally, permitting a bank SBSB to maintain its own SBS Customer Reserve Account is designed to strike an appropriate balance in terms of achieving the objectives of the segregation rule, while providing the firm with sufficient flexibility in terms of locating its reserve account deposits. This scenario also does not raise the same concerns that arise when an SBSB uses a separate bank to maintain its SBS Customer Reserve Account. Moreover, the Commission expects that most bank SBSBs will operate under the exemption from the omnibus segregation requirements of Rule 18a-4. Therefore, the Commission does not believe these modifications to the final rule will lead to undue risks for SBSBs and their customers.

In addition, the Commission is making a conforming modification to the text of the debit item with respect to margin relating to non-cleared security-based swaps. As discussed above, the definition of "excess securities collateral" has been modified to account for the fact that the prudential regulators require initial margin collected by a bank SBSB to be held at a third-party custodian (rather than being held directly by the bank SBSB).<sup>681</sup> The rule, as proposed, did not account for the possibility that a

nonbank SBSB might pledge a customer's initial margin to a third-party custodian pursuant to the margin rules of the prudential regulators. The modification to the definition of "excess securities collateral" discussed above addresses this issue with respect to the possession or control requirement. The modification to the debit item with respect to margin relating to non-cleared security-based swap transactions will address this issue with respect to the SBS Customer Reserve Account requirement. Specifically, the Commission is modifying the debit item to include margin related to non-cleared security-based swap transactions in accounts carried for security-based swap customers required and held at a "third-party custodial account" as that term is defined in the rules.<sup>682</sup> This will allow the SBSB to offset the corresponding credit item that results from using customer collateral to meet the margin requirement of another SBSB when the customer collateral is posted to a third-party custodian (rather than provided directly to the other SBSB).

The Commission originally proposed that it would be unlawful for an SBSB to accept or use credits identified in the items of the formula set forth in Exhibit A to the proposed rule "except to establish debits for the specified purposes in the items of the formula."<sup>683</sup> This phrase in proposed Rule 18a-4 varied from the phrase in the parallel pre-existing requirement in Rule 15c3-3.<sup>684</sup> The Commission did not intend to establish a different standard for SBSBs and is modifying the phrase as used in Rules 15c3-3, as amended, and 18a-4, as adopted, to align it with the pre-existing text.

For these reasons, the Commission is adopting these provisions relating to the

<sup>675</sup> To make this modification, the Commission revised the definition of "special reserve account for the exclusive benefit of security-based swap customers" to remove the provision requiring that the bank be unaffiliated. See paragraph (p)(1)(vii) of Rule 15c3-3, as amended; paragraph (a)(9) of Rule 18a-4, as adopted.

<sup>676</sup> See paragraph (p)(3)(i)(D) of Rule 15c3-3, as amended; paragraph (c)(1)(D) of Rule 18a-4, as adopted. See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53017-18 (soliciting comment on potential rule language that would modify the proposal in this manner).

<sup>677</sup> See 17 CFR 240.15c3-3(e)(5). See also *Financial Responsibility Rules for Broker-Dealers*, 78 FR at 51832-51833 (explaining the rationale for permitting securities but not cash to be held at an affiliated bank).

<sup>678</sup> See paragraph (c)(1)(ii) of Rule 18a-4, as adopted. The final rule text of paragraph (c)(1)(ii) of Rule 18a-4, as adopted, states "Exception. A security-based swap dealer for which there is a prudential regulator need not take the deduction specified in paragraph (c)(1)(i)(D) of this section if it maintains the special reserve account for the exclusive benefit of security-based swap customers itself rather than at an affiliated or non-affiliated bank." To add this exception, in the final rule, a "(i)" was inserted before the phrase "In determining the amount maintained" in paragraph (c)(1) of Rule 18a-1, as adopted, and paragraphs (c)(1)(i) through (iv) of Rule 18a-4, as proposed, were re-designated paragraphs (c)(1)(i)(A) through (D) in Rule 18a-4, as adopted. A new subparagraph (c)(1)(i)(E) provides "The total amount of cash deposited with an affiliated bank." The final phrasing of new subparagraph (c)(1)(i)(E) does not contain the phrase "for a security-based swap dealer for which there is not a prudential regulator" that was contained in the re-opening as a potential modification because it is redundant to the exception language in paragraph (c)(1)(ii) of Rule 18a-4, as adopted. See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53017-18 (soliciting comment on potential rule language that would modify the proposal in this manner).

<sup>679</sup> See Better Markets 11/19/2018 Letter. See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53017-18.

<sup>680</sup> See paragraph (f) of Rule 18a-4.

<sup>681</sup> See paragraph (p)(1)(ii)(B) of Rule 15c3-3, as amended; paragraph (a)(2)(ii) of Rule 18a-4, as adopted. See also 12 CFR 45.7; 12 CFR 237.7; 12 CFR 624.7; 12 CFR 1221.7; 17 CFR 23.157.

<sup>682</sup> See Rule 15c3-3b, as adopted, Item 16; Rule 18a-4a, as adopted, Item 14. In addition, the Commission is deleting Items 3 and 10 from Rule 18a-4a, as adopted, because that rule will be used by non-broker-dealer SBSBs. As discussed above, the security-based swap segregation requirements, including the SBS Reserve Account requirements, that apply to broker-dealers, including broker-dealer SBSBs, are being codified in Rule 15c3-3, as amended, and Exhibit B to Rule 15c3-3 (Rule 15c3-3b), as adopted. Items 3 and 10 relate to the broker-dealer margin account business with respect to securities other than security-based swaps. Consequently, these Line Items are not necessary for the security-based swap customer reserve formula that non-broker-dealer SBSBs will use to determine their SBS Reserve Account requirement and, therefore, are not included in the final rule. See Exhibit A to Rule 18a-4 (Rule 18a-4a), as adopted.

<sup>683</sup> See paragraph (c)(2) of Rule 18a-4, as proposed to be adopted.

<sup>684</sup> Compare 17 CFR 240.15c3-3(e)(2), with paragraph (c)(2) of Rule 18a-4, as proposed to be adopted.

SBS Customer Reserve Account with the modifications described above.<sup>685</sup>

c. Special Provisions for Non-Cleared Security-Based Swap Counterparties

i. Notice Requirement

Section 3E(f)(1)(A) of the Exchange Act provides that an SBSB 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.<sup>686</sup> To provide greater clarity as to the meaning of “beginning” as used in the statute, proposed Rule 18a-4 required an SBSB 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.<sup>687</sup> Consequently, the notice needed to be given in writing before the counterparty was required to deliver margin to the SBSB or MSBSP. This gave the counterparty an opportunity to determine whether to elect individual segregation, waive segregation, or

affirmatively or by default elect omnibus segregation.

A commenter recommended that the Commission clarify that the notice must be sent to the customer (or investment manager authorized to act on behalf of a customer) in accordance with mutually agreed terms by the parties, or absent such terms, to a person reasonably believed to be authorized to accept notices on behalf of a customer.<sup>688</sup> The Commission agrees that the rule should provide more clarity and has modified the requirement to provide that the notice must be sent to a duly authorized individual. This person could be an individual that is mutually agreed to by the parties.

For these reasons, the Commission is adopting the proposed notice requirement with the modification described above.<sup>689</sup> The notification provision in Rule 15c3-3 applies only to a broker-dealer SBSB or MSBSP because the notification requirements in Section 3E(f)(1)(A) of the Exchange Act apply only to SBSBs and MSBSPs (and not to stand-alone broker-dealers).

ii. Subordination Agreements

Proposed Rule 18a-4 required an SBSB to obtain agreements from counterparties that elect either individual segregation or waive segregation with respect to non-cleared security-based swaps under Section 3E(f) of the Exchange Act. In the agreements, the counterparties needed to subordinate all of their claims against the SBSB to the claims of security-based swap customers.<sup>690</sup> By entering into subordination agreements, these counterparties would be excluded from the definition of security-based swap customer in proposed Rule 18a-4.<sup>691</sup> They also would not be entitled to share ratably with security-based swap customers in the fund of customer property held by the SBSB if it was subject to a bankruptcy proceeding.

Under the proposal, an SBSB needed to obtain a conditional subordination agreement from a counterparty that elects individual segregation. The agreement was conditional because the subordination agreement would not be effective in a case where the counterparty's assets were included in the bankruptcy estate of the SBSB, notwithstanding that they had been held by a third-party custodian (rather than the SBSB). Specifically, the proposed rule provided that the counterparty must 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 in a formal liquidation proceeding.

An SBSB needed to obtain an unconditional subordination agreement from a counterparty that waives segregation altogether. By waiving individual and omnibus segregation, the counterparty agrees that cash, securities, and money market instruments delivered to the SBSB as initial margin can be used by the SBSB for any business purpose and need not be isolated from the proprietary assets of the SBSB. Therefore, these counterparties are foregoing the protections of segregation. As a consequence, they should not be entitled to a ratable share of the customer property of the SBSB in the event the SBSB is liquidated in a formal proceeding. If they were deemed security-based swap customers, they could have a *pro rata* priority claim on customer property. This could disadvantage the security-based swap customers that did not waive segregation by diminishing the amount of customer property available to be distributed to them.

A commenter stated that the subordination agreement required of customers that elect individual segregation was not necessary because the initial margin provided by the customer was held at a third-party custodian and therefore would not become “customer property” held by the failed SBSB.<sup>692</sup> The commenter argued that a “legally unnecessary subordination agreement is prone to creating ambiguity, unforeseen consequences and complication . . . and runs contrary to the goal of investor protection . . .” The Commission disagrees. The subordination agreement is designed to reduce ambiguity, unforeseen consequences, and complications that may arise during an SBSB's liquidation by clarifying that the subordinating customers are not entitled

<sup>685</sup> See paragraph (p)(3) of Rule 15c3-3, as amended; paragraph (c) of Rule 18a-4, adopted. The following non-substantive modifications are being made. The phrase “a political” is added before the phrase “subdivision of a state” in the definition of qualified security in paragraphs (p)(1)(v)(C) and (p)(3)(i) of Rule 15c3-3, as amended, and paragraphs (a)(7)(iii) and (c)(1) of Rule 18a-4, as adopted because, under Section 3E(d) of the Exchange Act, “obligations . . . of any political subdivision of a State” are “Permitted Investments.” The phrase “Consolidated Report of Condition and Income” is replaced with the phrase “Call Report or any successor form the bank is required to file by its appropriate federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act)” in paragraph (p)(3)(i)(D) of Rule 15c3-3, as amended, and paragraph (c)(1)(i)(D) of Rule 18a-4, as adopted. This modification uses the commonly known name of the report and accounts for the potential that bank regulators could change the form of the report in the future. The Commission replaced the phrase “It is unlawful for a security-based swap dealer” in paragraph (c)(2) of Rule 18a-4, as proposed, with the phrase “a security-based swap dealer must not.” See paragraph (p)(3)(ii) of Rule 15c3-3, as amended (using the phrase “a broker or dealer must not”). See also *Amendments to Financial Responsibility Rules for Broker-Dealers*, 72 FR 12862; *Financial Responsibility Rules for Broker-Dealers*, 78 FR at 51838 (similarly modifying the proposed amendments to Rule 15c3-3 to replace the phrase “It shall be unlawful” “because any violation of the rules and regulations promulgated under the Exchange Act is unlawful and therefore it is unnecessary to use this phrase in the final rule”). The Commission replaced the term “funds” in paragraph (c)(4) of Rule 18a-4, as proposed, with the term “cash.” See paragraph (p)(3)(iv) of Rule 15c3-3, as amended.

<sup>686</sup> See 15 U.S.C. 78c-5(f)(1)(A).

<sup>687</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70287.

<sup>688</sup> See SIFMA 2/22/2013 Letter.

<sup>689</sup> See paragraph (p)(4)(i) of Rule 15c3-3, as amended; paragraph (d)(1) of Rule 18a-4, as adopted. A non-substantive modification is being made to replace the term “effective date” with the term “compliance date” because, as discussed below in section III of this release, the effective of the final notification rules will fall before the compliance date. The Commission intended the notification requirement to apply to transactions that occur on or after the date SBSBs and MSBSPs begin complying with the rule. Finally, the word “swap” is inserted before the word “dealer.”

<sup>690</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70287-88. The proposed subordination requirements did not apply to MSBSPs because they would not have security-based swap customers.

<sup>691</sup> See paragraph (a)(6) of proposed Rule 18a-4.

<sup>692</sup> See Ropes & Gray Letter.



to a *pro rata* share of customer property from the liquidation. By entering into the subordination agreements, customers who elect individual segregation are affirmatively waiving their rights to make customer claims with respect to initial margin held by the third-party custodian. Their recourse is to the third-party custodian that is holding the collateral. Therefore, a properly designed and executed subordination agreement affirms the rights of customers that elect individual segregation as compared to the rights of customers whose assets are treated under the omnibus segregation requirements.

The Commission, however, is modifying the final subordination requirements for collateral held at a third-party custodian so that it is no longer limited to funds or other property that is segregated pursuant to Section 3E(f) of the Exchange Act. As discussed above in section II.A.2.b.ii. of this release, a counterparty's collateral to meet a margin requirement of the nonbank SBSB may be held at a third-party custodian pursuant to other laws. Consequently, the Commission is modifying the rule text to provide that the subordination agreement is required "from a counterparty whose funds or other property to meet a margin requirement of the [nonbank SBSB] are held at a third-party custodian."<sup>693</sup>

Another commenter stated that customers electing individual segregation should not be required to subordinate claims other than those with respect to such initial margin held by the third-party custodian.<sup>694</sup> The commenter objected to the provision in the proposed rule requiring the customer to subordinate *all* of its claims against the SBSB to the claims of other security-based swap customers. The Commission agrees that the proposed text of the rule was ambiguous and could be read to mean the customer must subordinate claims to property that is held by the SBSB (as opposed to the third-party custodian). Therefore, the Commission is modifying the final rule from the proposal to clarify that the counterparty electing individual segregation must subordinate its claims against the SBSB only for the funds or other property *held at the third-party custodian*.<sup>695</sup>

<sup>693</sup> See paragraph (p)(4)(ii)(A) of Rule 15c3-3, as amended; paragraph (d)(2)(i) of Rule 18a-4, as adopted.

<sup>694</sup> See Financial Services Roundtable Letter.

<sup>695</sup> See paragraph (p)(4)(ii)(A) of Rule 15c3-3, as amended; paragraph (d)(2)(i) of Rule 18a-4, as adopted. The provision in paragraph (p) of Rule 15c3-3 provides that the counterparty's subordination also does not apply to the extent that

Because a counterparty will not subordinate *all* of its claims against a stand-alone broker-dealer or broker-dealer SBSB, the Commission is making conforming modifications to the final rule to specifically identify the two classes of carrying broker-dealer customers that must be accounted for in the subordination agreements. In particular, the Commission is adding the phrase "(including PAB customers)" following the term "to the claims of customers" in paragraph (p)(1)(vi) and paragraphs (p)(4)(ii)(A) and (B) of Rule 15c3-3, as amended. PAB customers are other broker-dealers for whom the carrying broker-dealer is holding cash and/or securities.<sup>696</sup> Under amendments to Rule 15c3-3 adopted after the rules in this release were proposed, a carrying broker-dealer must include (and thereby protect) the cash and securities it carries for other customers by including them in a PAB reserve account computation.<sup>697</sup> Broker-dealer customers also have priority claims to cash and securities held at the carrying broker-dealer in a SIPA proceeding. Consequently, their status as a protected class of creditors must be accounted for in the provisions of the rule relating to subordination agreements.

Finally, as discussed above, the Commission is making a conforming amendment to the requirement that the stand-alone broker-dealer or broker-dealer SBSB obtain a subordination agreement from a person who waives segregation with respect to non-cleared security-based swaps to provide that the provision applies to *affiliates* that waive segregation because persons who are not affiliates cannot waive segregation.<sup>698</sup> For these reasons, the Commission is adopting the subordination requirements with the modifications discussed above.<sup>699</sup>

the funds or other property provided by the counterparty are treated as customer property as defined in 15 U.S.C. 78lll(4) in a liquidation of the broker-dealer. See paragraph (p)(4)(ii)(A) of Rule 15c3-3, as amended. This clause is being added to account for the fact that broker-dealers are liquidated in SIPA proceedings.

<sup>696</sup> "PAB" is an acronym for proprietary accounts of broker-dealers. See paragraph (a)(16) of Rule 15c3-3 (defining the term PAB account).

<sup>697</sup> *Financial Responsibility Rules for Broker-Dealers*, 78 FR at 51827-51832 (discussing PAB accounts); paragraph (e) of Rule 15c3-3; Rule 15c3-3a. Consequently, this modification more closely aligns the segregation requirements with the pre-existing requirements for traditional securities under existing Rule 15c3-3, and would clarify that a security-based swap customer's subordination includes a subordination to the claims of PAB customers.

<sup>698</sup> See paragraph (p)(4)(ii)(B) of Rule 15c3-3, as amended.

<sup>699</sup> See paragraph (p)(4)(ii) of Rule 15c3-3, as amended; paragraph (d)(2) of Rule 18a-4, as adopted. The Commission also made a non-

#### D. Alternative Compliance Mechanism

As discussed throughout this release, commenters urged the Commission to harmonize the requirements being adopted today with requirements of the CFTC. Commenters sought harmonization with respect to the Commission's capital requirements,<sup>700</sup> margin requirements,<sup>701</sup> and segregation requirements.<sup>702</sup> One commenter stated that "[i]f the Commission and CFTC do not harmonize their capital rules, they should defer to the capital rules of one another in the case of" an entity that is registered as an SBSB and a swap dealer and "whose swaps or [security-based swaps] represent a de minimis portion of the [entity's] combined swap and [security-based swap] business."<sup>703</sup> This commenter further stated that "[i]n cases where the firm is predominantly engaged in swap activity, imposing different capital requirements would be inefficient." Another commenter stated that "[i]f harmonization is not achievable, the rules should be coordinated so that [the Commission] defers to the capital and margin rules of the CFTC for an SBSB that is not a broker-dealer and whose [security-based swaps] constitute a very small proportion of its business (e.g., less than 10% of the notional amount of its outstanding combined swap and SBS positions)."<sup>704</sup>

In response to these comments seeking harmonization, the final capital, margin, and segregation rules being adopted today have been modified from the proposed rules to achieve greater consistency with the requirements of the CFTC. However, as discussed throughout this release, there are differences between the approaches taken by the Commission and the CFTC.

substantive amendment to replace the phrase "does not choose" with "affirmatively chooses not" to clarify that the requirements related to the subordination agreements where a counterparty elects to have no segregation only apply when a counterparty affirmatively chooses to waive segregation. See paragraph (p)(4)(ii)(B) of Rule 15c3-3, as amended; paragraph (d)(2)(ii) of Rule 18a-4, as adopted.

<sup>700</sup> See, e.g., Citadel 11/19/18 Letter; Financial Services Roundtable Letter; FIA 11/19/2018 Letter; Morgan Stanley 11/19/2018 Letter.

<sup>701</sup> See, e.g., American Council of Life Insurers 11/19/2018 Letter; Citadel 11/19/2018 Letter; Financial Services Roundtable Letter; MFA 2/22/2013 Letter; SIFMA 11/19/2018 Letter.

<sup>702</sup> See, e.g., AIMA 2/22/2013 Letter; ISDA 11/19/2018 Letter; MFA 2/22/2013 Letter; SIFMA AMG 2/22/2013 Letter; Vanguard Letter.

<sup>703</sup> See SIFMA 11/19/2018 Letter.

<sup>704</sup> See Mizuho/ING Letter. See also Center for Capital Markets Competitiveness, US Chamber of Commerce 11/19/2019 Letter. This commenter supported a safe harbor that would allow firms to rely on their compliance with the rules of the Commission or the CFTC to satisfy comparable requirements set by the other agency.

Moreover, the Commission believes that some registered swap dealers (or entities that will register as swap dealers in the future) will need to also register as security-based swap dealers because their security-based swaps business—while not a significant part of their overall business mix—exceeds the *de minimis* exception to the “security-based swap dealer” definition.<sup>705</sup> In light of the differences between the rules of the Commission and the CFTC, the Commission believes it is appropriate to permit such firms to comply with the capital, margin, and segregation requirements of the CEA and the CFTC’s rules, provided the firm’s security-based swaps business is not a significant part of the security-based swap market and predominantly involves dealing in swaps as compared to security-based swaps. In this circumstance, the CFTC’s regulatory interest in the firm will greatly exceed the Commission’s regulatory interest given the relative size of its swaps business as compared to its security-based swaps business.<sup>706</sup>

For these reasons, the Commission is adopting an alternative compliance mechanism in Rule 18a–10 pursuant to which a stand-alone SBSB that is registered as a swap dealer and predominantly engages in a swaps business may elect to comply with the capital, margin and segregation requirements of the CEA and the CFTC’s rules in lieu of complying with the capital, margin, and segregation requirements in Rules 18a–1, 18a–3, and 18a–4.<sup>707</sup> This will address the concern

raised by the commenters that it would be inefficient to impose differing requirements on a firm that is predominantly a swap dealer.

A firm may elect to operate pursuant to Rule 18a–10 if it meets certain conditions. First, under paragraphs (a)(1) through (3) of Rule 18a–10, the firm must be registered with the Commission as a stand-alone SBSB (*i.e.*, not also registered as a broker-dealer or an OTC derivatives dealer) and registered with the CFTC as a swap dealer. The Commission believes it is appropriate to permit stand-alone SBSBs—which will not be integrated into the traditional securities markets to the same degree as stand-alone broker-dealers and broker-dealer SBSBs—to comply with Rule 18a–10 because their securities activities will be limited to dealing in security-based swaps. The requirement to be registered with the CFTC is designed to ensure that the firm is subject to CFTC oversight given that it will be adhering to the CFTC’s rules.

Second, under paragraph (a)(4) of Rule 18a–10, the stand-alone SBSB must be exempt from the segregation requirements of Rule 18a–4. As discussed above in section II.C.2. of this release, the Commission has added a provision to Rule 18a–4 that will exempt a stand-alone or bank SBSB from the rule’s omnibus segregation requirements if it meets certain conditions, including that it does not clear security-based swaps for other persons. Section 3E(g) of the Exchange Act applies the customer protection elements of the stockbroker liquidation provisions to cleared security-based swaps and related collateral, and to collateral delivered as initial margin for non-cleared security-based swaps if the collateral is subject to a customer protection requirement under Section 15(c)(3) of the Exchange Act or a segregation requirement. Consequently, a stand-alone SBSB that does not have cleared security-based swap customers and is not subject to a segregation requirement with respect to collateral for non-cleared security-based swaps will not implicate the stockbroker liquidation provisions. Given this result, the Commission believes it would be appropriate to permit the firm to comply with CEA and CFTC segregation requirements to the extent applicable in lieu of Rule 18a–4.

Third, under paragraph (a)(5) of Rule 18a–10, the aggregate gross notional amount of the firm’s outstanding security-based swap positions must not exceed the lesser of two thresholds as of

the most recently ended quarter of the firm’s fiscal year.<sup>708</sup> The thresholds are: (1) The maximum fixed-dollar gross notional amount of open security-based swaps specified in paragraph (f) of the rule (“maximum fixed-dollar threshold”); and (2) 10% of the combined aggregate gross notional amount of the firm’s open security-based swap and swap positions (“10% threshold”).

These thresholds are designed to limit the availability of the alternative compliance mechanism to firms whose security-based swaps business is not a significant part of the security-based swap market and that are predominately engaged in a swaps business as compared to a security-based swaps business. In this regard, the capital, margin, and segregation requirements being adopted today are designed to promote the safety and soundness of an SBSB and the ability of the Commission to oversee the firm and, thereby, protect the firm, its counterparties, and the integrity of the security-based swap market. Moreover, the security-based swap market and the broader securities markets (such as the cash markets for equity and fixed-income securities) are interrelated, given that economically similar instruments can be traded in both markets (*e.g.*, an equity security in the cash market and a total return swap referencing that security in the security-based swap market). For these reasons, the Commission has a heightened regulatory interest in stand-alone SBSBs that will be significant participants in the security-based swap market. Therefore, in crafting the alternative compliance mechanism, the Commission sought to calibrate the maximum-fixed-dollar and 10% thresholds to exclude stand-alone SBSBs that will be significant participants in this market.<sup>709</sup>

The amount of the maximum fixed-dollar threshold is \$250 billion for a transitional period of 3 years and then will drop to \$50 billion (unless the Commission issues an order as discussed below). Based on current information about the security-based swap market and the participants and potential participants in that market, the Commission believes that a stand-alone SBSB with a gross notional amount of outstanding security-based swaps of no more than \$50 billion will not be a

<sup>708</sup> The gross notional amount is based on the notional amounts of the firm’s security-based swaps and swaps that are outstanding as of the quarter end. It is not based on transaction volume during the quarter.

<sup>709</sup> See also section VI. of the release (providing an economic analysis of Rule 18a–10, as adopted, including the costs and benefits of the rule).

<sup>705</sup> See 17 CFR 240.3a71–2 (“Rule 3a71–2”).

<sup>706</sup> In situations under Rule 18a–10 where a stand-alone SBSB elects to meet its regulatory requirements by complying with the CEA and the CFTC’s rules, because of the differences in the Commission’s and the CFTC’s rules, the Commission anticipates that its staff will work closely with the staffs of the CFTC and the National Futures Association.

<sup>707</sup> The term “stand-alone SBSB” when used in this section II.D. of the release does not include a firm that is also registered as an OTC derivatives dealer. As discussed below, the alternative compliance mechanism is not available to a nonbank SBSB that is also registered as a broker-dealer, including a broker-dealer that is an OTC derivatives dealer. In theory, a bank SBSB could use the alternative compliance mechanism if it met the required conditions. However, these entities will be subject to the Commission’s final segregation rule for stand-alone and bank SBSBs (Rule 18a–4), but not the Commission’s final capital and margin rules. Moreover, as discussed above in section II.C.2. of this release, Rule 18a–4, as adopted, contains an exemption provision. The Commission expects bank SBSBs will take advantage of the exemption provision in the segregation rule rather than use the alternative compliance mechanism. The reason for this belief is that the exemption in Rule 18a–4 does not place a limit on the size of the firm’s security-based swap business as a condition to qualify for the

exemption, and it does not require firms to comply with requirements of the CEA and the CFTC’s rules.

significant participant in the security-based swap market. However, as stated above in section I.A. of this release, the Commission recognizes that the firms subject to the capital, margin, and segregation requirements being adopted today are operating in a market that continues to experience significant changes in response to market and regulatory developments. For these reasons, the Commission believes it is appropriate to set a maximum fixed-dollar threshold that is well in excess of \$50 billion for a transitional period of 3 years. Therefore, the maximum fixed-dollar threshold will be \$250 billion for 3 years, starting on the compliance date for the capital, margin and segregation rules being adopted today. This transitional \$250 billion threshold will provide a stand-alone SBSD operating under the alternative compliance mechanism (*i.e.*, firms that are predominantly engaged in a swaps business) with a substantial amount of leeway to develop their security-based swaps business without managing the level of that business to the lower \$50 billion threshold. If the security-based swaps business of these firms develops to a degree that the \$50 billion threshold would require them to refrain from taking on additional business, the Commission can assess whether the amount of the additional business that causes them to exceed the threshold makes them a significant participant in the security-based swap market.

The transitional period therefore will provide the Commission with the opportunity to evaluate the impact that the \$50 billion threshold would have on firms operating pursuant to the alternative compliance mechanism before the threshold drops from \$250 billion to \$50 billion. Moreover, the final rule establishes a process through which the Commission, by order, can: (1) Maintain the maximum fixed-dollar amount at \$250 billion for an additional period of time or indefinitely after the 3-year transition period ends; or (2) lower it to an amount that is less than \$250 billion but greater than \$50 billion.<sup>710</sup> This process could provide firms operating under the alternative compliance mechanism with additional time to transition from the \$250 billion threshold to the \$50 billion threshold or another threshold.

The final rules provide that the Commission will issue an order after considering the levels of security-based swap activity of stand-alone SBSDs operating under the alternative compliance mechanism. The

Commission intends to analyze how significant these entities are to the security-based swap market and broader securities markets based on their levels of their security-based swap activity. The analysis will consider the firm's individual and collective impact on the security-based swap market. Based on this analysis, the Commission could decide to take no action and let the \$250 billion maximum fixed-dollar threshold transition to \$50 billion on the 3-year anniversary of the compliance date for the capital, margin, and segregation rules being adopted today.

Alternatively, the Commission could decide to reset the maximum fixed-dollar threshold to a level greater than \$50 billion (but no more than \$250 billion) or provide additional time for firms to transition from a \$250 billion threshold to the \$50 billion threshold.

The process in the final rule provides that the Commission will publish notice of the potential change to the maximum fixed-dollar threshold (*i.e.*, extending the \$250 billion threshold for an additional period of time or indefinitely, or lowering it to a level between \$250 billion and \$50 billion) and subsequently issue an order regarding the change. The Commission intends to provide such notice in sufficient time for the public to be aware of the potential change.

In summary, the maximum fixed-dollar threshold sets an absolute limit on the availability of the alternative compliance mechanism irrespective of the size of the firm's swaps business as compared to its security-based swaps business. Thus, a firm potentially may not exceed the 10% threshold given the large size of its swaps business but could exceed the maximum fixed-dollar threshold because its security-based swaps business is sufficiently large. This absolute limit is designed to exclude stand-alone SBSDs that are significant participants in the security-based swap market from qualifying for the alternative compliance mechanism.

The 10% threshold establishes a limit on the ratio of the firm's security-based swaps business to its combined security-based swaps and swaps businesses. In crafting this threshold, the Commission sought to limit the availability of the alternative compliance mechanism to firms that are predominantly engaged in a swaps business as compared to a security-based swaps business. Consequently, if the firm's security-based swap business does not exceed the maximum fixed-dollar threshold, it nonetheless may not qualify for the alternative compliance mechanism if its security-based swaps business exceeds the ratio set by the

10% threshold. This is designed to limit the alternative compliance mechanism to firms for which the CFTC (as opposed to the Commission) has a heightened regulatory interest.

Under paragraph (a)(5) of Rule 18a-10, the firm must not exceed the lesser of these thresholds as of the most recently ended quarter of its fiscal year. This point-in-time requirement is designed to simplify the process for determining whether the firm meets the condition by aligning it with when the firm closes its books for financial recordkeeping and reporting purposes. A quarterly test (as opposed to an annual test) also is designed to ensure that a firm using the alternative compliance mechanism consistently limits its security-based swaps business in a manner that aligns with the Commission's objective: To provide this option only to firms that are not a significant part of the security-based swap market and predominantly deal in swaps as compared to security-based swaps. Moreover, a quarterly test (as opposed to a requirement to meet the threshold test at all times) is designed to limit the possibility that a firm operating pursuant to the alternative compliance mechanism inadvertently exceeds one of the thresholds for a brief period of time (particularly by an immaterial amount) and, as a consequence, can no longer use it.

Paragraph (b) of Rule 18a-10 sets forth requirements for a firm that is operating pursuant to the rule. Paragraph (b)(1) provides that the firm must comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules applicable to swap dealers and treat security-based swaps and related collateral pursuant to those requirements to the extent the requirements do not specifically address security-based swaps and related collateral. Consequently, a firm that is subject to Rule 18a-10 must comply with applicable capital, margin, and segregation requirements of the CEA and the CFTC's rules and a failure to comply with one or more of those rules will constitute a failure to comply with Rule 18a-10. Moreover, the firm must treat security-based swaps and related collateral pursuant to the requirements of the CEA and the CFTC's rules even if the CEA and the CFTC's rules do not specifically address security-based swaps and related collateral. This provision is designed to ensure that security-based swaps and related collateral do not fall into a "regulatory gap" with respect to a nonbank SBSD operating under the alternative compliance mechanism. Thus, if a capital, margin, or segregation

<sup>710</sup> See paragraphs (f)(1)(i) and (ii) of Rule 18a-10, as adopted.

requirement applicable to a swap or collateral related to a swap is silent as to a security-based swap or collateral related to a security-based swap, the nonbank SBSB must treat the security-based swap or collateral related to a security-based swap pursuant to the requirement applicable to the swap or collateral related to the swap.<sup>711</sup>

Paragraph (b)(2) of Rule 18a-10 requires the firm to provide a written disclosure to its counterparties after it begins operating pursuant to the rule. The disclosure must be provided before the first transaction with the counterparty after the firm begins operating pursuant to the rule. The disclosure must notify the counterparty that the firm is complying with the applicable capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of complying with Rules 18a-1, 18a-3, and 18a-4. The disclosure requirement is designed to alert the counterparty that the firm is not complying with these Commission rules notwithstanding the fact that the firm is registered with the Commission as an SBSB. This will provide the counterparty with the opportunity to assess the implications of transacting with the SBSB under these circumstances.

Paragraph (b)(3) of Rule 18a-10 requires the firm to immediately notify the Commission and the CFTC in writing if it fails to meet a condition in paragraph (a) of the rule. This notice—by immediately alerting the Commission and the CFTC of the firm's status—will provide the agencies with the opportunity to promptly evaluate the situation and coordinate any regulatory responses such as increased monitoring of the firm.

Paragraph (c) of Rule 18a-10 addresses when a firm fails to comply with a condition in paragraph (a) of the rule and, therefore, no longer qualifies to operate pursuant to the rule. The paragraph provides that a firm in that circumstance must begin complying with Rules 18a-1, 18a-3, and 18a-4 no later than either: (1) Two months after the end of the month in which the firm failed to meet the condition in

paragraph (a); or (2) for a longer period of time as granted by the Commission by order subject to any conditions imposed by the Commission. This period of time to come into compliance with the Commission's rules ("compliance period") is modeled on the *de minimis* exception to the "security-based swap dealer" definition.<sup>712</sup> Under paragraph (b) of Rule 3a71-2, an entity that no longer meets the requirements of the *de minimis* exception will be deemed to not be an SBSB until the earlier of the date on which it submits a complete application to register as an SBSB or two months after the end of the month in which the entity becomes no longer able to take advantage of the exception. The compliance period in Rule 18a-10 is designed to provide an SBSB with time to implement systems, controls, policies, and procedures and take other necessary steps to comply with Rules 18a-1, 18a-3, and 18a-4. The Commission, by order, can grant the SBSB additional time if necessary.

The conditions in paragraphs (a)(1) through (4) of Rule 18a-10 must be met at all times an SBSB is operating pursuant to the rule. Consequently, the compliance period will begin to run on the day of a month that the SBSB fails to meet a condition in paragraphs (a)(1) through (4). As discussed above, whether a firm meets the condition in paragraph (a)(5) of Rule 18a-10 will be determined as of the most recently ended quarter of the firm's fiscal year. Therefore, a firm could fail to meet this condition only on a day that is the end of one of its fiscal year quarters. If the firm fails to meet the condition on one of those days, the compliance period will begin to run on that day.

Paragraph (d) of Rule 18a-10 addresses how a firm would elect to operate pursuant to the rule. Under paragraph (d)(1), a firm can make the election as part of the process of applying to register as an SBSB. In this case, the firm must provide written notice to the Commission and the CFTC during the registration process of its intent to operate pursuant to the rule. Upon being registered as an SBSB, the firm can begin complying with Rule 18a-10, provided it meets the conditions in paragraph (a) of the rule.

Under paragraph (d)(2) of Rule 18a-10, an SBSB can make the election after the firm has been registered as an SBSB. In this case, the firm must provide written notice to the Commission and the CFTC of its intent to operate pursuant to the rule and continue to comply with Rules 18a-1, 18a-3, and 18a-4 for two months after the end of

the month in which the firm provides the notice or for a shorter period of time as granted by the Commission by order subject to any conditions imposed by the Commission. The requirement that the firm continue complying with the Commission's rules for a period of time after making the election is designed to provide the Commission and the CFTC with an opportunity to examine the firm before it begins operating pursuant to the alternative compliance mechanism and to prepare for the firm no longer complying with the Commission's rules.

As discussed above, paragraph (b)(3) requires a firm operating pursuant to the rule to immediately notify the Commission and the CFTC in writing if the SBSB fails to meet a condition in paragraph (a). Further, paragraphs (d)(1) and (2) require a firm to provide written notice to the Commission and the CFTC of its intent to operate pursuant to the rule. Paragraph (e) of Rule 18a-10 provides that the notices required by the rule must be sent by facsimile transmission to the principal office of the Commission and the regional office of the Commission for the region in which the security-based swap dealer has its principal place of business or an email address to be specified separately, and to the principal office of the CFTC in a manner consistent with the notification requirements of the CFTC.<sup>713</sup> The paragraph also requires that notices include a brief summary of the reason for the notice and the contact information of an individual who can provide further information about the matter that is the subject of the notice. This will facilitate the ability of the Commission and the CFTC to follow-up with the firm and gather further information about the matter that triggered the notice requirement.

#### *E. Cross-Border Application of Capital, Margin, and Segregation Requirements*

##### *1. Capital and Margin Requirements*

In 2013, the Commission preliminarily interpreted the Title VII requirements associated with registration to apply generally to the activities of registered entities. In reaching that preliminary conclusion, the Commission did not concur with the views of certain commenters that the Title VII requirements should not apply to the foreign security-based swap activities of registered entities, stating that such a view could be difficult to

<sup>711</sup> See, e.g., Letter from Eileen T. Flaherty, Director, Division of Swap Dealer and Intermediary Oversight, and Jeffrey M. Bandman, Acting Director, Division of Clearing and Risk, CFTC, to Mary P. Johannes, Senior Director, ISDA (Aug. 23, 2016) (providing no-action relief to swap dealers and major swap participants with respect to the CFTC's margin rules for non-cleared swaps pursuant to which these entities can portfolio margin non-cleared swaps with non-cleared security-based swaps, provided, among other conditions, the security-based swaps shall be treated as if they were swaps for all applicable provisions of the CFTC's margin rules).

<sup>712</sup> See Rule 3a71-2.

<sup>713</sup> See 17 CFR 240.17a-11 (requiring a similar process to provide notice to the Commission and the CFTC). See also *Staff Guidance for Filing Broker-Dealer Notices, Statements, and Reports*, available at <https://www.sec.gov/divisions/marketreg/bdnotices.htm> (providing a fax number that broker-dealers may use to send these notices).

reconcile with, among other things, the statutory language describing the requirements applicable to SBSBs.<sup>714</sup>

#### a. Treatment of Cross-Border Transactions

The Commission further preliminarily identified capital and margin requirements as entity-level requirements, rather than requirements specifically applicable to particular transactions. Entity-level requirements primarily address concerns relating to the entity as a whole, with a particular focus on safety and soundness of the entity to reduce systemic risk in the U.S. financial system. The Commission accordingly proposed to apply the entity-level requirements on a firm-wide basis to address risks to the SBSB as a whole. The Commission did not propose any exception from the application of the entity-level requirements to SBSBs.<sup>715</sup>

Commenters did not address the proposal to treat capital requirements as entity-level requirements. The Commission continues to believe these requirements must apply to the entity as a whole. In reaching this conclusion, the Commission recognizes that the objective of the capital rule for SBSBs is the same as the capital rule for broker-dealers—to ensure that the entity maintains at all times sufficient liquid assets to promptly satisfy its liabilities, and to provide a cushion of liquid assets in excess of liabilities to cover potential market, credit, and other risks.<sup>716</sup> The tangible net worth standard applicable to nonbank MSBSPs is intended to be applied to the entity as a whole to ensure the MSBSP's solvency is based on tangible assets. Therefore, the Commission is also treating the nonbank MSBSP capital requirements as entity-level requirements.

With respect to margin, a commenter pointed out that “the application and enforcement of margin requirements applies on a transaction-by-transaction basis and the calculation of margin depends on the circumstances of a particular [security-based swap].”<sup>717</sup> Another commenter opposed

characterizing margin as an entity-level requirement due to a concern that doing so could result in a substituted compliance determination where firms could “comply with only a comparable foreign regime in every circumstance, regardless of who they transact with or where the transactions occur.”<sup>718</sup> The commenter advocated that the Commission “either treat margin as a transaction-level requirement or not permit substituted compliance in these transactions.” A number of commenters requested that margin be treated as a transaction-level requirement for consistency with other domestic and foreign regulators.<sup>719</sup> Some commenters also argued there could be costs and operational complications resulting from subjecting a foreign registrant to both Commission and home country margin requirements.<sup>720</sup>

Margin is designed to protect the nonbank SBSB or MSBSP from the consequences of a counterparty's default.<sup>721</sup> Permitting different margin requirements based on the location of the counterparty is not consistent with this objective. Further, treating margin as a transaction-level requirement could cause those counterparties entering into transactions that constitute the U.S. business of a nonbank registrant to bear a greater burden in ensuring the safety and soundness of the nonbank registrant than counterparties that are part of the nonbank registrant's foreign business.<sup>722</sup>

<sup>718</sup> See Letter from Dennis M. Kelleher, President and Chief Executive Officer, Stephen W. Hall, Securities Specialist, and Katelynn O. Bradley, Attorney, Better Markets, Inc. (Aug. 21, 2013) (“Better Markets 8/21/2013 Letter”).

<sup>719</sup> See, e.g., Letter from Koichi Ishikura, Executive Chief of Operations for International Headquarters, Japan Securities Dealers Association (Aug. 21, 2013) (“Japan SDA Letter”) (urging the Commission and the CFTC to align their rules to avoid “hamper[ing] efficient management of derivatives transactions”).

<sup>720</sup> See, e.g., Letter from Sarah A. Miller, Chief Executive Officer, Institute of International Bankers (Aug. 21, 2013) (“IIB 8/21/2013 Letter”) (stating that it would be “cost-intensive” to “negotiate and execute separate credit support documentation, make separate margin calculations and have separate operational procedures across its swap and [security-based swap] transactions”).

<sup>721</sup> The Commission acknowledges that the requirement that nonbank SBSBs post variation margin to counterparties is primarily designed to protect the counterparty from the consequences of the nonbank SBSB's default. However, because the collection of variation and initial margin by the nonbank SBSB is critical to the safety and soundness of the nonbank SBSB, the Commission believes it appropriate to treat margin as an entity-level requirement even though the component of the rule requiring the nonbank SBSB to post variation margin is designed to protect the counterparty.

<sup>722</sup> See Section 15F(e)(3)(A) of the Exchange Act (providing that the Commission's statutorily mandated initial and variation margin requirements shall “help ensure the safety and soundness” of the SBSB or MSBSP).

The Commission also concludes that treating margin solely as a transaction-level requirement would not adequately further the objectives of using margin to ensure the safety and soundness of nonbank registrants because it could result in entities with global businesses collecting significantly less collateral than would otherwise be required to the extent that they are not required by local law to collect comparable margin from their counterparties. This potential outcome could increase the registrant's risk of failure if certain counterparties are not required to post margin, especially during a period when the market is already unstable.<sup>723</sup>

In response to the comment that treating margin requirements as entity-level requirements would permit nonbank SBSBs in every circumstance to use foreign requirements to satisfy the margin requirements, the Commission intends to consider certain factors to mitigate this risk prior to making a substituted compliance determination. More specifically, the Commission intends to consider whether the foreign financial regulatory system requires registrants to adequately cover their current and potential future exposure to OTC derivatives counterparties, and ensures registrants' safety and soundness, in a manner comparable to the applicable provisions arising from the Exchange Act and its rules and regulations.<sup>724</sup>

For all of these reasons, the Commission is treating the nonbank SBSB margin requirements as entity-level requirements. The margin requirements applicable to nonbank MSBSPs are intended to be applied to the entity as a whole for the same reasons the margin requirements for nonbank SBSBs are intended to apply to the entity as a whole. Therefore, the Commission is also treating the nonbank

<sup>723</sup> 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. So, when “trigger events” occurred during the financial crisis, counterparties faced significant liquidity strains in seeking to meet the requirements to deliver collateral. As a result, some dealers experienced large uncollateralized exposures to counterparties experiencing financial difficulty, which, in turn, risked exacerbating the already severe market dislocation. See, e.g., Orice M. Williams, Director, Financial Markets and Community Investment, GAO, *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps*, GAO-09-397T (Mar. 2009); GAO, *Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc.*, GAO-11-616 (Sept. 2011).

<sup>724</sup> See paragraph (d)(5) of Rule 3a71-6, as amended.

<sup>714</sup> See *Cross-Border Proposing Release*, 78 FR at 30986.

<sup>715</sup> See 78 FR at 31011. The Commission similarly expressed the preliminary view that MSBSPs should be required to adhere to the entity-level requirements. See 78 FR at 31035.

<sup>716</sup> See *Cross-Border Proposing Release*, 78 FR at 31011.

<sup>717</sup> See Letter from Kenneth E. Bentsen, Jr., President, SIFMA, Walt Lukken, President and Chief Executive Officer, Futures Industry Association, and Richard M. Whiting, Executive Officer and General Counsel, The Financial Services Roundtable (Aug. 21, 2013) (“SIFMA 8/21/2013 Letter”).

MSBSP margin requirements as entity-level requirements.

The Commission preliminarily identified the SBSB segregation requirements as transaction-level requirements.<sup>725</sup> Consequently, proposed Rule 18a-4 contained provisions to address the application of the segregation requirements to cross-border security-based swap transactions of foreign SBSBs. The applicable segregation requirements are tailored depending on the type of registrant, security-based swap, and customer. The Commission did not receive comments specifically addressing this proposed treatment of segregation requirements. However, one commenter stated that it “support[s] the Commission’s overall proposal to distinguish between entity-level and transaction-level requirements” and that it “generally support[s] the Commission’s proposed cross-border application of segregation requirements to foreign SBSBs.”<sup>726</sup> The Commission continues to treat segregation requirements as transaction-level requirements.

#### Amendments to the Substituted Compliance Rule

The Commission proposed to make substituted compliance potentially available in connection with the requirements applicable to foreign SBSBs pursuant to Section 15F of the Exchange Act, other than the registration requirements. Because the capital and margin requirements were grounded in Section 15F, substituted compliance generally would have been available for those requirements under the proposal.<sup>727</sup> Upon a Commission substituted compliance determination, a person would be able to satisfy relevant capital or margin requirements by substituting compliance with corresponding requirements under a foreign regulatory system.

The Commission subsequently adopted Rule 3a71-6, which provides that substituted compliance is available with respect to the Commission’s business conduct requirements, and (rather than addressing all requirements under Section 15F of the Exchange Act) reserved the issue as to whether substituted compliance also would be available in connection with other requirements under that statute.<sup>728</sup> Rule

3a71-6 was amended to make substituted compliance available with respect to the Commission’s trade acknowledgment and verification requirements.<sup>729</sup> Today the Commission is amending Rule 3a71-6 to make the nonbank SBSB and MSBSP capital and margin requirements available for substituted compliance determinations.

One commenter expressed concerns that there is no adequate legal or policy justification for allowing substituted compliance.<sup>730</sup> In contrast to the implication of that comment, however, substituted compliance does not constitute exemptive relief and does not excuse registered SBSBs and MSBSPs from having to comply with the Commission’s capital and margin requirements. Instead, substituted compliance provides an alternative method of satisfying those requirements under Title VII.

#### i. Basis for Substituted Compliance in Connection With Capital and Margin Requirements

In light of the global nature of the security-based swap market and the prevalence of cross-border transactions within that market, there is the potential that the application of the Title VII capital and margin requirements may duplicate or conflict with applicable foreign requirements, even when the two sets of requirements implement similar goals and lead to similar results. Such duplications or conflicts could disrupt existing business relationships, and, more generally, reduce competition and market efficiency.<sup>731</sup>

To address those effects, the Commission concludes that under certain circumstances it may be appropriate to allow for the possibility of substituted compliance whereby foreign SBSBs and MSBSPs may satisfy Section 15F(e) of the Exchange Act and Rules 18a-1, 18a-2, and 18a-3 thereunder by complying with comparable foreign requirements. Allowing for the possibility of substituted compliance in this manner may help achieve the benefits of these capital and margin requirements in a way that helps avoid regulatory

duplication or conflict and hence promotes market efficiency, enhances competition, and facilitates a well-functioning global security-based swap market. Accordingly, Rule 3a71-6 is amended to identify Section 15F(e) of the Exchange Act and Rules 18a-1, 18a-2, and 18a-3 thereunder as being eligible for substituted compliance.<sup>732</sup>

A number of comments addressed substituted compliance as it specifically applies to the Commission’s capital and margin requirements. One commenter generally asked the Commission to “recognize local margin requirements” for foreign SBSBs,<sup>733</sup> while other commenters requested that the Commission coordinate with the prudential regulators on substituted compliance determinations for capital and margin.<sup>734</sup> Similarly, another commenter requested that the Commission jointly propose and adopt rules reflecting a harmonized and unified approach to the cross-border application of the security-based swaps and swaps provisions of Title VII of the Dodd-Frank Act.<sup>735</sup> While a joint rulemaking would present logistical challenges due to timing differences in agencies’ implementation of cross-border regimes, the Commission staff has consulted and coordinated with the CFTC, the prudential regulators, and foreign regulatory authorities on the cross-border application of its rules, and plans to continue such consultation and coordination during the substituted compliance determination process.<sup>736</sup>

A few commenters sought blanket substituted compliance determinations that would automatically grant substituted compliance without requiring an independent comparability determination with respect to firms subject to foreign capital or margin requirements that are consistent with

<sup>732</sup> See paragraph (d) of Rule 3a71-6, as adopted. Paragraph (a)(1) of Rule 3a71-6 provides that the Commission may, conditionally or unconditionally, by order, make a determination with respect to a foreign financial regulatory system that compliance with specified requirements under that foreign financial system by a registered SBSB and/or registered MSBSP, or class thereof, may satisfy the corresponding requirements identified in paragraph (d) of the rule that would otherwise apply.

<sup>733</sup> See ISDA 1/23/2013 Letter.

<sup>734</sup> See Center for Capital Markets Competitiveness, Chamber of Commerce 11/19/2018 Letter; ICI 11/19/2018 Letter; SIFMA 8/21/2013 Letter.

<sup>735</sup> See Letter from Walt L. Lukken, President and Chief Executive Officer, Futures Industry Association (Nov. 29, 2018) (“FIA 11/29/2018 Letter”).

<sup>736</sup> Section 712(a)(2) of the Dodd-Frank Act provides in part that the Commission shall “consult and coordinate to the extent possible with the [CFTC] and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible.”

<sup>725</sup> See *Cross-Border Proposing Release*, 78 FR at 31010–31011.

<sup>726</sup> See IIB 8/21/2013 Letter.

<sup>727</sup> See *Cross-Border Proposing Release*, 78 FR at 31085.

<sup>728</sup> See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, Exchange Release No. 77617

(Apr. 14, 2016). See *Cross-Border Proposing Release*, 78 FR at 31207.

<sup>729</sup> See *Trade Acknowledgment and Verification of Security-Based Swap Transactions*, Exchange Act Release No. 78011 (June 8, 2016), 81 FR 39808, 30143–44 (June 17, 2016).

<sup>730</sup> See *Better Markets* 11/19/2018 Letter. See also Harrington 11/19/2018 Letter.

<sup>731</sup> See generally *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR at 30073–74 (addressing the basis for making substituted compliance available in the context of the business conduct requirements).

certain international standards.<sup>737</sup> In contrast, another commenter recommended that the Commission *not* consider consistency with the prudential regulators, international standards, and foreign regulators when making substituted compliance determinations.<sup>738</sup> In response to these comments, the Commission believes it is appropriate to analyze directly a foreign jurisdiction's capital and margin requirements. In particular, jurisdictions may customize their capital and margin requirements to local markets and activities. In addition, Rule 3a71–6 provides that the Commission's substituted compliance determination will take into consideration the effectiveness of the supervisory compliance program administered and the enforcement authority exercised by the foreign regulatory authority, which are expected to vary among foreign jurisdictions. Consequently, the analysis of any particular foreign jurisdiction's capital and margin requirements will be fact specific and therefore a “blanket approach” would not be appropriate.

Another commenter sought an exemption for foreign firms with respect to the Commission's margin requirements (among other requirements) pursuant to which they could comply with local requirements that are not comparable to U.S. requirements, provided the aggregate notional value of swaps in the jurisdictions where this exemption is used does not exceed 15% of the firm's total swap activities.<sup>739</sup> The Commission does not believe such an exemption would be appropriate because it could negatively impact the safety and soundness of the firm if the local requirements were less rigorous than the Commission's requirements.

#### ii. Comparability Criteria, and Consideration of Related Requirements

The Commission will endeavor to take a holistic approach in determining the comparability of foreign requirements for substituted compliance purposes, focusing on regulatory outcomes as a whole rather than on requirement-by-requirement similarity.<sup>740</sup> The Commission's comparability assessments associated with Section 15F(e) of the Exchange Act and Rules 18a–1, 18a–2, and 18a–3

thereunder accordingly will consider whether, in the Commission's view, the foreign regulatory system achieves regulatory outcomes that are comparable to the regulatory outcomes associated with the capital and margin requirements. More specifically, paragraph (a)(2)(i) of Rule 3a71–6 provides that the Commission's substituted compliance determination will take into account factors that the Commission determines appropriate, such as, for example, “the scope and objectives of the relevant foreign regulatory requirements . . . , as well as the effectiveness of the supervisory compliance program administered, and the enforcement authority exercised, by a foreign financial regulatory authority or authorities in such system to support its oversight of such foreign security-based swap entity (or class thereof) or of the activities of such security-based swap entity (or class thereof).”

In reviewing applications, the Commission may determine to conduct its comparability analyses regarding the capital and margin requirements in conjunction with comparability analyses regarding other Exchange Act requirements that promote risk management in connection with SBSBs and MSBSPs. Accordingly, depending on the applicable facts and circumstances, the comparability assessment associated with the capital and margin requirements may constitute part of a broader assessment of the foreign regulatory system's risk mitigation requirements, and the applicable comparability assessments may be conducted at the level of those risk mitigation requirements as a whole. Commenters generally requested additional guidance regarding the criteria the Commission would consider when making a substituted compliance determination.<sup>741</sup> Such criteria have been set forth in the final rule as discussed below.

#### Comparability Criteria for Nonbank SBSB Capital Requirements

Rule 3a71–6 provides that prior to making a substituted compliance determination regarding SBSB capital requirements, the Commission intends to consider (in addition to any conditions imposed), whether the capital requirements of the foreign

financial regulatory system are designed to help ensure the safety and soundness of registrants<sup>742</sup> in a manner that is comparable to the applicable provisions arising under the Exchange Act and its rules and regulations.<sup>743</sup> Under this provision, the Commission would analyze whether the capital and other prudential requirements of the foreign jurisdiction from an outcome perspective help ensure the safety and soundness of the registrants in a manner that is comparable to the applicable provisions arising under the Exchange Act and its rules and regulations.

#### Comparability Criteria for Nonbank MSBSP Capital Requirements

Nonbank MSBSPs are subject to a tangible net worth standard, rather than a net liquid assets test. This different standard recognizes that the entities required to register as nonbank MSBSPs may engage in a diverse range of business activities different from, and broader than, the securities activities conducted by stand-alone broker-dealers or nonbank SBSBs. In light of these considerations, Rule 3a71–6 provides that prior to making a substituted compliance determination regarding MSBSP capital requirements, the Commission intends to consider (in addition to any conditions imposed), whether the capital requirements of the foreign financial regulatory system are comparable to the applicable provisions arising under the Exchange Act and its rules and regulations.<sup>744</sup>

#### Comparability Criteria for Nonbank SBSB and MSBSP Margin Requirements

Obtaining collateral is one of the ways OTC derivatives dealers manage their credit risk exposure to OTC derivatives counterparties. Prior to the financial crisis, in certain circumstances, counterparties were able to enter into OTC derivatives transactions without having to deliver collateral. When “trigger events” occurred during the financial crisis, those counterparties faced significant liquidity strains when they were required to deliver collateral.

In light of these considerations, Rule 3a71–6 provides that prior to making a substituted compliance determination regarding SBSB margin requirements, the Commission intends to consider (in addition to any conditions imposed) whether the foreign financial regulatory

<sup>737</sup> See, e.g., Citigroup 4/24/2018 Meeting; IIB/ SIFMA Letter; IIB 11/19/2018 Letter; ISDA 11/19/2018 Letter; SIFMA 3/12/2014 Letter; SIFMA 11/19/2018 Letter.

<sup>738</sup> See Harrington 11/19/2018 Letter.

<sup>739</sup> See SIFMA 8/21/2013 Letter.

<sup>740</sup> See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR at 30078–79.

<sup>741</sup> See, e.g., Letter from Americans for Financial Reform (Aug. 22, 2013) (“Americans for Financial Reform 8/22/2013 Letter”); Letter from Futures and Options Association (Aug. 21, 2013) (“Futures and Options Association Letter”). See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53018–19 (soliciting comment on potential rule language that would modify the proposal in this manner).

<sup>742</sup> See Section 15F(e)(3)(A) of the Exchange Act (providing that the capital requirements for SBSBs shall “help ensure the safety and soundness” of the SBSB).

<sup>743</sup> See paragraph (d)(4)(i) of Rule 3a71–6, as amended.

<sup>744</sup> See paragraph (d)(4)(ii) of Rule 3a71–6, as amended.



system requires registrants to adequately cover their current and future exposure to OTC derivatives counterparties,<sup>745</sup> and ensures registrants' safety and soundness,<sup>746</sup> in a manner comparable to the applicable provisions arising under the Exchange Act and its rules and regulations.<sup>747</sup>

Similarly, Rule 3a71–6 provides that prior to making a substituted compliance determination regarding MSBSP margin requirements, the Commission intends to consider (in addition to any conditions imposed) whether the foreign financial regulatory system requires registrants to adequately cover their current exposure to OTC derivatives counterparties, and ensures registrants' safety and soundness, in a manner comparable to the applicable provisions arising under the Exchange Act and its rules and regulations.<sup>748</sup>

## 2. Segregation Requirements

### a. Treatment of Cross-Border Transactions

As discussed above, the Commission proposed to treat the segregation requirements of Section 3E of the Exchange Act and proposed Rule 18a–4 as transaction-level requirements. Further, these requirements were not available for substituted compliance determinations. However, proposed Rule 18a–4 included provisions that addressed the applicability of these requirements with respect to different types of cross-border transactions.<sup>749</sup> These provisions in proposed Rule 18a–4 applied to foreign SBSDs and MSBSPs that were not dually registered as broker-dealers. Consequently, a broker-dealer SBSD needed to treat cross-border transactions no differently than any other types of transactions for purposes of the segregation requirements in Section 3E of the Exchange Act and proposed Rule 18a–4.

The cross-border provisions in proposed Rule 18a–4 for foreign stand-alone and bank SBSDs and MSBSPs distinguished between entities that were

a U.S. branch or agency of a foreign bank, or neither of the above, and between cleared or non-cleared security-based swap transactions. The objective underlying these distinctions was to ensure that U.S. customers of a foreign stand-alone or bank SBSD or MSBSP were protected in the event the firm needed to be liquidated in a formal proceeding. Consequently, the differing treatment of cross-border transactions depending on these distinctions was tied to the applicable bankruptcy or liquidation laws that would apply to a failed foreign stand-alone or bank SBSD or MSBSP.

A commenter expressed general support for the Commission's proposed cross-border treatment of segregation requirements for foreign SBSDs as "consistent with the objective of applying segregation requirements so they work in tandem with applicable insolvency laws."<sup>750</sup> Another commenter believed the Commission intended to make segregation requirements eligible for substituted compliance, and asked the Commission to clarify this fact.<sup>751</sup> The Commission is adopting the approach as proposed that segregation is a transaction-level (rather than entity-level) requirement, because the Commission believes transaction-based rules are the best mechanism for protecting U.S. customers, given that varying possible liquidation outcomes depending on the type of registrant, security-based swap, and customer involved.

Another commenter generally requested substituted compliance for all transaction-level requirements (which includes segregation requirements) to mitigate the risk of duplicative and/or conflicting regulatory requirements.<sup>752</sup> The transaction-based approach to segregation considers the risk of duplicative and/or conflicting regulatory requirements, but without requiring a substituted compliance application to be submitted. Similarly, another commenter asked for an exemption from the Commission's omnibus segregation requirements for foreign SBSDs (including foreign bank SBSDs) "whose segregation and custody

of customer assets are subject to the supervision of a local regulatory authority," because an insolvent or liquidated foreign SBSD would be subject to banking regulations or home country law, rather than SIPA or the U.S. Bankruptcy Code's stockbroker liquidation provisions.<sup>753</sup> However, the commenter's proposed approach does not consider that the Commission's approach is designed to protect U.S. customers of foreign SBSDs and MSBSPs.

The same commenter requested that the Commission follow the Department of Treasury's approach, which exempts banks from its government securities dealer customer protection requirements if they meet certain conditions and are subject to certain prudential regulator rules. More specifically, the commenter requested a blanket exemption from the Commission's omnibus segregation requirements for foreign SBSDs that are foreign banks with a U.S. branch because they would be liquidated under banking regulations instead of SIPA or the stockbroker liquidation provisions. In response, the Commission recognizes that a foreign SBSD that is not a registered broker-dealer but is a foreign bank may not be eligible to be liquidated pursuant to the stockbroker liquidation provisions, and as such, the foreign SBSD's insolvency proceeding would be administered under U.S. or foreign banking regulations. However, the Commission believes that due to existing ring-fencing laws, imposing segregation requirements on such a foreign SBSD with respect to certain security-based swap customers that are U.S. persons in all circumstances, and with respect to security-based swap customers regardless of U.S. person status when it receives funds or other property arising out of a transaction with a U.S. branch or agency of the foreign SBSD, will reduce the likelihood of U.S. counterparties incurring losses by helping identify customers' assets in an insolvency proceeding and would potentially minimize disruption to the U.S. security-based swap market.

A commenter requested that foreign SBSDs be exempted from transaction-level requirements (including segregation) when transacting with foreign funds managed by U.S. asset managers, because transaction-level requirements primarily focus on protecting counterparties by imposing certain obligations on both U.S. and foreign SBSDs.<sup>754</sup> A second commenter

<sup>745</sup> See Section 15F(e)(3) of the Exchange Act (stating that the margin requirements adopted under Section 15F(e)(2) of the Exchange Act must, among other things, "be appropriate for the risk associated with the non-cleared security-based swaps held as a [SBSD] or [MSBSP]").

<sup>746</sup> See Section 15F(e)(3) of the Exchange Act (stating that the margin requirements adopted under Section 15F(e)(2) of the Exchange Act must, among other things, "help ensure the safety and soundness of the [SBSD] or [MSBSP]").

<sup>747</sup> See paragraph (d)(5)(i) of Rule 3a71–6, as amended.

<sup>748</sup> See paragraph (d)(5)(ii) of Rule 3a71–6, as amended.

<sup>749</sup> See *Cross-Border Proposing Release*, 78 FR at 31018–22.

<sup>750</sup> See IIB 8/21/2013 Letter.

<sup>751</sup> See SIFMA 8/21/2013 Letter. See also IIB 11/19/2018 Letter (requesting that in connection with collateral for cleared security-based swaps, the Commission's segregation requirements should only apply to transactions with U.S. persons, and the foreign SBSD should be permitted to satisfy these requirements through substituted compliance.)

<sup>752</sup> See, e.g., Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, and Adam Jacobs, Director, Head of Markets Regulation, Alternative Investment Management Association (Aug. 19, 2013) ("MFA/AIMA 8/19/2013 Letter").

<sup>753</sup> See IIB 8/21/2013 Letter.

<sup>754</sup> See Letter from Karrie McMillan, General Counsel, Investment Company Institute, and Dan

stated that collateral segregation and disclosure requirements should only apply to transactions with U.S. counterparties, so long as the firm maintains a separate account for collateral collected from U.S. persons as a way to protect U.S. counterparties in case of bankruptcy. The commenter also requested that foreign branches of U.S. banks which are not part of registered broker-dealers not be subject to segregation requirements when transacting with non-U.S. persons, to “mitigate the competitive effects” foreign branches may suffer relative to foreign SBSBs that are subject to segregation requirements in a narrower set of circumstances.

In response to these comments, granting these exemption requests would put U.S. customers’ interests at risk in case of a foreign SBSB’s bankruptcy. A primary purpose of the Commission’s segregation requirements is to facilitate the prompt return of property to U.S. customers and security-based swap customers either before or during a liquidation if a registrant fails. The Commission is able to limit the segregation rules applicable to U.S. branches of foreign banks to a narrower set of transactions, because the applicable insolvency laws enable a ring-fencing mechanism by which regulators may ring fence creditor claims “arising out of transactions had by them with” the U.S. branches or agencies of the foreign bank.<sup>755</sup>

For the foregoing reasons, the Commission—as discussed below—is adopting the substance of the proposed segregation cross-border provisions in paragraph (e) of Rule 18a–4, but—as discussed in the next section—the Commission is modifying the structure of the paragraph by re-organizing it and making other non-substantive modifications.

#### Final Cross-Border Provisions for Foreign Bank SBSBs

A foreign bank SBSB that has a branch or agency in the United States should not be eligible to be a debtor under the U.S. stockbroker liquidation scheme.<sup>756</sup> Instead, the foreign bank’s U.S. branches and agencies would likely be liquidated under federal or state banking law which “ring fences” creditor claims “arising out of transactions had by them with” the U.S. branches or agencies.<sup>757</sup> With respect to a foreign bank SBSB that has no branch

or agency in the United States, such entities probably would not be liquidated in the United States for jurisdictional reasons. The treatment of U.S. customers in such a liquidation is unknown because it depends on the laws of the jurisdiction where the foreign SBSB is liquidated. However, many jurisdictions’ laws provide for ring fencing similar to U.S. bank liquidation laws.

The proposed cross-border segregation provisions for foreign bank SBSBs were based on the understanding that ring fencing prioritized the claims of U.S. creditors above the claims of foreign creditors (rather than the actuality that *both* U.S. and foreign creditor claims arising out of a transaction with U.S. branches and agencies receive priority). Therefore, proposed Rule 18a–4 required a foreign bank SBSB with a U.S. branch to comply with the segregation requirements in Section 3E of the Exchange Act, and the rules and regulations thereunder (*e.g.*, proposed Rule 18a–4), with respect to cleared and non-cleared security-based swap transactions only with U.S. persons. The proposed cross-border provisions did not expressly address a foreign bank SBSB that has no branch or agency in the United States.

For the foregoing reasons, Rule 18a–4, as adopted, clarifies that the segregation requirements of Section 3E of the Exchange Act, and the rules and regulations thereunder, apply to a foreign bank SBSB (*i.e.*, a foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, or credit union): (1) With respect to a security-based swap customer that is a U.S. person (regardless of which branch or agency the customer’s transactions arise out of), and (2) with respect to a security-based swap customer that is not a U.S. person if the foreign bank SBSB holds funds or other property arising out of a transaction had by such person with a U.S. branch or agency of the foreign SBSB.<sup>758</sup> Thus, the final cross-border provisions for foreign bank SBSBs expressly account for foreign bank SBSBs that do not have a U.S. branch and for foreign customers who transact with a U.S. branch of a foreign bank SBSB and, therefore, may be protected by U.S. ring fencing laws along with U.S. customers.

The Commission also proposed that the foreign bank SBSB maintain a special account designated for the exclusive benefit of U.S. security-based

swap customers.<sup>759</sup> However, this language is removed as extraneous text because Rule 18a–4, as adopted, already requires SBSBs to maintain a special reserve account for the exclusive benefit of security-based swap customers.<sup>760</sup>

#### Final Cross-Border Provisions for Foreign Stand-Alone SBSBs

A foreign stand-alone SBSB should be subject to the U.S. Bankruptcy Code’s stockholder liquidation provisions. In particular, Section 3E(g) of the Exchange Act provides “customer” status under the stockbroker liquidation provisions to all counterparties to cleared security-based swaps, making no distinction between U.S. and non-U.S. customers or counterparties.<sup>761</sup> If the Commission were to apply the segregation requirements only to assets of U.S. customers but not to assets of non-U.S. customers, the amount of assets segregated (*i.e.*, the assets of U.S. person customers) could be insufficient to satisfy the combined priority claims of both U.S. and non-U.S. customers in a stockbroker liquidation proceeding, potentially resulting in losses to U.S. customers. Therefore, proposed Rule 18a–4 required a foreign stand-alone SBSB to comply with the segregation requirements of Section 3E of the Exchange Act, and the rules and regulations thereunder, with respect to assets received from both U.S. and non-U.S. persons if the foreign stand-alone SBSB received collateral from at least one U.S. person to secure cleared security-based swaps.

Section 3E(g) of the Exchange Act also extends customer protection under the stockbroker liquidation provisions to collateral delivered as margin for non-cleared security-based swaps if the collateral is subject to a customer protection requirement under Section 15(c)(3) of the Exchange Act or a segregation requirement. Therefore, proposed Rule 18a–4 required a foreign stand-alone SBSB to comply with the segregation requirements of Section 3E of the Exchange Act, and the rules and regulations thereunder, with respect to non-cleared security-based swap transactions with U.S. persons (but not with non-U.S. persons). Under that approach, the collateral posted by U.S. person counterparties was subject to a segregation requirement and therefore these persons would have “customer” status under the stockbroker liquidation

Waters, Managing Director, ICI Global (Aug. 21, 2013) (“ICI 8/21/2013 Letter”).

<sup>755</sup> See 12 U.S.C. 3102(j).

<sup>756</sup> See 11 U.S.C. 109(b)(3)(B).

<sup>757</sup> See, *e.g.*, 12 U.S.C. 3102(j)(2); NY Banking Law § 606(4)(a).

<sup>758</sup> See paragraph (e)(1)(i) of Rule 18a–4, as adopted.

<sup>759</sup> See *Cross-Border Proposing Release*, 78 FR at 31022.

<sup>760</sup> See paragraph (c)(1) of Rule 18a–4, as adopted.

<sup>761</sup> See also 11 U.S.C. 741(2).

provisions.<sup>762</sup> Collateral posted by non-U.S. persons was not subject to a segregation requirement and, therefore, these persons would not have “customer” status.

For these reasons, the Commission is adopting the substance of the proposed cross-border provisions for foreign stand-alone SBSBs.<sup>763</sup> However, the Commission is making a clarifying modification to more clearly state that these provisions apply to a foreign SBSB that is not a broker-dealer and is not a foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, or credit union.<sup>764</sup>

#### Final Cross-Border Provisions for Foreign MSBSPs

The omnibus segregation requirements in Rule 18a-4 do not apply to MSBSPs. Consequently, if an MSBSP holds collateral for a security-based swap, it will be subject only to: (1) Paragraph (d) of Rule 18a-4, which requires an SBSB or MSBSP to provide notice of the customer’s right to require segregation, and (2) Section 3E(f)(1)(B) of the Exchange Act, which provides that, if requested by the security-based swap customer, the MSBSP shall separately segregate the funds or other property for the benefit of the security-based swap customer. Consequently, proposed Rule 18a-4 excepted a foreign MSBSP that is not a broker-dealer from the segregation requirements in Section 3E of the Exchange Act and the disclosure requirements in paragraph (d) of Rule 18a-4 with respect to assets received from a security-based swap customer that is not a U.S. person to secure security-based swaps.<sup>765</sup> The Commission did not receive comment on this proposed exception and is

adopting the substance of the proposal.<sup>766</sup>

#### b. Disclosure Requirements

The Commission proposed disclosure requirements for foreign SBSBs because the treatment of security-swap customers in a liquidation proceeding may vary depending on the foreign SBSB’s status and the insolvency laws applicable to the foreign SBSB. In particular, a foreign SBSB was required to disclose to a U.S. security-based swap customer—prior to accepting any assets from the person with respect to a security-based swap—the potential treatment of the assets segregated by the foreign SBSB pursuant to Section 3E of the Exchange Act, and the rules and regulations thereunder, in insolvency proceedings under U.S. bankruptcy law and applicable foreign insolvency laws.<sup>767</sup> The intent was to require that a foreign SBSB disclose whether it could be subject to the stockbroker liquidation provisions in the U.S. Bankruptcy Code, whether the segregated funds or other property could be afforded customer property treatment under the U.S. bankruptcy law, and any other relevant considerations that may affect the treatment of the assets segregated under Section 3E of the Exchange Act in such foreign SBSB’s insolvency proceedings. One commenter responded to the Commission’s request for comment by opposing applying segregation-related disclosure requirements to transactions with non-U.S. counterparties, because of the Commission’s more limited interest in non-U.S. counterparties. The Commission agrees and is adopting its proposal to limit the disclosure requirement to counterparties that are U.S. persons.

In addition, the Commission is modifying the rule text to clarify that the disclosures must be made in writing. As discussed above, the Commission intended that the matters to be disclosed would inform the counterparty about the application of U.S. bankruptcy and foreign insolvency laws to segregated funds or other property the SBSB will hold for the counterparty. The Commission does not believe that an SBSB could provide disclosure on these complex issues in a manner that, in fact, would inform the counterparty about them other than in writing. Therefore, the final rule explicitly provides that the disclosure must be in writing.

For the foregoing reasons, the Commission is adopting the disclosure

requirements with the modifications described above.<sup>768</sup>

#### c. Non-Substantive Modifications

The Commission is making several organizational, clarifying, and non-substantive modifications to the proposed cross-border segregation rule text.

Paragraph (e) of Rule 18a-4 now has a simplified organizational structure compared to paragraphs (e) and (f) of proposed Rule 18a-4. First, the rule text no longer explicitly states that a foreign broker-dealer SBSB is subject to Section 3E of the Exchange Act and the Commission’s security-based swap segregation requirements, even though broker-dealers continue to be subject to the segregation requirements.<sup>769</sup> The Commission’s security-based swap segregation requirements applicable to stand-alone broker-dealers are located in paragraph (p) of Rule 15c3-3.<sup>770</sup> Thus, all broker-dealers registered with the Commission are subject to Rule 15c3-3, and there are no cross-border exemptions from Rule 15c3-3, even if the broker-dealer is also a foreign SBSB or MSBSP. The proposed rule text was intended to identify exemptions from the Commission’s security-based swap segregation rules. As a result, it is not necessary to explicitly state that broker-dealers are subject to Rule 15c3-3 even if they are also foreign SBSBs or MSBSPs.

Second, rather than categorizing the applicable rules by cleared and non-cleared security-based swaps, and then further subdividing them by entity type, the rule paragraphs are now categorized by entity type. In addition, instead of a single paragraph addressing the cross-border non-cleared security-based swap segregation treatment of all foreign SBSBs that are not broker-dealers, there are separate paragraphs addressing foreign SBSBs that are not broker-dealers and are not foreign banks, and foreign SBSBs that are not broker-dealers and are foreign banks. Since a foreign SBSB that is neither a broker-dealer nor a foreign bank is the only entity that must apply a different rule depending on whether the security-based swaps are cleared or non-cleared, this is the only paragraph that requires

<sup>762</sup> Section 3E(g) of the Exchange Act provides that the term “customer,” as defined in Section 741 of title 11 of the U.S. Code, excludes any person, to the extent that such person has a claim based on any open repurchase agreement, open reverse repurchase agreement, stock borrowed agreement, non-cleared option, or non-cleared security-based swap except to the extent of any margin delivered to or by the customer with respect to which there is a customer protection requirement under Section 15(c)(3) of the Exchange Act or a segregation requirement.

<sup>763</sup> See paragraph (e)(1)(ii) of Rule 18a-4, as adopted.

<sup>764</sup> Throughout paragraph (e) of Rule 18a-4, as adopted, the phrase “foreign bank, foreign savings bank, foreign cooperative bank, foreign savings and loan association, foreign building and loan association, or foreign credit union” parallels and is intended to have the same meaning as the phrase “foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, or credit union” in 11 U.S.C. 109(b)(3)(B).

<sup>765</sup> See *Cross-Border Proposing Release*, 78 FR at 31035.

<sup>766</sup> See paragraph (e)(2) of Rule 18a-4, as adopted.

<sup>767</sup> See *Cross-Border Proposing Release*, 78 FR at 31022.

<sup>768</sup> See paragraph (e)(3) of Rule 18a-4, as adopted.

<sup>769</sup> See *Cross-Border Proposing Release*, 78 FR at 31020–21. As discussed below, the Commission is re-organizing paragraph (e) and making other non-substantive modifications to the paragraph.

<sup>770</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53016 (soliciting comment on potential rule language that would modify the proposal in this manner).

subparagraphs for cleared and non-cleared security-based swaps.<sup>771</sup>

Paragraph (e)(2) of Rule 18a-4, which prescribes the segregation requirements applicable to foreign MSBSPs, is now structured in the affirmative instead of the negative by identifying which requirements apply to foreign MSBSPs instead of identifying which requirements “shall not” apply to foreign MSBSPs.<sup>772</sup>

The Commission is also making several changes to simplify and clarify the rule text. Instead of including a cross-reference to the rule defining “foreign security-based swap dealer,” “foreign major security-based swap participant,” and “U.S. person” each time these terms appear, definitions of these terms are added to the “Definitions” section in Rule 18a-4.<sup>773</sup> With respect to SBSBs, “counterparty” is replaced with “security-based swap customer” for consistency with the rest of Rule 18a-4 which uses the defined term “security-based swap customer.” To eliminate ambiguity about the term “registered” SBSB, MSBSP, or broker-dealer, the rule text now clarifies that “registered” refers to an entity registered with the Commission by explicitly cross-referencing the section of the Exchange Act that the entity would register under (*i.e.*, “foreign [SBSB or MSBSP] registered under Section 15 of the Exchange Act (15 U.S.C. 78o-10)” or “broker or dealer registered under Section 15 of the Exchange Act (15 U.S.C. 78o)”).

Several simplifying changes are being made to the cross-border segregation rule text. Throughout the rule text, the phrase “any assets received . . . to margin, guarantee, or secure a [cleared or non-cleared] security-based swap (including money, securities, or property accruing to such [U.S. person or non-U.S. person] counterparty as the result of such a security-based swap transaction)” is simplified to better align with the language used in other rule text. Thus, paragraph (e)(1)(ii) of Rule 18a-4, as adopted, now references “funds or other property for [a or at least one] security-based swap customer that is a U.S. person with respect to a [cleared or non-cleared] security-based swap transaction” to parallel Rule 18a-4’s definition of a security-based swap customer. For the same reason, paragraph (e)(3) of Rule 18a-4, as adopted, now references “funds or other property” instead of “assets,” references

“funds or other property received, acquired, or held for” instead of “assets collected from,” and references “receiving, acquiring, or holding funds or other property” instead of “accepting any assets.” Finally, paragraph (e)(2) of Rule 18a-4, as adopted, now omits the reference to “assets . . . to margin, guarantee, or secure a security-based swap” as extraneous.<sup>774</sup>

#### *F. Delegation of Authority*

The Commission is amending its rules governing delegations of authority to the Director of the Division of Trading and Markets (“Division”). The amendments delegate authority to the Division with respect to requirements in Rules 18a-1 and 18a-4, and are modeled on preexisting delegations of authority with respect to requirements in parallel Rules 15c3-1 and 15c3-3 under 17 CFR 200.30-3 (“Rule 30-3”). The amendments also add additional delegations of authority with respect to Rule 18a-1d (Satisfactory Subordinated Loan Agreements), as well as to Appendix E to Rule 15c3-1 and paragraph (d) to Rule 18a-1 with respect to the approval of the temporary use of a provisional model. These delegations are intended to permit Commission staff to perform functions under Rule 18a-1d for stand-alone SBSBs that are currently performed by a broker-dealer’s DEA (*i.e.*, FINRA) under Appendix D to Rule 15c3-1.<sup>775</sup>

The amendments to Rule 30-3 authorize the Director of the Division to: (1) Review amendments to applications of SBSBs filed pursuant to paragraph (d) of Rule 18a-1 and to approve such amendments, unconditionally or subject to specified terms and conditions;<sup>776</sup> (2)

impose additional conditions, pursuant to paragraph (d)(9)(iii) of Rule 18a-1 on an SBSB that computes certain of its net capital deductions pursuant to paragraph (d) of Rule 18a-1;<sup>777</sup> (3) require that an SBSB provide information to the Commission pursuant to paragraph (d)(2) of Rule 18a-1;<sup>778</sup> (4) pursuant to Rule 15c3-3 and Rule 18a-4, find and designate as control locations for purposes of paragraph (p)(2)(ii)(E) of Rule 15c3-3, and paragraph (b)(2)(v) of Rule 18a-4, certain broker-dealer and SBSB accounts which are adequate for the protection of customer securities;<sup>779</sup> (5) pursuant to paragraph (b)(6) of Rule 18a-1d, approve prepayment of a subordinated loan;<sup>780</sup> (6) pursuant to paragraph (c)(4) of Rule 18a-1d, approve prepayment of a revolving subordinated loan agreement;<sup>781</sup> (7) pursuant to paragraph (c)(5) of Appendix D to Rule 18a-1, examine any proposed subordinated loan agreement filed by a security-based swap dealer and find the agreement acceptable;<sup>782</sup> (8) determine, pursuant § 240.18a-1(d)(7)(ii), that the notice a security-based swap dealer must provide to the Commission pursuant to § 240.18a-1(d)(7)(i) will become effective for a shorter or longer period of time;<sup>783</sup> and (9) approve, pursuant to § 240.15c3-1e(a)(7)(ii) and § 240.18a-1(d)(5)(ii) of this chapter, the temporary use of a provisional model, in whole or in part, unconditionally or subject to any conditions or limitations.<sup>784</sup> In addition, paragraph (a)(7)(i)’s cross-reference to Rule 15c3-1 is corrected to reference paragraph (a)(6)(iii)(B) instead of paragraph (a)(6)(iii)(E), and paragraph (a)(7)(iv)’s cross-reference to Rule 15c3-1 is corrected to reference paragraph (a)(1)(ii) instead of paragraphs (f)(1)(i) and (ii).

These delegations of authority are intended to preserve Commission resources and increase the effectiveness and efficiency of the Commission’s oversight of the financial responsibility rules for SBSBs being adopted today under the authority of the Dodd-Frank

<sup>771</sup> See paragraph (e)(1)(ii)(A) and (B) of Rule 18a-4, as adopted.

<sup>772</sup> See paragraph (e)(2) of Rule 18a-4, as adopted.

<sup>773</sup> See paragraphs (a)(3), (4), and (10) of Rule 18a-4, as adopted.

<sup>774</sup> Further, the phrase “[S]ection 3E(f) of the Act (15 U.S.C. 78c-5(f))” is replaced with “section 3E of the Act (15 U.S.C. 78c-5)” in paragraph (e)(2) of Rule 18a-4, as adopted, for consistency with the other subparagraphs under paragraph (e) of Rule 18a-4, which reference Section 3E of the Exchange Act. In addition, the following stylistic, corrective, and punctuation changes are being made to improve the rule’s readability: (1) Adding or elaborating on paragraph and subparagraph headings; (2) replacing “who” with “that” in paragraphs (e)(1)(i) and (e)(3) of Rule 18a-4; (3) replacing the word “shall” with the word “must” in paragraph (e)(3) of Rule 18a-4; (4) replacing “the U.S. bankruptcy law” with “U.S. bankruptcy law” in paragraph (e)(3) of Rule 18a-4; and (5) replacing “Section 3E of the Act” and “Section 3E of the Act, and the rules and regulations thereunder” with “section 3E of the Act (15 U.S.C. 3E), and the rules and regulations thereunder,” the second and third times it appears in paragraph (e)(3) for completeness and for consistency with the first reference to “Section 3E of the Act (15 U.S.C. 78c-5), and the rules and regulations thereunder” in the same paragraph.

<sup>775</sup> The Commission is the examining authority for stand-alone SBSBs because they are not required to be a member of an SRO.

<sup>776</sup> See paragraph (a)(7)(vi)(A) of Rule 30-3, as amended.

<sup>777</sup> See paragraph (a)(7)(vi)(C) of Rule 30-3, as amended.

<sup>778</sup> See paragraph (a)(7)(vi)(D) of Rule 30-3, as amended.

<sup>779</sup> See paragraph (a)(10)(i) of Rule 30-3, as amended.

<sup>780</sup> See paragraph (a)(7)(vii)(A) of Rule 30-3, as amended.

<sup>781</sup> See paragraph (a)(7)(vii)(B) of Rule 30-3, as amended.

<sup>782</sup> See paragraph (a)(7)(vii)(C) of Rule 30-3, as amended.

<sup>783</sup> See paragraph (a)(7)(vi)(E) of Rule 30-3, as amended.

<sup>784</sup> See paragraph (a)(7)(vi)(F) of Rule 30-3, as amended.

Act. Nevertheless, the Division may submit matters to the Commission for its consideration, as it deems appropriate.

#### Administrative Law Matters

The Commission finds, in accordance with the Administrative Procedure Act (“APA”),<sup>785</sup> that these amendments relate solely to agency organization, procedure, or practice, and do not relate to a substantive rule. Accordingly, the provisions of the APA regarding notice of rulemaking, opportunity for public comment, and publication of the amendment prior to its effective date are not applicable. For the same reason, and because this amendment does not substantively affect the rights or obligations of non-agency parties, the provisions of the Small Business Regulatory Enforcement Fairness Act,<sup>786</sup> are not applicable. Additionally, the provisions of the Regulatory Flexibility Act, which apply only when notice and comment are required by the APA or other law,<sup>787</sup> are not applicable. Further, because this amendment imposes no new burdens on private persons, the Commission does not believe that the amendment will have any anti-competitive effects for purposes of Section 23(a)(2) of the Exchange Act.<sup>788</sup> Finally, this amendment does not contain any collection of information requirements as defined by the Paperwork Reduction Act of 1980, as amended.

### III. Explanation of Dates

#### A. Effective Date

These final rules will be effective 60 days after the date of this release’s publication in the **Federal Register**.

#### B. Compliance Dates

In the release establishing the registration process for SBSBs and MSBSPs, the Commission adopted a compliance date for SBSB and MSBSP registration requirements (the “Registration Compliance Date”) that was tied to four then-pending rule sets.<sup>789</sup> Two of those four rule sets have

been adopted<sup>790</sup> and the Commission is adopting today in this release one of the remaining two rule sets. The Commission believes it appropriate to set the Registration Compliance Date in this release rather than in final rules establishing recordkeeping and reporting requirements for SBSBs and MSBSPs.<sup>791</sup> Accordingly, the Registration Compliance Date is 18 months after the later of: (1) The effective date of final rules establishing recordkeeping and reporting requirements for SBSBs and MSBSPs; or (2) the effective date of final rules addressing the cross-border application of certain security-based swap requirements.<sup>792</sup> Similarly, the compliance date for the rule amendments and new rules being adopted in this release is 18 months after the later of: (1) The effective date of final rules establishing recordkeeping and reporting requirements for SBSBs and MSBSPs; or (2) the effective date of final rules addressing the cross-border application of certain security-based swap requirements. The Commission believes this extended compliance date addresses commenters’ concerns about needing enough time to prepare for and come into compliance with the new requirements.<sup>793</sup> In this regard, the

subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBSB or MSBSP’s behalf. See *Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants*; Final Rule, 80 FR at 48988.

<sup>790</sup> See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, Exchange Act Release No. 77617 (Apr. 14, 2016), 81 FR 29960, 30081 (May 13, 2019); *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, Exchange Act Release No. 84858 (Dec. 19, 2018), 84 FR 4906, 4920 (Feb. 19, 2019).

<sup>791</sup> The Registration Compliance Date is also the compliance date for final rules establishing business conduct requirements under Sections 15F(h) and 15F(k) of the Exchange Act and for acknowledgement and verification of security-based swap transactions. Rule of Practice 194 was effective on April 22, 2019.

<sup>792</sup> The Commission proposed these rules on May 10, 2019, which include rules and/or guidance regarding security-based swap transactions “arranged, negotiated, or executed” by personnel located in the United States, the cross-border scope of the SBSB *de minimis* exception, the certification and opinion of counsel requirement of Rule 15Fb2–1, the questionnaire and application requirement of Rule 18a–5, and the cross-border application of the statutory disqualification prohibition within Section 15F(b)(6) of the Exchange Act. See *Proposed Guidance and Rule Amendments Addressing Cross-Border Application of Certain Security-Based Swap Requirements*, Exchange Act Release No. 85823 (May 10, 2019), 84 FR 24206 (May 24, 2019).

<sup>793</sup> See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53019 (soliciting comment on potential rule language that would modify the proposal in this manner).

Commission notes that commenters recommended a period of 18 to 24 months following adoption of final rules for firms to come into compliance.<sup>794</sup> With respect to the capital requirements being adopted today, a commenter recommended that SBSB capital requirements take effect at the later of: (1) 2 years after the start of the margin implementation period; and (2) the effective date of the swaps push-out rule, and that, once in effect, SBSB capital standards be determined with reference to the transaction activity of counterparties subject to then-applicable initial margin requirements, taking into account the transition period in the BCBS/IOSCO Paper.<sup>795</sup> The compliance date being adopted today is a reasonable amount of time to come into compliance with the new requirements, given that it is triggered by the adoption of rules that were only recently proposed. Consequently, in practice, the compliance date will be more than 18 months from today’s date.

Some commenters recommended that the Commission adopt a compliance date that is shorter than 18 months.<sup>796</sup> The Commission agrees that the Title VII dealer regime should be stood up as expeditiously as possible but must balance that objective with the need to provide firms with a reasonable amount of time to adapt to the new regime. Specifically, firms need time to familiarize themselves with the requirements in the rules being adopted today and how they interact with other security-based swap rules. Firms also need to make and implement informed decisions about business structure and to develop and build compliance systems and controls.

Regarding the Commission’s policy statement on the sequencing of final rules governing security-based swaps,<sup>797</sup> commenters recommended establishing phase-in periods for each major new

<sup>794</sup> See, e.g., IIB 11/19/2018 Letter (18 months); Letter from Karrie McMillan, General Counsel, Investment Company Institute (Aug. 13, 2012) (“ICI 8/13/2012 Letter”) (18–24 months); ICI 11/19/2018 Letter (24 months); ISDA 11/19/2018 Letter (18 months); Mizuho/ING Letter (4 years); Morgan Stanley 11/19/2018 Letter (18 months); SIFMA 11/19/2018 Letter (18 months).

<sup>795</sup> See Morgan Stanley 10/29/2014 Letter.

<sup>796</sup> See, e.g., Better Markets 11/19/2018 Letter (6 months); Harrington 11/19/2018 Letter (1 month).

<sup>797</sup> See *Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Exchange Act Release No. 67177 (June 11, 2012), 77 FR 35625 (June 14, 2012). Comments on the Sequencing Policy Statement which are relevant to the Commission’s capital, margin, and segregation requirements are available at <http://www.sec.gov/comments/s7-05-12/s70512.shtml>.

<sup>785</sup> See 5 U.S.C. 553(b)(3)(A).

<sup>786</sup> See 5 U.S.C. 804(3)(C).

<sup>787</sup> See 5 U.S.C. 603.

<sup>788</sup> See 15 U.S.C. 78w(a)(2).

<sup>789</sup> The Registration Compliance Date was set as the later of: Six months after the date of publication in the **Federal Register** of final rules establishing capital, margin, and segregation requirements for SBSBs and MSBSPs; the compliance date of final rules establishing recordkeeping and reporting requirements for SBSBs and MSBSPs; the compliance date of final rules establishing business conduct requirements under Sections 15F(h) and 15F(k) of the Exchange Act; or the compliance date for final rules establishing a process for a registered SBSB or MSBSP to make an application to the Commission to allow an associated person who is

requirement based on asset class and market participant type.<sup>798</sup> Commenters also suggested imposing requirements on the relatively less complex, more standardized, more liquid products and on interdealer transactions before imposing requirements on more complex, less standardized and less liquid products or transactions involving end users and other smaller market participants.<sup>799</sup> Another commenter suggested grouping rulemakings into two categories in terms of the applicable compliance date.<sup>800</sup> Other commenters requested that the Commission delay the compliance date for the rules being adopted today until after SBSBs and MSBSPs are required to register with the Commission.<sup>801</sup> In contrast, a commenter recommended that there should be a single compliance date with respect to the Commission's margin rules for all relevant market participants after a reasonable compliance period, arguing that a phased-in compliance schedule would create unfairly inconsistent treatment among market participants.<sup>802</sup>

The Commission does not believe it is necessary to phase in the capital, margin, and segregation requirements by asset or market participant type. The compliance date for the rules being adopted today will be more than 18 months from today's date. The Commission believes this will give entities adequate time to take the necessary steps to comply with the new requirements. The Commission also does not believe it would be appropriate to delay the compliance date for the Commission's capital, margin, and segregation rules beyond the date when SBSBs and MSBSPs must register with the Commission, because this would undermine the Commission's ability to effectively regulate and supervise these registrants.

A variety of comments stated that the implementation of the margin rules must be delayed in relation to domestic and foreign regulators, international standard setters, and the development of market infrastructure.<sup>803</sup> Several other jurisdictions and regulators, including the CFTC and the prudential regulators, have finalized margin requirements and certain entities are now subject to these requirements. Given this fact, coupled with a compliance date in excess of 18 months, the Commission believes the industry will have adequate time to come into compliance with the margin rules being adopted today.

Several commenters addressed the timing of the implementation of the Commission's margin rules relative to its clearing rules. A commenter believed that the Commission should not implement the final margin rules until after relevant mandatory central clearing is fully implemented under the Dodd-Frank Act.<sup>804</sup> Other commenters similarly suggested that the non-cleared margin rules should be implemented after clearing rules take effect.<sup>805</sup> A commenter noted that mandatory clearing has not been phased in across market participants and that rules relating to margin for non-cleared transactions should not apply to a particular market participant until the mandatory clearing requirement applies to that participant.<sup>806</sup>

<sup>803</sup> See Letter from Jason Shafer, Vice President/Senior Counsel, Center for Bank Derivatives Policy, American Bankers Association, and Cecilia Calaby, Executive Director and General Counsel, American Bankers Association Securities Association (July 29, 2016) ("American Bankers Association Letter") (asking U.S. regulators to synchronize their margin rules' effective dates with the European Union's schedule); ICI 11/24/2014 Letter (recommending coordinating a longer phase-in period for variation margin with the CFTC and the prudential regulators); IIB 11/19/2018 Letter (requesting a delay in the compliance date for margin rules if the compliance date falls before the final phase-in recommended by the BCBS and IOSCO); ISDA 2/5/2014 Letter (recommending a 2 year phase-in after final margin rules are adopted in the U.S., Europe, and Japan); PIMCO Letter (generally); SIFMA 3/12/2014 Letter (recommending a 2 year phase-in after final margin rules are adopted in the U.S., Europe, and Japan).

<sup>804</sup> See Sutherland Letter.

<sup>805</sup> See American Benefits Council, et al. 1/29/2013 Letter; ISDA 1/23/2013 Letter.

<sup>806</sup> See Letter from Kyle Brandon, Managing Director, Director of Research, Securities Industry and Financial Markets Association (Jan. 13, 2015) ("SIFMA 1/13/2015 Letter") ("[P]hasing in uncleared [security-based swap] margin requirements too close in time to clearing determinations could lead to such margin requirements becoming effective for a certain class of [security-based swap] before that class of [security-based swap] is required to be cleared—effectively forcing clearing before the class is ready, as the cost of engaging in uncleared [security-based swap] transactions would be greater."); SIFMA 3/12/2014 Letter.

In response to these comments, the Commission does not believe it would be appropriate to link the compliance date for the margin rules to the implementation of mandatory clearing. The margin rule applies to non-cleared security-based swaps and is designed to promote the safety and soundness of nonbank SBSBs and nonbank MSBSPs and to protect their counterparties. Therefore, the Commission believes the better approach is to make the compliance date of the margin rule the same as the Registration Compliance Date for SBSBs and MSBSPs. As discussed above, both of these compliance dates will be 18 months after the later of: (1) The effective date of final rules establishing recordkeeping and reporting requirements for SBSBs and MSBSPs; or (2) the effective date of final rules addressing the cross-border application of certain security-based swap requirements.

Another commenter suggested that non-cleared security-based swap margin rules should become effective only after operational requirements for non-cleared margin can be met, and submitted models have been reviewed.<sup>807</sup> A commenter recommended that the Commission adopt a compliance date that is at least 2 years from the effective date of a final capital rule to allow for sufficient time for the Commission or FINRA to approve internal models for capital purposes.<sup>808</sup> As discussed above, the compliance date will be in excess of 18 months after these rules are adopted. This should provide sufficient time for the Commission to review the models of entities that will register as nonbank SBSBs and whose models have not already been approved. Moreover, as discussed above, the final capital rules provide that the Commission can approve the temporary use of a provisional model under certain conditions.<sup>809</sup>

### *C. Effect on Existing Commission Exemptive Relief*

Compliance with certain provisions of the Exchange Act and certain rules and regulations thereunder in connection with security-based swap transactions, positions and/or activity is currently subject to temporary exemptive relief granted by the Commission. The rules

<sup>807</sup> See SIFMA AMG 2/22/2013 Letter. See also Mizuho/ING Letter (requesting that capital requirements be phased in if the Commission does not plan to approve models already approved by certain other regulators).

<sup>808</sup> See Citadel 5/15/2017 Letter.

<sup>809</sup> See paragraph (a)(7)(ii) of Rule 15c3–1e, as amended; paragraph (d)(5)(ii) of Rule 18a–1, as adopted.

<sup>798</sup> See ICI 8/13/2012 Letter; Letter from Jeff Gooch, Chief Executive Officer, MarkitSERV (Aug. 13, 2012) ("MarkitSERV Letter"); Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, Securities Industry and Financial Markets Association (Aug. 13, 2012) ("SIFMA 8/13/2012 Letter"); Letter from Douglas L. Friedman, General Counsel, Tradeweb Markets LLC (Sept. 5, 2012) ("Tradeweb Letter"), Appendix 1 (supporting the CFTC's proposal to phase in compliance with clearing, trade execution and trade reporting requirements by class of market participant and asset class).

<sup>799</sup> See SIFMA 8/13/2012 Letter (recommending certain single-name credit default swaps as examples of more liquid and standardized products and total return swaps on equity securities or loans as examples of less liquid and standardized products); ICI 8/13/2012 Letter.

<sup>800</sup> See Letter from Chris Barnard (Aug. 13, 2012) ("Barnard 8/13/2012 Letter").

<sup>801</sup> See ISDA 11/19/2018 Letter.

<sup>802</sup> See MFA 2/22/2013 Letter.



the Commission is adopting and amending today relate to temporary exemptive relief for 3 key areas of requirements applicable to SBSDs and MSBSPs: (1) Financial responsibility-related requirements; (2) segregation requirements for non-cleared security-based swaps; and (3) requirements in connection with certain CDS portfolio margin programs.

First, the Commission has provided limited exemptions for registered broker-dealers, subject to certain conditions and limitations, from the application of Sections 7 and 15(c)(3) of the Exchange Act, Rules 15c3–1, 15c3–3,<sup>810</sup> and 15c3–4, and Regulation T in connection with security-based swaps, some of which exemptions were solely to the extent the provisions or rules did not apply to the broker-dealer's security-based swap positions or activities as of July 15, 2011 (collectively, the "Financial Responsibility Rule Exemptions").<sup>811</sup> In connection with this and other exemptive relief, the Commission also provided that, until such time as the underlying exemptive relief expires, no contract entered into on or after July 16, 2011 shall be void or considered voidable by reason of Section 29(b) of the Exchange Act because any person that is a party to the contract violated a provision of the Exchange Act for which the Commission provided exemptive relief in the Exchange Act Exemptive Order ("Section 29(b) Exemption").<sup>812</sup> The Financial Responsibility Rule Exemptions are scheduled to expire on the compliance date for any final capital, margin, and segregation rules for SBSDs and MSBSPs.<sup>813</sup> Accordingly,

all of the Financial Responsibility Rule Exemptions, together with the portion of the Section 29(b) Exemption that relates to the Exchange Act provisions for which the Commission provided exemptive relief in the Financial Responsibility Rule Exemptions, will expire upon the compliance date set forth in section III.B. of this release.

Second, compliance with Section 3E(f) of the Exchange Act is currently subject to temporary exemptive relief.<sup>814</sup> That relief includes an exemption for SBSDs and MSBSPs from the segregation requirements for non-cleared security-based swaps in Section 3E(f) of the Exchange Act, as well as an exemption (similar but not identical to the Section 29(b) Exemption discussed above) providing that no SBS contract entered into on or after July 16, 2011 shall be void or considered voidable by reason of Section 29(b) of the Exchange Act because any person that is a party to the contract violated Section 3E(f) of the Exchange Act. Both of these exemptions will expire on the Registration Compliance Date set forth in section III.B. of this release.

Finally, on December 14, 2012, the Commission issued an order granting conditional exemptive relief from compliance with certain provisions of the Exchange Act in connection with a program to commingle and portfolio margin customer positions in cleared CDS that include both swaps and security-based swaps in a segregated account established and maintained in accordance with Section 4d(f) of the CEA.<sup>815</sup> This exemptive relief does not contain a sunset date; however, the exemptive relief for dually-registered

clearing agency/DCOs is subject to two conditions that will be triggered by the adoption of final rules setting forth margin and segregation requirements applicable to security-based swaps.<sup>816</sup> By their terms, these two conditions will begin to apply by the later of: (1) Six months after adoption of final margin and segregation rules applicable to security-based swaps consistent with Section 3E of the Exchange Act; or (2) the compliance date of such rules. As discussed above in section III.B. of this release, the compliance date for the rules the Commission is adopting today will be 18 months after the later of: (1) The effective date of final rules establishing recordkeeping and reporting requirements for SBSDs and MSBSPs; or (2) the effective date of final rules addressing the cross-border application of certain security-based swap requirements.<sup>817</sup> Accordingly, each dually registered clearing agency/DCO must comply with these two

<sup>816</sup> See CDS Portfolio Margin Order at 75219 (conditions (a)(1) and (2)). Specifically, the first condition requires that the clearing agency/DCO, by the later of (i) six months after the adoption date of final margin and segregation rules applicable to security-based swaps consistent with Section 3E of the Exchange Act or (ii) the compliance date of such rules, take all necessary action within its control to obtain any relief needed to permit its dually-registered broker-dealer/FCM clearing members to maintain customer money, securities, and property received by the broker-dealer/FCM to margin, guarantee, or secure customer positions in cleared CDS, which include both swaps and security-based swaps, in a segregated account established and maintained in accordance with Section 3E of the Exchange Act and any rules thereunder for the purpose of clearing (as a clearing member of the clearing agency/DCO) such customer positions under a program to commingle and portfolio margin CDS. The second condition requires that the clearing agency/DCO, by the later of (i) six months after the adoption date of final margin and segregation rules applicable to security-based swaps consistent with Section 3E of the Exchange Act or (ii) the compliance date of such rules, take all necessary action within its control to establish rules and operational practices to permit a dually-registered broker-dealer/FCM (at the broker-dealer/FCM's election) to maintain customer money, securities, and property received by the broker-dealer/FCM to margin, guarantee, or secure customer positions in cleared CDS, which include both swaps and security-based swaps, in a segregated account established and maintained in accordance with Section 3E of the Exchange Act and any rules thereunder for the purpose of clearing (as a clearing member of the clearing agency/DCO) such customer positions under a program to commingle and portfolio margin CDS.

These two conditions are intended to provide for portfolio margining within a securities account as an alternative for customers who may desire to conduct portfolio margining under a securities account structure as opposed to a swaps account. See CDS Portfolio Margining Order at 75215–75218 (discussing conditional exemptions for dually-registered Clearing Agencies/DCOs from Sections 3E(b), (d) and (e) of the Exchange Act).

<sup>817</sup> See Proposed Guidance and Rule Amendments Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 FR 24206.

<sup>810</sup> The exemption from Rule 15c3–3 was not available for activities and positions of a registered broker-dealer related to cleared security-based swaps to the extent that the registered broker-dealer is a member of a clearing agency that functions as a central counterparty for security-based swaps, and holds customer funds or securities in connection with cleared security-based swaps.

<sup>811</sup> See Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of "Security" to Encompass Security-Based Swaps, and Request for Comment, Exchange Act Release No. 64795 (July 1, 2011), 76 FR 39927 (July 7, 2011) ("Exchange Act Exemptive Order").

<sup>812</sup> See Exchange Act Exemptive Order at 39940.

<sup>813</sup> The Financial Responsibility Rule Exemptions originally were set to expire on the compliance date for final rules further defining the terms "security-based swap" and "eligible contract participant." See Exchange Act Exemptive Order at 39938–39. In the final rules further defining the term "security-based swap," the Commission extended this expiration date to February 13, 2013. See *Product Definitions Adopting Release* at 48304. On February 7, 2013, the Commission extended the expiration date until February 11, 2014. See *Order Extending Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Revision of the Definition of "Security" to*

*Encompass Security-Based Swaps, and Request for Comment*, Exchange Act Release No. 68864 (Feb. 7, 2013), 78 FR 10218, 10220 (Feb. 13, 2013). On February 5, 2014, the Commission further extended the expiration date until the compliance date set forth in any final capital, margin, and segregation rules for SBSDs and MSBSPs. See *Order Extending Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Revision of the Definition of "Security" to Encompass Security-Based Swaps, and Request for Comment*, Exchange Act Release No. 71485 (Feb. 5, 2014), 79 FR 7731, 7734 (Feb. 10, 2014).

<sup>814</sup> See *Order Pursuant to Sections 15(f)(6) and 36 of the Securities Exchange Act of 1934 Extending Certain Temporary Exemptions and a Temporary and Limited Exception Related to Security-Based Swaps*, Exchange Act Release No. 75919 (Sept. 15, 2015), 80 FR 56519 (Sept. 18, 2015); *Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps*, Exchange Act Release No. 64678 (June 15, 2011), 76 FR 36287 (June 22, 2011).

<sup>815</sup> *Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With Portfolio Margining of Swaps and Security-Based Swaps*, Exchange Act Release No. 68433 (Dec. 14, 2012), 77 FR 75211 (Dec. 19, 2012) ("CDS Portfolio Margin Order").



conditions no later than that date. Before the compliance date, the Commission intends to continue coordinating with the CFTC to address portfolio margining of security-based swaps and swaps by nonbank SBSDs and swap dealers.

#### *D. Application to Substituted Compliance*

For the amendments to Rule 3a71–6, the Commission is adopting an effective date of 60 days following publication in the **Federal Register**. There will be no separate compliance date in connection with that rule, as the rule does not impose obligations upon entities. As discussed above, SBSDs and MSBSPs will not be required to comply with the capital and margin requirements until they are registered, and the registration requirement for those entities will not be triggered until a number of regulatory benchmarks have been met.

In practice, the Commission recognizes that if the requirements of a foreign regime are comparable to Title VII requirements, and the other prerequisites to substituted compliance also have been satisfied, then it may be appropriate to permit an SBSD or MSBSP to rely on substituted compliance commencing at the time that entity is registered with the Commission. Accordingly, the Commission would consider substituted compliance requests that are submitted prior to the compliance date for its capital and margin requirements. The Commission believes this addresses commenters' concerns that the compliance date could be before substituted compliance determinations are made.<sup>818</sup>

#### **IV. Paperwork Reduction Act**

Certain provisions of the new rules and amendments contain “collection of information” requirements within the

meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>819</sup> The Commission published notice requesting comment on the collection of information requirements<sup>820</sup> and submitted the amendments and the proposed new rules to the Office of Management and Budget (“OMB”) for review in accordance with the PRA.<sup>821</sup> The Commission's earlier PRA assessments have been revised to reflect the modifications to the final rules and amendments from those that were proposed, the adoption of new Rule 18a–10 as a result of comments received,<sup>822</sup> and additional information and data now available to the Commission.<sup>823</sup> 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:

Rule	Rule title	OMB control No.
Rule 18a–1, Rule 18a–1a, Rule 18a–1b, Rule 18a–1c, and Rule 18a–1d.	Net capital requirements for SBSDs for which there is not a prudential regulator .....	3235–0701
Rule 18a–2 .....	Capital requirements for MSBSPs for which there is not a prudential regulator .....	3235–0699
Rule 18a–3 and Rule 18a–10 .....	Non-cleared security-based swap margin requirements for SBSDs and MSBSPs for which there is not a prudential regulator; Alternative compliance mechanism for security-based swap dealers that are registered as swap dealers and have limited security-based swap activities.	3235–0702
Rule 18a–4 and exhibit .....	Segregation requirements for SBSDs and MSBSPs .....	3235–0700
Rule 15c3–1 and appendices .....	Net capital requirements for brokers or dealers .....	3235–0200
Rule 15c3–3 and exhibits .....	Customer protection—reserves and custody of securities .....	<sup>824</sup> 3235–0078
Rule 3a71–6 .....	Substituted compliance for SBSDs and MSBSPs .....	3235–0715

#### *A. Summary of Collections of Information Under the Rules and Rule Amendments*

##### **1. Rule 18a–1 and Amendments to Rule 15c3–1**

Rule 18a–1 establishes minimum capital requirements for stand-alone SBSDs and the amendments to Rule 15c3–1 augment capital requirements

for broker-dealers to accommodate broker-dealer SBSDs and to enhance the provisions applicable to ANC broker-dealers. The new rule and amendments establish new collections of information requirements.

First, under paragraphs (a)(2) and (d) of Rule 18a–1, a stand-alone SBSD must apply to the Commission to be authorized to use internal models to

compute net capital. As part of the application process, a stand-alone SBSD is required to provide the Commission staff with information specified in the rule. In addition, a stand-alone SBSD authorized to use internal models will review and update the models it uses to compute market and credit risk, as well as backtest the models.

<sup>818</sup> See IIB 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>819</sup> See 44 U.S.C. 3501, *et seq.*

<sup>820</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR 70214; *Cross-Border Proposing Release*, 81 FR at 31204. See also *Trade Acknowledgment and Verification of Security-Based Swap Transactions*, 81 FR at 39831–33 (discussing the paperwork burden for Rule 3a71–6).

<sup>821</sup> See 44 U.S.C. 3507(d); 5 CFR 1320.11.

<sup>822</sup> As discussed in more detail below, the Commission is adopting new Rule 18a–10 in response to comments received on the proposal not related to the collection of information discussion in the proposing release. Therefore, the proposal did not contain a collection of information for this new rule. The Commission estimates that 3 stand-alone SBSDs will elect to operate under Rule 18a–10. As discussed in more detail below, however, these respondents were included in the proposing

release in other collections of information (Rule 18a–1 and Rule 18a–3, as proposed), and have been moved to the information collection for Rule 18a–10. Therefore, the total respondents in the collections of information for Rules 18a–1 and 18a–3, as adopted, have been adjusted by three respondents. The hour burdens and costs for the collection of information for Rule 18a–10, as adopted, are included in the collection of information for Rule 18a–3, as adopted.

<sup>823</sup> The hourly rates used for internal professionals used throughout this section IV of the release are taken from SIFMA's *Management & Professional Earnings in the Securities Industry 2013*, modified to account for an 1,800-hour work-year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead, in addition to SIFMA's *Office Salaries in the Securities Industry 2013*, modified by Commission staff to account for an 1,800-hour work-year and inflation, and multiplied by 2.93 to

account for bonuses, firm size, employee benefits, and overhead.

<sup>824</sup> The proposed hour burdens for the collection of information related to Rule 15c3–3, as amended, in this release were included in the collection of information for proposed Rule 18a–4 in the proposing release. These hours were moved (and modified as a result of comments) to the existing collection of information in Rule 15c3–3, as amended, as a result of changes made to the final rule to require that broker-dealers that are also registered as nonbank SBSDs comply with the segregation requirements of paragraph (p) to Rule 15c3–3, as amended, with respect to their security-based swap activities. In addition, as a result of comments received, the collection of information in the final rule related to Rule 15c3–3, as amended, contains additional respondents to account for the activities of stand-alone broker-dealers engaged in security-based swap activities.

Second, under paragraph (f) of Rule 18a-1 and paragraph (a)(10)(ii) of Rule 15c3-1, as amended, nonbank SBSBs, including broker-dealer SBSBs, are required to implement internal risk management controls in compliance with certain requirements of Rule 15c3-4.

Third, under paragraph (c)(1)(vi)(B)(1)(iii)(A) of Rule 18a-1 and paragraph (c)(2)(vi)(P)(1)(iii) of Rule 15c3-1, as amended, broker-dealers, broker-dealer SBSBs, and stand-alone SBSBs not using models are 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, for the purposes of calculating “haircuts” on non-cleared CDS. These firms could use a third-party classification system or develop their own classification system.

Fourth, under paragraph (h) of Rule 18a-1, stand-alone SBSBs are required to provide the Commission with certain written notices with respect to equity withdrawals.

Fifth, under paragraph (c)(5) of Rule 18a-1d, a stand-alone SBSB is required to file with the Commission two copies of any proposed subordinated loan agreement at least 30 days prior to the proposed execution date of the agreement, as well as a statement setting forth the name and address of the lender, the business relationship of the lender to the SBSB, and whether the SBSB carried an account for the lender effecting transactions in security-based swaps at or about the time the proposed agreement was filed.

Finally, under paragraph (c)(1)(ix)(C)(3) of Rule 18a-1 and paragraph (c)(2)(xv)(C)(3) of Rule 15c3-1, as amended, stand-alone broker-dealers and nonbank SBSBs may treat collateral held by a third-party custodian to meet an initial margin requirement of a security-based swap or swap customer as being held by the stand-alone broker-dealer or nonbank SBSB for purposes of avoiding the capital deduction in lieu of margin or credit risk charge if certain conditions are met.

## 2. Rule 18a-2

Rule 18a-2 establishes capital requirements for nonbank MSBSPs. In particular, a nonbank MSBSP is required at all times to have and maintain positive tangible net worth, and comply with Rule 15c3-4 with respect to its security-based swap and swap activities.

## 3. Rule 18a-3

Rule 18a-3 prescribes non-cleared security-based swap margin requirements for nonbank SBSBs and MSBSPs. Paragraph (e) of Rule 18a-3 requires a nonbank SBSB to monitor the risk of each account, and establish, maintain, and document procedures and guidelines for monitoring the risk.

Finally, under paragraph (d) to Rule 18a-3, a nonbank SBSB applying to the Commission for authorization to use and be responsible for a model to calculate the initial margin amount under the rule will be subject to the application process and ongoing conditions in Rule 15c3-1e or paragraph (d) of Rule 18a-1, as applicable, governing the use of internal models to compute net capital.

## 4. Rule 18a-4 and Amendments to Rule 15c3-3

Rule 18a-4 establishes segregation requirements for cleared and non-cleared security-based swap transactions for bank and stand-alone SBSBs, as well as notification requirements for these entities. Amendments to Rule 15c3-3 establish segregation requirements for stand-alone broker-dealers and broker-dealer SBSBs that are largely parallel to the requirements in Rule 18a-4. Specifically, new paragraph (p) to Rule 15c3-3 establishes segregation requirements for stand-alone broker-dealers and broker-dealer SBSBs with respect to their security-based swap activity. The provisions of Rule 18a-4, as well as the amendments to Rule 15c3-3, are modeled on existing Rule 15c3-3—the broker-dealer segregation rule. Rules 18a-4 and 15c3-3 also contain provisions that are not modeled specifically on Rule 15c3-3 as it exists today. First, paragraph (d) of Rule 18a-4 and paragraph (p)(4) of Rule 15c3-3 require SBSBs and MSBSPs 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. Second, SBSBs must obtain subordination agreements from counterparties that elect individual or omnibus segregation.

Additionally, paragraph (a)(5)(iii) of Rule 18a-4 and paragraph (p)(1)(iii) of Rule 15c3-3, as amended, impose documentation requirements with respect to a qualified clearing agency account a broker-dealer or SBSB maintains at a clearing agency that holds funds and other property in order to margin, guarantee, or secure cleared

security-based swaps of the firm's security-based swap customers.

Under paragraph (a)(4) of Rule 18a-4 and paragraph (p)(1)(iv) of Rule 15c3-3, as amended, a qualified registered security-based swap dealer account is defined to mean an account at an SBSB registered with the Commission pursuant to Section 15F of the Exchange Act that meets conditions that are largely identical to the conditions for a qualified clearing agency account.

Finally, paragraph (c)(1) of Rule 18a-4 and paragraph (p)(3)(i) of Rule 15c3-3 require an stand-alone broker-dealer and SBSB, among other things, to maintain a special reserve account for the exclusive benefit of security-based swap customers separate from any other bank account of the broker-dealer or SBSB.

Paragraph (c)(1) of Rule 18a-4 and paragraph (p)(3)(i) of Rule 15c3-3, as amended, provide that the stand-alone broker-dealer or SBSB must at all times maintain in a customer reserve account, through deposits into the account, cash and/or qualified securities in amounts computed weekly in accordance with the formula set forth in Exhibit A to Rule 18a-4 or Exhibit B to Rule 15c3-3, which is modeled on the formula in Exhibit A to Rule 15c3-3.

Paragraph (e) of Rule 18a-4 specifies when foreign stand-alone and bank SBSBs and MSBSPs are not required to comply with the segregation requirements in Section 3E of the Exchange Act and Rule 18a-4 thereunder. In addition, a foreign stand-alone or bank SBSB is required to disclose to a U.S. security-based swap customer the potential bankruptcy treatment of property segregated by the SBSB.

Finally, under paragraph (f) of Rule 18a-4, a stand-alone or bank SBSB will be exempt from the requirements of Rule 18a-4 if the SBSB meets certain conditions, including that the SBSB provides notice to the counterparty regarding the right to segregate initial margin at an independent third-party custodian, and provides certain disclosures in writing regarding the collateral received by the SBSB.

## 5. Rule 18a-10

Rule 18a-10 is an alternative compliance mechanism pursuant to which a stand-alone SBSB that is registered as a swap dealer and predominantly engages in a swaps business may elect to comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of complying with Rules 18a-1, 18a-3, and 18a-4.

Paragraph (b) of Rule 18a-10 sets forth certain requirements for a firm that is operating pursuant to the rule. Among other things, paragraph (b)(2) of Rule 18a-10 requires the firm to provide a written disclosure to its counterparties before the first transaction with the counterparty after the firm begins the operating pursuant to the rule notifying the counterparty that the firm is complying with the applicable capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of complying with applicable Commission rules. Paragraph (b)(3) of Rule 18a-10 requires a stand-alone SBSB operating pursuant to the rule to immediately notify the Commission and the CFTC in writing if it fails to meet a condition in paragraph (a) of the rule.

Finally, paragraph (d) of Rule 18a-10 addresses how a firm would elect to operate pursuant to the rule. Under paragraph (d)(1), a firm can make the election as part of the process of applying to register as an SBSB. In this case, the firm must provide written notice to the Commission and the CFTC during the registration process of its intent to operate pursuant to the rule. Under paragraph (d)(2) of Rule 18a-10, an SBSB can make an election to operate under the alternative compliance mechanism after the firm has been registered as an SBSB by providing written notice to the Commission and the CFTC of its intent to operate pursuant to the rule.

#### 6. Amendments to Rule 3a71-6

The Commission is amending Rule 3a71-6 to provide persons with the ability to apply for substituted compliance with respect to the capital and margin requirements of Section 15F(e) of the Exchange Act and Rules 18a-1, 18a-2, and 18a-3 thereunder.

#### B. Use of Information

The Commission, its staff, and SROs, as applicable, will use the information collected under Rules 18a-1, 18a-2, 18a-3, 18a-4, and 18a-10, as well as the amendments to Rule 15c3-1 and Rule 15c3-3 to evaluate whether an SBSB, MSBSP, or stand-alone broker-dealer is in compliance with each rule that applies to the entity and to help fulfill their oversight responsibilities. The Commission plans to use the information collected pursuant to Rule 3a71-6, as amended, to evaluate requests for substituted compliance with respect to the capital and margin requirements. The collections of information also will help to ensure that SBSBs, MSBSPs, and stand-alone broker-dealers are meeting their obligations under the new rules and rule

amendments and have the required policies and procedures in place. In this regard, the collections of information will be used by the Commission as part of its ongoing efforts to monitor and enforce compliance with the federal securities laws through, among other things, examinations and inspections.

Rules 18a-1 and 18a-2, and the amendments to Rule 15c3-1, are integral parts of the Commission's financial responsibility program for nonbank SBSBs and MSBSPs, and stand-alone broker-dealers. Rules 18a-1 and 15c3-1 are designed to ensure that nonbank SBSBs and stand-alone broker-dealers, respectively, have sufficient liquidity to meet all unsubordinated obligations to customers and counterparties and, consequently, if the nonbank SBSB or stand-alone broker-dealer fails, sufficient resources to wind-down in an orderly manner without the need for a formal proceeding. The collections of information in Rule 18a-1, Rule 18a-2 and the amendments to Rule 15c3-1 facilitate the monitoring of the financial condition of nonbank SBSBs and MSBSPs, and stand-alone broker-dealers by the Commission and its staff.

Rule 18a-3 is intended to help ensure the safety and soundness of the nonbank SBSB or MSBSP. Records maintained by these entities relating to the collection of collateral required by Rule 18a-3 will assist examiners in evaluating whether nonbank SBSBs are in compliance with requirements in the rule.

Rule 18a-4 and the amendments to Rule 15c3-3 are integral to the Commission's financial responsibility program as they are designed to protect the rights of security-based swap customers and their ability to promptly obtain their property from an SBSB or stand-alone broker-dealer. The collection of information requirements in the rule and amendments will facilitate the process by which the Commission and its staff monitor how SBSBs and stand-alone broker-dealers are fulfilling their custodial responsibilities to security-based swap customers. Rule 18a-4 and the amendments to Rule 15c3-3 also require that an SBSB to provide certain notices to its counterparties to alert them to the alternatives available to them with respect to segregation of non-cleared security-based swaps. The Commission and its staff will use this new collection of information to confirm registrants are providing the requisite notice to counterparties.

Rule 18a-10 requires a stand-alone SBSB to: (1) Provide certain disclosures to its counterparties to alert them that the firm will be complying with the

capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of Rules 18a-1, 18a-3, and 18a-4; (2) to notify the Commission and the CFTC the firm is electing to operate under the conditions of the rule; and (3) provide a notice to the Commission and the CFTC if it fails to meet a condition of the rule. The Commission and its staff will use this new collection of information to confirm which registrants are operating under the conditions of the rule. In addition, the Commission will use the information to confirm that registrants are providing the requisite disclosures to counterparties, and assist examiners in evaluating whether SBSBs are in compliance with requirements in the rule.

Finally, the requests for substituted compliance determinations under Rule 3a71-6 are required when a person seeks a substituted compliance determination with respect to the capital and margin requirements applicable to foreign SBSBs and MSBSPs. Consistent with Exchange Act Rule 0-13(h), the Commission will publish in the **Federal Register** a notice that a complete application has been submitted, and provide the public the opportunity to submit to the Commission any information that relates to the Commission action requested in the application.

#### C. Respondents

The Commission estimated the number of respondents in the proposing release.<sup>825</sup> The Commission received no comment on these estimates and continues to believe they are appropriate. However, the number of respondents has been updated to include stand-alone broker-dealers engaged in security-based swap activities as well as the number of foreign SBSBs and MSBSPs. In addition, in response to comments received, the Commission is adopting new Rule 18a-10, which has resulted in the number of respondents being updated in Rules 18a-1, as adopted, and Rule 18a-3, as adopted.

The following charts summarize the Commission's respondent estimates:

Type of respondent	Number of respondents
SBSBs .....	50
Bank SBSBs .....	25
Nonbank SBSBs .....	25
Broker-Dealer SBSBs .....	16
Non-broker-dealer SBSBs ....	34
Stand-Alone SBSBs .....	9

<sup>825</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70292-93.

Type of respondent	Number of respondents
ANC Broker-Dealer SBSDs ..	10
Broker-Dealer SBSDs (Not Using Models) .....	6
Stand-Alone SBSDs (Using Models) .....	4
Stand-Alone SBSDs (Not Using Models) .....	2
Stand-Alone Broker-Dealers	25
Nonbank MSBSPs .....	5
Nonbank SBSDs subject to Rule 18a-3 .....	22
Foreign SBSDs and MSBSPs .....	22
Foreign SBSDs and/or foreign MSBSPs submitting substituted compliance applications .....	3
Bank SBSDs exempt from requirements of Rule 18a-4 .....	25
Stand-Alone SBSDs exempt from requirements of Rule 18a-4 .....	6
Stand-Alone SBSDs operating under Rule 18a-10 ..	3

Consistent with prior releases, based on available data regarding the single-name CDS market—which the Commission believes will comprise the majority of security-based swaps—the Commission estimates that the number of nonbank MSBSPs likely will be five or fewer and, in actuality, may be zero.<sup>826</sup> Therefore, to capture the likely number of nonbank MSBSPs that may be subject to the collections of information for purposes of the PRA, the Commission estimates that five entities will register with the Commission as nonbank MSBSPs.<sup>827</sup> The Commission estimates there will be 1 broker-dealer MSBSP for the purposes of calculating paperwork burdens, in recognition that broker-dealer MSBSPs and stand-alone MSBSPs are subject to different burdens under the new and amended rules in certain instances.

Consistent with prior releases, the Commission estimates that 50 or fewer entities ultimately may be required to register with the Commission as SBSDs, and 16 broker-dealers will likely seek to register as SBSDs.<sup>828</sup>

Because many of the dealers that currently engage in OTC derivatives

activities are banks, the Commission estimates that approximately 75% of the 34 non-broker-dealer SBSDs will be bank SBSDs (*i.e.*, 25 firms), and the remaining 25% will be stand-alone SBSDs (*i.e.*, 9 firms).<sup>829</sup>

Of the nine stand-alone SBSDs, the Commission estimates, based on its experience with ANC broker-dealers and OTC derivatives dealers, that four firms will apply to use internal models to compute net capital under Rule 18a-1.<sup>830</sup> This estimate has been reduced from six in the proposing release<sup>831</sup> to four to account the adoption of Rule 18a-10, which will enable stand-alone SBSDs to elect an alternative compliance mechanism and comply with capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of Rules 18a-1, 18a-3, and 18a-4. Finally, in the proposing release, the Commission estimated that 3 stand-alone SBSDs would not apply to use models.<sup>832</sup> This estimate has been modified from 3 firms to 2 firms to account for the nonbank SBSDs that will elect the alternative compliance mechanism under Rule 18a-10.

Of the 16 broker-dealer SBSDs, the Commission estimates that 10 firms will operate as ANC broker-dealer SBSDs authorized to use internal models to compute net capital under Rule 15c3-1.<sup>833</sup>

The Commission estimates that 25 registered broker-dealers will be engaged in security-based swap activities but will not be required to register as an SBSD or MSBSP (*i.e.*, will be stand-alone broker-dealers). 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.<sup>834</sup> First, because the Exchange Act has not previously defined security-based swaps as securities, security-based swaps have not been required to be traded through registered broker-dealers.<sup>835</sup> 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. The existing financial responsibility requirements make it more costly to conduct these activities in a broker-dealer than in an unregulated entity. As a result, security-based swap activities are mostly concentrated in affiliates of stand-alone broker-dealers.<sup>836</sup>

For purposes of the exemption from the requirements of Rule 18a-4 for stand-alone SBSDs and bank SBSDs, the Commission estimates that 25 bank SBSDs and 6 stand-alone SBSDs will be exempt from the requirements of Rule 18a-4 pursuant to paragraph (f) of the rule.<sup>837</sup> For purposes Rule 18a-10, the Commission estimates that 3 stand-alone SBSDs will operate pursuant to the rule.<sup>838</sup>

For purposes of estimating the number of respondents with respect to the amendments to Rule 3a71-6, applications for substituted compliance may be filed by foreign financial authorities, or by non-U.S. SBSDs or MSBSPs. Consistent with prior estimates, the Commission staff expects that there may be approximately 22 non-

<sup>834</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70302.

<sup>835</sup> See Section 761 of the Dodd-Frank Act (amending definition of *security* in Section 3 of the Exchange Act).

<sup>836</sup> See *ISDA Margin Survey 2015* (Aug. 2015). The ISDA survey examines the state of collateral use and management among derivatives dealers and end-users. The appendix to the survey lists firms that responded to the survey, including broker-dealers. The ISDA margin surveys cited in this release are available at <https://www.isda.org/category/research/surveys/>.

<sup>837</sup> See paragraph (f) of Rule 18a-4, as adopted. The Commission estimates that all 25 bank SBSDs will be exempt from the requirements of Rule 18a-4. These bank SBSDs will be subject to disclosure and notice requirements under paragraph (f) of Rule 18a-4, as adopted.

<sup>838</sup> These respondents (2 stand-alone SBSDS using models and one stand-alone SBSD not using models) have been moved from the collections of information for proposed Rules 18a-1 and 18a-3. In the proposing release, the Commission estimated that 25 nonbank SBSDs would be subject to Rule 18a-3, as proposed. See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70293. As a result of the adoption of Rule 18a-10, the Commission estimates that 22 nonbank SBSDs will be subject to Rule 18a-3 (25 nonbank SBSDs minus 3 stand-alone SBSDs electing to operate under Rule 18a-10 = 22 respondents). As discussed above, the collection of information for Rule 18a-10 is included with the collection of information for Rule 18a-3.

<sup>826</sup> See *Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 80 FR at 48990. See also *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"*, 77 FR at 30727.

<sup>827</sup> See *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, 84 FR at 4921.

<sup>828</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70292.

<sup>829</sup> The Commission does not anticipate that any firms will be dually registered as a broker-dealer and a bank.

<sup>830</sup> Internal 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 will choose to do so.

<sup>831</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70293.

<sup>832</sup> See 77 FR at 70293.

<sup>833</sup> Currently, 5 broker-dealers are registered as ANC broker-dealers. The Commission has previously estimated that all current and future ANC broker-dealers will also register as SBSDs. See *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers*, 79 FR at 25261.

U.S. entities that may potentially register as SBSDs.<sup>839</sup> Potentially, all such non-U.S. SBSDs, or some subset thereof, may seek to rely on substituted compliance in connection with the requirements being adopted today.<sup>840</sup> For purposes of the PRA, however, consistent with prior estimates, the Commission estimates that 3 of these security-based swap entities will submit such applications in connection with the Commission's capital and margin requirements.<sup>841</sup>

#### *D. Total Initial and Annual Recordkeeping and Reporting Burden*

##### *1. Rule 18a–1 and Amendments to Rule 15c3–1*

The burden estimates for Rule 18a–1 and the amendments to Rule 15c3–1 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.<sup>842</sup>

First, under paragraph (a)(2) of Rule 18a–1, a stand-alone SBSD is required to file an application for authorization to compute net capital using internal models.<sup>843</sup> The requirements for the application are set forth in paragraph (d) of Rule 18a–1, which is modeled on the application requirements of Appendix E to Rule 15c3–1 applicable to ANC broker-dealers.<sup>844</sup>

Based on its experience with ANC broker-dealers and OTC derivatives dealers, the Commission expects that stand-alone SBSDs that apply to use internal models to calculate net capital will already have developed models and

internal risk management control systems. Rule 18a–1 also contains additional requirements that stand-alone SBSDs may not yet have incorporated into their models and control systems. Therefore, stand-alone SBSDs will incur one-time hour burdens and start-up costs in order to develop their models in accordance with Rule 18a–1, as well as submit the models along with their application to the Commission for approval. While the Commission's burden 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 4 stand-alone SBSDs that apply to use the internal models would spend approximately 1,000 hours to: (1) Develop and submit their models and the description of its risk management control systems to the Commission; (2) to create and compile the various documents to be included with their applications; and (3) to work with the Commission staff through the application process. The hour burdens include approximately 100 hours for an in-house attorney to complete a review of the application. Consequently, the Commission staff estimates that the total burden associated with the application process for the stand-alone SBSDs will result in an industry-wide one-time hour burden of approximately 4,000 hours.<sup>845</sup> In addition, the Commission staff allocates 75% (3,000 hours) of these one-time burden hours<sup>846</sup> to internal burden and the remaining 25% (1,000 hours) to external burden to hire outside professionals to assist in preparing and reviewing the stand-alone SBSD's application for submission to the Commission.<sup>847</sup> The Commission staff estimates \$400 per hour for external costs for retaining outside consultants, resulting in a one-time industry-wide external cost of \$400,000.<sup>848</sup>

<sup>845</sup> 4 stand-alone SBSDs × 1,000 hours = 4,000 hours.

<sup>846</sup> The internal hours likely will be performed by an in-house attorney (1,000 hours), a risk management specialist (1,000 hours), and a compliance manager (1,000 hours). Therefore, the estimated internal cost for this hour burden is calculated as follows: (In-house attorney for 1,000 hours at \$422 per hour) + (risk management specialist for 1,000 hours at \$202 per hour) + (compliance manager for 1,000 hours at \$314 per hour) = \$938,000.

<sup>847</sup> 4,000 hours × .75 = 3,000 hours; 4,000 hours × .25 = 1,000 hours. 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.

<sup>848</sup> 1,000 hours × \$400 per hour = \$400,000. See *Financial Responsibility Rules for Broker-Dealers*,

The Commission staff estimates that a stand-alone SBSD authorized to use internal models will 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. Consequently, the Commission staff estimates that the total burden associated with reviewing and back-testing the models for the 4 stand-alone SBSDs will result in an industry-wide annual hour burden of approximately 24,960 hours per year.<sup>849</sup> In addition, the Commission staff allocates 75% (18,720 hours)<sup>850</sup> of these burden hours to internal burden and the remaining 25% (6,240 hours) to external burden to hire outside professionals to assist in reviewing, updating and backtesting the models.<sup>851</sup> The Commission staff estimates \$400 per hour for external costs for retaining outside professionals, resulting in an industry-wide external cost of \$2.5 million annually.<sup>852</sup>

Stand-alone SBSDs electing to file an application with the Commission to use an internal model will incur start-up costs including information technology costs to comply with Rule 18a–1. Based on the estimates for the ANC broker-dealers,<sup>853</sup> it is expected that a stand-alone SBSD will incur an average of approximately \$8.0 million to modify its information technology systems to meet the model requirements of the Rule 18a–

<sup>78</sup> FR 51823 (citing PRA analysis in *Product Definitions Adopting Release*, 77 FR at 48334 (providing an estimate of \$400 per hour to engage an outside attorney)). See also *Crowdfunding*, Exchange Act Release No. 76324 (Oct. 30, 2015), 80 FR 71387 (Nov. 16, 2015); *FAST Act Modernization and Simplification of Regulation S-K*, Exchange Act Release No. 81851 (Oct. 11, 2017), 82 FR 50988 (Nov. 2, 2017). The Commission recognizes that the costs of retaining outside professionals may vary depending on the nature of the professional services, but for purposes of this PRA analysis, the Commission estimates that such costs would be an average of \$400 per hour.

<sup>849</sup> 4 stand-alone SBSDs × (5,600 hours + 640 hours) = 24,960 hours.

<sup>850</sup> These functions likely will be performed by a risk management specialist (9,360 hours) and a senior compliance examiner (9,360 hours). Therefore, the estimated internal cost for this hour burden is calculated as follows: (Risk management specialist for 9,360 hours at \$202 per hour) + (senior compliance examiner for 9,360 hours at \$241 per hour) = \$4,122,380.

<sup>851</sup> 24,960 hours × .75 = 18,720; 24,960 hours × .25 = 6,240. 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.

<sup>852</sup> 6,240 hours × \$400 per hour = \$2,496,000.

<sup>853</sup> See *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, 69 FR 34428.

<sup>839</sup> See *Trade Acknowledgment and Verification of Security-Based Swap Transactions*, 81 FR at 39832.

<sup>840</sup> It is possible that some subset of MSBSPs will be non-U.S. MSBSPs that will seek to rely on substituted compliance in connection with the final capital and margin rules. See *Trade Acknowledgment and Verification of Security-Based Swap Transactions*, 81 FR at 39832.

<sup>841</sup> See *Trade Acknowledgment and Verification of Security-Based Swap Transactions*, 81 FR at 38392.

<sup>842</sup> The burden hours related to the proposed collection of information requirements with respect to the proposed liquidity stress test requirements for nonbank SBSDs that were included in the proposing release have been deleted from the PRA collections of information in this release because these requirements are not being adopted today. See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70294.

<sup>843</sup> A broker-dealer SBSD seeking Commission authorization to use internal models to compute market and credit risk charges will apply under the existing provisions of Appendix E to Rule 15c3–1.

<sup>844</sup> 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. See Commission, *Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 15c3–1*.

1, for a total one-time industry-wide cost of \$32 million.<sup>854</sup>

Second, a nonbank SBSD is required to comply with most provisions of Rule 15c3-4, which requires the establishment of a risk management control system as if it were an OTC derivatives dealer.<sup>855</sup> ANC broker-dealers currently are required to comply with Rule 15c3-4.<sup>856</sup> The Commission staff estimates that the requirement to comply with Rule 15c3-4 will result in one-time and annual hour burdens to nonbank SBSDs. The Commission staff estimates that the average amount of time a firm will spend implementing its risk management control system will be 2,000 hours,<sup>857</sup> resulting in an industry-wide one-time hour burden of 24,000 hours across the 12 nonbank SBSDs not already subject to Rule 15c3-4.<sup>858</sup>

In implementing its policies and procedures, a nonbank SBSD is required to document and record its system of internal risk management controls. The Commission staff estimates that each of these 12 nonbank SBSDs will 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 3,000 hours.<sup>859</sup>

<sup>854</sup> 4 stand-alone SBSDs × \$8 million = \$32 million.

<sup>855</sup> See paragraph (f) to Rule 18a-1, as adopted; paragraph (a)(10)(ii) of Rule 15c3-1, as amended.

<sup>856</sup> See paragraph (a)(7)(iii) of Rule 15c3-1, as amended.

<sup>857</sup> This estimate is based on the one-time burden estimated for an OTC derivatives dealer to implement its 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. See Commission, *Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 15c3-4*.

<sup>858</sup> 25 nonbank SBSDs minus 10 ANC broker-dealer SBSDs = 15 nonbank SBSDs minus 3 nonbank SBSDs electing the alternative compliance mechanism under Rule 18a-10, as adopted = 12 nonbank SBSDs. 12 nonbank SBSDs × 2,000 hours = 24,000 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. This work will likely be performed by a combination of an in-house attorney (8,000 hours), a risk management specialist (8,000 hours), and an operations specialist (8,000 hours). Therefore, the estimated internal cost for this hour burden is calculated as follows: (Attorney for 8,000 hours at \$422 per hour) + (risk management specialist for 8,000 hours at \$202 per hour) + (operations specialist for 8,000 hours at \$139 per hour) = \$6,104,000.

<sup>859</sup> 12 nonbank SBSDs × 250 hours = 3,000 hours. These hour-burden estimates are consistent with similar collections of information under Appendix E to Rule 15c3-1. See *Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 15c3-1*. These hours likely will be performed by a risk management specialist. Therefore, the estimated internal cost for this hour

Nonbank SBSDs may incur start-up costs to comply with the provisions of Rules 15c3-1 and 18a-1 that require compliance with Rule 15c3-4, including information technology costs. Based on the estimates for similar collections of information,<sup>860</sup> it is expected that a nonbank SBSD will incur an average of approximately \$16,000 for initial hardware and software expenses, while the average ongoing cost will be approximately \$20,500 per nonbank SBSD to meet the requirements of the Rule 18a-1 and the amendments to Rule 15c3-1, for a total industry-wide initial cost of \$192,000 and an ongoing cost of \$246,000 per year.<sup>861</sup>

Third, under paragraph (c)(2)(vi)(P)(1)(iii) of Rule 15c3-1, as amended, and paragraph (c)(1)(vi)(B)(1)(iii)(A) of Rule 18a-1, nonbank SBSDs not authorized to use models are 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 CDS reference obligors for purposes of calculating “haircuts” on non-cleared security-based swaps under applicable net capital rules.

As discussed above, the Commission staff estimates that 4 broker-dealer SBSDs and 2 nonbank SBSDs not using models will utilize the CDS haircut provisions under the amendments to Rules 15c3-1 and 18a-1, respectively. Consequently, these firms will use an industry sector classification system that is documented for the credit default swap reference obligors. The Commission expects that these firms will utilize external classification 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 will spend approximately 1 hour per year documenting these industry sector classification systems, for a total annual hour burden of 6 hours.<sup>862</sup>

burden is calculated as follows: Risk management specialist for 3,000 hours at \$202 per hour = \$606,000.

<sup>860</sup> See, e.g., *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).

<sup>861</sup> 12 nonbank SBSDs × \$16,000 = \$192,000; 12 nonbank SBSDs × \$20,500 = \$246,000.

<sup>862</sup> (2 nonbank SBSDs not using models × 1 hour) + (4 broker-dealer SBSDs × 1 hour) = 6 hours. This work will likely be performed by an internal compliance attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Internal compliance attorney for 6 hours at \$371 per hour = \$2,226.

Fourth, under paragraph (h) of Rule 18a-1, a nonbank SBSD is required to file certain notices with the Commission relating to the withdrawal of equity capital. Broker-dealers—which will include broker-dealer SBSDs—currently are required to file these notices under paragraph (e) of Rule 15c3-1. Based on the number of notices currently filed by broker-dealers, the Commission staff estimates that the notice requirements will result in annual hour burdens to stand-alone SBSDs. The Commission staff estimates that each of the 6 stand-alone SBSDs will file approximately 2 notices annually with the Commission. In addition, the Commission staff estimates that it will take a stand-alone SBSD approximately 30 minutes to file these notices, resulting in an industry-wide annual hour burden of 6 hours.<sup>863</sup>

Fifth, under Rule 18a-1d, a nonbank SBSD is required to file a proposed subordinated loan agreement with the Commission (including nonconforming subordinated loan agreements). Broker-dealers currently are subject to such a requirement. Based on staff experience with Rule 15c3-1, the Commission staff estimates that each of the 6 stand-alone SBSDs will spend approximately 20 hours of internal employee resources drafting or updating its subordinated loan agreement template to comply with the requirement, resulting in an industry-wide one-time hour burden of approximately 120 hours.<sup>864</sup> In addition, based on staff experience with Rule 15c3-1, the Commission staff estimates that each stand-alone SBSD will file 1 proposed subordinated loan agreement with the Commission per year and that it will take a firm approximately 10 hours to prepare and file the agreement, resulting in an industry-wide annual hour burden of approximately 60 hours.<sup>865</sup>

Finally, as a result of comments received, Rules 15c3-1 and 18a-1

<sup>863</sup> (6 stand-alone SBSDs × 2 notices) × 30 minutes = 6 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. See *Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 15c3-1*. The Commission believes stand-alone SBSDs will likely perform these functions internally using an internal compliance attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Internal compliance attorney for 6 hours at \$371 per hour = \$2,226.

<sup>864</sup> 6 stand-alone SBSDs × 20 hours = 120 hours. This work will likely be performed by an in-house attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Attorney for 120 hours at \$422 per hour = \$50,640.

<sup>865</sup> 6 stand-alone SBSDs × 1 loan agreement × 10 hours = 60 hours. This work will likely be performed by an in-house attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Attorney for 60 hours at \$422 per hour = \$25,320.

permit a stand-alone broker-dealer and a nonbank SBSD to treat collateral held by a third-party custodian to meet an initial margin requirement of a security-based swap or swap customer as being held by the stand-alone broker-dealer or nonbank SBSD for purposes of the capital deduction in lieu of margin provisions of the rule if certain conditions are met. The Commission staff estimates that the 16 broker-dealer SBSDs and 6 stand-alone SBSDs will engage outside counsel to draft and review the account control agreement at a cost of \$400 per hour for an average of 20 hours per respondent, resulting in a one-time cost burden of \$176,000 for these 22 entities.<sup>866</sup> Based on staff experience with the net capital and customer protection rules, the Commission estimates that the 16 broker-dealer SBSDs and 6 stand-alone SBSDs will enter into approximately 100 account control agreements per year with security-based swap customers and that it will take approximately 2 hours to execute each account control agreement, resulting in an industry-wide annual hour burden of 4,400 hours.<sup>867</sup>

The Commission staff estimates 16 broker-dealer SBSDs and 6 stand-alone SBSDs will need to maintain written documentation of their legal analysis of the account control agreement. Based on staff experience, the Commission estimates that broker-dealers (including broker-dealer SBSDs) and stand-alone SBSDs will meet this requirement split evenly between obtaining a written opinion of outside legal counsel or through the firm's own "in-house" analysis. The Commission estimates that the approximate cost to a broker-dealer (including a broker-dealer SBSD) or a stand-alone SBSD to obtain an opinion of counsel will be \$8,000.<sup>868</sup> This figure is based on an estimate of 20 hours per opinion for outside counsel at \$400 per hour, resulting in an industry-wide one-time cost of \$88,000.<sup>869</sup> In addition, the

Commission estimates it will take a broker-dealer (including a broker-dealer SBSD) or a stand-alone SBSD approximately 20 hours to conduct a written "in house" analysis, resulting in an industry-wide one-time hour-burden of 220 hours.<sup>870</sup>

## 2. Rule 18a-2

Rule 18a-2 requires nonbank MSBSPs to have and maintain positive tangible net worth and implement a system of internal risk management controls under Rule 15c3-4. The Commission staff estimates that the average amount of time a firm will spend implementing its risk management control system will be 2,000 hours,<sup>871</sup> resulting in an industry-wide one-time hour burden of 10,000 hours.<sup>872</sup>

In implementing its policies and procedures, a nonbank MSBSP will be required to document and record its system of internal risk management controls, and prepare and maintain written guidelines regarding its internal control system. The Commission staff estimates that each of the 5 nonbank MSBSPs will 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 1,250 hours.<sup>873</sup>

opinion of outside counsel as required under Appendix C to Rule 15c3-1 and staff experience. (8 broker-dealer SBSDs + 3 stand-alone SBSDs) × \$400 per hour × 20 hours = \$88,000.

<sup>870</sup> (8 broker-dealer SBSDs + 3 stand-alone SBSDs) × 20 hours = 220 hours. This work will likely be performed by an internal compliance attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Compliance attorney for 220 hours at \$371 per hour = \$81,620.

<sup>871</sup> This estimate is based on the one-time burden estimated for an OTC derivatives dealer to implement 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. See *Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 15c3-4*.

<sup>872</sup> 5 MSBSPs × 2,000 hours = 10,000 hours. This work will 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 cost for this hour burden is calculated as follows: (Internal compliance attorney for 3,333.33 hours at \$371 per hour) + (risk management specialist for 3,333.33 hours at \$202 per hour) + (operations specialist for 3,333.33 hours at \$139 per hour) = \$2,373,330.96.

<sup>873</sup> 5 MSBSPs × 250 hours = 1,250 hours. These hour burden estimates are consistent with similar collections of information under Appendix E to Rule 15c3-1. See *Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 15c3-1*. This work will likely be performed by a risk management specialist. Therefore, the estimated internal cost for this hour burden is calculated as follows: Risk management specialist for 1,250 hours at \$202 per hour = \$252,500.

Because nonbank MSBSPs may not initially have the systems or expertise internally to meet the risk management requirements of Rule 18a-2, these firms will 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.<sup>874</sup>

Nonbank MSBSPs may incur start-up costs to comply with Rule 18a-2, including information technology costs. Based on the estimates for similar collections of information,<sup>875</sup> the Commission staff expects that a nonbank MSBSP will incur an average of approximately \$16,000 for initial hardware and software expenses, while the average ongoing cost will be approximately \$20,500 per nonbank MSBSP to meet the requirements of the Rule 18a-2, for a total industry-wide initial cost of \$80,000 and ongoing cost of \$102,500.<sup>876</sup>

## 3. Rule 18a-3

Paragraph (e) of Rule 18a-3 requires a nonbank SBSD to establish and implement risk monitoring procedures with respect to counterparty accounts. Because these firms will be required to comply with Rule 15c3-4, the Commission staff estimates that each of the 22 nonbank SBSDs will spend an average of approximately 210 hours establishing the written risk analysis methodology, resulting in an industry-wide one-time hour burden of approximately 4,620 hours.<sup>877</sup> In

<sup>874</sup> 5 nonbank MSBSPs × \$80,000 = \$400,000.

<sup>875</sup> See *Risk Management Controls for Brokers or Dealers with Market Access*, 75 FR at 69814.

<sup>876</sup> 5 nonbank MSBSPs × \$16,000 = \$80,000. 5 nonbank MSBSPs × \$20,500 = \$102,500.

<sup>877</sup> (25 nonbank SBSDs minus 3 stand-alone SBSDs electing the alternative compliance mechanism under Rule 18a-10, as adopted = 22 nonbank SBSDs) × 210 hours = 4,620 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 to use risk-based models and parameters to set and review margin requirements). This work will likely be performed internally by an assistant general counsel (1,540 hours), an internal compliance attorney (1,540 hours), and a risk management specialist (1,540 hours). Therefore, the estimated internal cost for this hour burden is calculated as follows: (Assistant general counsel for 1,540 hours at \$473 per hour) + (risk management specialist for 1,540 hours at \$202 per hour) + (compliance attorney for 1,540 hours at \$371 per hour) = \$1,610,840.

<sup>866</sup> (16 broker-dealer SBSDs + 6 stand-alone SBSDs) × \$400 per hour × 20 hours = \$176,000.

<sup>867</sup> (16 broker-dealer SBSDs + 6 stand-alone SBSDs) × 100 account control agreements × 2 hours = 4,400 hours. This work will likely be performed by an in-house attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Attorney for 4,400 hours at \$422 per hour = \$1,856,800.

<sup>868</sup> Consistent with the business conduct release, an opinion of counsel is estimated at \$400 per hour multiplied by the number of hours to produce the opinion. See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR 29960, 30137 n. 1732 (citing consistency with the opinion of counsel paperwork burden in the release adopting a registration process for SBSDs and MSBSPs).

<sup>869</sup> This estimate is based on the amount of time it is estimated for a broker-dealer to obtain an



addition, based on staff experience, the Commission staff estimates that a nonbank SBSB will 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.<sup>878</sup>

Start-up costs may vary depending on the size and complexity of the nonbank SBSB. In addition, the start-up costs may be less for the 16 broker-dealer SBSBs because these firms may already be subject to similar margin requirements.<sup>879</sup> For the remaining 6 nonbank SBSBs, because these written procedures may be novel undertakings for these firms, the Commission staff assumes these nonbank SBSBs will have their written risk analysis methodology reviewed by outside counsel. As a result, the Commission staff estimates that these nonbank SBSBs will likely incur \$2,000 in legal costs, or \$12,000 in the aggregate initial burden to review and comment on these materials.<sup>880</sup>

Based on comments received, the Commission modified the language in the final rule to provide that a nonbank SBSB may use a model to calculate the initial margin amount under the rule, if the use of the model has been approved by the Commission. Paragraph (d) of Rule 18a-3, as adopted, provides that a nonbank SBSB seeking approval to use a margin model will be subject to an application process and ongoing conditions set forth in Rule 15c3-1e and paragraph (d) of Rule 18a-1 governing the use of internal models to compute net capital.

Based on staff experience, the Commission estimates it will take a nonbank SBSB approximately 50 hours to prepare and submit an application to the Commission to seek authorization to use a model to calculate initial margin. Based on observations regarding market participants' implementation of final swap margin rules adopted by other regulators, the Commission believes it is likely that 22 nonbank SBSBs will seek

Commission approval to use a model to calculate initial margin resulting in a total industry-wide one-time hour burden of 1,100 hours.<sup>881</sup> The Commission also estimates that each nonbank SBSB will spend approximately 250 hours per year reviewing, updating, and backtesting their initial margin model, resulting in a total industry-wide annual hour burden of 5,500 hours.<sup>882</sup>

#### 4. Rule 18a-4 and Amendments to Rule 15c3-3

As discussed above in section II.C. of this release, the Commission is amending Rule 15c3-3 to establish security-based swap segregation requirements for stand-alone broker-dealers and broker-dealer SBSBs and adopting Rule 18a-4 to establish largely parallel segregation requirements applicable to stand-alone and bank SBSBs, as well as notification requirements for nonbank SBSBs. The Commission estimates that 41 respondents, consisting of 25 stand-alone broker-dealers and 16 broker-dealer SBSBs, will be subject to the physical possession or control and reserve account requirements for security-based swaps in paragraph (p) of Rule 15c3-3.<sup>883</sup> The Commission estimates that 17 respondents, consisting of 16 broker-dealer SBSBs and 1 broker-dealer MSBSP, will be subject to paragraph (p)(4)(i)'s counterparty notification requirement with respect to non-cleared security-based swap transactions. The Commission estimates that 16 broker-dealer SBSBs will be subject to the requirement to obtain a subordination agreement from counterparties in paragraph (p)(4)(ii) of Rule 15c3-3.

<sup>881</sup> 22 nonbank SBSBs  $\times$  50 hours = 1,100 hours. This work will likely be performed by an in-house attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Attorney for 1,100 hours at \$422 per hour = \$464,200. A nonbank SBSB may use standardized haircuts to compute initial margin because of the cost of using an initial margin model. However, the Commission is conservatively estimating that 22 nonbank SBSBs will choose to use a model to compute initial margin for purposes of this collection of information.

<sup>882</sup> 22 nonbank SBSBs  $\times$  250 hours = 5,500 hours. This work will likely be performed internally by a compliance attorney (2,750 hours) and a risk management specialist (2,750 hours). Therefore, the estimated internal cost for this hour burden is calculated as follows: (Risk management specialist for 2,750 hours at \$202 per hour) + (compliance attorney for 2,750 hours at \$371 per hour) = \$1,575,750.

<sup>883</sup> The 16 broker-dealer SBSB respondents were included in the proposed collection of information for proposed Rule 18a-4. Other than the addition of paragraph (p) to Rule 15c3-3, as amended, the Commission is not amending the requirements of existing Rule 15c3-3.

Rule 18a-4, as adopted, will apply to SBSBs and MSBSPs that are not also registered as broker-dealers with the Commission.<sup>884</sup> The Commission estimates that 3 stand-alone SBSBs and 4 MSBSPs will be subject to the collection of information requirements of Rule 18a-4, as adopted (because the Commission estimates that the 25 bank SBSB and 6 stand-alone SBSBs will be exempt from the omnibus segregation requirements).<sup>885</sup>

Under Rule 18a-4 and the amendments to Rule 15c3-3, SBSBs and broker-dealers engaged in security-based swap activities are required to establish special reserve accounts with banks and obtain written acknowledgements from, and enter into written contracts with, the banks. Based on staff experience with Rule 15c3-3, the Commission staff estimates that each of the 44 respondents<sup>886</sup> will establish 6 special reserve accounts at banks (2 for each type of special reserve account). Further, based on staff experience with Rule 15c3-3, the Commission staff estimates that each respondent will spend approximately 30 hours to draft and obtain the written acknowledgement and agreement for each account, resulting in an industry-wide one-time hour burden of approximately 7,920 hours.<sup>887</sup> The Commission staff estimates that 25%<sup>888</sup> of the 44 respondents (approximately 11 respondents) will establish a new special reserve account each year because, for example, they change their banking relationship, for each type of special reserve account. Therefore, the Commission staff estimates an industry-wide annual hour burden of approximately 990 hours.<sup>889</sup>

Paragraph (c)(1) of Rule 18a-4 and paragraph (p)(3)(i) of Rule 15c3-3

<sup>884</sup> See Rule 18a-4, as adopted.

<sup>885</sup> 50 SBSBs minus 16 broker-dealer SBSBs minus 25 bank SBSBs minus 6 stand-alone SBSBs = 3 stand-alone SBSBs. 5 nonbank MSBSPs minus 4 nonbank MSBSPs that are not broker-dealers = 1 broker-dealer MSBSP.

<sup>886</sup> 16 broker-dealer SBSBs + 3 stand-alone SBSBs + 25 stand-alone broker-dealers = 44 respondents.

<sup>887</sup> 44 respondents  $\times$  6 special reserve accounts  $\times$  30 hours = 7,920 hours. This work will likely be performed by an internal compliance attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Compliance attorney for 7,920 hours at \$371 per hour = \$2,938,320.

<sup>888</sup> This number is based on the currently approved PRA collection for Rule 15c3-3. See Commission, *Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 15c3-3*.

<sup>889</sup> 11 SBSBs  $\times$  3 types of special reserve accounts  $\times$  30 hours = 990 hours. This work will likely be performed by an internal compliance attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Internal compliance attorney for 990 hours at \$371 per hour = \$367,290.

<sup>878</sup> 22 stand-alone SBSBs  $\times$  60 hours = 1,320 hours. This work will likely be performed by an internal compliance attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Compliance attorney for 1,320 hours at \$371 per hour = \$489,720.

<sup>879</sup> See, e.g., FINRA Rules 4210 and 4240. See also *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR at 29967 (noting burden for paragraph (g) of Rule 15Fh-3 is based on existing FINRA rules).

<sup>880</sup> The Commission staff estimates the review of the written risk analysis methodology will require 5 hours of outside counsel time at a cost of \$400 per hour. See also *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR at 30093.

provide that the SBSB or broker-dealer engaged in security-based swap activities must at all times maintain in a special 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 and Exhibit B to Rule 15c3-3. Paragraph (c)(3) of Rule 18a-4 and paragraph (p)(3)(iii) of Rule 15c3-3 provide that the computations necessary to determine the amount required to be maintained in the special bank account must be made on a weekly basis. Based on experience with the Rule 15c3-3 reserve computation paperwork burden hours and with the OTC derivatives industry, the Commission staff estimates that it will take 1-5 hours to compute each reserve computation, and that the average time spent across all the respondents will be approximately 2.5 hours. Accordingly, the Commission staff estimates that the resulting industry-wide annual hour burden is approximately 5,720 hours.<sup>890</sup>

Under paragraph (d)(1) of Rule 18a-4, paragraph (f)(2) of Rule 18a-4, and paragraph (p)(4)(i) of Rule 15c3-3, an SBSB or an MSBSP is required to provide a notice to a counterparty prior to their first non-cleared security-based swap transaction after the compliance date. All 50 SBSBs and 5 MSBSPs are required to provide these notices to their counterparties. The Commission staff estimates that these 55 entities will 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.<sup>891</sup>

The number of notices sent in the first year the rule is effective will depend on the number of counterparties with which each SBSB or MSBSP engages in security-based swap transactions. The number of counterparties an SBSB or MSBSP has will vary depending on the size and complexity of the firm and its operations. The Commission staff estimates that each of the 50 SBSBs and 5 MSBSPs will have approximately 1,000 counterparties at any given

time.<sup>892</sup> Therefore, the Commission staff estimates that approximately 55,000 notices will be sent in the first year the rule is effective.<sup>893</sup> The Commission staff estimates that each of the 50 SBSBs and 5 MSBSPs will spend approximately 10 minutes sending out the notice, resulting in an industry-wide one-time hour burden of approximately 9,167 hours.<sup>894</sup> The Commission staff further estimates that the 50 SBSBs and 5 MSBSPs will establish account relationships with 200 new counterparties per year. Therefore, the Commission staff estimates that approximately 11,000 notices will be sent annually,<sup>895</sup> resulting in an industry-wide annual hour burden of approximately 1,833 hours.<sup>896</sup>

Under paragraph (d)(2) of Rule 18a-4 and paragraph (p)(4)(ii) of Rule 15c3-3, an SBSB is required to obtain subordination agreements from certain counterparties. The Commission staff estimates that each SBSB will spend, on average, approximately 200 hours to draft and prepare standard subordination agreements, resulting in an industry-wide one-time hour burden of 3,800 hours.<sup>897</sup> Because the SBSB will enter into these agreements with security-based swap customers, after the

<sup>892</sup> The Commission previously estimated that there are approximately 10,900 market participants in security-based swap transactions. See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR at 30089. Based on the 10,900 market participants and Commission staff experience with the securities and OTC derivatives industry, the Commission staff estimates that each SBSB and MSBSP will have 1,000 counterparties at any given time. The number of counterparties may widely vary depending on the size of the SBSB 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 will establish account relationships with approximately 200 new counterparties per year, or approximately 20% of a firm's existing counterparties.

<sup>893</sup>  $(50 \text{ SBSBs} + 5 \text{ MSBSPs}) \times 1,000 \text{ counterparties} = 55,000 \text{ notices}$ .

<sup>894</sup>  $55,000 \text{ notices} \times (10 \text{ minutes}/60 \text{ minutes}) = 9,167 \text{ hours}$ . A compliance clerk will likely send these notices. Therefore, the estimated internal cost for this hour burden is calculated as follows: Compliance clerk for 9,167 hours at \$71 per hour = \$650,857.

<sup>895</sup>  $(50 \text{ SBSBs} + 5 \text{ MSBSPs}) \times 200 \text{ counterparties} = 11,000 \text{ notices}$ .

<sup>896</sup>  $11,000 \text{ notices} \times (10 \text{ minutes}/60 \text{ minutes}) = 1,833 \text{ hours}$ . A compliance clerk will likely send these notices. Therefore, the estimated internal cost for this hour burden is calculated as follows: Compliance clerk for 1,833 hours at \$71 per hour = \$130,143.

<sup>897</sup>  $200 \text{ hours} \times 19 \text{ SBSBs} = 3,800 \text{ hours}$ . An in-house attorney will likely draft these agreements because the Commission staff expects that drafting contracts will be one of the typical job functions of an in-house attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Attorney for 3,800 hours at \$422 per hour = \$1,603,600.

SBSB prepares a standard subordination agreement in-house, the Commission staff also estimates that an SBSB will have outside counsel review the standard subordination agreements and that the review will take approximately 20 hours at a cost of approximately \$400 per hour. As a result, the Commission staff estimates that each SBSB will incur one-time costs of approximately \$8,000,<sup>898</sup> resulting in an industry-wide one-time cost of approximately \$152,000.<sup>899</sup>

As discussed above, the Commission staff estimates that each of the 19 SBSBs would have approximately 1,000 counterparties at any given time. The Commission staff further estimates that approximately 50% of these counterparties will either elect individual segregation or, if permitted, to waive segregation altogether.<sup>900</sup> The Commission staff estimates that an SBSB will spend 20 hours per counterparty to enter into a written subordination agreement, resulting in an industry-wide one-time hour burden of approximately 190,000 hours.<sup>901</sup> Further, as discussed above, the Commission staff estimates that each of the 19 SBSBs will establish account relationships with 200 new counterparties per year. The Commission staff further estimates that 50% or 100 of these counterparties will either elect individual segregation or, if permitted, to waive segregation altogether. Therefore, the Commission staff estimates an industry-wide annual hour burden of approximately 38,000 hours.<sup>902</sup>

<sup>898</sup>  $\$400 \times 20 \text{ hours} = \$8,000$ .

<sup>899</sup>  $\$8,000 \times 19 \text{ SBSBs} = \$152,000$ .

<sup>900</sup> 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 choose to avoid the potential additional cost associated with individual segregation. Therefore, the Commission staff estimates that approximately 50% of counterparties will either elect individual segregation or, if permitted, to waive segregation altogether.

<sup>901</sup>  $19 \text{ SBSBs} \times 500 \text{ counterparties} \times 20 \text{ hours} = 190,000$ . This work will likely be performed by an internal compliance attorney (95,000 hours) and a compliance clerk (95,000 hours). Therefore, the estimated internal cost for this hour burden is calculated as follows: (Internal compliance attorney for 95,000 hours at \$371 per hour) + (compliance clerk for 95,000 hours at \$71 per hour) = \$41,990,000.

<sup>902</sup>  $19 \text{ SBSBs} \times 100 \text{ counterparties} \times 20 \text{ hours} = 38,000 \text{ hours}$ . This work will likely be performed by an internal compliance attorney (19,000 hours) and a compliance clerk (19,000 hours). Therefore, the estimated internal cost for this hour burden is calculated as follows: (Compliance attorney for 19,000 hours at \$371 per hour) + (compliance clerk for 19,000 hours at \$71 per hour) = \$8,398,000.

<sup>890</sup>  $44 \text{ respondents} \times 52 \text{ weeks} \times 2.5 \text{ hours/week} = 5,720 \text{ hours}$ . This work will likely be performed by a financial reporting manager. Therefore, the estimated internal cost for this hour burden is calculated as follows: Financial reporting manager for 5,720 hours at \$295 per hour = \$1,687,400.

<sup>891</sup>  $(50 \text{ SBSBs} + 5 \text{ MSBSPs}) \times \$400 \text{ per hour} \times 10 \text{ hours} = \$220,000$ . This work will likely be performed by an outside counsel with expertise in financial services law to help ensure that counterparties are receiving the proper notice under the statutory requirement.

Paragraph (e) of Rule 18a–4 establishes exemptions for foreign stand-alone or bank SBSBs and MSBSPs from the segregation requirements in Section 3E of the Exchange Act, and the rules and regulations thereunder, with respect to certain transactions. The Commission previously estimated that there will be 22 foreign SBSBs, but does not have sufficient information to reasonably estimate the number of foreign firms that are dually registered as broker-dealers or are foreign banks, how many U.S. counterparties foreign stand-alone or bank SBSBs will have, and how many eligible firms will opt out of complying with Section 3E of the Exchange Act and the rules and regulations thereunder. Moreover, as discussed above, the Commission estimates that the 25 bank SBSBs and 6 stand-alone SBSBs will be exempt from the omnibus segregation requirements. Therefore, the Commission is making the conservative estimate that 22 foreign SBSBs will be subject to paragraph (e) of Rule 18a–4.

Under paragraph (e)(3) of Rule 18a–4, foreign SBSBs are required to provide disclosures in writing to their U.S. counterparties. The Commission believes that, in most cases, these disclosures will be made through amendments to the foreign SBSB's existing trading documentation.<sup>903</sup> Because these disclosures relate to new regulatory requirements, the Commission anticipates that all foreign SBSBs will need to incorporate new language into their existing trading documentation with U.S. counterparties. Disclosure of the potential treatment of segregated assets in insolvency proceedings under U.S. bankruptcy law and foreign insolvency laws pursuant to paragraph (e)(3) of Rule 18a–4 will likely vary depending on the counterparty's jurisdiction. Accordingly, the Commission expects that these disclosures often may need to be tailored to address the particular circumstances of each trading relationship. However, in some cases, trade associations or industry working groups may be able to develop standard disclosure forms that can be adopted by foreign SBSBs with little or no modification. In either case, the paperwork burden associated with developing new disclosure language and incorporating this language into a registered foreign SBSB's trading documentation will vary depending on: (1) The number of non-U.S. counterparties with whom the registered

foreign SBSB trades; (2) the number of jurisdictions represented by the foreign SBSB's counterparties; and (3) the availability of standardized disclosure language. To the extent standardized disclosures become available, the paperwork burden on foreign SBSBs will be limited to amending existing trading documentation to incorporate the standardized disclosures. Conversely, more time will be necessary where a greater degree of customization is required to develop the required disclosures and incorporate this language into existing documentation.

The Commission estimates the maximum total paperwork burden associated with developing new disclosure language will require each of the 22 foreign SBSBs to spend 5 hours of in-house counsel time on 30 jurisdictions.<sup>904</sup> This will create a total one-time industry burden of 3,300 hours.<sup>905</sup> This estimate assumes little or no reliance on standardized disclosure language. In addition, the Commission estimates the total paperwork burden associated with incorporating new disclosure language into each foreign SBSB's trading documentation will be approximately 11,000 hours for all 22 foreign SBSBs.<sup>906</sup>

The Commission expects that the majority of the paperwork burden associated with the new disclosure requirements will be experienced during the first year as language is developed, whether by individual foreign SBSBs or through collaborative efforts, and trading documentation is amended. After the new disclosure language is developed and incorporated into trading documentation, the Commission believes that the ongoing burden associated with paragraph (e) of Rule 18a–4, as adopted, will be limited to periodically updating the disclosures to reflect changes in the applicable law or to incorporate new jurisdictions with security-based swap counterparties. The Commission estimates that this ongoing paperwork burden will not exceed 110 hours per year for all 22 foreign SBSBs

(approximately 5 hours per foreign SBSB per year).

Paragraph (f) of Rule 18a–4 provides an exemption from the rule's requirements if certain conditions are met. These conditions include a requirement in paragraph (f)(3) of the rule that the stand-alone or bank SBSB must provide notice to a counterparty regarding the right to segregate initial margin at an independent third-party custodian, and make certain disclosures in writing regarding collateral received by the SBSB.<sup>907</sup>

Paragraph (f)(3) of Rule 18a–4 requires disclosure that margin collateral received and held by the firm will not be subject to a segregation requirement and of how a claim of a counterparty for the collateral would be treated in a bankruptcy or other formal liquidation proceeding of the firm. The Commission estimates the maximum total paperwork burden associated with developing new disclosure language for the purposes of this provision will require each of the 31 SBSBs (25 bank SBSBs and 6 stand-alone SBSBs) to spend 5 hours of in-house counsel time. This will create a total one-time industry burden of 155 hours.<sup>908</sup> This estimate assumes little or no reliance on standardized disclosure language. In addition, the Commission estimates the total paperwork burden associated with incorporating new disclosure language into each SBSB's trading documentation will be approximately 310,000 hours for all 31 SBSBs.<sup>909</sup> The Commission expects that the majority of the paperwork burden associated with the new disclosure requirements under paragraph (f)(3) of Rule 18a–4, as adopted will be experienced during the first year as language is developed. After the new disclosure language is developed and incorporated into trading documentation, the Commission believes that the ongoing burden associated with paragraph (f)(3) of Rule 18a–4, as adopted, will be limited to periodically updating the disclosures. The Commission estimates that this ongoing paperwork burden will not exceed 155 hours per year for all 31

<sup>904</sup> The Commission staff estimates the total paperwork burden associated with developing new disclosure language for each foreign SBSB would be 5 hours spent on disclosure agreements relating to 30 potential jurisdictions. See *Cross-Border Proposing Release*, 78 FR at 31107 (providing similar estimates).

<sup>905</sup> 22 foreign SBSBs × 5 in-house counsel hours × 30 potential jurisdictions = 3,300 hours.

<sup>906</sup> The Commission staff estimates that the average foreign SBSB will have 50 active non-U.S. counterparties. Accordingly, the Commission staff estimates the cost of incorporating new disclosure language into the trading documentation of an average foreign SBSB would be 500 hours per foreign SBSB (based on 10 hours of in-house counsel time × 50 active non-U.S. counterparties).

<sup>907</sup> The PRA estimates for paragraph (f)(2) of Rule 18a–4 are discussed above with the notice provisions of paragraph (d)(2) to Rule 18a–4.

<sup>908</sup> 31 SBSBs (25 bank SBSBs + 6 stand-alone SBSBs) × 5 in-house counsel hours = 155 hours.

<sup>909</sup> The Commission staff estimates that the average SBSB will have approximately 1,000 counterparties at any given time. Accordingly, the Commission staff estimates the cost of incorporating new disclosure language into the trading documentation of an average SBSB would be 10,000 hours per SBSB (based on 10 hours of in-house counsel time × 1,000 counterparties).

<sup>903</sup> See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR 29960.

SBSDs (approximately 5 hours per SBSD per year).<sup>910</sup>

#### 5. Rule 18a-10

In response to comments urging the Commission to harmonize requirements with the CFTC, as well as specific comments requesting that the Commission defer to the CFTC's rules if a nonbank SBSD is registered as a swap dealer and conducts only a limited amount of security-based swaps business, the Commission is adopting new Rule 18a-10. Rule 18a-10 contains an alternative compliance mechanism pursuant to which a stand-alone SBSD that is registered as a swap dealer and predominantly engages in a swaps business may elect to comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of complying with Rules 18a-1, 18a-3, and 18a-4. As discussed above, the Commission estimates that 3 stand-alone SBSDs will elect to operate under Rule 18a-10. These respondents were included in the proposing release in other collections of information (Rule 18a-1 and Rule 18a-3, as proposed), and have been moved to the information collection for new Rule 18a-10.<sup>911</sup>

The Commission estimates paperwork burden associated with developing new disclosure language under paragraph (b)(2) of Rule 18a-10 will require each of the 3 stand-alone SBSDs to spend 5 hours of in-house counsel time. This would create a total one-time industry burden of 15 hours.<sup>912</sup> This estimate assumes little or no reliance on standardized disclosure language. In addition, the Commission estimates the total paperwork burden associated with incorporating new disclosure language into each stand-alone SBSD's trading documentation will be approximately 30,000 hours for all 3 stand-alone SBSDs.<sup>913</sup> The Commission expects that

the majority of the paperwork burden associated with the new disclosure requirements under paragraph (b)(2) of Rule 18a-10, as adopted, will be experienced during the first year as language is developed. After the new disclosure language is developed and incorporated into trading documentation, the Commission believes that the ongoing burden associated with paragraph (b)(2) of Rule 18a-10 will be limited to periodically updating the disclosures. The Commission estimates that this ongoing paperwork burden will not exceed 15 hours per year for all 3 stand-alone SBSDs.<sup>914</sup>

Based on the number of notices currently filed by broker-dealers, the Commission staff estimates that the notice requirement of paragraph (b)(3) of Rule 18a-10 will result in annual hour burdens to stand-alone SBSDs. The Commission staff estimates that 1 stand-alone SBSD will file 1 notice annually with the Commission. In addition, the Commission staff estimates that it will take a stand-alone SBSD approximately 30 minutes to file this notice, resulting in an industry-wide annual hour burden of 30 minutes.<sup>915</sup>

Finally, under paragraphs (d)(1) and (d)(2) of Rule 18a-10, respectively, a stand-alone SBSD can make an election to operate under the alternative compliance mechanism, during the registration process or after the firm registers as an SBSD, by providing written notice to the Commission and the CFTC of its intent to operate pursuant to the rule. The Commission believes that in the first 3 years of the effective date of the rule that the 3 nonbank SBSDs that elect to operate under Rule 18a-10 will file the notice as part of their application process. Therefore, the Commission believes that the time it would take an entity to file a notice as part of the application process would be *de minimis* and, therefore, would not result in an hour burden for this collection of information or any collection of information associated with registering with the Commission as an SBSD.<sup>916</sup> Finally,

since the Commission believes that the 3 nonbank SBSDs will elect to operate under the rule as part of their registration process, the Commission believes that there will be no respondents, and no paperwork hour or cost burden under the PRA associated with paragraph (d)(2) of Rule 18a-10, as adopted.

#### 6. Rule 3a71-6

Rule 3a71-6, as amended, will require submission of certain information to the Commission to the extent person request a substituted compliance determination with respect to the Title VII capital and margin requirements. The Commission expects that foreign SBSDs and MSBSPs will seek to rely on substituted compliance upon registration, and that it is likely that the majority of such requests will be made during the first year following the effective date of this amendment. Requests would not be necessary with regard to applicable rules and regulations of a foreign jurisdiction that have previously been the subject of a substituted compliance determination in connection with the applicable rules.

The Commission expects that the majority of substituted compliance applications will be submitted by foreign authorities, and that very few substituted compliance requests will come from SBSDs or MSBSPs. For purposes of this assessment, the Commission estimates that 3 SBSDs or MSBSPs will submit such applications in connection with the Commission's capital and margin requirements.<sup>917</sup> After consideration of the release adopting Rule 3a71-6, the Commission estimates that the total paperwork burden incurred by such entities associated with preparing and submitting a request for a substituted compliance determination in connection with the capital and margin requirements will be approximately 240 hours, plus \$240,000 for the services of outside professionals for all 3 requests.<sup>918</sup>

*Swap Participants*, Exchange Act Release No. 75611 (Aug. 5, 2015), 80 FR 48964, 48989 (Aug. 14, 2015).

<sup>917</sup> See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR at 30097. See also *Trade Acknowledgment and Verification of Security-Based Swap Transactions*, 81 FR at 39382.

<sup>918</sup> See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR at 30097 ("The Commission estimates that the total one-time paperwork burden incurred by such entities associated with preparing and submitting a request for a substituted compliance determination in connection with the business conduct requirements will be approximately 240 hours, plus \$240,000 for the services of outside professionals for all three

<sup>910</sup> 31 SBSDs (25 bank SBSDs + 6 stand-alone SBSDs) × 5 hours per SBSD = 155 hours.

<sup>911</sup> As a result, the total respondents for Rules 18a-1 and 18a-3 have been reduced by three. In addition, these respondents will be exempt from Rule 18a-4 under the conditions of paragraph (f) of the rule if they meet certain conditions, but will continue to be included in the collection of information for the rule because the conditions in paragraph (f) contain a collection of information under the PRA. Finally, the collections of information for Rule 18a-10 will be included with the collections of information with Rule 18a-3 for purposes of submission to OMB.

<sup>912</sup> 3 stand-alone SBSDs × 5 in-house counsel hours = 15 hours.

<sup>913</sup> The Commission staff estimates that the average SBSD will have approximately 1,000 counterparties at any given time. Accordingly, the Commission staff estimates the cost of incorporating new disclosure language into the trading documentation of an average SBSD would be 10,000 hours per stand-alone SBSD (based on 10 hours of in-house counsel time × 1,000 counterparties).

<sup>914</sup> 3 stand-alone SBSDs × 5 hours per SBSD = 15 hours.

<sup>915</sup> 1 stand-alone SBSD × 1 notice × 30 minutes = 30 minutes. This estimate is based on the 30 minutes it is estimated a stand-alone broker-dealer spends filing a notice under Rule 15c3-1. See *Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 15c3-1*. This work will likely be performed by an internal compliance attorney. Therefore, the estimated internal cost for this hour burden is calculated as follows: Internal compliance attorney for 30 minutes at \$371 per hour = \$185.50.

<sup>916</sup> See also *Registration Process for Security-Based Swap Dealers and Major Security-Based*

### *E. Collection of Information is Mandatory*

The collections of information pursuant to the amendments and new rules are mandatory, as applicable, for ANC broker-dealers, broker-dealers, SBSBs, and MSBSBs. Compliance with the collection of information requirements associated with Rule 3a71–6, regarding the availability of substituted compliance, is mandatory for all foreign financial authorities, foreign SBSBs, or foreign MSBSBs that seek a substituted compliance determination. Compliance with the collection of information requirements associated with Rule 18a–10 regarding the availability of an alternative compliance mechanism is mandatory for all stand-alone SBSBs that elect to operate under the conditions of the rule.

### *F. Confidentiality*

The Commission expects to receive confidential information in connection with the collections of information. To the extent that the Commission receives confidential information pursuant to these collections of information, such information will be kept confidential, subject to the provisions of applicable law.<sup>919</sup>

requests”). The Commission further stated that in practice those amounts may overestimate the costs of requests pursuant to Rule 3a71–6 as adopted, as such requests would solely address the business conduct requirements, rather than the broader proposed scope of substituted compliance set forth in the cross-border proposing release. 81 FR at 30097 n. 1583. To the extent that an SBSB submits substituted compliance requests in connection with the business conduct requirements, the trade acknowledgment and verification requirements, and the capital and margin requirements, the Commission believes that the paperwork burden associated with the requests would be greater than that associated with a narrower request, given the need for more information regarding the comparability of the relevant rules and the adequacy of the associated supervision and enforcement practices. In the Commission’s view, however, the burden associated with such a combined request would not exceed the prior estimate. *See Trade Acknowledgment and Verification of Security-Based Swap Transactions*, 81 FR at 39833 n. 258.

<sup>919</sup> 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 or “FOIA”). See also paragraph (d)(1) of Rule 18a–1. FOIA provides at least two pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for matters that are “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).

### *G. Retention Period for Recordkeeping Requirements*

Under Rule 17a–4, ANC broker-dealers are required to preserve for a period of not less than 3 years, the first 2 years in an easily accessible place, certain records required under Rule 15c3–4 and certain records under Rule 15c3–1e. Rule 17a–4 specifies the required retention periods for a broker-dealer. Many of a broker-dealer’s records must be retained for 3 years; certain other records must be retained for longer periods.

### **V. Other Matters**

Pursuant to the Congressional Review Act,<sup>920</sup> the Office of Information and Regulatory Affairs has designated these rules as a “major rule,” as defined by 5 U.S.C. 804(2).

### **VI. Economic Analysis**

The Commission is adopting: (1) Rules 18a–1 and 18a–2, and amendments to Rule 15c3–1, to establish capital requirements for nonbank SBSBs and MSBSBs; (2) Rule 18a–3 to establish margin requirements for non-cleared security-based swaps applicable to nonbank SBSBs and MSBSBs; and (3) Rule 18a–4, and amendments to Rule 15c3–3, to establish segregation requirements for SBSBs and notification requirements with respect to segregation for SBSBs and MSBSBs.<sup>921</sup> Some of the amendments to Rules 15c3–1 and 15c3–3 will apply to stand-alone broker-dealers to the extent that they engage in security-based swap or swap activities.<sup>922</sup> The Commission also is amending Rule 15c3–1 to increase the minimum net capital requirements for ANC broker-dealers and amending Rule 3a71–6 to address the potential availability of substituted compliance in connection with the Commission’s capital and margin requirements for foreign SBSBs and MSBSBs. Further, the Commission is adopting an alternative compliance mechanism in Rule 18a–10 pursuant to which a stand-alone SBSB that is registered as a swap dealer and predominantly engages in a swaps business may elect to comply with the capital, margin, and segregation requirements of the CEA and the CFTC’s rules in lieu of complying with the capital, margin, and segregation requirements being adopted today. Finally, the Commission is

adopting a rule that specifies when a foreign non-broker-dealer SBSB or MSBSB need not comply with the segregation requirements of Section 3E of the Exchange Act and the rules thereunder.

The Commission is sensitive to the economic impacts of the rules it is adopting. Some of the 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 economic effects—including the benefits, costs, and effects on efficiency, competition, and capital formation—that will result from the adoption of Rules 18a–1, 18a–2, 18a–3, 18a–4, and Rule 18a–10, and from the adoption of the amendments to Rules 15c3–1, 15c3–3, and 3a71–6. The economic effects considered in adopting these new rules and amendments are discussed below and have informed the policy choices described throughout this release.

The discussion below provides a baseline against which the rules may be evaluated. For the purposes of this economic analysis, the baseline incorporates the state of the security-based swap and swap markets as they exist today and does not include any of the regulatory provisions that have not yet been adopted. However, to the extent that such provisions have been anticipated by and therefore affected the behavior of market participants those practices will be considered part of the baseline.

The Commission does not currently have comprehensive data on the state of the U.S. security-based swap and swap markets. Consequently, the Commission is using the limited data currently available to develop the baseline and to inform the following analysis of the anticipated costs and benefits resulting from the rules and amendments being adopted today.<sup>923</sup> These rules and amendments have the potential to significantly affect efficiency, competition, and capital formation in the security-based swap and swap markets, with the impact not being limited to the specific entities that fall within the meaning of the terms “security-based swap dealer” and “major security-based swap

<sup>923</sup> In the proposing release, the Commission requested data and information from commenters to assist it in analyzing the economic consequences of the proposed rules. *See Capital, Margin, and Segregation Proposing Release*, 77 FR at 70300. *See also Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53019–20 (similarly requesting data).

<sup>920</sup> 5 U.S.C. 801 *et seq.*

<sup>921</sup> See section II of this release.

<sup>922</sup> For example, the standardized haircuts for security-based swaps and swaps will apply to stand-alone broker-dealers as will the segregation requirements for security-based swaps.

participant.” The following analysis will also consider these effects.

#### A. Baseline

To assess the economic impact of the capital, margin, and segregation rules being adopted today, the Commission is using as its baseline the state of the security-based swap and swap markets as they exist at the time of this release, including applicable rules the Commission has already adopted, but excluding rules the Commission has proposed but not finalized.<sup>924</sup> The analysis includes the statutory provisions that currently govern the security-based swap market pursuant to the Dodd-Frank Act, and rules adopted by the Commission regarding: (1) Entity definitions;<sup>925</sup> (2) cross-border activities;<sup>926</sup> (3) registration of security-based swap data repositories;<sup>927</sup> (4) registration of SBSBs and MSBSPs;<sup>928</sup> (5) reporting and dissemination of security-based swap information;<sup>929</sup> (6) dealing activity of non-U.S. persons with a U.S. connection;<sup>930</sup> (7) business conduct standards;<sup>931</sup> (8) trade acknowledgments;<sup>932</sup> and (9) applications with respect to statutory

disqualifications.<sup>933</sup> These statutes and final rules—even if compliance is not yet required—are part of the existing regulatory landscape that market participants expect to govern their security-based swap activity. There are limitations in the degree to which the Commission can quantitatively characterize the current state of the security-based swap market. As described in more detail below, because the available data on security-based swap transactions do not cover the entire market, the Commission has developed its understanding of market activity using a sample that includes only certain portions of the market.

Under the baseline, the security-based swap and swap markets are dominated, both globally and domestically, by a small number of firms, generally entities that are, or are affiliated with, large commercial banks.<sup>934</sup> The economic impacts of the rules and amendments being adopted here are expected to primarily stem from their effect on the relatively small number of entities that act as dealers and major participants in this market. These firms will become subject to the segregation requirements of Rule 15c3–3, as amended, or Rule 18a–4 with respect to security-based swap transactions. These firms—if they are a stand-alone broker-dealer, nonbank SBSB, or nonbank MSBSP—will also become subject to the capital requirements of Rules 15c3–1, 18a–1, and/or 18a–2, as applicable, and—if they are a nonbank SBSB and MSBSP—will also become subject to the margin requirements of Rule 18a–3.<sup>935</sup> Many of the directly affected entities—including nonbank entities—are currently part of a bank holding company. Therefore, certain Federal Reserve regulations applicable to these entities (at the bank-holding company level) enter into the baseline and otherwise impact the analysis of the costs and benefits. Moreover, participants in the security-based swap and swap markets can fall under a number of other regulatory regimes, including those of: the prudential regulators, the CFTC, or numerous international regulatory authorities.<sup>936</sup>

Prior to the Dodd-Frank Act, many participants in the security-based swap and swap markets generally were not directly supervised by the Commission.<sup>937</sup> The Commission does not possess regulatory reports from many of these entities that can be used to determine the nature and extent of their participation in these markets. Consequently, in the Commission’s analysis, the nature of an entity’s participation in these markets will generally be inferred from transaction data. Market participants meeting the registration thresholds outlined in the Commission’s intermediary definitions<sup>938</sup> and cross-border rules are expected to register with the Commission.<sup>939</sup> As discussed elsewhere, the Commission expects that up to 50 entities may register as SBSBs, and that up to an additional five entities may register as MSBSPs.<sup>940</sup> In addition, the Commission estimates that, of the 50 entities expected to register as SBSBs, 16 are registered with the Commission as broker-dealers.<sup>941</sup> Of the 50 entities expected to register as SBSBs, 22 are expected to be non-U.S. persons.<sup>942</sup>

Certain provisions in the amendments and the rules being adopted today affect broker-dealers. Thus, the baseline incorporates the current capital and segregation requirements for broker-dealers under Rules 15c3–1 and 15c3–3 as well as the current state of the

derivatives, central counterparties and trade repositories (July 4, 2012).

<sup>937</sup> See section VI.A.1. of this release.

<sup>938</sup> See *Entity Definitions Adopting Release*, 77 FR 30596; *Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities*, 79 FR 47278.

<sup>939</sup> Though the Commission’s SBSB and MSBSP registration rules are effective, compliance will not be required until the Commission has adopted other rules applicable to these entities. See section III of this release discussing effective and compliance dates.

<sup>940</sup> See *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, 84 FR 4906; see also section VI.B.1.b. of this release. The Commission’s estimate of the number of SBSBs is based on data obtained from the Depository Trust & Clearing Corporation Derivatives Repository Limited Trade Information Warehouse (“DTCC-TIW”), which consists of data regarding the activity of market participants in the single-name CDS market during 2017.

<sup>941</sup> See *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, 84 FR 4906.

<sup>942</sup> See *Security-Based Swap Transactions Connected With a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception*, 81 FR at 8605.

<sup>924</sup> The Commission also considered, where appropriate, the impact of rules and technical standards promulgated by other regulators, such as the CFTC, the prudential regulators, and the European Securities and Markets Authority, on practices in the security-based swap and swap markets.

<sup>925</sup> See *Entity Definitions Adopting Release*, 77 FR 30596.

<sup>926</sup> See *Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities*, Exchange Act Release No. 72472 (June 25, 2014), 79 FR 47278 (Aug. 12, 2014).

<sup>927</sup> See *Security-Based Swap Data Repository Registration, Duties, and Core Principles*, Exchange Act Release No. 74246 (Feb. 11, 2015), 80 FR 14438 (Mar. 19, 2015).

<sup>928</sup> See *Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 80 FR 48964.

<sup>929</sup> See *Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information*, Exchange Act Release No. 74244 (Feb. 11, 2015), 80 FR 14563 (Mar. 19, 2015). See also *Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information*, Exchange Act Release No. 78321 (July 14, 2016), 81 FR 53546 (Aug. 12, 2016).

<sup>930</sup> See *Security-Based Swap Transactions Connected With a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception*, Exchange Act Release No. 77104 (Feb. 10, 2016), 81 FR 8598 (Feb. 19, 2016).

<sup>931</sup> See *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR 29960; *Commission Statement on Certain Provisions of Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, Exchange Act Release No. 84511 (Oct. 31, 2018), 83 FR 55486 (Nov. 6, 2018).

<sup>932</sup> See *Trade Acknowledgment and Verification of Security-Based Swap Transactions*, 81 FR 39808.

<sup>933</sup> See *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, 84 FR 4906.

<sup>934</sup> See, e.g., *ISDA Margin Survey 2012* (May 2012).

<sup>935</sup> A bank SBSB or MSBSP will be subject to the capital and margin requirements of its prudential regulator. See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR 74840.

<sup>936</sup> See, e.g., Regulation (EU) No. 648/2012 of the European Parliament and of the Council on OTC

broker-dealer industry.<sup>943</sup> However, because the Exchange Act's definition of "security" did not include security-based swaps until the definition was amended by the Dodd-Frank Act, dealing activity in security-based swaps did not require registration with the Commission as a broker-dealer. Therefore, these entities were not subject to the broker-dealer capital and segregation requirements of the Commission or the margin requirements of the Federal Reserve and the SROs. Moreover, existing broker-dealer capital and segregation requirements made it relatively costly for broker-dealers to trade security-based swaps.<sup>944</sup> As a result, security-based swap transactions have often been effected via entities that are affiliated with broker-dealers, but not via broker-dealers themselves.

The Commission is adopting requirements that apply to MSBSPs. An entity is an MSBSP if it is not an SBSB but nonetheless either: (1) Maintains a "substantial position" in security-based swaps for any of the major security-based swap categories; (2) has outstanding security-based swaps that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (3) is a "financial entity" that is "highly leveraged" relative to the amount of capital it holds (and that is not subject to capital requirements established by an appropriate federal banking agency) and maintains a "substantial position" in outstanding swaps or security-based swaps in any major category.<sup>945</sup> As with SBSBs, such entities have previously operated without the Commission's direct supervision (unless separately required to register as a broker-dealer). Based on available transaction data, the Commission has previously estimated that five or fewer entities currently active in the security-based swap market may ultimately register as MSBSPs.<sup>946</sup>

Because many of the entities that may register as SBSBs or MSBSPs are subsidiaries of U.S. and international bank holding companies, the baseline is

affected by the relevant Federal Reserve regulations currently applicable at the consolidated bank holding company level,<sup>947</sup> as well as current foreign regulations of security-based swaps.

The amendments and rules being adopted today are primarily focused on security-based swap activities of stand-alone broker-dealers and nonbank SBSBs and MSBSPs. However, certain aspects of the amendments and rules being adopted will also affect the treatment of swaps such as interest rate swaps or CDS on broad-based security indices. For example, entities that are registered with the Commission as nonbank SBSBs but who also participate in the swap market will account for the swap positions in their capital calculations under the requirements being adopted today. Therefore, the Commission's analysis (and the baseline thereto) focuses on security-based swaps, but considers the broader swap market where appropriate.

The Commission's analysis of the state of the current security-based swap market is based on data obtained from the DTCC-TIW, particularly data regarding the activity of market participants in the single-name CDS market during the period from 2008 to 2017.<sup>948</sup> Although the capital, segregation, and margin rules being adopted today apply to all security-based swaps, not just single-name CDS, single-name CDS represent a significant portion of the security-based swap market.<sup>949</sup>

Although the Commission believes the DTCC-TIW data to be sufficient for characterizing the baseline state of the security-based swap market, the complexity of the U.S. regulatory structure presents difficulties in drawing inferences from this baseline. The security-based swap market is dominated by a small number of global financial firms.<sup>950</sup> These firms typically have considerable flexibility in structuring their activities. Such firms may choose to house their security-

based swap dealing activities in one of several affiliated entities; the degree to which the rules and amendments being adopted today will apply will depend on these choices. If such activities are placed in a bank SBSB or MSBSP, such as a federally insured depository institution, the capital and margin rules being adopted today will not apply.<sup>951</sup> Conversely, if these activities are instead housed in an affiliated (U.S.) nonbank SBSB, the requirements being adopted today will apply in full. Thus, the requirements' impact will depend on firms' choice of organizational structure, which, in turn, will depend, in part, on the requirements' relative attractiveness compared to those of other regulators.

Available information about the global OTC derivatives market suggests that swap transactions, in contrast to security-based swap transactions, dominate trading activities, notional amounts, and market values.<sup>952</sup> The BIS estimates that the total notional amounts outstanding and gross market value of global OTC derivatives were \$532 trillion and \$11.0 trillion, respectively, as of the end of 2017. Of these totals, the BIS estimates that foreign exchange contracts, interest rate contracts, and commodity contracts comprised 97% of the total notional amount and 92% of the gross market value. CDS, including index CDS, comprised 1.8% of the total notional amount and 2.9% of the gross market value. Equity-linked contracts, including forwards, swaps and options, comprised an additional 1.2% of the total notional amount and 5.3% of the gross market value. Because the capital, margin, and segregation rules being adopted today for SBSBs and MSBSPs would apply to dealers and participants in the security-based swap market, they are expected to affect a substantially smaller portion of the U.S. OTC derivatives market than the capital, margin, and segregation rules of the CFTC and the prudential regulators for swap dealers and major swap participants.<sup>953</sup> Moreover, many of the

<sup>943</sup> The current state of the broker-dealer industry is affected by, among other things, market practice and relevant SRO regulations, as well as margin rules set by the Federal Reserve (*i.e.*, Regulation T).

<sup>944</sup> For example, because the segregation rules in the United States were stricter than those in the United Kingdom, prime-brokerage services were often provided through London-based broker-dealer affiliates. See Kenneth R. French et. al., *The Squam Lake Report: Fixing the Financial System* (2010).

<sup>945</sup> See 17 CFR. 240.3a67-1.

<sup>946</sup> See *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, 84 FR at 4925.

<sup>947</sup> See 12 CFR 225, Appendix A.

<sup>948</sup> See *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, 84 FR at 4924-25 (describing the features of the DTCC-TIW, including CDS transactions that are not part of the data).

<sup>949</sup> See *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, 84 FR at 4924 n. 245 (providing a breakdown of the global security-based swap market and indicating that single-name CDSs represent approximately 59% of this market in terms of gross notional outstanding at the end of 2017).

<sup>950</sup> See, e.g., *ISDA Margin Survey 2012*.

<sup>951</sup> The capital and margin requirements adopted today apply to nonbank SBSBs and MSBSPs, but the segregation requirements adopted today apply to both bank and nonbank SBSBs and MSBSPs. Bank SBSBs are subject to the prudential regulators' capital and margin requirements. See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR 74840.

<sup>952</sup> See BIS, *OTC derivatives statistics at end-December 2017* (May 2018).

<sup>953</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR 74840; *CFTC Margin Adopting Release*, 81 FR 636; *CFTC Capital Proposing Release*, 81 FR 91252. The effect of the Commission's capital rules on the U.S. OTC derivatives markets potentially will be more significant depending on the number of CFTC-



participants in these markets may choose to engage in security-based swap transactions through their banking subsidiaries, further reducing the impact of the Commission's requirements.<sup>954</sup>

#### 1. Market Participants

Transaction data from the DTCC-TIW indicates that security-based swap dealing activity is concentrated among a few dozen entities. In addition to these entities, thousands of other participants appear as counterparties to security-based swaps in the Commission's

registered dealers that also register as nonbank SBSDs, given the application of the capital requirements to the entire business of such dually-registered firms.

<sup>954</sup> Section 716 of the Dodd-Frank Act significantly limited the security-based swap activities of insured depository institutions, effectively requiring that such activities be pushed out into affiliated nonbank SBSDs registered with the Commission. Section 630 of the Consolidated and Further Continuing Appropriations Act of 2015 eliminated most of Section 716's limitations; excepting structured financed swaps, insured depository institutions may directly engage in security-based swap activity. See Public Law 113–235 § 630.

sample, and include, but are not limited to, investment companies, pension funds, private hedge funds, sovereign entities, and industrial companies. A detailed discussion of security-based swap market participants can be found in the Commission's release regarding applications with respect to statutory disqualifications.<sup>955</sup>

#### a. Dealing Structures

SBSDs use a variety of business models and legal structures to engage in dealing business for a variety of legal, tax, strategic, and business reasons.<sup>956</sup> Dealers may use a variety of structures in part to reduce risk and enhance credit protection based on the particular characteristics of each entity's business.

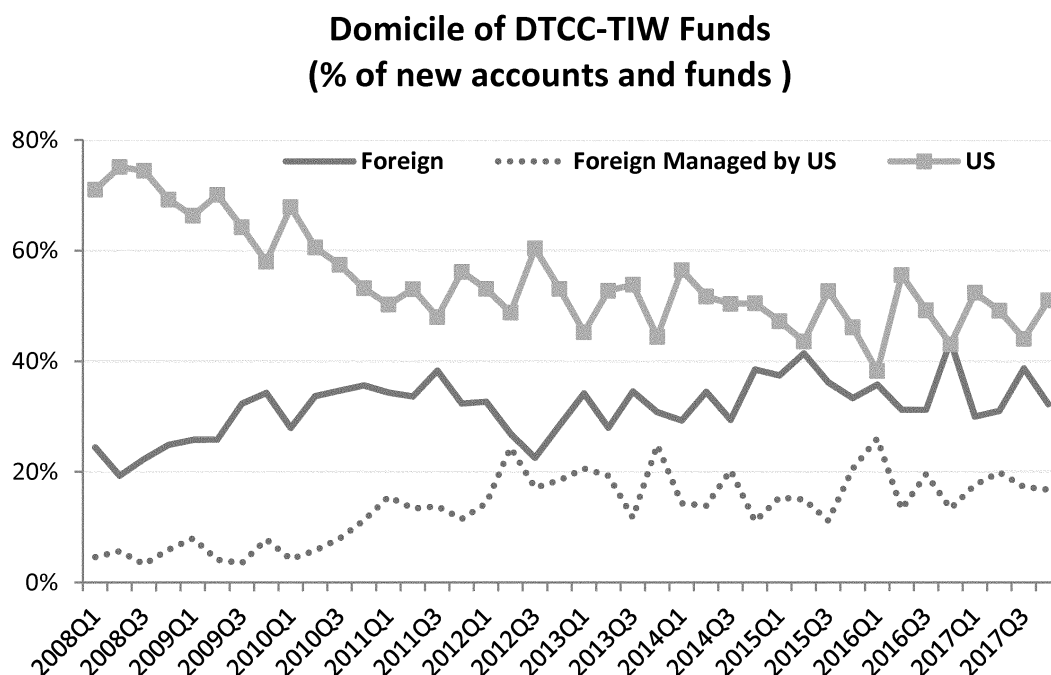
<sup>955</sup> See *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, 84 FR at 4925–26.

<sup>956</sup> See *Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities; Republication*, 79 FR at 47283.

Bank and nonbank holding companies may use subsidiaries to deal with counterparties. Further, dealers may rely on multiple sales forces to originate security-based swap transactions. For example, a U.S. bank dealer may use a sales force in its U.S. home office to originate security-based swap transactions in the United States and use separate sales forces spread across foreign branches to originate security-based swap transactions with counterparties in foreign markets.

In some situations, an entity's performance under a security-based swap transaction may be supported by a guarantee provided by an affiliate. More generally, guarantees may take the form of a blanket guarantee of an affiliate's performance on all security-based swap contracts, or a guarantee may apply only to a specific transaction or counterparty. Guarantees may give counterparties to the dealer direct recourse to the holding company or another affiliate for its dealer-affiliate's obligations under security-based swap transactions for which that dealer-affiliate acts as counterparty.

**Figure 1:** The percentage of (1) new accounts with a domicile in the United States (referred to as “US”), (2) new accounts with a domicile outside the United States (referred to as “Foreign”), and (3) new accounts outside the United States but managed by a U.S. person, account of a foreign branch of a U.S. person, and accounts of a foreign subsidiary of a U.S. person (collectively referred to as “Foreign Managed by US”).<sup>957</sup> Unique, new accounts are aggregated each quarter and percentages are computed on a quarterly basis, from January 2008 through December 2017.



#### b. Security-Based Swap Market Participant Domiciles

As depicted in Figure 1, domiciles of new accounts participating in the market have shifted over time. It is unclear whether these shifts represent changes in the types of participants active in this market, changes in reporting, or changes in transaction volumes in particular underliers. For example, the percentage of new entrants that are foreign accounts increased from 24.4% in the first quarter of 2008 to 32.3% in the last quarter of 2017, which may reflect an increase in participation by foreign account holders in the security-based swap market, though the total number of new entrants that are foreign accounts decreased from 112 in the first quarter of 2008 to 48 in the last quarter of 2017.<sup>958</sup> Additionally, the

percentage of the subset of new entrants that are foreign accounts managed by U.S. persons increased from 4.6% in the first quarter of 2008 to 16.8% in the last quarter of 2017, and the absolute number rose from 21 to 25, which also may reflect more specifically the flexibility with which market participants can restructure their market participation in response to regulatory intervention, competitive pressures, and

other stimuli.<sup>959</sup> At the same time, apparent changes in the percentage of new accounts with foreign domiciles may also reflect improvements in reporting to the DTCC-TIW by market participants, an increase in the percentage of transactions between U.S. and non-U.S. counterparties, and/or increased transactions in single-name CDS on U.S. reference entities by foreign persons.<sup>960</sup>

surveyed market participants, asking for the physical address associated with each of their accounts (i.e., where the account is organized as a legal entity). This address is designated the registered office location by the DTCC-TIW. When an account does not report a registered office location, the Commission has assumed that the settlement country reported by the investment adviser or parent entity to the fund or account is the place of domicile. This treatment assumes that the registered office location reflects the place of domicile for the fund or account.

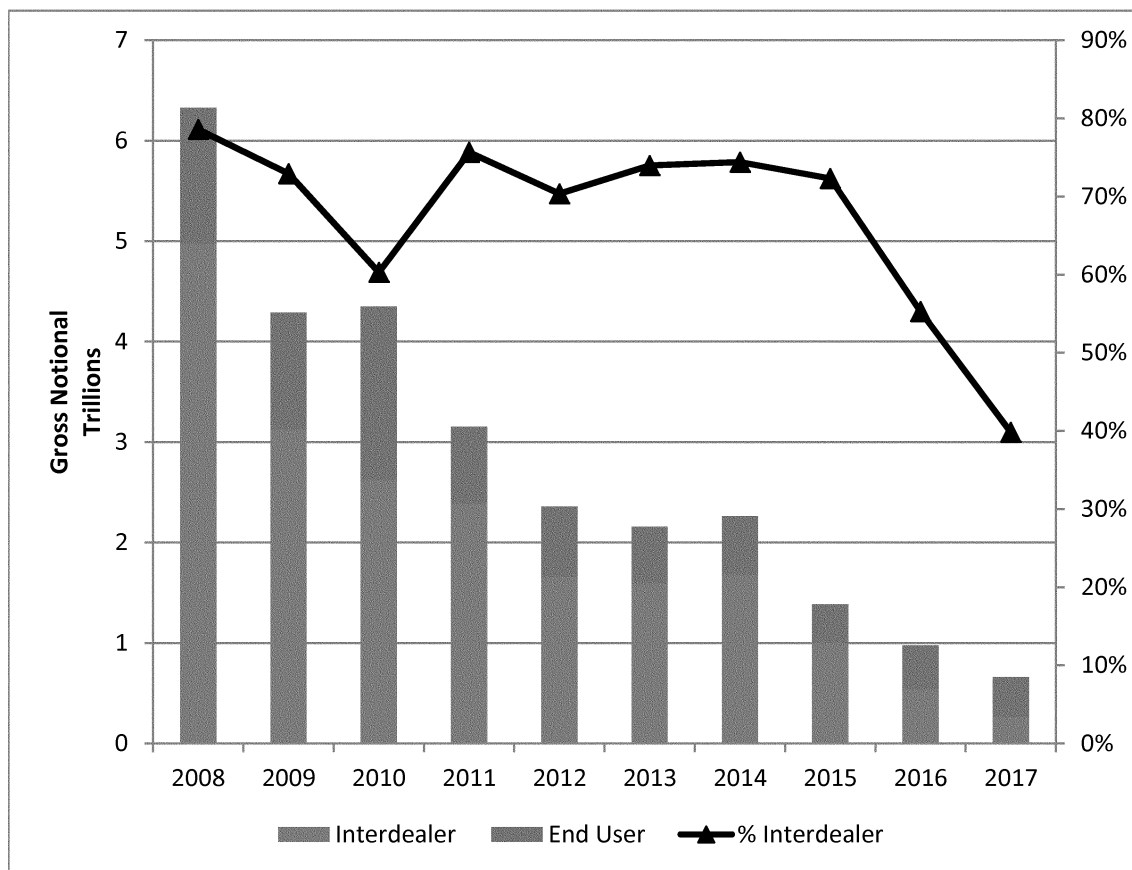
<sup>958</sup> These estimates were calculated by Commission staff using DTCC-TIW data.

<sup>959</sup> See Charles Levinson, *U.S. banks moved billions in trades beyond the CFTC's reach*, Reuters, Aug. 21, 2015, available at <http://www.reuters.com/article/2015/08/21/usa-banks-swaps-idUSL3N10S57R20150821>. The estimates of 21 and 25 were calculated by Commission staff using DTCC-TIW data.

<sup>960</sup> The available data do not include all security-based swap transactions but only transactions in single name CDS that involve either: (1) At least one account domiciled in the United States (regardless of the reference entity); or (2) single-name CDS on a U.S. reference entity (regardless of the domicile of the counterparties).

<sup>957</sup> Following publication of the Warehouse Trust Guidance on CDS data access, the DTCC-TIW

**Figure 2:** Global, notional trading volume in North American corporate single-name CDS by calendar year and the fraction of volume that is interdealer.



#### c. Security-Based Swap Market: Levels of Security-Based Swap Trading Activity

As noted above, firms that act as dealers play a central role in the security-based swap market. Based on an analysis of 2017 single-name CDS data from the DTCC-TIW, accounts of those firms that are likely to exceed the security-based swap dealer *de minimis* thresholds and trigger registration requirements intermediated transactions with a gross notional amount of approximately \$2.9 trillion, approximately 55% of which was intermediated by the top five dealer accounts.<sup>961</sup> A commenter stated that security-based swap dealing activity is largely concentrated in U.S. and foreign banks, foreign dealers, OTC derivatives dealers, and “stand-alone SBSDs,” and that stand-alone broker-dealers are not significant participants.<sup>962</sup>

These dealers transact with hundreds or thousands of counterparties. Approximately 21% of accounts of firms expected to register as SBSDs and observable in the DTCC-TIW have entered into security-based swaps with over 1,000 unique counterparty accounts as of year-end 2017.<sup>963</sup> Another 25% of these accounts transacted with 500 to 1,000 unique counterparty accounts; 29% transacted with 100 to 500 unique accounts; and 25% of these accounts intermediated security-based swaps with fewer than 100 unique counterparties in 2017. The median dealer account transacted with 495 unique accounts (with an average of approximately 570 unique accounts). Non-dealer counterparties transacted almost exclusively with these dealers. The median non-dealer counterparty transacted with two dealer accounts (with an average of approximately 3 dealer accounts) in 2017.

Figure 2 describes the percentage of global, notional transaction volume in North American corporate single-name CDS reported to the DTCC-TIW from January 2008 through December 2017, separated by whether transactions are between two ISDA-recognized dealers (interdealer transactions) or whether a transaction has at least one non-dealer counterparty.

Figure 2 also shows that the portion of the notional volume of North American corporate single-name CDS represented by interdealer transactions has remained fairly constant through 2015 before falling from approximately 72% in 2015 to approximately 40% in 2017. This fall corresponds to the availability of clearing to non-dealers. Interdealer transactions continue to represent a significant portion of trading activity even as notional volume has declined over the past 10 years,<sup>964</sup> from

<sup>961</sup> The Commission staff analysis of DTCC-TIW transaction records indicates that approximately 99% of single-name CDS price-forming transactions in 2017 involved an ISDA-recognized dealer.

<sup>962</sup> See SIFMA 11/19/2018 Letter.

<sup>963</sup> Many dealer entities and financial groups transact through numerous accounts. Given that individual accounts may transact with hundreds of counterparties, the Commission infers that entities and financial groups may transact with at least as many counterparties as the largest of their accounts.

<sup>964</sup> The start of this decline predates the enactment of the Dodd-Frank Act and the proposal of security-based swap rules thereunder.

more than \$6 trillion in 2008 to less than \$700 billion in 2017.<sup>965</sup>

Against this backdrop of declining North American corporate single-name CDS activity, about half of the trading activity in North American corporate single-name CDS reflected in the analyzed dataset was between counterparties domiciled in the United States and counterparties domiciled abroad, as shown in Figure 3 below. Using the self-reported registered office location of the DTCC-TIW accounts as a proxy for domicile, Commission staff estimates that only 12% of the global transaction volume by notional volume between 2008 and 2017 was between two U.S.-domiciled counterparties, compared to 49% entered into between one U.S.-domiciled counterparty and a foreign-domiciled counterparty and 39% entered into between two foreign-domiciled counterparties.<sup>966</sup>

<sup>965</sup> This estimate is lower than the gross notional amount of \$7.2 trillion noted above as it includes only the subset of single-name CDS referencing North American corporate documentation, as discussed above.

<sup>966</sup> For purposes of this discussion, Commission staff has assumed that the registered office location reflects the place of domicile for the fund or account, but it is possible that this domicile does not necessarily correspond to the location of an entity's sales or trading desk. See *Application of*

If one considers the number of cross-border transactions instead from the perspective of the domicile of the corporate group (e.g., by classifying a foreign bank branch or foreign subsidiary of a U.S. entity as domiciled in the United States), the percentages shift significantly. Under this approach, the fraction of transactions entered into between two U.S.-domiciled counterparties increases to 34%, and to 51% for transactions entered into between a U.S.-domiciled counterparty and a foreign-domiciled counterparty.

By contrast, the proportion of activity between two foreign-domiciled counterparties drops from 39% to 15%. This change in respective shares based on different classifications suggests that the activity of foreign subsidiaries of U.S. firms and foreign branches of U.S. banks accounts for a higher percentage of security-based swap activity than the activity of U.S. subsidiaries of foreign firms and U.S. branches of foreign banks. It also demonstrates that

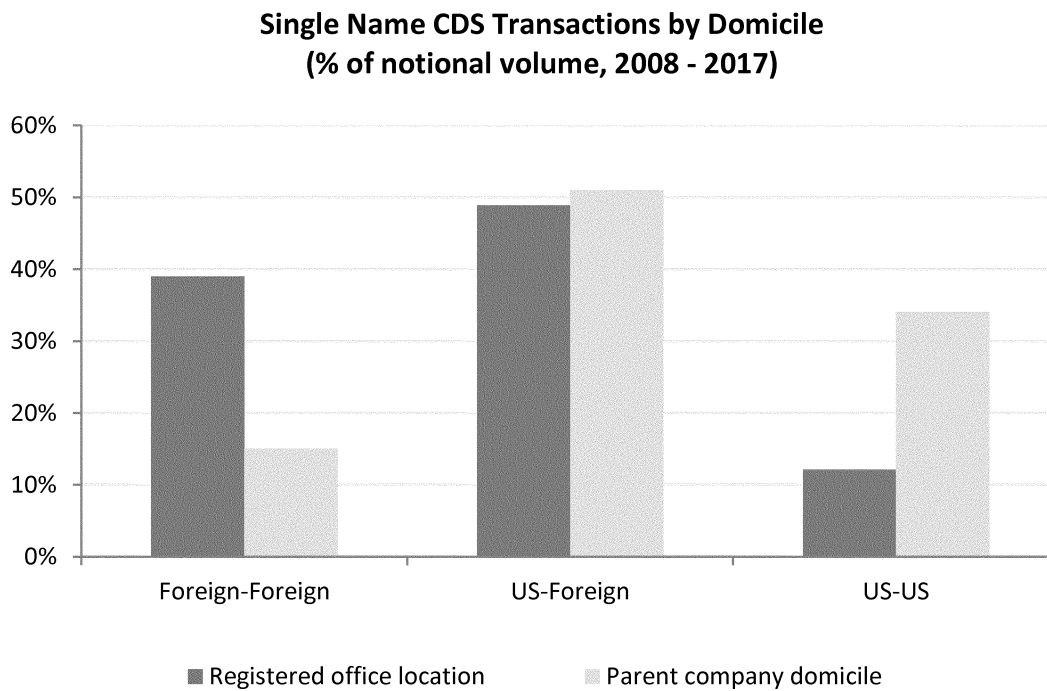
*Certain Title VII Requirements to Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent*, Exchange Act Release No. 74834 (Apr. 29, 2015), 80 FR 27452 (May 13, 2015).

financial groups based in the United States are involved in an overwhelming majority (approximately 85%) of all reported transactions in North American corporate single-name CDS.

Financial groups based in the United States are also involved in a majority of interdealer transactions in North American corporate single-name CDS. Of the 2017 transactions in North American corporate single-name CDS between two ISDA-recognized dealers and their branches or affiliates, 94% of transaction notional volume involved at least one account of an entity with a U.S. parent.

In addition, a majority of North American corporate single-name CDS transactions occur in the interdealer market or between dealers and foreign non-dealers, with the remaining portion of the market consisting of transactions between dealers and U.S.-person non-dealers. Specifically, 60% of North American corporate single-name CDS transactions involved either two ISDA-recognized dealers or an ISDA-recognized dealer and a foreign non-dealer. Approximately 39% of such transactions involved an ISDA-recognized dealer and a U.S.-person non-dealer.

**Figure 3:** The fraction of notional volume in North American corporate single-name CDS between (1) 2 U.S.-domiciled accounts, (2) one U.S.-domiciled account and one non-U.S.-domiciled account, and (3) two non-U.S.-domiciled accounts, computed from January 2008 through December 2017.



#### d. Open Positions

Based on analysis of data from the DTCC-TIW, Table 1 describes the gross notional amount of open positions in non-cleared single-name CDS between different types of market participants (*i.e.*, “accounts”) at the end of 2017. Gross notional amount of open positions between two types of market participants is the sum of the notional amounts in U.S. dollars of all outstanding CDS contracts between the two types of market participants.

At the end of 2017, the gross notional amount of open positions between

ISDA-recognized dealers far exceeded the gross notional amount of open positions between all other types of market participants. In particular, the gross notional amount of open positions between ISDA-recognized dealers (“interdealer”) was approximately \$1.25 trillion in non-cleared single-name CDS contracts and \$557 billion in non-cleared index CDS contracts. The gross notional amount of open positions other than interdealer was approximately \$525 billion in non-cleared single-name CDS contracts and just over \$1 trillion in non-cleared index CDS contracts.

Banks and private funds were among the most active market participants that were not ISDA-recognized dealers. The gross notional amount of open positions between ISDA-recognized dealers and banks was approximately \$184 billion in non-cleared single-name CDS contracts and \$113 billion in non-cleared index CDS contracts. Similarly, the gross notional amount of open positions between ISDA-recognized dealers and private funds was approximately \$176 billion in non-cleared single-name CDS contracts and \$410 billion in non-cleared index CDS contracts.

**TABLE 1—GROSS NOTIONAL AMOUNT OF DEALER-INTERMEDIATED OPEN POSITIONS IN NON-CLEARED CDS AT THE END OF 2017**

[Billions of U.S. dollars]

	Single-name CDS	Index CDS
ISDA-Recognized Dealers .....	1,252	557
Banks .....	184	113
Insurance Companies .....	20	30
Private Funds .....	176	410
Registered Investment Companies .....	24	62
Non-financial Corporations .....	<1	<1
DFA Special Entities .....	4	4
Foreign Sovereign .....	6	18
Finance Companies .....	1	<1
Others .....	100	187

TABLE 1—GROSS NOTIONAL AMOUNT OF DEALER-INTERMEDIATED OPEN POSITIONS IN NON-CLEARED CDS AT THE END OF 2017—Continued  
[Billions of U.S. dollars]

	Single-name CDS	Index CDS
Others/Unclassified .....	<1	188.57

Dealing entities that are likely to register as SBSs generally have significant open positions in the single-name CDS market. For each dealing entity that is expected to register as an SBS and for which DTCC-TIW positions data are available as of the end of September 2017, the Commission identifies the cleared and non-cleared single-name CDS positions that the entity holds against its counterparties. The Commission then calculates the aggregate gross notional amount of each entity's open single-name CDS positions. For these 23 dealing entities, the mean, median, maximum, and minimum aggregate gross notional amount are respectively, \$219 billion, \$115 billion, \$902 billion, and \$3 billion. The standard deviation in aggregate gross notional amounts is \$242 billion.

These entities also engage in dealing activity in the swap market. The aggregate gross notional amounts of their open positions in the swap market have a mean of \$11,725 billion, a median of \$10,244 billion, a minimum of \$72 billion, a maximum of \$45,264 billion, and a standard deviation of \$10,496 billion.<sup>967</sup> To gauge the relative significance of single-name CDS open positions, the Commission expresses each entity's single-name CDS aggregate gross notional amount as a percentage of its combined swaps and single-name CDS aggregate gross notional amount. The mean, median, maximum, and minimum percentages are respectively 1.34%, 1.23%, 0.03%, and 5.39%. The standard deviation is 1.13%.

#### e. Cross-Market Participation

The numerous financial markets are integrated, often attracting the same market participants that trade across corporate bond, swap, and security-based swap markets, among others. In a prior release, the Commission discussed the hedging opportunities across the single-name CDS and index CDS markets and how such hedging opportunities in turn influence the extent to which participants that are active in the single-name CDS market

are likely to be active in the index CDS market.<sup>968</sup>

#### 2. Counterparty Credit Risk Mitigation

In contrast to the securities markets, counterparty credit risk represents a major source of risk to participants in the OTC security-based swap market.<sup>969</sup> For example, in a CDS transaction, the first party, the protection buyer, agrees to pay the second party, the protection seller, a periodic premium for a set time period in exchange for the protection seller agreeing to pay some amount in the event of the occurrence of a given credit event during the same period. The ongoing reciprocal obligations of the parties in such transactions expose each to ongoing reciprocal counterparty credit risk.

Currently, security-based swap market participants mitigate counterparty credit risk by: (1) Using a central counterparty ("CCP") such as a clearing agency or DCO to clear a trade; (2) using standardized netting agreements between counterparties; (3) performing portfolio compression to minimize counterparty exposure; and (4) requiring margin (*i.e.*, collateral). Below is a brief discussion of the extent to which market participants make use of each of these practices in the CDS market, which comprises the majority of security-based swap transactions.

##### a. Clearing

Central clearing through a CCP provides a method for dealing with the counterparty credit risk inherent in security-based swap transactions. Where a clearing agency provides CCP services, clearance and settlement of security-based swap contracts replaces bilateral counterparty exposures with exposures against the clearing agency providing CCP services.<sup>970</sup> Using a CCP to centrally manage credit risk can reduce the monitoring costs and counterparty

credit risk of both parties to the original transaction. A centralized clearing structure, when widely adopted, also maximizes the opportunities for netting offsetting contracts thus reducing collateral requirements in centrally-cleared transactions. It can also improve price discovery and financial stability.

Although central clearing offers a number of advantages, it is not without limitations. For example, "bespoke" or otherwise illiquid contracts are not amenable to clearing. Widespread adoption of central clearing in security-based swap markets would raise the systemic importance of CCPs.

The ratio of the aggregate notional amount of outstanding CDS contracts cleared through CCPs to the aggregate notional amount of all outstanding CDS contracts has been increasing steadily since 2010.<sup>971</sup> In 2017, this ratio peaked at 27.5%, representing a significant increase over 2016 (21.8%), 2015 (17.1%), 2014 (14.6%), 2013 (13.13%), 2012 (9.75%), 2011 (9.55%), and 2010 (7.36%).<sup>972</sup> Limiting attention to just single-name CDS contracts (*i.e.*, excluding index CDS and multi-name non-index CDS) provides a less consistent picture. While the percentage of single-name CDS contracts that were cleared has increased from 36% in 2010 to 40% in 2017, the upward trend has not been uniform, with a local peak in 2011 (46%) followed by a decline in

<sup>971</sup> 2010 is the first year the BIS' OTC derivatives market surveys separate out CDS market activity by counterparty, including CCPs. See BIS, *OTC derivatives market activity in the second half of 2010* (May 2011).

<sup>972</sup> See BIS, *OTC derivatives statistics at end-December 2017* (May 2018); BIS, *OTC derivatives statistics at end-December 2016* (May 2017); BIS, *OTC derivatives statistics at end-December 2015* (May 2016); BIS, *OTC derivatives statistics at end-December 2014* (Apr. 2015); BIS, *OTC derivatives statistics at end-December 2013* (May 2014); BIS, *OTC derivatives statistics at end-December 2012* (May 2013); BIS, *OTC derivatives statistics at end-December 2011* (May 2012); BIS, *OTC derivatives market activity in the second half of 2010* (May 2011). For each year, the original ratio is obtained from Table 4 (replaced by Table D10.1 beginning with 2015) of the statistical releases and is calculated by dividing the CCPs' outstanding aggregate notional amount by the total outstanding aggregate notional amount, with the result divided by two (a contract submitted for clearing to a CCP is replaced, post-novation, by two contracts (with the same notional value as the original contract) between the CCP and each of the original counterparties).

<sup>967</sup> The Commission obtained these entities' open positions in interest rate swaps, currency swaps, and index CDS from the CFTC.

<sup>968</sup> See *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*, 84 FR at 4927.

<sup>969</sup> See Robert R. Bliss and Robert S. Steigerwald, *Derivatives Clearing and Settlement: A Comparison of Central Counterparties and Alternative Structures*, Economic Perspectives 30, no. 4.

<sup>970</sup> See *Standards for Covered Clearing Agencies*, 81 FR 70786.

2012 (45%) and 2013 (37%), an increase in 2014 (43.5%) and 2015 (48%), and then another decline in 2016 (47%) and 2017 (40%).<sup>973</sup>

#### b. Netting Agreements

Netting agreements between counterparties can mitigate counterparty risk by allowing the positive exposure of counterparty A to counterparty B in a transaction to offset the positive exposure of counterparty B to counterparty A in another transaction. Such offsets are made possible through master netting agreements (“MNAs”).<sup>974</sup>

One way to measure the degree of netting in a set of positions is with the “net-to-gross ratio,” the ratio of the absolute value of the sum of the marked-to-market values of the positions after all product-specific netting agreements (cross-product agreements are excluded) are given effect, to the sum of the positions’ absolute marked-to-market values. The more the gains on some positions offset losses on others, the lower the ratio. On an aggregate basis (*i.e.*, across all market participants), the net-to-gross ratio for security-based swaps positions was 27% in 2015. This is a significant increase compared to 2014 (23%) and 2013 (21%), and a marginal increase compared to 2012 (24%) and 2011 (26%).<sup>975</sup>

On a disaggregated basis, there is substantial variation in the degree of netting across different market participants. For instance, in 2015, the ratio of net market value to gross market value was as low as 18% and 20% for CCPs and dealers, respectively, and as high as 78% for insurance companies.<sup>976</sup> These differences in the net-to-gross ratio across different types of market participants reflect differences

in their participation in the security-based swap market.

#### c. Portfolio Compression

Portfolio compression reduces counterparty risk through the termination of early redundant derivatives trades without changing the net exposure of any of the counterparties. The amount of redundant notional amount eliminated through portfolio compression declined steadily over the years, from more than \$30 trillion in 2008<sup>977</sup> and more than \$15 trillion in 2009, to \$9.8 trillion in 2010, \$6.4 trillion in 2011, and \$4.1 trillion in 2012.<sup>978</sup>

#### d. Margin

Participants in the security-based swap market may mitigate counterparty risk by collecting collateral through margin assessment under an active collateral agreement.<sup>979</sup> The Commission lacks regulatory data on the use of collateral by participants in the security-based swap and swap markets.<sup>980</sup> Thus, the Commission’s quantitative understanding of margin practices in these markets is largely based on the ISDA’s annual margin surveys. These surveys suggest that: (1) The use of collateral has generally increased over the last decade; (2) collateral practices vary by type of market participant and counterparty; (3) segregation of collateral is not widespread; and (4) use of central clearing is increasing.<sup>981</sup>

<sup>977</sup> See TriOptima, triReduce Statistics, available at <http://www.trioptima.com/resource-center/statistics/triReduce.html>. The amount of portfolio compression as reported by TriOptima, a provider of third-party portfolio compression services.

<sup>978</sup> ISDA, *OTC Derivatives Market Analysis Year-End 2012* (June 2013, rev. Aug. 9, 2013). 2012 is the last year when ISDA reported aggregate compression statistics.

<sup>979</sup> A collateral agreement specifies the terms for the use of collateral to support a bilateral derivatives trade. According to the ISDA, a collateral agreement is active when: (1) There is an open exposure with active trades beneath it, regardless of whether collateral has been collected or delivered for any of the trades; and (2) collateral has actually been collected or delivered. See *ISDA Margin Survey 2015*. In contrast, inactive collateral agreements are those that have been executed and have no current outstanding exposure, or those that show no current activity but may be used to trade at some point in the future. Cleared OTC derivatives trades are generally subject to collateral agreements specified by the CCP.

<sup>980</sup> In the proposing release, the Commission requested data and information from commenters to assist it in analyzing the economic consequences of the proposed rules; no additional data was provided. See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70300. See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53019–20.

<sup>981</sup> The discussion in this section of the release is based on the *ISDA Margin Survey 2009* (Apr. 15, 2009), *ISDA Margin Survey 2010* (Aug. 15, 2010),

The statistics in the margin surveys suggest that the use of collateral in security-based swap and swap transactions generally increased in the period from the end of 2002 through the end of 2012.<sup>982</sup> At the end of 2002, 53% of fixed income derivatives transactions and 30% of credit derivatives transactions were subject to a credit support agreement (“CSA”); by 2009, the percentages were 63% and 71%, respectively.<sup>983</sup> By 2012, similar statistics indicated that 79% of fixed income derivative transactions and 83% of credit derivative transactions were subject to CSAs.<sup>984</sup> With respect to non-cleared transactions, the 2012 percentages of fixed income derivative trades and credit derivative trades subject to a CSA were 73% and 79%, respectively.

While the industry margin surveys suggest that the prevalence of CSAs in derivative transactions increased over time, they provide less recent information about collateralization levels and their cross-sectional characteristics. The ISDA reports that, in 2010, an estimated 73% of aggregate OTC derivatives exposures were collateralized.<sup>985</sup> According to the ISDA, collateralization levels in 2010 varied considerably depending on the type of counterparty.<sup>986</sup> Collateralization of exposures to sovereigns was very limited (18%). Collateralization of exposures to hedge funds was much more extensive (160%),<sup>987</sup> reflecting a greater tendency to collect initial margin from those participants. In between these extremes were collateralization levels of current

*ISDA Margin Survey 2011* (Apr. 14, 2011), *ISDA Margin Survey 2012*, *ISDA Margin Survey 2013* (June 21, 2013), *ISDA Margin Survey 2014* (Apr. 10, 2014), and *ISDA Margin Survey 2015*. The format of these reports has not remained constant over time. Consequently, certain statistics are only available in the earlier surveys.

<sup>982</sup> See *ISDA Margin Survey 2009* at Table 4.2; *ISDA Margin Survey 2010* at Table 3.3; *ISDA Margin Survey 2011* at Table 3.2; *ISDA Margin Survey 2012* at Table 3.2; *ISDA, ISDA Margin Survey 2013* at Table 3.4.

<sup>983</sup> See *ISDA Margin Survey 2009* at Table 4.2. This table reports the fraction of transactions (cleared and non-cleared) subject to a CSA.

<sup>984</sup> See *ISDA Margin Survey 2013* at Table 3.4. Due to methodological changes, the 2002 through 2009 statistics and the 2012 statistics are not directly comparable. Comparable statistics were not reported in more recent surveys.

<sup>985</sup> See *ISDA Margin Survey 2011* at Table 3.3. Statistics based on derivatives type (*e.g.*, credit derivatives) were not provided. More recent ISDA margin surveys do not report these statistics.

<sup>986</sup> In this discussion, collateralization level means the ratio of collateral to current exposure.

<sup>987</sup> The 160% collateralization level for hedge funds indicates that on average, current exposures to hedge funds were fully collateralized and that some additional margin covering potential future exposures (*i.e.*, initial margin) was also collected.

<sup>973</sup> These percentages are obtained from Table 4 (replaced by Table D10.1 beginning with 2015) of the statistical releases, by dividing the CCPs’ outstanding aggregate notional amount for single-name CDS by the CCPs’ outstanding aggregate notional amount for all CDS contracts.

<sup>974</sup> Under the ISDA Master Agreement, netting can take two forms: (1) Settlement (or payment) netting, which is the process of combining offsetting cash flow obligations between solvent counterparties into a single net payment; and (2) close-out netting, which is the process of terminating and netting the marked-to-market values of all outstanding transactions when one of the counterparties becomes insolvent. The former is optional, while the latter is a contractual obligation under the ISDA Master Agreement.

<sup>975</sup> See BIS, *OTC derivatives statistics at end-December 2015*; BIS, *OTC derivatives statistics at end-December 2014*; BIS, *OTC derivatives statistics at end-December 2013*.

<sup>976</sup> See BIS, *OTC derivatives statistics at end-December 2015*; BIS, *OTC derivatives statistics at end-December 2014*; BIS, *OTC derivatives statistics at end-December 2013*.



exposures to mutual funds (100%), banks and broker-dealers (79%), pension funds (71%), insurance companies (68%), energy and/or commodity firms (37.2%), non-financial firms (37%), and special purpose vehicles (19%). The statistics for 2009 reveal a similar pattern.<sup>988</sup> These collateralization level patterns are consistent with the following stylized facts: (1) A counterparty's exposure to a special purpose vehicle is generally not covered to any significant extent; (2) counterparties do not generally require initial margin from dealers, banks, pension funds, and insurance companies, but will collect variation margin in certain cases or on an ad-hoc basis; (3) counterparties require hedge funds to post variation margin and initial margin; (4) counterparties require variation margin from mutual funds, but generally do not require mutual funds to post initial margin; (5) non-financial end-users are generally not required to post margin.<sup>989</sup>

An ISDA margin survey provides some evidence about the asset composition of collateral. According to this survey, in 2014, of the collateral received/(delivered) by survey respondents to cover initial margin, 55.4%/(64.7%) was in cash, 24.2%/(11.1%) was in government securities, and the rest was in other securities. In addition, of the collateral received/(delivered) to cover variation margin, 77.2%/(75.3%) was in cash, 16.3%/(21.4%) was in government securities, and the rest was in other securities. Finally, of the collateral received/(delivered) to cover commingled initial and variation margin, 71.7%/(76.4%) was in cash, 12%/(20.9%) was in government securities, and the rest was in other securities.<sup>990</sup>

The margin surveys also suggest that collateral for non-cleared derivatives is generally not segregated. According to an ISDA margin survey, where initial margin is collected, ISDA members reported that most (72%) was commingled with variation margin and not segregated, and only 5% of the amount received was segregated with a third-party custodian.<sup>991</sup>

Finally, an ISDA margin survey also reports a significant increase in the number of active collateral agreements for client's cleared trades. Specifically, 2014 saw a 67.1% increase in collateral agreements covering client's cleared trades over the previous year.<sup>992</sup> This significant increase is most likely due to the introduction of the clearing mandates in 2013 under the Dodd-Frank Act in the US.<sup>993</sup>

In response to a commenter's suggestion,<sup>994</sup> the Commission has supplemented its analysis of the ISDA margin surveys with an analysis of initial margins estimated for dealer CDS positions. For each dealing entity that is expected to register as an SBSB, the Commission uses DTCC-TIW data as of the end of September 2017 to identify the single-name and index CDS positions that the entity holds against its counterparties. For each dealing entity, the Commission then calculates the initial margin amount<sup>995</sup> from its single-name and index CDS positions with each counterparty by using historical CDS price movements<sup>996</sup> from five one-year samples: 2008, 2011, 2012, 2017, and 2018. The Commission believes the 2008, 2011, and 2012 samples are likely to capture stressed market conditions, while the 2017 and 2018 samples are likely to capture normal market conditions. For each sample and each dealing entity, the Commission then calculates the risk margin amount (*i.e.*, initial margin amounts) of its cleared and non-cleared CDS positions by

amount (initial margin) and variation margin together continued to be the industry standard both contractually and operationally, the ability to segregate had been made increasingly available to counterparties over the previous three years on a voluntary basis, and had led to 26% of the independent amounts received and 27.8% of independent amounts delivered being segregated in some respects. *See id.* at 10. *See also* ISDA, *Independent Amounts*, Release 2.0 (Mar. 1, 2010).

<sup>992</sup> *See ISDA Margin Survey 2015*. The ISDA also reported that the number of active agreements for house cleared trades was 258 for 2014, which was a decline of 21.3% compared to 2013.

<sup>993</sup> The CFTC mandate regarding clearing of certain index CDS came into effect on March 11, 2013. *See Clearing Requirement Determination Under Section 2(h) of the CEA*, 77 FR 74284 (Dec. 13, 2012).

<sup>994</sup> *See* SIFMA 11/19/2018 Letter (suggesting that the Commission provide data or analysis to support its proposed 8% margin factor, which depended, in part, on the total amount of initial margin calculated by the nonbank SBSB with respect to cleared and non-cleared security-based swaps).

<sup>995</sup> The Commission calculates initial margin using the methodology described in Darrell Duffie, Martin Scheicher, and Guillaume Vuilleme, *Central Clearing and Collateral Demand*, *Journal of Financial Economics* 116, no. 2, 237–256 (May 2015).

<sup>996</sup> These price movements are derived from historical pricing data on single-name CDS contracts. The data are purchased from ICE Data Services.

summing up the initial margins calculated above across all counterparties. Table 2 Panel A below reports a number of statistics, such as minimum, maximum, mean, standard deviation, and the quartiles of the distribution, that summarize the distribution of the dealers' risk margin amounts for each sample.

The Commission can make a number of observations from Table 2 Panel A. The risk margin amounts vary across the five annual samples. Risk margin amounts tend to be larger in 2008 and 2017, but smaller in 2011, 2012, and 2018. For example, the mean risk margin amount in 2008 and 2017 are \$768 million and \$507 million, respectively, while the mean risk margin amount in 2011, 2012, and 2018 range between \$260 and \$329 million. The risk margin amounts also vary across dealing entities, suggesting that these entities may hold single-name and index CDS positions with different levels of risk. For example, in the 2008 sample, risk margin amounts range from a minimum of \$9.89 million to a maximum of \$3,302.12 million. The variation in risk margin amounts across dealing entities, as measured by the standard deviation, also changes across the five annual samples. The standard deviation is higher in 2008 and 2017 and lower in 2011, 2012, and 2018.

The Commission repeats the preceding analysis using only interdealer CDS positions (*i.e.*, calculating risk margin amounts for single-name and index CDS positions held by a dealing entity against another dealing entity). Table 2 Panel B reports statistics summarizing the distribution of these interdealer risk margin amounts for each sample. A key result from Table 2 Panel B is that interdealer risk margin amounts are significantly smaller than risk margin amounts based on single-name and index CDS positions held by a dealer against all its counterparties. For example, in Table 2 Panel A, the mean risk margin amount ranges between \$260 million and \$768 million, while in Table 2 Panel B, the mean risk margin amount ranges between \$8.4 million and \$23.1 million. Interdealer risk margin amounts tend to be larger in 2008 and 2017, but smaller in 2011, 2012, and 2018. Interdealer risk margin amounts also vary across different pairs of dealing entities, suggesting that these entities may hold single-name and index CDS positions with different levels of risk. The variation in interdealer risk margin amounts across different pairs of dealing entities, as measured by the standard deviation, also changes across the five annual samples.

<sup>988</sup> *See ISDA Margin Survey 2010* at Table 3.3.

<sup>989</sup> *See generally ISDA Margin Survey 2011; ISDA Margin Survey 2012*. The results of the surveys, however, could be substantially different if limited only to U.S. participants, because the data contained in the surveys is global. *See id.* For example, 47% of the institutions responding to the ISDA margin survey published in 2012 were based in Europe, the Middle East, or Africa, and 31% were based in the Americas. *See ISDA Margin Survey 2012* at Chart 1.1.

<sup>990</sup> *See ISDA Margin Survey 2015* at Table 7.

<sup>991</sup> *See ISDA Margin Survey 2012*. The survey also notes that while the holding of the independent

*Table 2: Risk Margin Amounts.* This table reports summary statistics of risk margin amounts for the single-name and index CDS positions held by dealers against all counterparties (Panel A) and risk margin amounts for the single-name

and index CDS positions held by dealers against other dealers (Panel B) as of the end of September 2017. Risk margin amounts are in millions of dollars. The summary statistics are Min (minimum), P25 (first quartile/25th percentile), P50

(second quartile/50th percentile), P75 (third quartile/75th percentile), Max (maximum), Mean, and Std (standard deviation).

PANEL A: RISK MARGIN AMOUNTS FOR SINGLE-NAME AND INDEX CDS POSITIONS HELD BY DEALERS AGAINST ALL COUNTERPARTIES

Year	Min	P25	P50	P75	Max	Mean	Std
2008 .....	9.89	255.73	488.50	673.46	3302.12	767.76	817.96
2011 .....	7.43	95.46	188.56	449.53	1377.82	329.30	381.85
2012 .....	6.67	80.60	154.86	321.10	1137.43	260.05	295.31
2017 .....	1.39	138.58	385.75	600.70	1487.74	507.48	472.19
2018 .....	2.82	95.99	204.94	376.68	1380.57	316.00	350.30

PANEL B: RISK MARGIN AMOUNTS FOR SINGLE-NAME AND INDEX CDS POSITIONS HELD BY DEALERS AGAINST OTHER DEALERS

Year	Min	P25	P50	P75	Max	Mean	Std
2008 .....	0.01	3.35	10.00	29.98	170.89	21.81	28.39
2011 .....	0.00	1.27	3.28	10.56	100.38	10.32	16.56
2012 .....	0.00	0.92	3.34	8.97	64.82	8.45	12.43
2017 .....	0.00	0.50	3.08	17.23	528.61	23.07	60.24
2018 .....	0.00	0.75	3.83	11.84	67.07	9.46	14.07

### 3. Global Regulatory Efforts

In 2009, the G20 leaders—whose membership includes the United States, 18 other countries, and the European Union—addressed global improvements in the OTC derivatives market. They expressed their view on a variety of issues relating to OTC derivatives contracts. In subsequent summits, the G20 leaders have returned to OTC derivatives regulatory reform and encouraged international consultation in developing standards for these markets.<sup>997</sup>

Many SBSDs likely will be subject to foreign regulation of their security-based swap activities that is similar to regulations that may apply to them pursuant to Title VII of the Dodd-Frank Act, even if the relevant foreign jurisdictions do not classify certain market participants as “dealers” for regulatory purposes. Some of these regulations may duplicate, and in some cases conflict with, certain elements of the Title VII regulatory framework.

Foreign legislative and regulatory efforts have generally focused on five areas: (1) Moving OTC derivatives onto organized trading platforms; (2) requiring central clearing of OTC derivatives; (3) requiring post-trade reporting of transaction data for regulatory purposes and public

dissemination of anonymized versions of such data; (4) establishing or enhancing capital requirements for non-centrally cleared OTC derivatives transactions; and (5) establishing or enhancing margin and other risk mitigation requirements for non-centrally cleared OTC derivatives transactions. Foreign jurisdictions have been actively implementing regulations in connection with each of these categories of requirements. A number of major foreign jurisdictions have initiated the process of implementing margin and other risk mitigation requirements for non-centrally cleared OTC derivatives transactions.<sup>998</sup>

Notably, the European Parliament and the European Council have adopted the European Market Infrastructure Regulation (“EMIR”), which includes provisions aimed at increasing the safety and transparency of the OTC derivatives market. EMIR mandates the European Supervisory Authorities (“ESAs”) to develop regulatory technical standards specifying margin requirements for non-centrally cleared

OTC derivative contracts.<sup>999</sup> The ESAs have developed, and in October 2016 the European Commission adopted, these regulatory technical standards.<sup>1000</sup>

Several jurisdictions have also taken steps to implement the Basel III recommendations governing capital requirements for financial entities, which include enhanced capital charges for non-centrally cleared OTC derivatives transactions.<sup>1001</sup> Moreover, as discussed above, subsequent to the publication of the proposing release, the BCBS and IOSCO issued the BCBS/IOSCO Paper. The BCBS/IOSCO Paper recommended (among other things): (1) That all financial entities and systemically important non-financial

<sup>999</sup> The ESAs are the European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority.

<sup>1000</sup> See ESAs, *Final Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012* (Mar. 8, 2016). See also Commission Delegated Regulation (EU) 2016/2251 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (Oct. 4, 2016).

<sup>1001</sup> In November 2018, the Financial Stability Board reported that 23 of the 24 member jurisdictions participating in its thirteenth progress report on OTC derivatives market reforms had in force interim standards for higher capital requirements for non-centrally cleared transactions. See Financial Stability Board, *OTC Derivatives Market Reforms Thirteenth Progress Report on Implementation* (Nov. 19, 2018).

<sup>997</sup> See, e.g., *The G20 Toronto Summit Declaration* (June 27, 2010) at paragraph 25; *Cannes Summit Final Declaration—Building Our Common Future: Renewed Collective Action for the Benefit of All* (Nov. 4, 2011) at paragraph 24.

<sup>998</sup> In November 2018, the Financial Stability Board reported that 16 member jurisdictions participating in its thirteenth progress report on OTC derivatives market reforms had in force margin requirements for non-centrally cleared derivatives. A further 4 jurisdictions made some progress leading to a change in reported implementation status during the reporting period. See Financial Stability Board, *OTC Derivatives Market Reforms Thirteenth Progress Report on Implementation* (Nov. 19, 2018), available at <http://www.fsb.org/wp-content/uploads/P191118-5.pdf>.

entities exchange variation and initial margin appropriate for the counterparty risk posed by such transactions; (2) that initial margin should be exchanged without provisions for “netting” and held in a manner that protects both parties in the event of the other’s default; and (3) that the margin regimes of the various regulators should interact so as to be sufficiently consistent and non-duplicative.<sup>1002</sup>

#### 4. Capital Regulation

It is difficult to precisely delineate a baseline for capital requirements and capital levels in the security-based swap market. As discussed in prior sections, the entities that participate in this market may be subject to several overlapping regulatory regimes, including Federal Reserve capital standards at the bank holding company level,<sup>1003</sup> bank capital standards of the OCC and FDIC that apply to bank security-based swap entities,<sup>1004</sup> as well as the net capital requirements applicable to stand-alone broker-dealers. In addition, many entities in this space may be subject to the capital requirements applicable to FCMs, as well to the regimes of foreign regulators.<sup>1005</sup> Finally, certain entities may not be subject to any (direct) capital requirements under the baseline. In the discussion that follows, the relevant aspects of the capital regimes applicable to the various entities operating in the security-based swap market are reviewed, and their relation to the baseline is noted. The discussion focuses on the capital treatment of market risk arising from an entity’s proprietary positions in security-based swap transactions specifically, and OTC derivative transactions generally as well

as the capital treatment of credit risk arising from exposures to counterparties in OTC derivative transactions.

##### a. Commission-Registered Broker-Dealers

As described in the prior section, security-based swap dealing activity is concentrated in a small number of large financial firms.<sup>1006</sup> Historically, these firms have not undertaken their security-based swap activities and OTC derivative transactions through Commission-registered broker-dealers. Rather, the dealing activity of these financial firms was housed either in its bank affiliates, its unregistered nonbank affiliates, or in affiliated foreign entities. These arrangements reflected the lack of a legal requirement to house such activities in entities regulated by the Commission, the potential disadvantage in the capital treatment of these activities under Rule 15c3–1,<sup>1007</sup> as well as restrictions on the use of customers’ collateral under the Commission’s customer protection rule.<sup>1008</sup>

In 1998, the Commission established a program for broker-dealers that operate as OTC derivatives dealers. The program, among other things, permitted OTC derivatives dealers to use internal models to compute capital charges for market and credit risk. In 2004, the Commission extended the use of such models to broker-dealers subject to consolidated supervision with the adoption of alternative net capital requirements for ANC broker-dealers. Today, only a small fraction of broker-dealers are ANC broker-dealers; however, these few ANC broker-dealers are large and account for nearly all of the assets held by Commission-supervised broker-dealers. The capital requirements being adopted today for nonbank SBSBs, including permitting

nonbank SBSBs to elect to use models to compute net capital, are modeled on the Commission’s net capital rule currently applicable to broker-dealers.

The existing broker-dealer net capital requirements are codified in Rule 15c3–1 and seven appendices to Rule 15c3–1. Specifically, Rule 15c3–1 requires broker-dealers to maintain a minimum level of net capital (meaning highly liquid capital) at all times. Paragraph (a) of 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; and (2) a computation of the amount of net capital the broker-dealer is maintaining. The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying 1 of 2 financial ratios: The 15-to-1 ratio or the 2% debit item ratio. Large broker-dealers that dominate the industry use the 2% debit item ratio.

Requirements for computing net capital are set forth in paragraph (c)(2) of Rule 15c3–1, which defines the term “net capital.” The first step in a net capital calculation is to compute the broker-dealer’s net worth under GAAP. Next, the broker-dealer must make certain adjustments to its net worth. These adjustments are designed to leave the firm in a position in which each dollar of unsubordinated liabilities is matched by more than a dollar of highly liquid assets. There are fourteen categories of net worth adjustments required by the rule, including the application of haircuts.<sup>1009</sup> Broker-dealers use either standardized haircuts or model-based haircuts that are comprised of market and credit risk charges.

##### Market Risk Charges

The internal models used by ANC broker-dealers and OTC derivatives dealers to compute market risk charges must meet certain qualitative and quantitative requirements under Appendix E or F that parallel requirements for U.S. banking agencies under Basel II.<sup>1010</sup> The use of internal

<sup>1002</sup> One commenter noted that since 2015, the prudential Regulators, CFTC, and a number of foreign regulators have adopted margin requirements that implement the framework in the BCBS/IOSCO Paper. See SIFMA 11/19/2018 Letter.

<sup>1003</sup> These standards are based on the Basel II and Basel III framework. See BCBS, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework—Comprehensive Version* (June 2006), available at <http://www.bis.org/publ/bcbs128.htm>; BCBS, *Basel III: A global regulatory framework for more resilient banks and banking systems* (June 2011), available at <http://www.bis.org/publ/bcbs189.pdf>.

<sup>1004</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR 74840.

<sup>1005</sup> The Commission expects that most entities that will register with the Commission and become subject to these final capital, margin, and segregation rules have registered with the CFTC as swap entities or with the Commission as broker-dealers. The Commission has previously estimated that, of the total 55 entities expected to register with the Commission as an SBSB or MSBSP, 35 will be registered with the CFTC as swap dealers or major swap participants. See *Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 80 FR at 49000.

<sup>1006</sup> See section VI.A. of this release.

<sup>1007</sup> OTC derivatives dealers and ANC broker-dealers have been permitted to use internal models to compute net capital since 1998 and 2004, respectively. See *OTC Derivatives Dealers*, 63 FR 59362; *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, 69 FR 34428. However, this has not led to increased dealing in security-based swaps by broker-dealers.

<sup>1008</sup> The existing possession or control and customer reserve account requirements of Rule 15c3–3 as applied to initial margin held for security-based swaps has made it disadvantageous for broker-dealers to deal in security-based swaps as compared to entities (such as unregulated dealers) that were not subject to these requirements. The requirements of Rule 15c3–3 are designed to protect customers by preventing broker-dealers from using customer assets to finance any part of their business unrelated to servicing customer securities activities. Unregulated entities would not be subject to these restrictions and could freely use collateral received from security-based swap transactions in their business, including to finance proprietary activities.

<sup>1009</sup> See paragraphs (c)(2)(i) through (xiv) of Rule 15c3–1.

<sup>1010</sup> See generally *OTC Derivatives Dealers*, 63 FR 59362; *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, 69 FR 34428. The requirements for banks were subsequently enhanced by the prudential regulators with the implementation of capital requirements consistent with the Basel III framework. See *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based*

models to compute market risk charges can substantially reduce the deductions to the market value of proprietary positions as compared to standardized haircuts. Consequently, large broker-dealers that dominate the industry rely on internal models rather than the standardized haircuts to compute net capital. However, ANC broker-dealers and OTC derivative dealers (*i.e.*, dealers using internal models to compute net capital) are subject to higher fixed-dollar minimum capital requirements than broker-dealers using the standardized haircuts. Under existing paragraph (a)(7) of Rule 15c3-1, ANC broker-dealers are required to maintain tentative net capital of not less than \$1 billion and net capital of not less than \$500,000,000. In addition, ANC broker-dealers are required to provide notice to the Commission if their tentative net capital falls below \$5 billion. For OTC derivative dealers, under existing paragraph (a)(5) of Rule 15c3-1, the corresponding fixed-dollar minimums are \$100 million in tentative net capital and \$20 million in net capital.

#### Credit Risk Charges

For ANC broker-dealers, the credit risk charge is the sum of 3 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 50% of the firm's tentative net capital.<sup>1011</sup> The OTCDD credit risk model is similar to the ANC credit risk model except that the former does not include a portfolio concentration charge.<sup>1012</sup>

#### b. Banking Entities

As described in previous sections, the security-based swap market is dominated by a small number of global financial firms. Of the firms expected to register with the Commission as SBSs, the Commission believes that most will, in the near-term, be subsidiaries of a U.S. bank holding company and therefore be subject to consolidated supervision by the Federal Reserve. Nonbank SBSs and MSBSPs will be subject not only to the Commission's capital requirements but also indirectly to the capital standards applicable at their parent bank holding companies. For the purposes of satisfying the capital requirements at the bank holding company level, the OTC derivatives

positions booked under any consolidated bank subsidiary are accounted for in the capital computation of the holding company. The bank holding companies' consolidated bank subsidiaries also are subject to direct capital requirements of the prudential regulators and indirect capital requirements applicable to their parent bank holding companies. Below is a discussion of the relevant aspects of the capital regime for bank holding companies as it relates to security-based swap positions (and OTC derivative positions in general).

In July 2013, the Federal Reserve and OCC adopted a final rule that implements in the U.S. the Basel III regulatory capital reforms from the BCBS and certain changes to the existing capital standards required by the Dodd-Frank Act.<sup>1013</sup> These rules generally strengthened the capital regime for bank holding companies and banks (collectively, "banks") by increasing both the quality and the quantity of bank regulatory capital.<sup>1014</sup>

The bank capital regime for OTC derivative transactions prescribes the capital treatment of the transactions' market risk and credit risk exposures. Banks with significant presence in the security-based swap market tend to be large global firms that employ the internal models methodology to compute charges for market risk. The quantitative requirements for these models resemble in many respects those applicable to the market risk models of ANC broker-dealers and OTC derivative dealers.<sup>1015</sup>

Banks calculate market risk capital charges using a model with a one-tailed 99% confidence interval.<sup>1016</sup> These

charges are subject to specific risk additions and backtesting adjustments.<sup>1017</sup> Following adoption of the Basel III framework by the prudential regulators, these capital requirements were strengthened; they now include an additional "stressed VaR" floor to the capital charge, as well as potentially binding leverage ratios.<sup>1018</sup>

Capital charges for a bank's credit risk exposure to its OTC derivative counterparties are based on the RWA framework. In general, under the RWA framework, the capital requirement for a credit exposure is 8% times the RWA-equivalent amount of the credit exposure. Under the 2013 capital rule, large banking organizations (*i.e.*, the type of organizations that dominate dealing in the security-based swap market) are required to calculate capital requirements using the advanced approaches.<sup>1019</sup> In the advanced approaches, the RWA-equivalent of a counterparty exposure is calculated according to the internal rating-based ("IRB") capital formula, where the bank's internal credit risk model along with the bank's estimates of the probability of default and the loss-given default is used to calculate the effective risk weight on the exposure amount.

Under the advanced approach, the exposure amount (exposure at default ("EAD")) for an OTC derivative transaction may be calculated under either the current exposure method ("CEM") or using the internal models method ("IMM"), with the latter being subject to regulatory approval.<sup>1020</sup> Under the current exposure method, the capital charge is the sum of the current exposure and potential future exposure. The potential future exposure is calculated as the product of the

liabilities that exceed \$1 billion or 10% of total assets are subject to the market risk rule. *See Risk-Based Capital Standards: Market Risk*, 61 FR 47358 (Sept. 6, 1996).

<sup>1017</sup> See 12 CFR 3.122(i)(4)(iii); 12 CFR 3.131.

<sup>1018</sup> See *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 FR 62018.

<sup>1019</sup> See *id.*

<sup>1020</sup> The OCC, Federal Reserve, and the FDIC have issued a notice of proposed rulemaking to provide an updated framework for measuring derivative counterparty credit exposure. The proposed rule would replace the existing CEM with the Standardized Approach for Counterparty Credit Risk (SA-CCR) for banks subject to the advanced approaches, while permitting smaller banks to use CEM or SA-CCR. *See Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 83 FR 64660 (Dec. 17, 2018). *See also Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements*, 83 FR 66024 (Dec. 21, 2018).

*Capital Rule, and Market Risk Capital Rule*, 78 FR 62018 (Oct. 11, 2013).

<sup>1011</sup> See paragraph (c) of Rule 15c3-1e.

<sup>1012</sup> See paragraph (d) of Rule 15c3-1f.

<sup>1013</sup> See *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 FR 62018.

<sup>1014</sup> See *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 FR 62018. Among other things, the new rules implemented a revised definition of regulatory capital, a new common equity tier 1 minimum capital requirement, a higher minimum tier 1 capital requirement, and, for banking organizations subject to the advanced approaches risk-based capital rules, a supplementary leverage ratio. The new rules also amended the methodologies for determining risk-weighted assets ("RWAs").

<sup>1015</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74876.

<sup>1016</sup> This discussion assumes that the bank is subject to market risk capital charges. Banking organizations with aggregate trading assets and

derivative's notional amount and a conversion factor that depends on the risk and maturity of the transaction. The conversion factors range from 0% to 15% and are specified in the regulations.<sup>1021</sup> For a group of transactions within the same asset class that are covered by a qualifying master netting agreement, the current exposure for the group is calculated on a net basis. Potential future exposure for a group of transactions subject to a qualifying master netting agreement is calculated as the sum of gross potential future exposures (*i.e.*, no netting), multiplied by a factor that is a function of the net-to-gross ratio ("NGR") of current exposures.<sup>1022</sup> For banks that engage in off-setting transactions, the NGR is typically far lower than one, permitting some netting benefits.<sup>1023</sup>

Banks are allowed to recognize a broad set of collateral as credit risk mitigants in calculating credit risk charges.<sup>1024</sup> They may use either the simple approach or the collateral haircut approach to reduce credit risk capital charges. Under the simple approach, the risk weight of a collateralized credit exposure to an OTC derivative counterparty is replaced with the risk weight of the collateral posted by that counterparty. Under this approach, subject to certain exceptions, the risk weight assigned to the collateralized portion of the exposure must be at least 20%.<sup>1025</sup> Under the collateral haircut approach, the risk

weight of the counterparty exposure does not change, but the exposure amount is adjusted by the haircut-adjusted value of the collateral received. Banks using the advanced approach to calculate RWA may use internal models to compute these haircuts, otherwise regulatory haircuts are used.<sup>1026</sup>

Accounting rules now generally require banks to take into account the creditworthiness of an OTC derivative counterparty in determining the fair value of an OTC derivative position. During the financial crisis, approximately two-thirds of credit losses on OTC derivative positions were the result of accounting adjustments rather than outright counterparty defaults.<sup>1027</sup> Subsequently, Basel III requirements as implemented by the prudential regulators introduced capital charges for potential accounting losses resulting from such credit valuation adjustments ("CVA") due to an increase in credit risk of the counterparty. Banks that are subject to the advanced approach have to calculate a CVA capital charge using either the advanced CVA approach, if the bank is approved to use this method, or the simple CVA approach. The former relies on a bank's internal credit models while the latter uses a combination of supervisory risk weights, external ratings, and the bank's credit-risk calculations.<sup>1028</sup>

#### c. CFTC-Registered Entities

Starting in October 2012, swap dealers and major swap participants were required to provisionally register with the CFTC. However, as of now, neither swap dealers nor major swap participants are subject to any capital requirements, unless they are also registered as FCMs.<sup>1029</sup>

CFTC Rule 1.17 requires FCMs to maintain adjusted net capital in excess of a minimum adjusted net capital amount. The rule prescribes a net liquid assets test similar to the broker-dealer net capital rule. The CFTC defines

adjusted net capital as liquid assets net of liabilities, after taking into account certain capital deductions for market and credit risk. The minimum net adjusted capital depends, among other things, on the margin amount of the client-cleared OTC swap positions.

With respect to the treatment of OTC derivatives positions, an FCM is required to account for an OTC derivatives position by first marking-to-market the position and then deducting (adding) the full amount of the loss (collateralized portion of the gain) from (to) its adjusted net capital. In addition, an FCM also has to take a capital charge for the market risk of its OTC derivatives position. Paragraph (c) of CFTC Rule 1.17 allows FCMs registered with the Commission as an ANC broker-dealer to compute this capital charge using models approved by the Commission.

#### 5. Margin Regulation

The baseline regulatory regime for margin regulation of security-based swaps is the phase-in of regulations adopted by U.S. prudential regulators, foreign regulators, and the CFTC, as well as the broker-dealer SRO margin rules.

##### a. Prudential Regulators, CFTC, and Foreign Regulators

##### Prudential Regulators

In October 2015, the U.S. prudential regulators adopted new rules to address minimum margin requirements for bank swap dealers, major swap participants, SBSBs, and MSBSPs with respect to non-cleared security-based swaps and swaps.<sup>1030</sup> For these entities, the margin rules became effective on April 1, 2016, with compliance phased-in over 4 years beginning in September 2016. The rules impose initial and variation margin requirements on bank SBSBs, MSBSPs, swap dealers, and major swap participants for non-cleared security-based swaps and swaps.

Bank SBSBs, MSBSPs, swap dealers, and major swap participants are required to collect and post variation and initial margin from (to) certain counterparties. Initial margin must be collected in the form of cash or other eligible collateral. Variation margin must be collected on a daily basis and be in the form of cash for a transaction with an SBSB, MSBSP, swap dealer, or major swap participant, or cash or other eligible collateral for a transaction with a financial end user. These bank entities are also required to both collect and post initial margin for transactions with

<sup>1021</sup> See *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 FR 62018, at Table 19.

<sup>1022</sup> The potential future exposure for the group equals  $((0.4 + 0.6 \times \text{NGR}) \times \text{AGross})$ , where AGross is aggregate gross potential future exposure for positions subject to a qualifying master netting agreement, and NGR is the ratio of net current exposure to gross current credit exposure for the group.

<sup>1023</sup> See *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 FR 62018.

<sup>1024</sup> Generally, the credit risk of the collateral must not be positively correlated with the credit risk of the collateralized exposure. The set of eligible collateral has been broadened to include investment grade corporate debt securities and publicly traded equity securities. 78 FR at 62107.

<sup>1025</sup> 78 FR 62018. One exception is when the collateral consists of "cash on deposit," in which case the risk weight is 0%. Another exception is when the collateral is a sovereign that qualifies for a 0% risk weight under the general risk weight provision and it is subject to certain haircuts or account maintenance practices, in which case the risk weight can be either 0% or 10%.

<sup>1026</sup> See 78 FR at 62239.

<sup>1027</sup> See BCBS, *Basel Committee finalizes capital treatment for bilateral counterparty credit risk* (June 2011), available at <http://www.bis.org/press/p110601.pdf>.

<sup>1028</sup> *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 FR at 62134.

<sup>1029</sup> The CFTC re-proposed capital requirements for swap dealers and major swap participants in 2016. See *CFTC Capital Proposing Release*, 81 FR 91252. The current capital requirements for FCMs make it particularly costly for FCMs to engage in OTC CDS. For this reason, traditionally, OTC CDS have been conducted outside of FCMs, in affiliated entities. See *Capital Requirements of Swap Dealers and Major Swap Participants*, 76 FR 27802.

<sup>1030</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR 74840.

SBSDs, MSBSPs, swap dealers, major swap participants, and with financial end users that have material swaps exposure (*i.e.*, gross notional exposure in excess of \$8 billion). Initial margin must be computed using standardized haircuts or an approved model. The initial margin is to be computed on a daily basis but its exchange is not required if it falls below a consolidated \$50 million threshold. The rules further require that the initial margin collected or posted by bank SBSBs, MSBSPs, swap dealers, and swap participants be segregated with a third-party custodian and prohibit its re-hypothecation. The rules provide an exception to the initial margin requirements in transactions involving an affiliated entity: In such cases, initial margin need not be posted to an affiliated financial end user with material swaps exposure.

In December 2015, the CFTC adopted new rules that address margin requirements for nonbank swap dealers and major swap participants with respect to non-cleared swaps.<sup>1031</sup> Similar to the prudential regulators' final rules, the rules became effective on April 1, 2016, with compliance phased-in over 4 years beginning in September 2016. The rules are similar to the final margin rules of the prudential regulators. However, with respect to affiliates, swap dealers and major swap participants need to collect or post initial margin under certain conditions.

Foreign entities, including foreign subsidiaries of U.S. entities that transact in the security-based swap market fall under a variety of foreign regulations, principally those of regulators in certain European countries. European regulators have adopted or proposed a series of regulations covering mandatory clearing of OTC derivatives as well as margin requirements for those derivatives not subject to the mandatory clearing requirement.<sup>1032</sup>

Currently, the European regulations require central clearing of certain security-based swap transactions involving parties that are not covered by exemptions from the clearing requirement.<sup>1033</sup> Exemptions include certain inter-affiliate transactions, as well as transactions involving non-

financial counterparties with gross notional values of OTC derivative transactions that fall below the regulatory clearing thresholds. These clearing requirements are currently being phased in and will take full effect by mid-2019.

The European margin rules on non-cleared security-based swap transactions will apply to entities with gross notional values for OTC derivatives of more than €8 billion. Such entities will generally have an obligation to collect and post margin.<sup>1034</sup>

Entities subject to the European rules will be required to collect and post variation margin for non-cleared security-based transactions with other covered entities, financial counterparties, as well as non-financial counterparties that fall above the clearing thresholds. Variation margin will have to be exchanged on a daily basis, subject to certain *de minimis* exceptions.

Entities subject to the European rules (*i.e.*, those with gross notional values for OTC derivatives of more than €8 billion) will also be required to exchange initial margin. The requirement to collect initial margin will not apply if the initial margin amount is less than €50 million. Initial margin is limited to cash and other high quality assets. The amount of initial margin may be computed using a model that satisfies certain technical criteria. The initial margin amount must be recomputed under conditions enumerated in the regulations; in practice this will generally be on a daily basis. The party collecting initial margin must ensure that the collateral received is segregated either through a third-party custodian, or through other legally binding arrangements. Re-hypothecation of initial margin is not permitted. The rules further require that the collecting party provide the posting party the option to segregate its initial margin from the assets of other posting counterparties.

While the minimum margin requirements adopted by the prudential regulators, CFTC, and foreign regulators will not be completely phased in until September 2020, there is already some evidence on how market participants are reacting to these requirements. A June 2017 survey on dealer financing terms noted that some of the survey respondents indicated that their clients' transaction volume or their own

transaction volume in non-cleared swaps decreased somewhat over the period of September 2016 to June 2017.<sup>1035</sup> However, the respondents reported no changes in the prices that they quote to their clients in non-cleared swaps over this period. This evidence indicates that some dealers responded to margin requirements by reducing the level of intermediation services they provided to other market participants on a non-cleared basis. One-fifth of the survey respondents also reported that they would be less likely to exchange daily variation margin with mutual funds, exchange-traded funds, pension plans, endowments, and separately managed accounts established with investment advisers due primarily to lack of operational readiness (*e.g.*, the need to establish or update the necessary credit support annexes to cover daily exchange of variation margin) over this period. Two-fifths of the survey respondents also reported that the volume of mark and collateral disputes on variation margin has increased somewhat over this period. Furthermore, the survey noted that there is variation among respondents with respect to the number of days it takes to resolve a mark and collateral dispute on variation margin, with 1/3 reporting less than two days, while 3/5 reporting more than two days but less than a week, on average.

In addition, the ISDA margin survey covering 2017 documents the amount and type of collateral collected and posted by the 20 firms with the largest non-cleared derivatives exposures ("phase-one" firms), that were subject to the first phase of the new margin regulations for non-cleared derivatives in the US, Canada, and Japan from September 2016, and Europe from February 2017. The survey distinguishes between initial margin collected or posted by the phase-one firms to comply with the new margin requirements ("regulatory initial margin") and other initial margin collected or posted by these firms ("discretionary initial margin"). At the end of 2017, phase-one firms collected and posted regulatory initial margin in the amount of \$73.7 billion and \$75.2 billion, respectively. Relative to the end of the first quarter of 2017, these amounts reflect a 58% and 59% increase, respectively. The similarity in these two amounts may reflect the two-way initial margin requirement applicable to phase-one

<sup>1031</sup> See CFTC Margin Adopting Release, 81 FR 636.

<sup>1032</sup> See Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (July 4, 2012).

<sup>1033</sup> Starting on February 9, 2017, certain iTraxx Europe Index CDS became subject to the clearing obligation. See Commission Delegated Regulation (EU) 2016/592 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation (Mar. 1, 2016).

<sup>1034</sup> See Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (July 4, 2012).

<sup>1035</sup> See Yesol Huh, Division of Research and Statistics, Board of Governors of the Federal Reserve System, *The June 2017 Senior Credit Officer Opinion Survey on Dealer Financing Terms*, available at [https://www.federalreserve.gov/data/scoos/files/scoos\\_201706.pdf](https://www.federalreserve.gov/data/scoos/files/scoos_201706.pdf).

firms. In contrast, at the end of 2017, phase-one firms collected and posted \$56.9 billion and \$6.4 billion, respectively, in discretionary initial margin. These amounts reflect a decline in the level of initial margin collected and posted by phase-one firms of 6% and 61%, respectively, relative to the end of the first quarter of 2017. The large discrepancy between these two rates is probably the result of phase-one firms continuing to collect initial margin on a discretionary basis for transactions that are not yet within the scope of the new margin requirements as more counterparties to whom phase-one firms post discretionary initial margin become subject to the new margin requirements (e.g., phase two of the implementation started in September 2017).

The survey also reports the amount of variation margin collected and posted by phase-one firms. At the end of the 2017, phase-one firms collected and posted \$893.7 billion and \$631.7 billion, respectively, in variation margin, including both regulatory and discretionary.

Of the regulatory initial margin posted, 85.3% consisted of government securities; while 14.7% consisted of other securities. Similarly, of the discretionary initial margin posted, 39.8% was in government securities, 37% in cash, and, 23.2% in other securities. In contrast, of the variation margin posted, 85.8% was in cash, followed by 12.1% in government securities, and, finally, 2.1% in other securities.

The ISDA margin survey covering 2018 applies the methodology of the ISDA margin survey covering 2017 but also expands the set of surveyed firms to include not just the 20 phase-one firms described above, but also firms that were subject to the new margin regulations from September 2017 ("phase-two firms") and September 2018 ("phase-3 firms"), respectively.<sup>1036</sup> At the end of 2018, phase-one firms collected and posted regulatory initial margin in the amount of \$83.8 billion and \$83.2 billion, respectively. Relative to the end of 2017, these amounts reflect a 14% and 11% increase, respectively. At the end of 2018, phase-one firms collected and posted \$74.1 billion and \$10.1 billion, respectively, in discretionary initial margin. These amounts have increased by 30% and 57%, respectively, relative to the end of 2017. The 4 phase-two and 3 phase-3

firms that participated in the survey collected \$4.8 billion of initial margin at the end of 2018, of which \$2.2 billion is regulatory initial margin and \$2.6 billion is discretionary initial margin.

At the end of 2018, phase-one firms collected and posted \$858.6 billion and \$583.9 billion, respectively, in variation margin, including both regulatory and discretionary. Relative to the end of 2017, these amounts represent a 4% and 8% decrease for variation margin collected and posted, respectively.

At the end of 2018, of the regulatory initial margin posted, 88.4% consisted of government securities while 11.6% consisted of other securities. Of the discretionary initial margin posted, 42% was in government securities, 44.4% in cash, and, 13.6% in other securities. Of the variation margin posted, 86.5% was in cash, followed by 12% in government securities, and, finally, 1.5% in other securities.

#### b. Broker-Dealer Margin Rules

Broker-dealers are subject to margin requirements in Regulation T promulgated by the Federal Reserve, in rules promulgated by the SROs, and, with respect to security futures, in rules jointly promulgated by the Commission and the CFTC.<sup>1037</sup>

Although the Dodd-Frank Act expanded the definition of "security" to include security-based swaps and in so doing expanded the applicability of the aforementioned rules and regulations to security-based swap transactions, the Commission has issued a series of exemptive orders exempting security-based swaps from, among other things, the margin requirements of Regulation T.<sup>1038</sup>

#### 6. Segregation

Existing market practice under the baseline is for dealers generally not to segregate initial margin related to OTC derivative transactions. An ISDA margin survey reports that in 2010, 71% of initial margin received was commingled with variation margin.<sup>1039</sup> Of the remaining 29%, 9% was segregated on the books of the dealer,<sup>1040</sup> 6% was segregated with a custodian, and 14%

was subject to tri-party arrangements.<sup>1041</sup> For large dealers, on average 89% of collateral received was eligible for re-hypothecation, while 74% of collateral received was actually re-hypothecated.<sup>1042</sup>

The Dodd-Frank Act amended the Exchange Act to establish segregation requirements for cleared and non-cleared security-based swaps. Section 3E(b) of the Exchange Act provides that, for cleared security-based swaps, the money, securities, and property of a security-based swap customer 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. However, Section 3E(c)(1) of the Exchange Act also provides that, for cleared security-based swaps, customers' money, securities, and property may, for convenience, be commingled and deposited in the same one or more accounts with any bank, trust company, or clearing agency. Section 3E(c)(2) further provides that, notwithstanding Section 3E(b), in accordance with such terms and conditions as the Commission may prescribe by rule, regulation, or order, any money, securities, or property of the security-based swaps customer of a broker, dealer, or security-based swap dealer described in Section 3E(b) may be commingled and deposited as provided in Section 3E with any other money, securities, or property received by the broker, dealer, or security-based swap dealer and required by the Commission to be separately accounted for and treated and dealt with as belonging to the security-based swaps customer of the broker, dealer, or security-based swap dealer.

Section 3E(f) of the Exchange Act establishes a program by which a counterparty to non-cleared security-based swaps with an SBSD or MSBSP can elect to have initial margin held at an independent third-party custodian (individual segregation). 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 report to the counterparty on a quarterly basis stating

<sup>1036</sup> ISDA received responses from four phase-two firms (out of the six in scope) and three phase-three firms (out of the eight firms in scope). See *ISDA Margin Survey Year-End 2018* (Apr. 2019) at p.5.

<sup>1037</sup> See 12 CFR 220.1, *et seq.*; FINRA Rules 4210 through 4240; CBOE Rules 12.1–12.12; 17 CFR 242.400 through 406. See also *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70259 (discussing broker-dealer margin rules and equity requirements).

<sup>1038</sup> See section III.C. of this release (discussing the exemption orders).

<sup>1039</sup> See *ISDA Margin Survey 2011* at Table 2.3

<sup>1040</sup> See *id.* The ISDA survey does not define what it means for margin to be "segregated on the books of the dealer." Therefore, it is not certain that margin segregated in this manner would substantially satisfy the omnibus segregation requirements of Rule 18a–4, as adopted.

<sup>1041</sup> See *id.* The ISDA survey does not define what it means for margin to be "segregated with custodian" and "tri-party." Therefore, it is not certain that margin segregated in this manner would substantially satisfy the individual segregation requirements of Section 3E(f) of the Exchange Act or the requirements in Rule 18a–4, as adopted, relating to third-party custodians.

<sup>1042</sup> *ISDA Margin Survey 2011* at Table 2.4.



that the firm's back office procedures relating to margin and collateral requirements are in compliance with the agreement of the counterparties. The Exchange Act also provides that the segregation requirements for non-cleared security-based swaps do not apply to variation margin payments, so that the right of an SBSB or MSBSP counterparty to require individual segregation applies only to initial and not variation margin.

The statutory provisions of Sections 3E(b) and (f) of the Exchange Act are self-executing. The baseline incorporates these self-executing provisions in the Exchange Act.

## 7. Historical Pricing Data

The profits and losses of a security-based swap position depend on the fluctuations in risk factors, other than counterparty risks, that are relevant to the position. The cumulative exposure of the position to these risk factors is commonly referred to as the market risk of the position. For entities subject to capital requirements, the market risk of their trading books (and corresponding market risk charges the trading book positions incur) may affect the amount of capital that they have available to establish new trades. Stand-alone broker-dealers must maintain capital to cover the market risk of their trading portfolios. The use of standardized haircuts is a common method for calculating the amount of capital necessary to cover the market risk of a position.<sup>1043</sup>

One commenter suggested that the Commission conduct further economic analysis to confirm that the standardized haircuts proposed for security-based swaps are appropriately tailored to the risk the relevant positions present. The commenter further suggested that the analysis should be based on quantitative data regarding the security-based swap and swap markets since the enactment of the Dodd-Frank Act.<sup>1044</sup> In response to these comments, the Commission is providing additional support to the discussion in the proposal<sup>1045</sup> by analyzing historical pricing data for single-name and index CDS contracts.<sup>1046</sup> Specifically, the analysis uses historical pricing data to

estimate the losses stemming from historical price movements of security-based swap and swap positions and compares those estimated losses with the Commission's proposed standardized haircuts for CDS that are security-based swaps or swaps. The Commission analyzes historical prices in several one-year samples: 3 samples that are likely to capture stressed market conditions (2008, 2011, and 2012), and two samples that are likely to capture normal market conditions (2017 and 2018).<sup>1047</sup>

For each day of each sample, the Commission assigns each single-name CDS contract to the appropriate cell in the grid set forth in paragraph (c)(2)(vi)(P)(1)(i) of Rule 15c3-1, as amended.<sup>1048</sup> The Commission then calculates the 10-day change in the value of the contract based on the historical pricing data for that contract and expresses the change as a percentage of the notional value of the contract. The Commission repeats this process for each day of the sample for all single-name CDS contracts with historical pricing data to generate a distribution of 10-day value changes for each cell in the grid set forth in paragraph (c)(2)(vi)(P)(1)(i) of Rule 15c3-1. The Commission estimates the extreme, but plausible loss for each cell as the loss that is only exceeded by 1% of the observations in that cell.<sup>1049</sup> The Commission summarizes the distribution of such extreme but plausible losses for all cells in the grid by calculating the minimum, maximum, mean, standard deviation, and the quartiles of the distribution. The Commission reports the summary statistics for each sample in Panel A of Table 3. In Panel B of Table 3, the Commission reports the summary statistics of extreme but plausible losses on long credit default swap positions.

To analyze extreme, but plausible losses experienced by CDS referencing

broad-based securities indices ("index CDS"), the Commission repeats the analyses of Panels A and B but uses historical pricing data on index CDS contracts and the maturity and spread combinations set forth in (b)(2)(i)(A) of Rule 15c3-1b, as amended. The Commission reports the summary statistics of extreme, but plausible losses on short index CDS and long index CDS in Panels C and D of Table 3, respectively.

The summary statistics for CDS provide a number of findings as reflected in Table 3, Panels A and B. For both short and long positions, the mean and median losses vary across the five annual samples. The biggest mean and median losses occurred in 2008, possibly a reflection of severe market stresses experienced in that year. Short CDS positions tend to experience larger losses than long CDS positions. For example, the mean losses on short positions are larger than those on long positions for each of the five annual samples. Losses on short CDS positions also tend to be more variable than losses on long CDS positions. The standard deviation, which captures the extent to which losses deviate from the mean, is higher for short positions than for long positions in all five annual samples.

The summary statistics for index CDS provide broadly similar findings, although differences exist as reflected in Table 3, Panels C and D. For both short and long index CDS positions, the mean and median losses vary across the five annual samples. Short index CDS positions have the highest mean and median losses in 2008. In contrast, long index CDS positions have the highest mean and median losses in 2012. Compared to long positions, short positions tend to experience larger losses in 2008 and 2011, but smaller losses in 2012, 2017, and 2018. For example, in 2008 the mean losses on short and long positions are 17.1% and 4.7%, respectively; in 2012 the mean losses on short and long positions are 2.4% and 5.1%, respectively. For two of the five annual samples (2008 and 2018), losses on short index CDS positions tend to be more variable than losses on long index CDS positions based on the standard deviation. For the other 3 annual samples, long index CDS positions tend to have more variable losses than short index CDS positions.

### Table 3: Extreme But Plausible Losses Based on Historical CDS Pricing Data.

This table reports summary statistics of the distribution of extreme, but plausible losses stemming from historical price movements that could have impacted credit default swap positions. Losses are in percentages. The

<sup>1043</sup> See, e.g., Rule 15c3-1; *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework—Comprehensive Version* (June 2006); *Basel III: A global regulatory framework for more resilient banks and banking systems* (June 2011); *CFTC Capital Proposing Release*, 81 FR 91252.

<sup>1044</sup> See SIFMA 11/19/2018 Letter.

<sup>1045</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70311-12.

<sup>1046</sup> The pricing data were purchased from ICE Data Services.

<sup>1047</sup> With respect to including data from 2008, the Commission acknowledges the commenter's suggestion that quantitative data since the enactment of the Dodd-Frank Act should be used. However, the Commission believes that the inclusion of 2008 data is justified because the stressed market conditions in that year would help ensure that the analysis does not underestimate the riskiness of security-based swap positions. Therefore, the Commission has retained 2008 data in the analysis. At the same time, most of the data used in the analysis (i.e., 2011, 2012, 2017, and 2018) are from the period since the enactment of the Dodd-Frank Act.

<sup>1048</sup> The Commission assigns the single-name CDS contracts based on the length of time to maturity and midpoint spread on the CDS (i.e., the average of the basis point spread bid and offer on the CDS).

<sup>1049</sup> In other words, only 1% of the observations experienced losses that are larger than the extreme but plausible loss.

summary statistics are Min (minimum), P25 (first quartile/25th percentile), P50

(second quartile/50th percentile), P75 (third quartile/75th percentile), Max

(maximum), Mean, and Std (standard deviation).

#### SINGLE-NAME CREDIT DEFAULT SWAPS

Year	Min	P25	P50	P75	Max	Mean	Std
<b>Panel A: Short Positions</b>							
2008 .....	0.85	6.08	12.10	20.55	71.89	18.49	19.08
2011 .....	0.33	2.94	6.30	11.37	40.89	10.41	11.42
2012 .....	0.00	1.52	3.54	6.26	27.93	6.56	8.11
2017 .....	0.07	1.63	4.44	8.46	71.92	11.24	17.66
2018 .....	0.09	2.33	5.15	9.54	41.35	9.40	11.04

<b>Panel B: Long Positions</b>							
2008 .....	0.15	1.53	4.36	9.52	46.72	7.90	9.72
2011 .....	0.22	1.52	3.49	6.53	19.06	5.34	5.37
2012 .....	0.23	1.38	3.38	6.57	19.18	5.23	5.30
2017 .....	0.08	1.58	3.21	5.75	23.22	5.13	5.31
2018 .....	0.05	1.16	3.32	6.40	20.39	5.18	5.67

#### INDEX CREDIT DEFAULT SWAPS

Year	Min	P25	P50	P75	Max	Mean	Std
<b>Panel C: Short Positions</b>							
2008 .....	1.51	2.98	8.02	24.09	87.24	17.06	20.48
2011 .....	0.26	1.61	3.31	5.88	12.46	4.01	3.09
2012 .....	0.19	0.98	1.78	3.15	6.91	2.38	1.92
2017 .....	0.00	0.39	0.76	1.54	3.83	1.12	1.07
2018 .....	0.00	0.34	1.01	2.18	4.50	1.46	1.30

<b>Panel D: Long Positions</b>							
2008 .....	0.00	0.34	1.90	3.59	36.85	4.74	9.24
2011 .....	0.12	1.04	2.08	4.04	30.37	3.83	5.80
2012 .....	0.07	1.33	3.51	4.65	44.16	5.07	8.65
2017 .....	0.10	0.52	1.80	4.74	9.33	2.81	2.60
2018 .....	0.00	0.21	0.66	1.53	3.16	0.91	0.85

#### B. Analysis of the Final Rules and Alternatives

Prior to the passage of the Dodd-Frank Act, the non-cleared security-based swap and swap markets were characterized by opaque and complex bilateral exposure networks. As a result, it was not possible for market participants to accurately ascertain counterparty exposures to other market participants. Moreover, because counterparties did not demand margin in support of transactions, nor were such margins required by regulation, there was considerable potential for market participants to develop large exposures to their counterparties. As a result of these large exposures, the failure of a market participant could undermine the financial condition of its counterparties, leading to sequential counterparty failure. Moreover, the possibility of large exposures when combined with uncertainty about where such potential exposures lie could cause markets to quickly become illiquid when doubts about the viability of even

one of the major participants surfaced. Specifically, counterparties might be unwilling to extend credit or to trade with each other.

Title VII of the Dodd-Frank Act established a new regulatory framework for U.S. markets in security-based swaps and swaps. The Dodd-Frank Act requires all sufficiently standardized swaps to be cleared through a CCP. However, the Dodd-Frank Act does not subject all transactions to the mandatory clearing requirement. Section 764 of the Dodd-Frank Act requires the Commission to adopt rules imposing margin and capital requirements on such “non-cleared” security-based swap transactions when the transactions are undertaken by entities subject to the Commission’s oversight<sup>1050</sup> and for which there is no prudential regulator. These requirements are intended to offset the greater risk to the entity and

<sup>1050</sup> These entities include nonbank SBSDs and MSBSPs.

the financial system from such transactions.

In formulating the new rules and amendments to existing rules being adopted today (collectively the “final rules”), the Commission has considered the potential benefits of reducing 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. It has also taken into account the potential costs to firms, the financial markets, and the U.S. financial system of complying with capital, margin, and segregation requirements. The Commission also considered related requirements that have been adopted or proposed by other U.S. and foreign financial regulators.

The current broker-dealer capital, margin, and segregation requirements serve as the template for the final rules. However, the Commission recognized that there may be other appropriate approaches to establishing capital, margin, and segregation requirements—including, for example, requirements

based on the proposed or adopted capital, margin, and segregation standards of the prudential regulators or the CFTC. In determining the appropriate capital, margin, and segregation requirements—whether based on current broker-dealer rules or other alternative approaches—the Commission has assessed and considered a number of different approaches, and the Commission recognizes that determinations it has made could have a variety of economic consequences for the relevant firms, markets, and the financial system as a whole.

The capital, margin, and segregation requirements being adopted today by the Commission are broadly intended to work in tandem to improve the resilience of the market for security-based swaps. The margin requirements are designed to reduce a dealer's uncollateralized counterparty exposures from non-cleared security-based swap positions and the potential losses from such exposures in the event of counterparty failure. In cases where a nonbank SBSB is not required to collect margin (*i.e.*, the counterparty or the security-based swap transaction is subject to an exception in Rule 18a–3), capital requirements are designed to complement the margin requirements to reduce the nonbank SBSB's risk of failure due to potential losses from uncollateralized exposures. Specifically, capital requirements are designed to enhance the safety and soundness of nonbank SBSBs and reduce the likelihood of sequential dealer failure by setting capital standards that adjust dynamically with the risk of exposures in security-based swaps. In addition, the capital and margin requirements work together to reduce the incentives of market participants to engage in excessive risk-taking strategies, restrict their implicit leverage through non-cleared security-based swap transactions, and reduce the potential cost advantage of non-cleared transactions relative to cleared transactions, and thereby encourage clearing. Finally, the segregation requirements are designed to complement the margin and capital requirements by helping ensure that the collateral posted by a counterparty is adequately protected and readily available to be returned if the nonbank SBSB fails.

The Commission acknowledges that the new requirements of the final rules will impose direct costs on the individual firms. These direct costs could lead to potentially significant collective costs for the security-based swap market and the financial system.

For example, 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 swap market, increasing transaction costs, and harming price discovery. These, in turn, can impose 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 capital formation.

Several commenters discussed the absence of an economic analysis in the 2018 comment reopening. A commenter stated that the Commission “offered no economic analysis of the proposed changes or of the original proposals despite the now very different regulatory context.”<sup>1051</sup> Another commenter noted significant changes to security-based swap market since the original 2012 proposal, stating that “the cost-benefit analysis conducted by the Commission in 2012 is simply out of date.”<sup>1052</sup> Other commenters voiced similar concerns.<sup>1053</sup> In addition, a number of commenters had specific concerns about the impact of the adopted rules on individual firms, market participants, and society in general, and requested that the economic analysis address these concerns.<sup>1054</sup>

The Commission is sensitive to the issues raised by commenters. As noted in the 2018 comment reopening, the 2012 proposals contained an analysis of the potential economic consequences, and the Commission sought further comment on that analysis, including changes to the baseline. The economic analysis in this adopting release takes into consideration the changes to the baseline since 2012 and, relative to the economic analysis in the 2012 proposing release, provides a more thorough and complete discussion of the issues involved because it has been informed by commenters and addresses the issues they raised. In particular, the analysis takes into consideration market trends and changes to market practices, the regulatory environment, and regulatory data to identify the

appropriate baseline. The analysis also evaluates the costs and the benefits of the final rules and their impact on the efficiency, competition, and capital formation relative to this baseline.

In addition, as discussed in the 2018 comment reopening, the Commission proposed the amendments in 2012, extended the comment period once, reopened the comment period in connection with the cross-border release and proposed an additional security-based swap nonbank capital requirement in 2014. In the 2012 proposal, 2013 proposal and 2014 proposal, the Commission described the potential economic consequences, including the baseline against which the proposed rules and amendments may be evaluated, the potential costs and benefits, reasonable alternatives, and the potential effects on efficiency, competition and capital formation. The Commission also has issued other releases related to Title VII rulemakings since 2014. The economic analysis from 2012 was brought forward and made more current by these later releases.

With respect to the magnitude of the economic impact of the final rules, it is generally difficult to quantify certain benefits and costs that may result from them. For example, although the adverse spillover effects of defaults on liquidity and valuations were evident during the financial crisis, 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 future sequential counterparty failures. Similarly, although capital, margin, or segregation requirements may, among other things, affect liquidity and transaction costs in the security-based swap market, 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 compounded by the availability of limited public and regulatory data related to the security-based swap market, in general, and to security-based swap market participants in particular, all of which could assist in quantifying certain benefits and costs. In light of these challenges, much of the discussion of the final rules in this economic analysis will remain qualitative in nature, although where possible the economic analysis attempts to quantify these benefits and costs. The

<sup>1051</sup> See Better Markets 11/19/2018 Letter.

<sup>1052</sup> See SIFMA 11/19/2018 Letter.

<sup>1053</sup> See Citadel 11/19/2018 Letter; Harrington 11/19/2018 Letter; ICI 11/19/2018 Letter; ISDA 11/19/2018 Letter; MFA/AIMA 11/19/2018 Letter; SIFMA AMG 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>1054</sup> See American Council of Life Insurers 11/19/2018 Letter; Better Markets 11/19/2018 Letter; Citadel 11/29/2018 Letter; FIA 11/18/2019 Letter; Harrington 11/19/2018 Letter; ICI 11/19/2018 Letter; IIB 11/19/2018 Letter; ISDA 11/19/2018 Letter; MFA/AIMA 11/19/2018 Letter; Morgan Stanley 11/19/2018 Letter; SIFMA AMG 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

inability to quantify certain benefits and costs, however, does not mean that the overall benefits and costs of the final rules are any less significant.

In addition, as noted above, the final rules include a number of specific quantitative requirements, such as numerical thresholds, limits, deductions, and ratios. These quantitative requirements have not been derived directly from econometric or mathematical models, but are based on the Commission's prior experience and understanding of the markets, and by rules promulgated by the CFTC and SROs. 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. Where possible, the Commission supplements the qualitative discussion of these requirements with quantitative analysis of historical data.

#### 1. The Capital Rules for Nonbank SBSBs—Rules 15c3–1 and 18a–1

As noted earlier, dealers and major participants in the non-cleared security based swap market are generally not subject to capital requirements. Given the central role played by these entities, the lack of a capital standard may raise concerns about the continued safety and soundness of these firms and the provision of liquidity in this market. Such concerns can destabilize the market in the event of a dealer failure, especially in times of economic stress. The new capital rules are intended to alleviate such concerns by imposing capital standards for nonbank SBSBs that are designed to adjust dynamically with the risk of their security-based swap exposures. In this section, the Commission first describes the mechanics of the new capital requirements, and then discusses in detail the benefits and the costs associated with these requirements.

##### a. Overview

The key features of Rule 18a–1, as adopted and Rule 15c3–1, as amended, are regulatory minimum levels of capital, capital charges for posting margin, capital charges in lieu of collecting margin, methods for computing haircuts for security-based swaps and swaps, and risk management procedures. Each of these features is considered in turn.

##### i. Minimum Net Capital Requirements

The minimum requirements consist of a fixed-dollar component and a variable component. These components differ

across different types of nonbank SBSBs, and for nonbank SBSBs that are also registered as broker-dealers.

As described in detail in section II.A.2.a. of this release, nonbank SBSBs authorized to use models are subject to minimum tentative net capital and net capital requirements. Nonbank SBSBs not authorized to use models are subject to minimum net capital requirements (but not minimum tentative net capital requirements). The minimum tentative net capital requirement for an ANC broker-dealer, including an ANC broker-dealer SBSB, is \$5 billion and the minimum net capital requirement is the greater of \$1 billion or the applicable existing financial ratio amount (the 15-to-1 ratio or 2% debit item ratio) plus the 2% margin factor. The tentative net capital requirement for a stand-alone SBSB authorized to use models (including a firm registered as an OTC derivatives dealer) is \$100 million and the minimum net capital requirements is the greater of \$20 million or the 2% margin factor. The minimum net capital requirement for a broker-dealer SBSB not authorized to use models is the greater of \$20 million or the applicable existing financial ratio amount (the 15-to-1 ratio or 2% debit item ratio) plus the 2% margin factor. The minimum net capital requirement for a stand-alone SBSB not approved to use internal models is the greater of a \$20 million or the 2% margin factor.

The 2% margin factor will remain level for 3 years after the compliance date of the rule. After 3 years, the multiplier could increase to not more than 4% by Commission order, and after 5 years the multiplier could increase to not more than 8% by Commission order if the Commission had previously issued an order raising the multiplier to 4% or less. The final rules further provide that the Commission will consider the capital and leverage levels of the firms subject to these requirements as well as the risks of their security-based swap positions and provide notice before issuing an order raising the multiplier. This approach will enable the Commission to analyze the impact of the new requirement.

##### ii. Capital Charge for Posting Initial Margin

As described in detail in section II.A.2.b.i. of this release, if a broker-dealer or nonbank SBSB delivers initial margin to another SBSB or other counterparty, it must take a capital charge in the amount of the posted collateral. The Commission is providing interpretive guidance as to how a broker-dealer or nonbank SBSB can avoid taking this capital charge. Under

the guidance, initial margin provided by the broker-dealer or nonbank SBSB to a counterparty need not be deducted from net worth when computing net capital if:

- The initial margin requirement is funded by a fully executed written loan agreement with an affiliate of the broker-dealer or nonbank SBSB;
- The loan agreement provides that the lender waives re-payment of the loan until the initial margin is returned to the broker-dealer or nonbank SBSB; and
- The liability of the broker-dealer or the nonbank SBSB to the lender can be fully satisfied by delivering the collateral serving as initial margin to the lender.

Nonbank SBSBs and broker-dealers may apply this guidance to security-based swap and swap transactions.

##### iii. Capital Deductions in Lieu of Margin

As described in detail in section II.A.2.b.ii. of this release, broker-dealers and nonbank SBSBs will be required to take a deduction for under-margined accounts because of a failure to collect margin required under Commission, CFTC, clearing agency, DCO, or DEA) rules (*i.e.*, a failure to collect margin when there is no exception from collecting margin). These firms also will be required to take deductions when they elect not to collect margin pursuant to exceptions in the margin rules of the Commission and the CFTC for non-cleared security-based swaps and swaps, respectively. For firms that are not approved to use models, these deductions for electing not to collect margin must equal 100% of the amount of margin that would have been required to be collected from the security-based swap or swap counterparty in the absence of an exception. These deductions can be reduced by the value of collateral held in the account.

Regarding the capital charges for initial margin collected but segregated with a third-party custodian, the final rule contains a provision that allows a nonbank SBSB to avoid taking a capital deduction or the alternative credit risk charge for the initial margin collected but held with a third-party custodian as long as certain conditions are satisfied.

##### iv. Standardized Haircuts for Security-Based Swaps

As described in detail in section II.A.2.b.iii. of this release, a nonbank SBSB will be required to apply standardized haircuts to its proprietary positions (including security-based swap and swap positions), unless the Commission has approved its use of

model-based haircuts. The standardized haircuts for positions—other than security-based swaps and swaps—generally are the pre-existing standardized haircuts required by Rule 15c3–1. With respect to security-based swaps and swaps, the Commission is prescribing standardized haircuts tailored to those instruments. In the case of a cleared security-based swap and swap, the standardized haircut is the applicable clearing agency or DCO margin requirement. For a non-cleared CDS, the standardized haircut is set forth in two grids (one for security-based swaps and one for swaps) in which the amount of the deduction is based on two variables: The length of time to maturity of the CDS contract and the amount of the current offered basis point spread on the CDS. For other types of non-cleared security-based swaps and swaps, the standardized haircut generally is the percentage deduction of the standardized haircut that applies to the underlying or referenced position multiplied by the notional amount of the security-based swap or swap.

#### v. Credit Risk Charges

As described in detail in section II.A.2.b.v. of this release, ANC broker-dealers and stand-alone SBSBs authorized to use models may take credit risk charges instead of the deductions in lieu of margin discussed in section II.A.2.b.ii. of this release. More specifically, an ANC broker-dealer (including a firm registered as an SBSB) and a stand-alone SBSB approved to use models for capital purposes can apply a credit risk charge with respect to uncollateralized exposures arising from derivatives instruments, including exposures arising from not collecting variation and/or initial margin pursuant to exceptions in the non-cleared security-based swap and swap margin rules of the Commission and CFTC, respectively. In applying the credit risk charges, ANC broker-dealers (including firms registered as SBSBs) are subject to a portfolio concentration charge that has a threshold equal to 10% of the firm's tentative net capital. Under the portfolio concentration charge, the application of the credit risk charges to uncollateralized *current* exposure across all counterparties arising from derivatives transactions is limited to an amount of the current exposure equal to no more than 10% of the firm's tentative net capital. The firm must take a charge equal to 100% of the amount of the firm's aggregate current exposure in excess of 10% of its tentative net capital. Stand-alone SBSBs, including SBSBs operating as OTC derivatives

dealers, are not subject to a portfolio concentration charge with respect to uncollateralized current exposure.

#### vi. Risk Management Procedures

As described in detail in section II.A.2.c. of this release, nonbank SBSBs will be required to comply with the risk management provisions of Rule 15c3–4 as if they were OTC derivatives dealers. The risks of trading 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.<sup>1055</sup>

#### b. Benefits and Costs of the Capital Rules for Nonbank SBSBs

The OTC market for security-based swaps as it exists today is characterized by complex networks of bilateral exposures. At the center of these networks are the dealers, who are the main liquidity providers to this market. The networks are fairly opaque; market participants have little or no knowledge about a dealer's uncollateralized exposure to any given counterparty or the dealer's ability to withstand potential losses from such exposure. In times of market stress, uncertainty about the safety and soundness of the dealers may hinder the efficient allocation of capital between market participants. For instance, in the event of a dealer or a major participant failure, uncertainty about the uncollateralized exposures of the surviving dealers to the failed entity and their ability to withstand potential losses from such exposures may discourage some market participants from seeking new transactions with the surviving dealers. This “run” by the market participants on the surviving dealers may cause some of these dealers to fail. Sequential dealer failure would have a significant negative impact on the provision of liquidity in this market, and may ultimately cause the security-based swap market to break down.

The safety and soundness of the dealer, including its ability to withstand losses from its trading activity depends ultimately on the dealer's capital. As noted earlier, there are no market-imposed capital standards in the market for non-cleared security-based swaps.

Some of the dealers in this market are affiliated with broker-dealers, but are not subject to the capital requirements applicable to broker-dealers. In addition, a majority of the dealers are

organized as subsidiaries of bank holding companies and, while they may not be subject to direct capital requirements, they are indirectly subject to capital requirements imposed on their bank holding company parent. Some dealers are not affiliated with a broker-dealer or have a parent bank holding company and, consequently, are not subject to direct or indirect capital requirements.

Given that most of the dealers in this market are affiliated with institutions that are subject to capital regulation, it is likely that these dealers are organized as dealing structures designed to efficiently deploy capital. Such capital-efficient dealing structures may not voluntarily maintain capital buffers that adjust with the risk of their exposures, such as to minimize the risk of their own failure and the cost of externalities caused by such failure. Dealers currently not subject to direct capital regulation may choose capital levels and capital assets that, while privately optimal, are too low and too illiquid from a market stability perspective.

The final capital rules in this adopting release impose a capital standard on nonbank SBSBs. This capital standard requires that, among other things, a nonbank SBSB maintain a minimum level of net capital that adjusts dynamically with the risk of its exposure in security-based swap market and that promotes the liquidity of the firm. This capital standard is intended to enhance the safety and soundness of nonbank SBSBs by reducing their incentives to engage in excessive risk-taking, by increasing their ability to withstand losses from their trading activity, and by reducing the risk of sequential counterparty failure. The Commission acknowledges, however, that the new capital requirements may impose direct costs on nonbank SBSBs, and indirect costs on the rest of the market participants.

Due to the opacity of the market for non-cleared security-based swaps, dealers currently may have an incentive to engage in excessive risk-taking behavior. As a result, aside from reputational concerns, the market, as it exists today, lacks mechanisms that would force dealers to internalize the cost of the negative externalities created by their excessive risk-taking behavior.

The final capital rules require nonbank SBSBs to allocate additional liquid capital for any new security-based swap position, cleared or non-cleared. Specifically, nonbank SBSBs will need to maintain net capital (and, for firms authorized to use models, tentative net capital) levels that are no less than their minimum fixed-dollar

<sup>1055</sup> For example, individually negotiated OTC derivatives, 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.

requirements. Further, once their ratio-based minimum net capital requirements equal or exceed their fixed-dollar minimum net capital requirements, nonbank SBSBs will have to increase their minimum net capital to enter a new cleared or non-cleared security-based swap position (*i.e.*, because the amount required under the 2% margin factor will increase). In addition, the nonbank SBSB will have to take a capital charge against the market risk of the position (*e.g.*, risk of that a change in value or default of the reference entity will cause a mark-to-market loss for the security-based swap position). Furthermore, to the extent that the credit exposure is uncollateralized (*e.g.*, the counterparty is subject to a margin collection exception), the nonbank SBSB will also have to take a capital deduction to act as a buffer against potential losses from replacing or closing out the position in the event of the counterparty's failure. These capital charges increase with the risk of the position. In particular, these capital charges may discourage risk-taking. A reduction in risk-taking by nonbank SBSBs would arise because the firms will have to allocate capital to account for the market and credit exposures created by their trading positions. In some instances, reduced risk-taking may represent an intended economic consequence of the final rules, for example, if it manifests as a lower propensity to establish large directional positions in security-based swaps that may impose negative externalities on other market participants (*e.g.*, such positions may not take into account the cost of the SBSB's potential failure on its counterparties). In other cases, however, reduced risk taking could impede market functioning by, for example, increasing the compensation that nonbank SBSBs demand to intermediate transactions between other market participants, potentially impairing efficient risk sharing.

The requirements of the final margin rule may further discourage risk-taking behavior among nonbank SBSBs. For instance, the final margin rule requires that nonbank SBSBs post variation margin to all their counterparties that are not subject to a variation margin exception. In particular, a nonbank SBSB will have to post more variation margin to a counterparty as the counterparty's current exposure to the dealer increases. Here too, reductions in nonbank SBSB risk-taking may reflect margin requirements that cause nonbank SBSBs to appropriately internalize more of the costs their

activities impose on other market participants, even as these margin requirements potentially curtail efficient reallocation of risk by market participants.

In general, by requiring nonbank SBSBs to allocate capital in an amount that scales up with the size of the security-based swap positions, and by requiring nonbank SBSBs to post variation margin whenever they create an exposure, the capital and margin requirements of the final capital and margin rules and amendments are intended to reduce a nonbank SBSB's incentive to engage in excessive risk-taking behavior in the market for non-cleared security-based swaps.

Similarly, due to the opacity of the market for security-based swaps, currently, it is not always clear whether a dealer is financially sound. In particular, it is not clear whether dealers are adequately capitalized to withstand losses from their trading activity. The final capital rules impose a capital standard on nonbank SBSBs. As discussed above, this capital standard requires a nonbank SBSB to allocate capital against the market and credit exposures created by a security-based swap position, which would permit the nonbank SBSB to cover potential losses stemming from these exposures. These capital charges are designed to help a nonbank SBSB manage losses from its trading activities in cases where the nonbank SBSB cannot rely entirely on collateral.

Moreover, by imposing a capital standard on nonbank SBSBs that complements the requirements of the final margin rule, the capital and margin requirements of the final capital and margin rules and amendments are intended to increase a nonbank SBSB's viability, including its ability to withstand potential losses from its trading activity. In general, when a counterparty to a non-cleared security-based swap transaction fails, the dealer may want to replace the position. To this end, under the final capital and margin rules, a nonbank SBSB will be able to rely on the collateral posted by the counterparty prior to its default (*e.g.*, variation and initial margin) and the capital that the nonbank SBSB allocated at the outset and throughout the life of the position (*e.g.*, the capital charges against the market and credit exposure created by the position). If in the aftermath of the counterparty's failure the market exposure of the position continues to deteriorate, the collateral that the dealer collected from the counterparty prior to its default may not be enough to offset the replacement cost of the position. In this case the nonbank

SBSB may incur losses on the position. However, the nonbank SBSB's losses would be limited by the capital that the nonbank SBSB was required to allocate by way of a capital charge to support the position prior to the counterparty's default as well as the increase in the minimum net capital amount that reflects the exposure of the position and that the nonbank SBSB is required to maintain at all times (*e.g.*, the incremental adjustment to the 2% margin factor resulting from the position).

Finally, due to the opacity of the market for security-based swaps, dealers do not know other dealers' exposures outside the positions that they have in common. In particular, losses from trading activity may cause a dealer to fail, which in turn, may cause losses for surviving counterparty dealers and precipitate their failure. In other words, the market for security-based swaps as it exists today is subject to the risk of sequential dealer failure.

Because the final margin rule would require nonbank SBSBs to collect variation margin but not initial margin from other nonbank SBSBs and financial market intermediaries, nonbank SBSBs would have credit exposures to each other that may not be fully collateralized (*i.e.*, no inter-dealer exchange of initial margin). However, the final capital rules and amendments work in tandem with the final margin rules to impose a capital standard on nonbank SBSBs that requires them to allocate capital against the market and credit exposures created by the inter-dealer positions, and further increase their minimum net capital by an amount that is proportional to the exposure created by the positions. This capital buffer is designed to help a nonbank SBSB withstand potential losses from replacing inter-dealer positions that expose the dealer to uncollateralized credit exposure, because of the absence of inter-dealer collection of initial margin. In addition, while nonbank SBSBs are not required to collect initial margin from each other, they are not prohibited from doing so.

Thus, by requiring nonbank SBSBs to allocate capital that scales up with the risk of the inter-dealer credit exposures (whether or not collateralized), the capital and margin requirements of the final capital and margin rules and amendments are expected to reduce the likelihood that the losses at one nonbank SBSB impact the other nonbank SBSB. In turn, the final capital and margin rules, taken together, should reduce the risk of sequential dealer failure.

The final capital rules and amendments will impose direct compliance costs on nonbank SBSDs. To be adequately capitalized, SBSDs will have to ensure that their net capital is larger than the required minimum net capital. An SBSD will have to calculate its net capital by taking capital charges against their tentative net capital for the uncollateralized exposures created by their trading activity. As noted earlier, the minimum net capital, through the 2% margin factor, as well as the capital charges (*i.e.*, standardized or model-based haircuts) scale up with a nonbank SBSD's trading activity in the security-based swap market. Thus, the new capital requirements directly constrain a nonbank SBSD's trading activity, and the profits that the nonbank SBSD expects to generate from such activity. In turn, these capital constraints may limit the provision of liquidity in the market for non-cleared security-based swaps, and the resulting reduction in price discovery may, in turn, impose a cost on market participants.

The Commission has made two significant modifications to the final capital rules for nonbank SBSDs. First, as discussed above in section II.A.2.b.v. of this release, the Commission has modified Rule 18a-1 so that it no longer contains a portfolio concentration charge that is triggered when the aggregate current exposure of the stand-alone SBSD to its derivatives counterparties exceeds 50% of the firm's tentative net capital.<sup>1056</sup> This means that stand-alone SBSDs that have been authorized to use models will not be subject to this limit on applying the credit risk charges to uncollateralized current exposures related to derivatives transactions. The second significant modification is an alternative compliance mechanism.

The Commission acknowledges that under these two modifications a stand-alone SBSD will be subject to: (1) A capital standard that is less rigid than Rule 15c3-1 in terms of imposing a net liquid assets test (in the case of firms that will comply with Rule 18a-1); or (2) a capital standard that potentially does not impose a net liquid assets test (in the case of firms that will operate under the alternative compliance mechanism and, therefore, comply with the CFTC's capital rules). Accordingly, this will mean that the final rules may not enhance these firms' liquidity position to the same degree as they will for broker-dealer SBSDs. As a result, the

risk that a stand-alone SBSD may not be able to self-liquidate in an orderly manner will be higher relative to broker-dealer SBSDs. However, stand-alone SBSDs will likely engage in a more limited business than broker-dealers, including broker-dealer SBSDs. Thus, they will likely be less significant participants in the overall securities markets. For example, they will not be dealers in the cash securities markets or the markets for listed options and they will not maintain custody of cash or securities for retail investors in those markets. Given their limited role, the Commission believes that it is appropriate to more closely align the requirements for stand-alone SBSDs with the requirements of the CFTC and the prudential regulators.

As a result of these modifications, stand-alone SBSDs will likely be able to comply with the final rules at a lower cost than broker-dealer SBSDs. First, a stand-alone SBSD will not be subject to a portfolio concentration charge if its aggregate current exposures to derivatives counterparties exceed 10% of its tentative net capital, reducing its overall capital requirement, and attendant costs, under the final rules. Second, stand-alone SBSDs would be permitted to comply solely with CFTC capital rules if they meet the conditions of the alternative compliance mechanism. While this may preserve stand-alone SBSDs' ability to intermediate transactions in the security-based swap market, it may also shift competition among nonbank SBSDs in favor of stand-alone SBSDs.

One commenter argued that the Commission failed to provide an analysis showing the economic impact of the proposed rules on investors, systemic stability, and crisis prevention.<sup>1057</sup> Another commenter argued that the Commission should analyze the operational risks and concerns associated with not maintaining adequate levels of capital.<sup>1058</sup> Finally, a commenter recommended that the Commission provide an economic analysis in a final rulemaking to justify changes to Rule 15c3-1.<sup>1059</sup>

In response to these commenters, the analysis provided in the adopting release addresses the effects of the final capital rules and amendments on the safety and soundness of nonbank SBSDs, including the risk of sequential dealer failure. As noted in the discussion above, the analysis starts with a discussion of the problems that

may arise in OTC markets when dealers are not subject to explicit capital or margin requirements. In particular, it notes that lack of adequate capitalization or collateralization may encourage excessive risk taking, may cause a dealer to fail, and may result in sequential dealer failure. The discussion also describes how the final capital rules and amendments work together with the final margin rules to address these issues. The analysis that follows discusses in more detail the costs and benefits associated with specific capital requirements in the final capital rules for both stand-alone and broker-dealer SBSDs as well as other market participants and attempts to provide quantitative estimates whenever possible.

#### i. Minimum Net Capital Requirements

As noted above, the minimum capital requirements contain both a minimum fixed-dollar component and a variable component (the 2% margin factor).<sup>1060</sup> The fixed-dollar component sets a lower bound on the amount of tentative and net capital that a nonbank SBSD must hold, as applicable. The variable component sets a lower bound on the amount of capital for a nonbank SBSD that scales up with the security-based swap activity of the dealer. These two components are likely to affect a nonbank SBSD differently based on the volume of its security-based swap activity. For instance, a nonbank SBSD that engages in limited amount of security-based swap activity will likely care more about the fixed-dollar component than the variable component. On the other hand, a nonbank SBSD that engages in substantial amount of security-based swap activity will likely care more about the variable component than the fixed-dollar component. More generally, the design of these two components of minimum capital requirements will likely affect the entry costs in the nonbank SBSD industry, and the distribution of firms, by activity, within this industry. The analysis below focuses on these two aspects when identifying the main costs and the benefits associated with the design of the minimum capital requirements.

The \$20 million fixed-dollar minimum net capital requirement for nonbank SBSDs (other than firms that are ANC broker-dealers) is consistent with the \$20 million fixed-dollar minimum requirement applicable to

<sup>1056</sup> See paragraph (e)(2) of Rule 18a-1, as adopted. See also *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70244 (proposing a portfolio concentration charge in Rule 18a-1 for stand-alone SBSDs).

<sup>1057</sup> See Better Markets 11/19/2018 Letter.

<sup>1058</sup> See Harrington 11/19/2018 Letter.

<sup>1059</sup> See Morgan Stanley 11/19/2018 Letter.

<sup>1060</sup> As discussed above, the 2% margin factor for all nonbank SBSDs will remain level for 3 years from the compliance date of the rule, and the rule prescribes a process by which the Commission, by order, could increase the 2% multiplier thereafter.



OTC derivatives dealers under paragraph (a)(5) of Rule 15c3–1, and is therefore already familiar to certain market participants. OTC derivatives dealers are limited purpose broker-dealers that are authorized to trade in certain derivatives, including security-based swaps, and use internal models to calculate net capital. They also are required to maintain minimum tentative net capital of \$100 million. These current fixed-dollar minimums have been the capital standards for OTC derivative dealers for 20 years. A commenter supported the Commission's thresholds for the fixed-dollar component of the minimum capital requirements stating that they are generally consistent with the capital requirements for OTC derivatives dealers.<sup>1061</sup>

Stand-alone SBSBs not authorized to use models will be required to maintain minimum net capital of the greater of \$20 million or the 2% margin factor.<sup>1062</sup> The \$20 million fixed-dollar minimum net capital requirement for these SBSBs is substantially higher than the fixed-dollar minimums in Rule 15c3–1 currently applicable to broker-dealers that are not authorized to use models.<sup>1063</sup> In cases where the 2% margin factor results in a net capital requirement greater than \$20 million, the total net capital requirement for these nonbank SBSBs will be greater than \$20 million minimum requirement for OTC derivatives dealers as well. The more stringent minimum net capital requirement of the greater of \$20 million or the 2% margin factor for stand-alone SBSBs not approved to use models reflects that these firms to a greater extent than broker-dealers that are not SBSBs, 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 other types of securities. Moreover, stand-alone SBSBs, unlike OTC derivative dealers, have direct

customer relationships and have custody of customer funds. Therefore, the failure of a stand-alone SBSB would have a broader adverse impact on a larger number of market participants, including customers and counterparties. Relatively higher capital requirements for stand-alone SBSBs as compared to broker-dealers and OTC derivatives dealers (which will not be subject to the 2% margin factor, unless they are also registered as a nonbank SBSB or ANC broker-dealer) are intended to mitigate these relatively more substantial risks.

Consequently, a benefit of these heightened minimum capital requirements is that they should enhance the safety and soundness of the nonbank SBSBs not authorized to use models, and, indirectly, should reduce the cost of counterparty failure that market participants internalize when transferring credit risk in the security-based swap market.

Stand-alone SBSBs authorized to use models will be required to maintain minimum net capital of the greater of \$20 million or the 2% 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 generally lead to market and credit risk charges that are substantially lower than the standardized haircuts and 100% capital deductions, respectively.<sup>1064</sup> As a consequence, the minimum tentative net capital requirement for firms using models is intended to provide an additional assurance of adequate capital to reflect this concern and to account for risks that may not be fully captured by the models.

Under the amendments to paragraph (a)(7) of Rule 15c3–1, ANC broker-dealers, including ANC broker-dealer SBSBs, will 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 Rule 15c3–1 *plus* the 2% margin factor. These requirements are higher than current requirements for ANC broker-dealers in a number of ways. First, the

inclusion of a 2% margin factor represents an additional capital requirement that reflects, and scales with, an ANC broker-dealers' security-based swap activities. Second, the final rules increase the existing tentative net capital requirement of \$1 billion and net capital requirement of \$500 million.

These higher minimum capital requirements for ANC broker-dealers (as compared with the requirements for other types of broker-dealers) reflect the substantial and diverse range of business activities engaged in by these entities and their importance as intermediaries in the securities markets. Further, the heightened capital requirements reflect the fact that, as noted above, 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 models may not capture all risks.<sup>1065</sup>

One commenter argues that allowing certain nonbank SBSBs to use models for the purpose of calculating net capital could give these dealers a competitive advantage over the rest of nonbank SBSBs not authorized to use models.<sup>1066</sup> This commenter further argues that models routinely fail in a crisis and, importantly, they may encourage dealers to engage in additional risk-taking by permitting dealers to use models to lower their minimum required regulatory capital. As noted above, nonbank SBSBs that are approved to use internal models are subject to more stringent capital requirements than nonbank SBSBs that do not use internal models. In particular, ANC broker-dealer SBSBs are subject to a much higher minimum net capital requirement than broker-dealer SBSBs that do not use internal models, with a fixed-dollar component of \$1 billion versus a fixed-dollar component of \$20 million. Furthermore, both stand-alone SBSBs using internal models and ANC broker-dealers are subject to a tentative net capital requirement that does not apply to broker-dealer SBSBs that do not use internal models. These heightened capital requirements are designed to accommodate potential losses associated with higher trading activity, including losses induced by model failure. In other words, to the extent that a nonbank SBSB's model underestimates exposures, on occasion, and to the extent that some of these exposures result in losses for the

<sup>1061</sup> See SIFMA 2/22/2013 Letter.

<sup>1062</sup> This 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*, 81 FR 91252.

<sup>1063</sup> For example, a broker-dealer that carries customer accounts has a fixed-dollar minimum net capital requirement of \$250,000; a broker-dealer that does not carry customer accounts but engages in proprietary securities trading (defined as more than 10 trades per year) has a fixed-dollar minimum net capital requirement of \$100,000; and a broker-dealer that does not carry accounts for customers or otherwise receive or hold securities or cash for customers, and does not engage in proprietary trading activities, has a fixed-dollar minimum net capital requirement of \$5,000. See paragraph (a)(2) of Rule 15c3–1.

<sup>1064</sup> See, e.g., *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, 69 FR at 34455 (stating that the "major benefit for the broker-dealer" of using an internal model "will be lower deductions from net capital for market and credit risk"). See also *OTC Derivatives Dealer Release*, 63 FR 59362. Given the significant benefits of using models in reducing the capital required for security-based swap positions, it is likely that for new entrants to capture substantial volume in security-based swaps they will need to use models.

<sup>1065</sup> See *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, 69 FR 34428.

<sup>1066</sup> See Systemic Risk Council 1/24/2013 Letter.

nonbank SBSB using the model, the heightened capital requirements for the nonbank SBSB should help absorb these losses.

The use of internal models for the purpose of calculating net capital should permit nonbank SBSBs to significantly reduce the amount of capital that they have to allocate to support their trading activity (e.g., the capital charges for the market and credit risk of a position). This capital savings may increase the trading capacity of nonbank SBSBs that are authorized to use internal models, which, in turn, may increase liquidity provision in the security-based swap market. This benefit together with the heightened capital requirements for this type of nonbank SBSB potentially offsets some of the potential costs associated with the impact on competition of permitting certain nonbank SBSBs to use internal models for the purpose of calculating net capital. In addition, the final capital rules include a provision that grants a nonbank SBSB temporary use of a provisional model that has been approved by certain other regulators, while the nonbank SBSB has an application pending for its internal model. Under certain conditions, this provision could facilitate dealing structures that currently rely on internal models approved by other regulators to continue to use their models after they register as nonbank SBSBs, while their application for approval to use an internal model for the purposes of the final capital rules is pending.<sup>1067</sup>

Finally, as discussed above, the final margin and capital rules would cause nonbank SBSBs to internalize a significant portion of the negative externalities associated with a nonbank SBSB's potential risk-taking behavior that could arise under the baseline.<sup>1068</sup> Nonbank SBSBs may pass on some of these costs to their customers and counterparties.

Based on financial information reported by the ANC broker-dealers in their FOCUS Reports filed with the Commission, the five current ANC broker-dealers maintain capital levels in excess of these increased minimum requirements. Further, under paragraph (a)(7)(ii) of Rule 15c3-1, ANC broker-dealers are currently required to notify

the Commission if their tentative net capital falls below \$5 billion. The Commission uses this notification provision 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 under Rule 17a-11. 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 this regulatory notice that their tentative net capital has fallen below the early warning level.

The increases to the minimum tentative and minimum net capital requirements in the final capital rules may not present a material cost to the current ANC broker-dealers because, currently, they already hold more tentative and net capital than the new minimum requirements. The more relevant number is the increase in the early warning notification threshold from \$5 billion to \$6 billion. The new "early warning" threshold for ANC broker-dealers of \$6 billion in tentative net capital is modeled on a similar requirement for OTC derivatives dealers. The existing early warning requirement for OTC derivatives dealers under paragraph (c)(3) of Rule 17a-11 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 (i.e., the early warning threshold for tentative net capital is \$120 million).

Based on the Commission staff's supervision of the ANC broker-dealers, the current ANC broker-dealers report tentative net capital levels that are generally well in excess of \$6 billion threshold. As a result, the costs to the ANC broker-dealers to comply with the new minimum tentative net capital requirement are not expected to be material. However, these costs may be prohibitive to prospective registrants that are not already ANC broker-dealers and that wish to register as broker-dealer SBSBs using internal models (i.e., ANC broker-dealers). As discussed below in this section, such barriers to entry may prevent or reduce competition among SBSBs, which in turn can lead to higher transaction costs and less liquidity than would otherwise exist.

In addition to the fixed-dollar-amount components, the minimum net capital requirements also include the 2%

margin factor.<sup>1069</sup> This variable component is intended to establish a minimum capital requirement that scales with the level of the nonbank SBSB's security-based swap activity.

The 2% margin factor is similar to an existing requirement in the CFTC's net capital rule for FCMs, and the CFTC's proposed capital requirements for swap dealers and major swap participants registered as FCMs.<sup>1070</sup> Under the process set forth in the final rules, the 2% multiplier will remain level for 3 years after the compliance date of the rule. After 3 years, the multiplier could increase to not more than 4% by Commission order, and after 5 years the multiplier could increase to not more than 8% by Commission order if the Commission had previously issued an order raising the multiplier to 4% or less. The process sets an upper limit for the multiplier of 8% (the day-1 multiplier under the proposed rules) and requires the issuance of two successive orders to raise the multiplier to as much as 8% (or an amount between 4% and 8%).

The 2% margin factor will provide a nonbank SBSB with a buffer of liquid capital that should complement the SBSB's capital charges against the market and credit risk associated with its exposures from transacting in security-based swaps. This capital buffer would be useful in situations where unanticipated losses on a security-based swap position exceed the value of the collateral that the SBSB collects or the capital charges that the SBSB takes against the exposures created by the position. Such situations may arise when the standardized or model-based haircuts that apply to the exposures created by a security-based swap position or the collateral collected to cover that exposure are not large enough to cover the actual losses from the position.<sup>1071</sup> In the case of cleared security-based swap positions, the 2% margin factor will also create a capital

<sup>1069</sup> The 2% margin factor will be additive to the existing Rule 15c3-1 ratio-based minimum net capital requirement for an ANC broker-dealer. Therefore, the cost impact to an ANC broker-dealer will depend on whether and how much the 2% margin factor increases that ANC broker-dealer's minimum net capital requirement relative to the existing ratio-based minimum net capital requirements in Rule 15c3-1 in the baseline as well as the amount of excess net capital the firm maintains.

<sup>1070</sup> See *CFTC Capital Proposing Release*, 81 FR at 91306. The 8% calculation under the CFTC's proposal relates to cleared and non-cleared swaps or futures transactions, as well as cleared and non-cleared security-based swaps, whereas the 2% margin factor in Rule 15c3-1, as amended, and Rule 18a-1, as adopted, is based on cleared and non-cleared security-based swaps.

<sup>1071</sup> Situations where actual losses exceed model-based haircuts are instances of model risk.

<sup>1067</sup> See paragraph (a)(7)(ii) of Rule 15c3-1e, as amended; paragraph (d)(5)(ii) of Rule 18a-1, as adopted.

<sup>1068</sup> While it is likely that a counterparty may demand compensation (e.g., better pricing terms) for the credit risk associated with a security-based swap position with a nonbank SBSB, the counterparty's other counterparties may not have sufficient information about indirect exposures to the nonbank SBSB to also demand compensation for these indirect risks.

buffer that a nonbank SBSB with credit exposure to a CCP could access in the scenario that a CCP fails. This capital buffer should improve the financial stability of a nonbank SBSB, because the final capital rule and amendments do not require that a nonbank SBSB collect initial margin from a CCP or take a capital deduction for margin posted to a CCP.

The 2% margin factor will also provide a nonbank SBSB with a buffer of liquid capital that may be needed in situations where the SBSB cannot access in a timely manner the initial margin collected from a failing counterparty, but that is not under the SBSB's control (*e.g.*, the collateral is either re-hypothecated or segregated at a third-party custodian, in the case of non-cleared security-based swaps, or posted with a CCP, as part of the SBSB's client clearing business in the case of a cleared security-based swap). The nonbank SBSB could rely on the liquid capital provided by the 2% margin factor to offset some of the replacement or liquidation costs of the positions with the failed counterparty, before it takes possession of, and potentially liquidates, the failing counterparty's collateral. Furthermore, the nonbank SBSB will be able to recover in whole or in part the portion of the 2% margin factor that it used as a temporary source of liquidity, after it liquidates the recovered collateral.

As noted above, absent the capital buffer created by the 2% margin factor, a nonbank SBSB may be short on liquid capital precisely at the time when the value of this capital is high (*e.g.*, when markets are stressed and SBSBs face unanticipated losses on their positions that exceed the capital charges associated with the positions). To raise the needed liquid capital, on demand, nonbank SBSBs may face significant costs (*e.g.*, the SBSB may have to engage in a "fire sale" of assets that it would not sell otherwise), which could destabilize the SBSB. The 2% margin factor is intended to ensure that nonbank SBSBs have a buffer of liquid capital at all times, and reduce the need to source liquid capital at times when such capital is needed. As a result, the 2% margin factor should improve the financial stability of nonbank SBSBs, and therefore benefit market participants that rely on liquidity provided by nonbank SBSBs.

In summary, the 2% margin factor is intended to ensure that nonbank SBSBs have needed liquid capital in situations where collateral collected or capital charges may not fully cover the actual losses from a security-based swap positions. As a consequence, the 2%

margin factor should improve the safety and soundness of nonbank SBSBs, which ultimately, should benefit market participants that rely on liquidity provided by nonbank SBSBs.

However, the 2% margin factor likely also will impose direct costs on nonbank SBSBs, as the dealer may have to either access the capital markets or restructure illiquid assets and liabilities on its balance sheet to ensure that it stays above the minimum net capital threshold established by this requirement. Furthermore, the 2% margin factor scales up with a nonbank SBSB's security-based swap activity, and increases with each new security-based swap position, regardless of the direction of the position, whether the SBSB hedges the position, or whether the SBSB collects initial margin on the position. For instance, if the nonbank SBSB enters into two similar positions but in opposite directions (*i.e.*, zero net market risk) and with different counterparties, the SBSB will have to allocate capital towards the 2% margin factor for each of the two positions. Similarly, if the nonbank SBSB collects initial margin on the position, it still has to allocate capital towards the 2% margin factor for that position.

The 2% margin factor may have an initial impact on nonbank SBSBs with legacy security-based swap positions. As noted above, nonbank SBSB may have margin requirements that are sufficiently large that the 2% margin factor plus the Rule 15c3-1 financial ratio, if applicable, yields a net capital requirement that exceeds the fixed-dollar minimums specified in Rules 15c3-1 and 18a-1, as applicable. Under the final rules, these nonbank SBSBs will have to allocate additional capital towards the 2% margin factor for each new security-based swap position, as well as for all its legacy security-based swap positions. Firms that anticipate a large initial impact of the 2% margin factor due to their legacy positions may change their behavior prior to the implementation date of the final capital rules to avoid registration as a nonbank SBSB or to mitigate costs associated with being subject to the nonbank SBSB capital rules once it is required to register. Specifically, these firms may have an incentive to reduce their security-based swap activity in the run-up to the implementation date. However, lower security-based swap activity may result in reduced liquidity provision in the security-based swap market, which may manifest in higher prices for market participants. From this perspective, the application of the 2% margin factor to legacy positions may

impose indirect costs on market participants.

Nevertheless, as noted above, the final rule and amendments permit a phase-in over time of the margin factor. As a result, the impact of the margin factor on nonbank SBSBs would be smaller at the outset of the implementation, and then become progressively larger if the Commission chooses to increase the requirement's percent multiplier. The rate of increase of the impact of the margin factor is limited by the final rules, because the Commission can use the process set forth in the rules to, at most, double the margin factor after 3 years and, at most, double the margin factor again after 5 years. Moreover, under the process in the final rules, the percent multiplier for the margin factor can be raised to no more than 8%, limiting the overall impact of the margin factor on nonbank SBSBs. The initial multiplier in the final rules is similar to an existing minimum net capital requirement for broker-dealers, namely the 2% debit item ratio.

In addition, for a given position with a given counterparty, a firm that is authorized to use a margin model would generally allocate less capital for that position towards the 2% margin factor than a firm that is not authorized to use a margin model. Firms that are not authorized to use a margin model would have to calculate the 2% margin factor using standardized haircuts for the initial margin calculation with respect to the non-cleared security-based swap. In contrast, firms that are approved to use a margin model would be permitted to calculate the 2% margin factor using the margin model. The Commission expects that most firms would seek approval to use models for the purpose of calculating net capital and initial margin requirements for non-cleared security-based swap transactions with counterparties.

The 2% margin factor of the final capital rules may also impose additional costs on nonbank SBSBs due to regulatory uncertainty. Because the Commission, after 3 years, could use the process in the final rules to increase the multiplier to not more than 4% by order, and, the Commission, after 5 years, could increase the multiplier to not more than 8% by order (if the Commission had previously issued an order raising the multiplier to 4% or less), firms face uncertainty about when or if the new increase in the margin factor would take place, and whether they would have the additional capital needed to meet the requirement. However, the Commission also could modify any of the new requirements

being adopted today (including the 2% margin factor) by rule amendment.

Relative to the proposed capital rules, the final capital rules also reduce the costs to nonbank SBSBs due to overlapping regulatory requirements. As discussed above, one of the components of the 2% margin factor addresses cleared security-based swaps. Nonbank SBSBs that are also registered as FCMs with the CFTC will also have to comply with the CFTC's capital requirements for FCMs with respect to cleared swaps and security-based swaps. These requirements are based on the initial margin calculated by the clearing agency or DCO. In contrast, the 2012 proposal required that nonbank SBSBs allocate capital towards the proposed 8% margin factor for a cleared security-based swap in an amount equal to 8% times the maximum of the initial margin calculated by the clearing agency and the capital deductions that the SBSB would have to take were this position proprietary. However, the final capital rules require that nonbank SBSBs allocate capital towards the 2% margin factor for a cleared security-based swap in an amount equal to the initial margin calculated by the clearing agency times the 2% margin factor requirement. Thus, the 2% margin factor requirement for cleared security-based swaps aligns more closely with the CFTC's existing and proposed capital requirements (*i.e.*, because risk margin amount for a cleared security-based swap is based solely on the initial margin calculated by the clearing agency).

In general, firms may pass on some of the capital costs arising from complying with the 2% margin factor requirement to their counterparties in the form of higher prices. As a result, the 2% margin factor may impose indirect costs on market participants.

A number of commenters raised concerns about the proposed 8% margin factor requirement. A commenter suggested that the Commission replace the proposed requirement with an alternative requirement modeled on the 2% debit items ratio in Rule 15c3-1.<sup>1072</sup> Another commenter stated that a minimum capital requirement that is scalable to the volume, size, and risk of a nonbank SBSB's activities would be consistent with the safety and soundness standards mandated by the Dodd-Frank Act and the Basel Accords and would be comparable to the requirements established by the CFTC and the prudential regulators.<sup>1073</sup> The commenter, however, expressed concern that the proposed 8% margin

factor was not appropriately risk-based.<sup>1074</sup> The commenter also suggested that, if the proposed 8% margin factor is retained, the Commission should exclude security-based swaps that are portfolio margined with swaps or futures in a CFTC-supervised account.<sup>1075</sup> Another commenter believed that a broker-dealer dually registered as an FCM should be subject to a single risk margin amount calculated pursuant to the CFTC's rules, since the CFTC calculation incorporates both security-based swaps and swaps.<sup>1076</sup> A commenter suggested modifying the proposed definition of the risk margin amount to reflect the lower risk associated with central clearing by ensuring that capital requirements for cleared security-based swaps are lower than the requirements for equivalent non-cleared security-based swaps.<sup>1077</sup> Other commenters argued that the proposed 8% margin factor may undermine existing regulatory standards for security-based swaps and swaps.<sup>1078</sup> Another commenter argued that the Commission should identify the areas of divergence and assess the impact of conflicting rules on entities that are registered with the Commission and the CFTC.<sup>1079</sup> Finally, a commenter questioned the usefulness of the proposed 8% margin factor arguing that it does not serve a purpose outside the capital charges that a firm would have to take against the market and credit exposures from its trading activity.<sup>1080</sup>

Commenters also addressed the modifications to the proposed rule text in the 2018 comment reopening pursuant to which the input for cleared security-based swaps in the risk margin amount would be determined solely by reference to the amount of initial margin required by clearing agencies (*i.e.*, not be the greater of those amounts or the amount of the haircuts that would apply to the cleared security-based swap positions). Some commenters supported the potential rule language

modifications.<sup>1081</sup> Other commenters opposed them.<sup>1082</sup> A commenter opposing the modifications stated that the "greater of" provision creates a backstop to protect against the possibility that varying margin requirements across clearing agencies and over time could be insufficient to reflect the true risk to an SBSB arising from its customers' positions.<sup>1083</sup> Another commenter believed that eliminating the haircut requirement may incentivize clearing agencies to compete on the basis of margin requirements.<sup>1084</sup>

The Commission acknowledges the commenters' concerns about the potential impact of the 2% margin factor requirement. In response to concerns about the proposed requirement being inconsistent with the 2% debit item ratio requirement for broker-dealers, the final capital rules could phase in the margin factor over time, as discussed above in section II.A.2.a. of this release, and set the initial multiplier for the margin factor at 2%. The phase-in of the margin factor over time will result in an initial impact on the capital costs of the nonbank SBSBs that is lower than the impact that would have resulted if the multiplier had initially been 8%, as proposed. However, the final rules will result in lower initial levels of minimum net capital, relative to the 2012 proposal. As discussed above, lower levels of minimum net capital may negatively impact a nonbank SBSB's safety and soundness.

In response to concerns about the proposed 8% margin factor not being appropriately risk-based, as discussed above, the final 2% margin factor is designed to complement the capital charges that nonbank SBSBs would be required to take against the uncollateralized exposures created by their security-based swap positions. The 2% margin factor will cause capital charges and net capital requirements (beyond the fixed dollar minimum capital requirements) to increase as the nonbank SBSB's exposures increase and thus should be sensitive to the risk of the firm's exposures.

In response to concerns about potential costs of the proposed 8% margin factor requirement due to regulatory overlap, the Commission modified the proposed 8% margin factor in the final capital rules such that the risk margin amount for cleared security-

<sup>1074</sup> See SIFMA 2/22/2013 Letter. SIFMA suggested two approaches: One for nonbank SBSBs authorized to use models and one for nonbank SBSBs not authorized to use models. Under the first approach, the risk margin amount would be a percent of the firm's aggregate model-based haircuts. The second approach was a credit quality adjusted version of the proposed 8% margin factor.

<sup>1075</sup> See SIFMA 11/19/18 Letter.

<sup>1076</sup> See Morgan Stanley 11/19/2018 Letter.

<sup>1077</sup> See MFA 2/22/2013 Letter. See also OneChicago 11/19/18 Letter.

<sup>1078</sup> See FIA 11/19/2018 Letter; MFA/AIMA 11/19/2018 Letter; Morgan Stanley 11/19/2018 Letter; SIFMA 2/22/2013 Letter.

<sup>1079</sup> See Citadel 11/19/2018 Letter.

<sup>1080</sup> See SIFMA 2/22/2013 Letter.

<sup>1081</sup> See ICI 11/19/18 Letter; MFA/AIMA 11/19/2019 Letter; SIFMA 11/19/2018 Letter.

<sup>1082</sup> See Americans for Financial Reform Education Fund Letter; Better Markets 11/19/2018 Letter; Rutkowski 11/20/2018 Letter.

<sup>1083</sup> See Better Markets 11/19/2018 Letter.

<sup>1084</sup> See Americans for Financial Reform Education Fund Letter.

<sup>1072</sup> See SIFMA 11/19/2018 Letter.

<sup>1073</sup> See SIFMA 2/22/2013 Letter.

based swaps equals the initial margin calculated by the clearing agency. This modification aligns more closely the final capital rules with the CFTC's existing and proposed capital requirements, and therefore should reduce the potential costs arising from regulatory overlap on cleared security-based swaps. The proposed requirement to calculate the margin amount for cleared security-based swaps based on the haircuts that would apply to the position would have reduced the SBSB's exposure to CCP margin requirements, due, for example, to requirements established in response to competition among CCPs. However, as noted further below, because nonbank SBSBs would have likely passed on the additional capital costs of the proposed requirement to their counterparties, the proposed requirement could have reduced market participants' incentives to clear security-based swaps.

With respect to the portfolio margining concern, the Commission plans to coordinate further with CFTC on the issue.

In general, it is difficult to quantify the costs of the minimum capital requirements on nonbank SBSBs. However, for ANC broker-dealers, who will experience an increase in both in the early warning level and in the minimum tentative net capital and net capital requirements, one can provide preliminary estimates of this cost by comparing the fixed components of the minimum capital requirements against the firm's current levels of net capital. This exercise will provide an indication of the costs of complying with the minimum capital requirements of the final capital rule and amendments for ANC broker-dealers and for broker-dealer SBSBs.

Based on FOCUS Report information as of year-end 2017, approximately 16 broker-dealers, including the current ANC broker-dealers, maintain tentative net capital in excess of \$5 billion, approximately 48 broker-dealers maintain tentative net capital in excess of \$1 billion, approximately 191 broker-dealers maintain tentative net capital in excess of \$100 million, and approximately 446 broker-dealers maintain net capital in excess of \$20 million.

Although the increase in minimum capital and early warning requirements for ANC broker-dealers will not affect firms that already have this classification (*i.e.*, the 5 ANC broker-dealers), it does reduce the number of additional firms (from 44 to 11, according to FOCUS Report data) that currently qualify for this designation (*i.e.*, broker-dealers with tentative net

capital in excess of \$1 billion that are not ANC broker-dealers). Each of the 11 broker-dealers that have tentative net capital in excess of \$5 billion but less than \$6 billion and are not ANC broker-dealers will have to raise at most \$1 billion in additional capital to be able to clear the early warning threshold and to be eligible to register as ANC broker-dealer or as an ANC broker-dealer SBSB. This amount increases to a maximum of \$5 billion for each of the 44 broker-dealers that have tentative net capital in excess of \$1 billion but less than \$6 billion and that wants to register as ANC broker-dealer or as an ANC broker-dealer SBSB. Thus, the potential cost of registering as an ANC broker-dealer or as an ANC broker-dealer SBSB could be large, especially for broker-dealers that currently maintain tentative net capital levels below \$5 billion and/or net capital levels below \$1 billion. A broker-dealer may avoid these costs by choosing to register as a nonbank SBSB that is not authorized to use models or by limiting its security-based swap trading activity to the point where it does not need to register as an SBSB. A firm that is not a broker-dealer could avoid these costs by registering as a stand-alone SBSB.

In general, absent the minimum net capital requirements, there might be greater opportunities for more competition among entities that are engaging in dealing activities in the security-based swap market, which in turn might lower transaction costs and increase liquidity in this market.

However, higher minimum capital requirements for ANC broker-dealers, including ANC broker-dealer SBSBs, are intended to mitigate the risk of disruptions to financial markets by supporting the scale and scope of activities that these entities engage in. An ANC broker-dealer SBSB will be able to engage in the entire spectrum of activities that are traditionally associated with large ANC broker-dealers, including prime brokerage services, securities lending, financing assets for clients (*e.g.*, financing securities on margin). The ability to use internal models for the purpose of calculating net capital further allows ANC broker-dealers, including ANC broker-dealer SBSBs, to engage in these activities at a scale that is far larger than that of non-ANC broker-dealers. The same applies to the security-based swap market, where ANC broker-dealers, including ANC broker-dealer SBSBs, can enter into new transactions at a lower cost compared to broker-dealers and nonbank SBSBs that do not use internal models. Two reasons underpin this conclusion. First, the model-based

haircuts for market risk exposure on a security-based swap position are typically much smaller than the standardized haircuts for the same position. Second, an ANC broker-dealer that holds both cash securities positions and security-based swap positions (or otherwise offsetting positions) can further reduce these model-based haircuts by taking advantage of the natural hedge between these two types of instruments within a portfolio.

Relative to broker-dealers and nonbank SBSBs that do not use internal models, ANC broker-dealers, including those registered as SBSBs, can enter security-based swap transactions at lower cost and therefore may trade in larger volumes. However, more volume could expose an ANC broker-dealer, including an ANC broker-dealer SBSB, to either a higher incidence of losses or an increase in the size of the losses. The former could happen when more volume is achieved by expanding the portfolio of security-based swaps, while the latter could happen when more volume is achieved by increasing the size of the positions. Generally speaking, a broker-dealer or an SBSB that neutralizes both the market risk of all its security-based swap positions (*i.e.*, it hedges or book-matches all its security-based swap positions) and the counterparty risk (*e.g.*, by collecting variation and initial margin) should have minimal remaining exposure to losses on its portfolio of security-based swap positions. In contrast, when neither market risk nor counterparty risk is neutralized, the broker-dealer or the SBSB may be exposed to losses from its security-based swap positions. As discussed in more detail below, an ANC broker-dealer, including an ANC broker-dealer SBSB, may not fully neutralize counterparty risk for its positions with counterparties that are subject to a margin collection exception, because ANC broker-dealers, including ANC broker-dealers SBSBs, are allowed to take the alternative credit risk charge, as applicable, instead of the 100% capital deduction for transactions in derivatives instruments with counterparties, including uncollected margin from these counterparties. The alternative credit risk charge is typically much smaller than the 100% capital deduction, and therefore an ANC broker-dealer, including an ANC broker-dealer SBSB, may incur losses from exposure to counterparty risk. These losses could scale up with the ANC broker-dealer's trading activity on security-based swap market. In addition, as discussed above, an ANC broker-dealer may also incur losses from

exposure to market risk from security-based swap positions that are subject to a margin collection exception or that are not book-matched, and these losses could also scale up with the ANC broker-dealer's trading activity.

The potential losses from security-based swap trading activity are on top of the losses that an ANC broker-dealer may incur from its activities that are not related to trading in security-based swap market (e.g., swap market). The 2% margin factor requirement will create a capital buffer to cover potential losses from security-based swap trading activity that is sensitive to the risks arising from security-based swap exposures. It does not increase with respect to swaps activity. However, swaps will be subject to the model-based haircuts applied by ANC broker-dealers and uncollateralized exposures arising from swap transactions will be subject to the credit risk charges. Moreover, to the extent an ANC broker-dealer engages in more than a *de minimis* amount of swap activity, it will need to register as a swap dealer and be subject to the CFTC's minimum capital requirements when they are adopted and with the CFTC's margin rules for non-cleared swaps.

Two commenters argue that the fixed component of the final capital rules will act as a barrier to entry for prospective dealers that want to register as ANC broker-dealers, and could force incumbent dealers that cannot maintain these minimum capital requirements to exit the industry.<sup>1085</sup> As discussed above and at the beginning of the section, less conservative capital requirements for ANC broker-dealers could compromise the safety and soundness of this type of broker-dealer. The use of models allows ANC broker-dealers to economize on the regulatory capital required to open and maintain positions in the security-based swap market, which, in turn, allows them to trade in larger volumes compared to other broker-dealers. However, more volume could expose ANC broker-dealers to more overall losses, and therefore ANC broker-dealers should maintain higher levels of capital compared to other types of broker-dealers. In addition, since losses from trading activity in the security-based swap market add to the losses that ANC broker-dealers may incur from other activities unrelated to security-based swap market, the capital requirements for ANC broker-dealer SBSDs should be at least as conservative as the capital

requirements for ANC broker-dealers under Rule 15c3-1.

The higher minimum net capital thresholds for ANC broker-dealers in the final capital rule and amendments could be regarded as a barrier to entry for broker-dealers that want to register as ANC broker-dealer, regardless of whether they engage in security-based swap dealing activity. As noted above, the minimum net capital requirements for ANC broker-dealers can impose substantial costs on non-ANC broker-dealers that want to register as ANC broker-dealers, relative to the baseline. For example, any non-ANC broker-dealers with tentative net capital below \$5 billion and that want to register as an ANC broker-dealer would need to raise enough capital to meet the \$6 billion early warning threshold in the final capital rules.

The higher minimum capital requirements for ANC broker-dealers may be a barrier to entry for prospective nonbank SBSDs that want to register as ANC broker-dealers. However, to the extent that potential new entrants are able to operate effectively in these markets as stand-alone SBSDs (i.e., SBSDs that are not registered as broker-dealers), they will be eligible for lower minimum capital requirements and able to compete for security-based swap dealing business without the heightened requirements for ANC broker-dealers. For instance, a stand-alone SBSD could seek the Commission's approval to use an internal model for the purpose of calculating its net capital. The Commission believes that most nonbank SBSDs will seek approval to use an internal model for this purpose.

As discussed above in section VI.A. of this release, 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 446 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.<sup>1086</sup> At the same time, the

<sup>1086</sup> According to the most recent version (i.e., 2017) of the Focus Report statistics that the Commission publishes on a periodic basis, carrying broker-dealers are financed with 5.4% equity capital and 94.6% liabilities, on average. Of these liabilities, 34.7% consist of repurchase agreements, 10.9% consist of other non-subordinated debt, and 3% consist of subordinated debt. The other non-subordinated debt includes publicly issued commercial paper and corporate bonds. The average overnight Treasury GC repo rate from a daily survey

minimum capital requirements could discourage entry by entities other than the approximately 446 broker-dealers that already have capital in excess of the required minimums.

One commenter suggested that the Commission provide a detailed quantitative analysis of the costs associated with capital requirements for nonbank SBSDs.<sup>1087</sup> Other commenters suggested that the Commission provide an analysis that supports the quantitative requirements of the proposed 8% margin factor.<sup>1088</sup> However, in order to provide a reliable quantitative analysis of these costs, the Commission would have to make significant assumptions about individual firms' ultimate organizational structure. In particular, the Commission would have to make assumptions about how much of U.S. security-based swap dealing activity would eventually be housed in nonbank SBSDs rather than in bank SBSDs not subject to the Commission's capital rules. In addition, the Commission would have to make further assumptions about the number of nonbank SBSDs that register as stand-alone SBSDs, as opposed to broker-dealer SBSDs. Such assumptions are highly speculative in nature. Moreover, the minimum capital requirements may not bind for all nonbank SBSDs; any estimate of capital costs would depend on assumptions about the amount of capital that those entities assumed to register as nonbank SBSDs currently carry.<sup>1089</sup>

of the primary dealers for 2017 was 90 basis points. These estimates are derived from the data on the overnight Treasury GC repo primary dealers survey rate collected by the Federal Reserve Bank of New York on a daily basis, available at <https://www.newyorkfed.org/medialibrary/media/markets/HistoricalOvernightTreasGCRepoPriDealerSurvRate.xlsx>. In contrast, the average 3-month AA-rated financial commercial paper rate for 2017 was 106 basis points. These rates provide an incomplete but informative picture of the costs that broker-dealers face in raising new capital.

<sup>1087</sup> See Sutherland Letter.

<sup>1088</sup> See FIA 11/19/2018 Letter; Morgan Stanley 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>1089</sup> In addition, under the final rules, minimum capital requirements vary across entities that are authorized to use models and entities that use standardized haircuts; any estimates of the costs associated with capital requirements for nonbanks SBSDs require the Commission to make assumptions about the number of entities the Commission approves to use models in the future. In section IV.C. of this release, the Commission estimates that out of 25 estimated nonbank SBSDs, 14 will use models to calculate model-based haircuts (10 ANC broker-dealer SBSDs and 4 stand-alone SBSDs). The Commission expects that 8 nonbank SBSDs (6 broker-dealer SBSDs and 2 stand-alone SBSDs) will use standardized haircuts. The Commission expects the remaining 3 stand-alone SBSDs to elect the alternative compliance mechanism under Rule 18a-10. Even with these

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<sup>1085</sup> See Better Markets 1/23/2013 Letter; MFA 2/23/2013 Letter.

In response to these comments, with respect to the proposed 8% margin factor, section VI.A.2. of this release contains an analysis of the risk margin amount of current dealers based on their current level of trading activity. The Commission has used this analysis to provide a range of estimates for the potential costs of complying with the final 2% margin factor requirement, under certain assumptions.

The first of these assumptions is that, at the time when the final rules are implemented, a dealer that would register as nonbank SBSD has a level of trading activity (*i.e.*, legacy transactions) that falls within the range of trading activity currently observed among current dealers. Because it is uncertain which of the current dealers will register as nonbank SBSDs, and because risk margin amounts vary widely across dealing entities, this assumption allows the Commission to focus on the costs of the requirement on the average nonbank SBSD from its legacy security-based swap positions at the time of the implementation produced by the range of trading activity currently observed among current dealers.

The second and third assumptions are related to net capital requirements. The second assumption is that current dealers will be required to hold more capital as a result of the 2% margin factor (and the Rule 15c3-1 financial ratio, if applicable,) than the fixed-dollar amounts of \$20 million (for all stand-alone SBSDs, and for broker-dealer SBSDs not authorized to use models) and \$1 billion (for broker-dealer SBSDs authorized to use models) because their security-based swap positions are sufficiently large or risky. In other words, likely nonbank SBSDs have sufficient levels of security-based swap positions that the 2% margin factor is relevant for calculation of required net capital. The third assumption is that dealers that are likely to register as nonbank SBSDs currently maintain only enough capital to cover the market and credit risk exposures of their positions, so that current levels of net capital represent the minimum level of net capital required under the baseline. Because the final capital rules also require that a nonbank SBSD take capital charges with respect to the market and credit risk exposures from its legacy transactions, this assumption

estimates, the Commission would need to make assumptions about the distribution of dealing activity across bank and nonbank SBSDs, as well as the amount of capital these nonbank SBSDs currently carry. Given this uncertainty, the Commission does not believe that its estimates of the numbers of registered SBSDs would assist in producing reliable estimates of capital costs.

allows the Commission to focus on the impact of legacy transactions on the minimum net capital, generally, and the final 2% margin factor, specifically.

Under these assumptions, the Commission estimates the initial capital impact of the 2% margin factor (*i.e.*, percent multiplier set to 2%) on a nonbank SBSD to range from \$0.03 million to \$66.04 million, depending on the year and on where the SBSD's level of trading activity from legacy transactions falls within the range of trading activity currently observed among current dealers. Within this range, the average initial capital impact of the 2% margin factor can be estimated in each sample year and the average impact is between \$5.2 million and \$15.35 million. However, the precision of the estimate of the average initial capital impact of the 2% margin factor varies significantly over the sample years. For example, the \$5.2 million estimate has the highest precision with the shortest 95% confidence interval, namely \$2.74 million to \$7.67 million. In contrast, the \$15.35 million estimate has the lowest precision with the longest 95% confidence interval, namely \$8.52 million to \$22.19 million.<sup>1090</sup>

A nonbank SBSD will have to compare the initial capital impact of the 2% margin factor against the fixed component of the minimum net capital requirement to determine the amount of capital it needs to comply with the minimum capital requirement. For example, for a stand-alone SBSD, the capital needed to comply with the minimum net capital requirement will

<sup>1090</sup> The Commission calculates the range for the initial capital impact of the 2% margin factor by multiplying the minimum and maximum risk margin amounts across sample years in Table 2, Panel A, of Section VI.A.2. of this release by 2%. For example, \$66.04 million equals 2% multiplied by the maximum risk margin amount over the sample years (*i.e.*, \$3,303.12 million). The Commission calculates the range for the average initial capital impact of the 2% margin factor by multiplying the average risk margin amount in each sample year by 2%. For example, the average initial capital impact of the 2% margin factor based on the 2008 sample is \$15.35 million and equals 2% multiplied by the average risk margin amount for that sample year (*i.e.*, \$767.76 million). Assuming that the risk margin amounts are approximately normally distributed, the Commission calculates the 95% confidence interval around an estimate by subtracting (for the lower end of the interval) or adding (for the upper end of the interval) 1.96 multiplied by the standard error of the mean, which is defined as the standard deviation for the sample divided by the square root of the sample size. Each of the annual samples has the same size, namely 22. For example, the lower end of the 95% confidence interval for \$15.35 million estimate is \$8.52 million and equals \$15.35 million—1.96 \* (2% \* \$817.96 million)/√22. Similarly, the upper end of that interval is \$22.19 million and equals \$15.35 million + 1.96 \* (2% \* \$817.96 million)/√22.

be the greater of \$20 million or the 2% margin factor.

Similarly, if the percent multiplier of the margin factor requirement increases by *f*% from the initial percent multiplier, 2%, or other interim percent multiplier, the additional capital impact of the requirement on nonbank SBSDs due to this increase would be the initial capital impact of the requirement estimated above multiplied by *f*/2. For example, if the percentage multiplier increases from 2% to 3% (*i.e.*, *f* = 1), the additional capital impact on SBSDs due to this change equals the initial capital impact estimated above multiplied by 0.5.

In addition, and to further respond to comments, a more limited analysis that focuses exclusively on registered broker-dealers that would potentially register as broker-dealer SBSDs (*e.g.*, because the security-based swap dealing affiliate of a broker-dealer is folded into the broker-dealer, which then registers as a broker-dealer SBSD) can provide an indication of the costs. As discussed above, if the 5 ANC broker-dealers were to consolidate their SBSD subsidiaries and register as an ANC broker-dealer SBSD, they would incur no additional capital requirements because their current capital levels already exceed the early warning tentative net capital threshold of \$6 billion. An additional 11 broker-dealers that have between \$5 billion and \$6 billion in tentative net capital but are not ANC broker-dealers could register as nonbank ANC broker-dealer SBSDs. Assuming that all these 11 broker-dealers do so, their total additional tentative net capital shortfall is capped at \$11 billion. Of the remaining broker-dealers whose tentative net capital range between \$1 billion and \$5 billion, it is not clear if any of them would consider registering as a nonbank ANC broker-dealer SBSD. To the extent that one such broker-dealer does register, its potential tentative net capital shortfall would range between \$1 billion and \$5 billion.

One commenter believed that the proposed rule would impose costs that are disproportionate to the risks of security-based swap dealing activity.<sup>1091</sup> More specifically, this commenter believed that the proposed 8% margin factor would require the maintenance of resources far in excess of the risks posed by an SBSD's exposures, and that the 100% deduction for collateral held by third-party custodians and legacy account positions were excessive, and inconsistent with other regulators. This commenter stated that, at the time of the letter, the ANC broker-dealers have

<sup>1091</sup> See SIFMA 2/22/2013 Letter.



preliminarily projected that, in light of the severity of these requirements, the amount of capital that would be required for the single business line of security-based swap dealing under the proposal would exceed \$87 billion, the amount of capital currently devoted to all of those firms' securities businesses combined, including investment banking, prime brokerage, market making, and retail brokerage.<sup>1092</sup>

In response to this commenter, as noted above, the 2% margin factor would be relevant for nonbank SBSBs that engage in an amount of security-based swap activity that requires more supporting capital than the fixed-dollar minimum capital thresholds. As discussed at the beginning of this section, these types of nonbank SBSBs are instrumental for the overall liquidity provision in the security-based swap market, and, given their centrality in this market, they have to be adequately capitalized. To this end, the 2% margin factor is intended to ensure that the minimum capital requirements of these central SBSBs scale proportionally with their trading activity. As further noted above, the 2% margin factor also will help address the issue of funding the replacement cost or close-out costs of a nonbank SBSB's positions with a failed counterparty, when the margin collected from the counterparty is temporarily unavailable or was not collected because of an exception in the margin rules.

With regard to the commenter's estimated \$87 billion in capital needed for the ANC broker-dealers to become compliant with the final capital rules, most of these costs were the result of the proposed 100% capital deduction for initial margin collected but held at third-party custodians, the proposed 100% capital deduction for initial margin posted away, and the proposed 100% capital deduction for uncollateralized legacy security-based swaps. Modifications to the final rules should help reduce the costs to the ANC broker-dealers of becoming compliant

with the new requirements. The final capital rules contain a provision that allows nonbank SBSBs to avoid any capital deduction for initial margin held at a third-party custodian under certain conditions. Similarly, this release contains guidance with respect to Rules 15c3-1 and 18a-1 for a method by which the nonbank SBSB could fund the initial margin posted to a counterparty through an affiliate and avoid taking a 100% deduction for initial margin posted away. Finally, under the final rules, an ANC broker-dealer (including an ANC broker-dealer SBSB) and a stand-alone SBSB approved to use models for capital purposes can apply a credit risk charge with respect to uncollateralized exposures arising from transactions in derivatives instruments, including exposures arising from not collecting variation and/or initial margin pursuant to exceptions in the non-cleared security-based swap and swap margin rules of the Commission and CFTC, respectively. In particular, the final rule, unlike the proposed rule, allows ANC broker-dealer SBSBs to avoid taking a 100% capital deduction in lieu of margin for legacy security-based swaps and instead take an alternative credit risk charge.<sup>1093</sup> This credit risk charge is usually much smaller than the 100% capital charge, which should further reduce the costs to the ANC broker-dealers of becoming compliant with the capital requirements of nonbank SBSBs.

#### ii. Capital Charge for Posting Initial Margin

As discussed above, if a nonbank SBSB delivers initial margin to another SBSB or other counterparty, it must take a capital deduction in the amount of the posted collateral.<sup>1094</sup> This capital

deduction will increase the nonbank SBSB's transaction costs because the nonbank SBSB will incur a cost to obtain the capital to account for the deduction, a cost that it need not incur in the absence of such a deduction. To the extent that nonbank SBSBs pass on the increased transaction costs to their customers in the form of higher prices for liquidity provision, those customers could incur higher costs when transacting with nonbank SBSBs in the security-based swap market. The degree to which the increased transaction costs could be passed on to customers depends in part on the intensity of competition for liquidity provision in the security-based swap market. If competition for liquidity provision is strong, nonbank SBSBs may pass on a smaller portion of the increased costs to customers in order to stay competitive. Conversely, if competition for liquidity provision is more limited, nonbank SBSBs may pass on a larger portion of the increased costs to customers. The effects discussed above could be mitigated if nonbank SBSBs avoid the capital deduction by following the Commission's interpretive guidance as discussed above in section II.A.2.b.i. of this release. In addition to the preceding, the capital deduction could affect the competition between nonbank SBSBs and bank SBSBs, as discussed below in section VI.D.2. of this release.

#### iii. Capital Deductions in Lieu of Margin

The final capital rules and amendments require that nonbank SBSBs take capital deductions in lieu of margin with respect to non-cleared security-based swap transactions when the SBSB has failed to collect required margin or has elected to not collect margin pursuant to an exception in the margin rules of the Commission or the CFTC. Deductions in lieu of margin are designed to address the risks associated with exposures to counterparties and may incentivize the nonbank SBSB to collect margin even when it is not required to do so under the rules. In general, the capital deductions in lieu of margin for uncollateralized exposures from security-based swap or swap positions will be 100% of the amount of the uncollected margin (*i.e.*, dollar for dollar). However, nonbank SBSBs approved to use internal models for the purpose of calculating net capital will be allowed to take a model-based credit risk charge as an alternative to the 100% capital deduction. As discussed below

therefore, not deduct the value of the collateral from net worth when computing net capital. See paragraph (c)(2)(iv)(E)(3) of Rule 15c3-1, as amended; paragraph (c)(1)(iii) of Rule 18a-1, as adopted.

<sup>1092</sup> The commenter stated that the six SIFMA member firms who operate as ANC broker-dealers estimated the amount capital currently devoted to their securities businesses by determining the amount of capital, after deductions for non-allowable assets and capital charges, necessary for them to have net capital in excess of the early warning level specified in Rule 17a-11. However, the majority of the estimated costs flowed from the proposed 100% capital deduction for initial margin collected but held at third-party custodians, the proposed 100% capital deduction for initial margin posted away, and the proposed 100% capital deduction for uncollateralized legacy security-based swaps. As discussed above in section II.A. of this release and further below, the final rules include significant modifications to these requirements, as proposed.

<sup>1093</sup> As discussed above, for non-cleared security-based swaps and swaps, a capital deduction in lieu of margin must be taken when the SBSB elects not to collect margin under an exception in the Commission's rule for non-cleared swaps (including the exception for legacy security-based swaps) or an exception for initial margin for swap transactions under the CFTC's margin rules. These capital deductions in lieu of margin are for 100% of the amount of margin that would have been collected. However, a nonbank SBSB authorized to use models can apply a credit risk charge rather than take this deduction (which may result in significantly less than a 100% deduction). An ANC broker-dealer, including an ANC broker-dealer SBSB, must take a portfolio concentration charge for uncollateralized current exposures to the extent the amounts to which the credit risk charges are applied, in the aggregate, exceed 10% of the firm's tentative net capital. A 100% capital charge will apply to the amount that exceeds 10% of the firm's tentative net capital.

<sup>1094</sup> Furthermore, under the final capital rules, stand-alone broker-dealers and nonbank SBSBs may treat margin collateral posted to a clearing agency for cleared security-based swaps or to a DCO for cleared swaps as a "clearing deposit" and,

in section VI.B.1.b.v. of this release, these credit charges could be substantially smaller than the comparable 100% capital deductions.

The final capital rules do not require that nonbank SBSBs take a capital deduction for the difference between clearing agency or DCO margin requirements for customers' cleared security-based swaps and the haircuts that would apply to those positions if they were proprietary positions, as was proposed.<sup>1095</sup>

As discussed above in section II.A.2.b.ii. of this release, broker-dealers and nonbank SBSBs will be required to take a deduction for under-margined accounts because of a failure to collect margin required under Commission, CFTC, clearing agency, DCO, or designated examining authority rules (*i.e.*, a failure to collect margin when there is no exception from collecting margin). Nonbank SBSBs are also required to take capital deductions in lieu of margin when an exception to the final margin rule applies, such as where the initial margin falls below the \$50 million threshold or the counterparty is a financial market intermediary. In addition, the Commission modified the final capital rules from the proposal such that nonbank SBSBs will be required to take capital deductions in lieu of margin with respect to uncollected margin on swap positions that are subject to a variation or initial margin exception in the rules of the CFTC. The Commission has also added an exception in the final rule that allows a nonbank SBSB to treat initial margin with respect to a non-cleared security-based swap or swap held at a third-party custodian as if the collateral were delivered to the nonbank SBSB and, thereby, avoid taking the capital deduction for failing to hold the collateral directly.

As discussed above, the final capital rules are designed to enhance the safety and soundness of nonbank SBSBs by requiring them to take capital deductions in situations where collateral is not available to cover counterparty exposures. The capital buffer created by capital deduction or charge is designed to complement the capital buffer created by other capital requirements (*e.g.*, minimum net capital) to permit a nonbank SBSB to cover losses from uncollateralized exposures. The capital deduction and charges are also designed to incentivize a nonbank SBSB to collect margin.

The capital deduction in lieu of margin or credit risk charge is intended to perform a particularly important function in an SBSB's non-cleared security based transactions with financial market intermediaries, including with other nonbank SBSBs. A capital deduction in lieu of margin or credit risk charge is required for uncollateralized exposures to other financial market intermediaries from non-cleared security-based swap positions that are subject to an exception of the final margin rule. For transactions with financial market intermediaries, the final margin rule requires that nonbank SBSBs collect and post variation margin but not collect initial margin from these types of counterparties. This means that nonbank SBSBs will have credit exposure (*i.e.*, potential future exposure) to financial market intermediaries, including other nonbank SBSBs, from non-cleared security-based swap transactions. In the event that a financial market intermediary counterparty fails, the nonbank SBSB would have to bear the potential costs of replacing or closing out the positions with the failed counterparty, and, therefore, incur potential losses. Because these positions could be large (*e.g.*, as noted in section VI.A.1.d. of this release, interdealer positions are generally large), the losses that a nonbank SBSB may face as a result of a failed financial market intermediary counterparty could be large, and could eventually precipitate the demise of the nonbank SBSB. Imposing capital deductions in lieu of margin is intended to increase the likelihood that the nonbank SBSB has a buffer of capital to absorb potential losses from uncollateralized exposures to the failed financial market intermediary counterparty. These capital deductions are designed to increase with the size of the positions with the failed counterparty and provide the nonbank SBSB with a capital buffer against potential losses from replacing or closing out these positions. Furthermore, for every new non-cleared and uncollateralized security-based swap position with a financial market intermediary, a nonbank SBSB will be required to increase its net capital (or have sufficient excess net capital) to accommodate the capital deductions resulting from the uncollateralized exposures created by the new position. In other words, a nonbank SBSB cannot enter a new non-cleared security-based swap position with a financial market intermediary that creates uncollateralized exposures without

increasing its net capital or having sufficient excess net capital.

The capital deductions for uncollateralized security-based swap exposures to financial market intermediaries create a capital buffer against potential losses from such exposures, and, therefore, reduce the risk of a nonbank SBSB's failure and the potential for sequential SBSB failure. As a result, these deductions and charges should enhance the safety and soundness of the nonbank SBSBs and, therefore, provide an important benefit for market participants that rely on liquidity provision and other services provided by nonbank SBSBs. However, the requirement to take capital deductions in lieu of margin against uncollateralized exposures from security-based swap transactions with financial market intermediaries may impose costs on nonbank SBSBs to the extent that reallocating capital from other activities or raising additional capital to support the SBSB's security-based swap trading activity is costly. These costs could increase a nonbank SBSB's costs of hedging non-cleared security-based swap positions, relative to the baseline. Nonbank SBSBs generally rely on financial market intermediaries to hedge their market risk exposures from non-cleared security-based swaps with other market participants. If transacting with financial market intermediaries becomes more costly, nonbank SBSBs would face higher hedging costs, relative to the baseline. Nonbank SBSBs may pass on these hedging costs to the market participants that access the market for security-based swaps through nonbank SBSBs. Because market participants can access this market through market intermediaries that are not nonbank SBSBs, competitive pressure may limit the extent to which nonbank SBSBs could pass on their potentially higher hedging costs to the market participants.

Nonbank SBSBs will also have to take capital deductions in lieu of margin for uncollateralized exposures from swaps that are subject to an exception in the margin rules of the CFTC. Absent these capital deductions or charges, potential losses from uncollateralized swap exposure to counterparties that are subject to an exception in the margin rules of CFTC may destabilize a nonbank SBSB even if the SBSB is adequately capitalized with respect to its dealing activity in the security-based swap market. Thus, capital deductions for uncollateralized swap exposures create a capital buffer against potential losses from uncollateralized swap positions that should enhance the safety and soundness of a nonbank SBSB that

<sup>1095</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70245–46. See also *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53009–10.

engages in swap activity. This potential enhancement should benefit the market participants that rely on liquidity provision and other services provided by nonbank SBSBs.

However, the requirement to take capital deductions for uncollateralized swap exposures will also impose costs on nonbank SBSBs, because reallocating capital from other activities to support the SBSB's swap trading activity or raising additional capital is generally costly. These costs may put a nonbank SBSB at a competitive disadvantage compared to a swap dealer that is not a nonbank SBSB and that is not required to take similar capital deduction by the rules of the CFTC. However, under certain conditions, a stand-alone SBSB that engages in limited security-based swap activity may be permitted to use the alternative compliance mechanism to the capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of complying with Rules 18a-1, 18a-3, and 18a-4. These rules may not have provisions for such capital charges.

The final capital rules will also require that nonbank SBSBs take a capital deduction in lieu of margin or credit risk charge for legacy security-based swap and swap positions. This requirement is designed to ensure that the nonbank SBSB's credit risk exposures from legacy security-based swap and swap positions are either collateralized (*i.e.*, required variation and initial margin has been collected) or uncollateralized but supported with adequate capital (*i.e.*, the capital deduction in lieu of margin or credit risk charge). Absent this requirement, nonbank SBSBs would be exposed to uncollateralized credit risk from these legacy positions without any compensating capital buffer, which, in turn, would compromise the effectiveness of the final capital rules post implementation.

The requirement could impose costs on some nonbank SBSBs with legacy security-based swap and swap positions because reallocating capital from other activities or raising new capital to support these legacy positions is generally costly. These potential costs generally scale up with the size of the legacy positions.<sup>1096</sup> As discussed above

<sup>1096</sup> If the nonbank SBSB is reallocating capital from other activities to support its legacy positions, the cost to the firm is the opportunity cost associated with those other activities. This cost scales up with the amount of capital being reallocated. If the nonbank SBSB is raising new capital to support its legacy positions, the cost to the firm is the cost of capital that investors demand in return for their capital and the costs associated with underwriting the financial instruments that facilitate the transfer of capital from investors to the

in section VI.A.1.e. of this release, certain dealers that may register as nonbank SBSBs carry large legacy swap positions. The capital deductions on the swap legacy positions and the new swap positions that these firms would face if they were to register as nonbank SBSBs may impact these firms' decision whether to register as nonbank SBSBs, particularly if they plan to maintain a level of swap trading activity similar to the current one. In particular, some firms may choose to register as nonbank SBSBs but keep the swap trading activity outside the SBSB structure. This potential separation of trading activity between security-based swaps and swaps may reduce the benefits that firms currently enjoy from managing risk exposures from these activities on a centralized basis. However, as discussed below, the inter-affiliate exception to the final margin rule for initial margin may offset the change in the benefits from centralized risk management. Alternatively, some firms may choose to maintain a level of security-based swap activity that is sufficiently low to meet the conditions necessary to operate under the alternative compliance mechanism.<sup>1097</sup> As discussed below, nonbank SBSBs that make use of the alternative compliance mechanism will be subject to a different capital, margin, and segregation regime that may offer different protections to the market participants that access the security-based swap market through nonbank SBSBs that use the mechanism relative to nonbank SBSBs that do not. If this difference is not reflected in prices, some market participants may be overpaying for transacting in the security-based swap market (*e.g.*, SBSBs that are subject to different regimes that offer different levels of protection charging their counterparties similar prices).

Nonbank SBSBs that expect to face large costs due to their legacy security-based swap and swap positions may reduce these costs by reassigning a portion of their legacy positions to SBSBs that are subject to a regulatory regime that does not impose these type of capital deductions (*e.g.*, bank SBSBs), prior to the final capital rules and amendments taking effect, as long as such transactions are feasible (*i.e.*, the cost associated with reassigning the legacy positions does not dominate the

firm. Some of these costs (*e.g.*, the cost of capital) scale up with the amount of capital being transferred.

<sup>1097</sup> See section II.D. of this release (discussing these conditions and their economic impact).

legacy capital deduction or charge for the position).

The legacy capital deduction for a nonbank SBSB could cause a nonbank SBSB to renegotiate its legacy security-based swaps and swaps with its counterparties immediately after the final capital rules take effect. The incentives of the two parties to renegotiate a legacy security-based swap or swap would depend on the costs of replacing the legacy transaction with the new transaction and how the new transaction would be treated under the final capital and margin rules as compared with the legacy transaction. In particular, if the net effect of these two factors leaves both parties better off, the parties would have an incentive to renegotiate.

The requirement that nonbank SBSBs take a capital deduction in lieu of margin or credit risk charge for their legacy security-based swap and swap positions also reduces the aggregate demand for collateral that nonbank SBSBs would otherwise need to meet the requirements of the final margin rule. Absent such a requirement, counterparties to nonbank SBSBs' security-based swap positions would have to post variation and initial margin at the same time—namely, at the time when the final rules and amendments take effect. This systemic call for margin could be potentially destabilizing for those counterparties that have large legacy security-based swap positions.

Two commenters argued that capital deductions, including those for legacy accounts, impose costs on nonbank SBSBs, which may be passed on, directly or indirectly, to the nonbank SBSB's counterparties.<sup>1098</sup> Other commenters argued that the legacy account deduction is inconsistent with the capital regimes of the prudential regulators and the proposed capital regime of the CFTC, and would result in unwarranted variations in regulated entities' capital requirements, which could lead to market fragmentation.<sup>1099</sup>

In response to these commenters' concerns, to the extent that nonbank SBSBs expect to face large costs due to their legacy security-based swap and swap positions, these SBSBs may reduce these costs by reassigning a portion of their legacy positions to SBSBs that are subject to a regulatory regime that does not impose these type of capital deductions (*e.g.*, bank SBSBs). Furthermore, under certain conditions, a nonbank SBSB may be able to make use of the alternative compliance mechanism and therefore potentially

<sup>1098</sup> See PIMCO Letter; SIFMA 2/22/2013 Letter.

<sup>1099</sup> See Morgan Stanley 2/22/2013 Letter.

avoid taking capital deductions for legacy positions. This means of avoiding the deductions or charges will depend on whether the CFTC's final capital rules for swap dealers do not include such deductions.

The Commission estimates that most nonbank SBSBs will be authorized to use internal models and therefore will take the credit risk charges instead of the capital deductions in lieu of margin. Under the assumption that dealers that are likely to register as nonbank SBSBs currently maintain only enough capital to cover the market risk exposures of their positions and that they maintain a level of trading activity (*i.e.*, legacy transactions) that falls within the range of trading activity currently observed among current dealers, the Commission estimates that the initial impact of the credit risk charges on a nonbank SBSB to range between 0 and \$253.73 million. Within this range, the average initial capital impact of capital charges for credit risk exposures can be estimated in each sample year and the average impact is between \$0.41 million and \$11.07 million. However, the precision of the estimate of the average initial capital impact of capital charges for credit risk exposures varies significantly over the sample years. For example, among the estimates in the range above, the \$0.41 million estimate has a shorter 95% confidence interval, and therefore higher precision, namely \$0.32 million to \$0.49 million, while the \$11.07 million estimate has a longer 95% confidence interval, and therefore lower precision, namely \$6.73 million to \$15.42 million.<sup>1100</sup>

<sup>1100</sup> The Commission calculates the range for the initial capital impact of the capital charges for credit risk exposures by multiplying the minimum and the maximum risk margin amounts across sample years in Table 2, Panel B, of section VI.A.2. of this release with the lower bound and upper bound of the range of estimates for the size of the credit risk charge as a fraction of the 100% capital deduction calculated in section II.B.1.b.v. of this release (*i.e.*, 4.8% and 48%). For example, \$253.73 million equals 48% multiplied by the maximum risk margin amount over the sample years (*i.e.*, \$528.61 million). The Commission calculates the range for the average initial capital impact of the capital charges for credit risk exposures by multiplying the average risk margin amount in each sample year with the upper and lower bounds of the range of estimates for the size of the credit risk charge as a fraction of the 100% capital deduction. For example, the average initial capital impact of the capital charges for credit risk exposures based on the 2017 sample is \$11.07 million and equals the average risk margin amount for that sample year (*i.e.*, \$23.07 million) multiplied by the upper bound of the range above (*i.e.*, 48%). Assuming that the risk margin amounts are approximately normally distributed, the Commission calculates the 95% confidence interval around an estimate by subtracting (for the lower end of the interval) or adding (for the upper end of the interval) 1.96 multiplied by the standard error of the mean, which is defined as the standard deviation for the sample

Nonbank SBSBs will also be required to take a capital deduction in lieu of margin or credit risk charge for initial margin collateral that a counterparty chooses to segregate with an independent third-party custodian if the conditions for qualifying for the exception from taking the charge are not met. These conditions may impose costs on a firm. For example, one condition requires that the nonbank SBSB must maintain written documentation of its analysis that the tri-party custodial agreement is legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency, or a similar proceeding of any of the parties to the agreement. However, these conditions are designed so that existing agreements with counterparties entered into for the purposes of the third-party custodian and documentation rules of the CFTC and the prudential regulators will suffice for purposes of the final rule.

Those nonbank SBSBs that do not qualify for the exception will have to take a capital deduction for the initial margin collateral held at a third-party custodian, which they will likely pass on to the counterparties that elect to segregate initial margin in this manner. This cost, if large, may undermine the benefits associated with safeguarding the collateral from a potential default by the nonbank SBSB, and may reduce the appeal of the individual segregation option relative to other options (*e.g.*, omnibus segregation). However, market participants may avoid this cost by choosing to trade with a nonbank SBSB that qualifies for the exception, with a nonbank SBSB that elects to use the alternative compliance mechanism, or with a bank SBSB.

Several commenters suggested that the Commission should eliminate the capital deduction in lieu of margin for margin collateral held at a third-party custodian noting that customers will ultimately incur the additional cost, and the proposed capital charge would make electing individual segregation prohibitively expensive.<sup>1101</sup> Another commenter believed that applying the

divided by the square root of the sample size. Each of the annual samples has approximately the same size, namely 170. For example, the lower end of the 95% confidence interval for the \$11.07 million estimate is  $\$6.73 \text{ million} \text{ and equals } \$11.07 \text{ million} - 1.96 * (48\% * \$60.24 \text{ million}) / \sqrt{170}$ . Similarly, the upper end of that interval is  $\$15.42 \text{ million and equals } \$11.07 \text{ million} + 1.96 * (48\% * \$60.24 \text{ million}) / \sqrt{170}$ .

<sup>1101</sup> See AIMA 2/22/2013 Letter; American Benefits Council, et al. 5/19/2014 Letter; Financial Services Roundtable Letter; ICI 12/5/2013 Letter; MFA 2/22/2013 Letter; MFA 2/24/2014 Letter; Morgan Stanley 2/22/2013 Letter; SIFMA AMG 2/22/2013 Letter; SIFMA 2/22/2013 Letter.

deduction would also make such collateral arrangements prohibitively expensive, frustrating Congress's clear intention that such arrangements should be available to counterparties.<sup>1102</sup> Several commenters noted that the SBSBs would simply pass on the capital charge to the counterparties, which would undermine the benefits of third-party segregation.<sup>1103</sup> Some commenters suggested that, at a minimum, the capital charge should be waived where custodian arrangements meet robust legal and operational criteria to ensure the nonbank SBSB's access to collateral in the event of counterparty default.<sup>1104</sup> One commenter stated that the third-party custodian deduction would make nonbank SBSBs uncompetitive and would result in huge disparities in capital requirements for bank and nonbank SBSBs engaged in identical market activities.<sup>1105</sup> Two commenters expressed concerns with the implementation costs of the provision, generally, and the inclusion of a legal opinion, specifically.<sup>1106</sup>

In response to commenters' concerns regarding the impact of the capital deduction for margin collateral held at a third-party custodian, as discussed above, the final capital rules contain a provision that will allow nonbank SBSBs to avoid taking this capital deduction all together, if they meet certain conditions. In particular, this provision will make third-party segregation a viable option for market participants that prefer to access the security-based swap market using a nonbank SBSB that qualifies for the exception.

Furthermore, in response to commenters' concerns regarding the potential conditions for the exception that were asked about in the 2018 comment reopening, in the final rule, the Commission has balanced the potential difficulties in obtaining a legal opinion of outside counsel with the need for the broker-dealer or nonbank SBSB to enter into a custodial agreement that will operate as intended under the relevant laws. Therefore, the final rules do not require the broker-dealer or nonbank SBSB to obtain a legal opinion of outside counsel. Instead, the final rules require the

<sup>1102</sup> See ICI 12/5/2013 Letter; MFA 2/24/2014 Letter; Morgan Stanley 2/22/2013 Letter.

<sup>1103</sup> See American Council of Life Insurers 11/19/2018 Letter; ICI 11/19/2018 Letter; SIFMA 11/19/2018 Letter.

<sup>1104</sup> See ICI 12/5/2013 Letter; MFA 2/24/2014 Letter; Morgan Stanley 10/29/2014 Letter; SIFMA 2/22/2013 Letter.

<sup>1105</sup> See SIFMA 2/22/2013 Letter.

<sup>1106</sup> See ICI 11/24/2014 Letter; SIFMA AMG 11/19/2018 Letter.

broker-dealer or nonbank SBSB to maintain written documentation of its analysis that in the event of a legal challenge the relevant court or administrative authorities would find the account control agreement to be legal, valid, binding, and enforceable under the applicable law, including in the event of the receivership, conservatorship, insolvency, liquidation, or a similar proceeding of any of the parties to the agreement. This documentation requirement will benefit the parties involved by reducing legal uncertainty about whether and when such an agreement is binding, and mitigating the risk of litigation (and its associated costs) among parties to the agreement. Absent such requirement, the costs associated with such litigation could be passed on to the party to the agreement that requested individual segregation (e.g., the counterparty to a nonbank SBSB), potentially increasing the cost of electing this form of segregation.

The final capital rules will also require nonbank SBSBs to take a capital deduction in lieu of margin or credit risk charge for uncollected initial margin amounts from commercial end users, sovereign entities, the BIS, the European Stability Mechanism, and certain multilateral development banks. In addition, the final rule and amendments also require that nonbank SBSBs take a capital deduction in lieu of margin or credit risk charge with respect to unsecured receivables arising from electing not to collect variation margin from commercial end users, the BIS, the European Stability Mechanism, and certain multilateral development banks.

Finally, the final capital rules will also require nonbank SBSBs to take a capital deduction in lieu of margin or credit risk charge for electing not to collect initial margin under other exceptions in the margin rules for non-cleared security-based swaps and swaps, such as the \$50 million initial margin threshold exception of Rule 18a-3.

A nonbank SBSB will also be required to take a capital deduction in lieu of margin or credit risk charge for uncollateralized credit risk exposure created by non-cleared security-based swaps with an affiliate (i.e., pursuant to an initial margin exception for affiliates). Parent companies of nonbank SBSBs may rely on inter-affiliate transactions to manage risk exposures within the organization. For example, a nonbank SBSB and a bank affiliate that share the same parent may have exposure to the same entity as a result of dealing in security-based swaps and

as a result of extending credit (e.g., loans), respectively. The parent may decide to minimize its overall exposure to the entity by having the nonbank SBSB and the bank affiliate enter into a security based swap with each other (i.e., an inter-affiliate transaction). This centralized management of risk exposures may benefit the parent and its affiliates. The requirement that nonbank SBSBs take a capital deduction in lieu of margin or credit risk charge for inter-affiliate security-based swap transactions may impose costs on nonbank SBSB—such as costs associated with reallocating capital from other activities or from raising new capital—that may reduce the benefits associated with managing risk exposures on a centralized basis.

Nonbank SBSBs will likely pass on the potential costs associated with these capital deductions or charges to these counterparties. Some counterparties may prefer to incur this cost and enter an uncollateralized transaction rather than incurring the opportunity cost of reallocating capital from other activities (e.g., productive capital) to finance margin collateral and enter a collateralized transaction. Market participants, however, may be able to avoid these indirect costs of transacting with a nonbank SBSB entirely by accessing the security-based swap market through SBSBs that are not subject to similar capital deductions, such as a bank SBSB or a nonbank SBSB that is subject to the alternative compliance mechanism. Thus, competitive pressure from these SBSBs may limit the extent to which a nonbank SBSB is able to pass on the costs associated with these capital deductions to their counterparties.

At the same time, uncollateralized exposures from inter-affiliate security-based swaps may expose a nonbank SBSB to the failure of its affiliates. While some of the affiliates may themselves be subject to regulatory capital and margin requirements, others may not (e.g., a hedge fund affiliate). In particular, some affiliates may operate with minimal levels of capital that, while privately optimal, may not be adequate for the level of risk associated with their positions. The failure of such an affiliate may destabilize a nonbank SBSB that has an uncollateralized exposure to this affiliate. The requirement to take a capital deduction for uncollateralized inter-affiliate exposures should reduce the likelihood that the failure of a counterparty that is an affiliate of the nonbank SBSB may cause the SBSB to fail. From this perspective, the requirement may enhance the safety and soundness of a

nonbank SBSB that engages in inter-affiliate transactions, which, in turn, may benefit the market participants that rely on liquidity provision and other services provided by nonbank SBSBs.

#### iv. Standardized Haircuts for Security-Based Swaps

Standardized haircuts are applied to a firm's proprietary positions, and deducted from tentative net capital to calculate the firm's net capital. Nonbank SBSBs may apply model-based haircuts to positions for which they have been authorized by the Commission to use models. For all other types of positions, a nonbank SBSB must use the standardized haircuts.

The standardized CDS haircut grids in the final rules are unchanged relative to the 2012 proposal; however, in the final rule, they are only applied to non-cleared CDS. The number of maturity and spread categories in the grids for single-name and index CDS are based on staff's experience with the maturity grids for other securities in Rule 15c3-1 and, in part, on FINRA Rule 4240. The standardized haircuts for cleared security-based swaps and swaps will be the applicable clearing agency margin or DCO margin requirements.

The offsets recognized under the standardized haircut approach for calculating net capital may permit a nonbank SBSB that relies on this approach to deploy the capital savings that are the result of these offsets in other areas of operations more efficiently, as well as enhance operational efficiencies.

The benefit of the standardized haircut approach of measuring market risk, besides its inherent simplicity, is that, compared to the model-based approach, it may reduce the likelihood of default or failure by nonbank SBSBs that have not demonstrated that they have the risk management capabilities, of which internal models are an integral part, or capital levels to support the use of internal models. Therefore, the standardized haircut approach, in turn, may improve customer protections and reduce the likelihood of a nonbank SBSB's failure compared to the model-based approach. In addition, a standardized haircut approach may reduce costs for the nonbank SBSB compared to the model-based approach related to the risk of failing to observe or correct a problem with the use of internal models that could adversely impact the firm's financial condition, because the use of internal models will require the allocation by the nonbank SBSB of additional firm resources and personnel.

Conversely, if the standardized haircuts are too conservative, security-based swap business may face increased transaction costs and be unable to engage security-based swap transactions. This would reduce liquidity, and reduce the availability of security-based swaps, including for risk mitigation by financial market intermediaries and end users.

The standardized haircut approach for calculating net capital in the final rules, like other types of standardized haircuts, will likely require a higher amount of capital to support open security-based swap positions in contrast to the model-based approach. While the standardized haircuts, including the non-cleared CDS grids, recognize certain offsets, standardized haircuts generally result in higher capital charges because the standardized approaches do not recognize all ways in which a nonbank SBSB might offset its exposures, and impose a relatively conservative charge for the remaining (net) exposure. The higher capital charges resulting from using the standardized haircuts may be acceptable for nonbank SBSBs 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 security-based swaps in general will likely choose to use the more cost-efficient models to measure and manage the risks of their positions over time. Moreover, while the standardized approach may result in higher haircuts, ANC broker-dealers and stand-alone SBSBs that will use the model-based approach will be subject to higher minimum capital requirements and ongoing monitoring with respect to their use of and governance over the models.

One commenter expressed concerns with the magnitude of the standardized haircuts relative to the model-based haircuts and suggested that the Commission perform a more thorough review of the standardized haircuts required by the proposed CDS grids

based on empirical data on historical volatility and loss given default.<sup>1107</sup> The commenter also suggested that the Commission conduct further economic analysis to confirm that the standardized haircuts are appropriately tailored to the risk of the relevant positions and suggested that the analysis should be based on quantitative data regarding the security-based swap and swap markets since the enactment of the Dodd-Frank Act.<sup>1108</sup> In response to the commenters, the standardized haircut grids in the final rules are based on existing Rule 15c3–1 and, in part, on FINRA Rule 4240, and will apply to non-cleared CDS. Furthermore, as discussed above in section VI.A.7 of this release, the Commission has provided an analysis of the extreme but plausible losses on CDS positions observed from historical data.<sup>1109</sup> The Commission uses this analysis to measure the extent to which the extreme but plausible loss in a cell is covered by the associated standardized haircut. To this end, the Commission calculates the loss divided by the standardized haircut, which is referred to as the “loss coverage ratio.” If this ratio is smaller than or equal to 1, then the standardized haircut covers the loss. If this ratio is larger than 1, then the haircut does not fully cover the loss. The Commission summarizes the distribution of loss coverage ratios for all cells in the grid by calculating a number of statistics, including the mean, standard deviation, and the range. The Commission reports the summary statistics for each year sample in Table 4. Panels A and B of Table 4 focus on short and long CDS positions that reference single-name obligors, while panels C and D of Table 4 focus on short and long CDS positions that reference broad-based securities indexes. For each panel the Commission uses the standardized haircut grids, as specified by the final rules.

With respect to short CDS referencing single-name obligors (Table 4, Panel A), the mean of the loss coverage ratio is below one in all annual samples except the 2008 sample. In response to the commenter, based on this analysis, the standardized haircuts would not, on

their own, cover losses similar to the losses of short single-name CDS positions in the 2008 sample. However, with the exception of 2008, the standardized haircuts are sufficiently large to cover the losses of these positions, on average. The average loss coverage ratio in the 2011–2018 samples ranges from 38% to 59%. For 2008, the average loss coverage ratio is 1.07 meaning that the average loss in 2008 exceeds the appropriate haircut by about 7%. For long CDS referencing single-name obligors (Table 4, Panel B), the average loss coverage ratio ranges from 55% to 82%. This result suggests that the proposed haircuts for long CDS referencing single-name obligors are sufficiently large to cover the losses of these positions, on average. Moreover, the requirements in the final capital rules to mark-to-market the value of positions in computing net capital and to maintain the required minimum amount of net capital at all times are designed to ensure that a firm maintains sufficient regulatory capital during periods of volatility.

With respect to CDS referencing a broad-based securities index, the results are qualitatively similar, but the magnitudes are slightly different. For instance, while the average loss coverage ratio is usually not as high as for single-name CDS in the 2011–2018 samples (*i.e.*, the standardized haircuts are more likely to cover losses), the average loss coverage ratio exceeded that for single-name CDS in the 2008 sample (*e.g.*, on the short positions). Further, in contrast to the single-name CDS, the maximum loss coverage ratio can be less than one for CDS referencing a broad-based securities index.

Table 4: Analysis of the Proposed Haircut Grids. This table reports summary statistics of the distribution of loss coverage ratio, which is the extreme but plausible loss divided by the standardized haircut. The summary statistics are Min (minimum), P25 (first quartile/25th percentile), P50 (second quartile/50th percentile), P75 (third quartile/75th percentile), Max (maximum), Mean, and Std (standard deviation).

Single-Name Credit Default Swaps

Year	Min	P25	P50	P75	Max	Mean	Std
<b>Panel A: Short Positions</b>							
2008 .....	0.43	0.76	0.84	1.13	4.04	1.07	0.64
2011 .....	0.22	0.39	0.45	0.49	2.01	0.56	0.38
2012 .....	0.00	0.21	0.25	0.31	1.86	0.38	0.37
2017 .....	0.07	0.20	0.31	0.44	4.11	0.59	0.86

<sup>1107</sup> See SIFMA 2/22/2013 Letter.

<sup>1108</sup> See SIFMA 11/19/2018 Letter.

<sup>1109</sup> See section VI.A.7. of this release.

## Single-Name Credit Default Swaps

Year	Min	P25	P50	P75	Max	Mean	Std
2018 .....	0.09	0.25	0.36	0.49	2.46	0.52	0.50

## Panel B: Long Positions

2008 .....	0.22	0.41	0.59	0.78	6.23	0.82	0.89
2011 .....	0.20	0.43	0.50	0.58	2.39	0.59	0.38
2012 .....	0.18	0.43	0.52	0.58	2.21	0.59	0.36
2017 .....	0.16	0.39	0.47	0.55	1.85	0.56	0.34
2018 .....	0.10	0.33	0.42	0.56	1.99	0.55	0.41

## Index Credit Default Swaps

## Panel C: Short Positions

2008 .....	0.19	0.31	0.37	2.52	17.61	2.98	4.79
2011 .....	0.07	0.21	0.33	0.43	1.56	0.37	0.27
2012 .....	0.05	0.18	0.21	0.25	0.42	0.21	0.09
2017 .....	0.00	0.05	0.09	0.15	0.27	0.11	0.07
2018 .....	0.00	0.06	0.16	0.21	0.29	0.15	0.09

## Panel D: Long Positions

2008 .....	0.00	0.13	0.37	0.54	2.63	0.54	0.71
2011 .....	0.20	0.30	0.45	0.53	1.82	0.49	0.32
2012 .....	0.02	0.45	0.53	0.71	2.65	0.65	0.48
2017 .....	0.01	0.22	0.49	0.73	1.02	0.48	0.29
2018 .....	0.00	0.09	0.20	0.32	0.46	0.20	0.14

This analysis shows that the maximum loss coverage ratio exceeds 1 in all sample years for CDS positions referencing single-name obligors. However, this is not always the case for CDS positions referencing an index. These results suggest that the standardized haircuts in the final rules are generally not set at the most conservative level, as losses on some positions exceed the corresponding standardized haircuts. The standardized haircuts are intended to strike a balance between being sufficiently conservative to cover losses in most cases, including stressed market conditions, and being sufficiently nimble to allow dealers to operate efficiently in all market conditions. In response to the commenter, based on the results of the analysis, as described above, the Commission believes that the standardized haircuts in the final rules take into account this tradeoff. The standardized haircut grids are designed to produce margin amounts that generally scale with risk of the underlying positions, and are designed to capture the relative risk of the underlying positions across maturity and credit spread. Finally, the standardized haircut grids for non-cleared CDS are based on well-established haircuts prescribed in Rule 15c3-1 and FINRA Rule 4240, haircuts that have been used by broker-dealers for many years.

In the final rules, the standardized haircuts for cleared security-based

swaps and swaps are based on clearing agency margin requirements. This will impose direct costs on nonbank SBSBs that clear proprietary security-based swaps and swaps. For example, these costs will impact nonbank SBSBs that make a market in security-based swaps and/or swaps, and hedge some of their market risk exposure to their counterparties by entering into cleared security-based swap or swap positions. A nonbank SBSB that makes a market in non-cleared CDS and that has some residual market risk exposure (e.g., the nonbank SBSB is not running a flat trading book) could hedge some of that exposure by entering into a cleared index CDS (i.e., a swap) on its own account. Applying standardized haircuts to cleared positions will make this type of hedging activity more costly relative to the baseline. To offset the costs imposed by this requirement, SBSBs may charge counterparties more for providing liquidity in the security-based swap market. In particular, the costs to market participants of trading in these markets may be higher, relative to the baseline.

However, the costs associated with the standardized haircuts for cleared security-based swaps would be in part mitigated by the use of model-based haircuts as an alternative to the standardized haircuts. Specifically, ANC broker-dealers and stand-alone SBSBs approved to use internal models would be allowed to use the model-based haircuts. As noted above, model-

based haircuts can be substantially smaller than standardized haircuts. Furthermore, as noted above, the Commission believes that most nonbank SBSBs will seek approval to use internal models for capital purposes, including for the calculation of model-based haircuts of cleared and non-cleared security-based swap and swap positions.

## v. Credit Risk Charges

Section VI.B.1.b.iii. of this release analyzes the benefits and costs associated with the capital deductions in lieu of margin. These benefits and costs associated with the capital deductions in lieu of margin depend on whether the ANC broker-dealer or stand-alone SBSB will be allowed to take the alternative model-based credit risk charge. Since the credit risk charge is substantially smaller than the 100% capital deduction, an ANC broker-dealer or stand-alone SBSB that is authorized to use internal models and that takes the alternative credit risk charge instead of the capital deduction in lieu of margin will face substantially lower costs compared to a broker-dealer or nonbank SBSB that is not using internal models and that has to take the 100% capital deduction.<sup>1110</sup>

<sup>1110</sup> See section II.A.2.b.v. of this release (discussing the calculation of the model-based credit risk charge); section II.B.2.a.i. of this release (discussing the calculation of the model-based initial margin requirement). The alternative credit risk charge can range from approximately 4.8% to



While the alternative credit risk charge may allow ANC broker-dealers and nonbank SBSBs to economize on the direct costs associated with capital charges in lieu of margin, it also provides less of a buffer against potential losses compared to the 100% capital deduction. The 100% capital deduction for the uncollateralized credit risk exposure created by a security-based swap or swap position provides a capital buffer that is similar in size with the margin requirement of the position that the ANC broker-dealer or stand-alone SBSB will calculate for the counterparty. In contrast, the alternative credit risk charge for the uncollateralized exposure of the same position provides a capital buffer that could be substantially smaller than the margin requirement of the position. Thus, in general, the capital buffer created by the 100% capital deduction could be substantially more effective against potential losses from an uncollateralized exposure compared to the capital buffer created by the alternative credit risk charge. Everything else equal, the likelihood of the failure of an ANC broker-dealer or stand-alone SBSB because of losses from uncollateralized exposures is smaller if the firm takes the 100% capital deduction against this exposure compared to the alternative credit risk charge.

In addition, and as a corollary, compared to a nonbank SBSB that is not using internal models, an ANC broker-dealer or stand-alone SBSB that is approved to use internal models, and that takes the alternative credit risk charge, will allocate less capital ex-ante (when the counterparty is solvent) but may potentially require more capital ex-post (when the counterparty is insolvent). From this perspective, the net capital of an ANC broker-dealer or stand-alone SBSB that is approved to use internal models is more sensitive to the risk of counterparty failure. However, as discussed above, ANC broker-dealers and stand-alone SBSBs that are approved to use internal models are subject to higher minimum capital requirements.

Finally, as discussed above, in applying the credit risk charges, ANC broker-dealers (including ANC broker-

dealer SBSBs) are subject to a portfolio concentration charge that has a threshold equal to 10% of the firm's tentative net capital. Under the portfolio concentration charge, the application of the credit risk charges to uncollateralized *current* exposure across all counterparties arising from derivatives transactions is limited to an amount of the current exposure equal to no more than 10% of the firm's tentative net capital. The firm must take a charge equal to 100% of the amount of the firm's aggregate current exposure in excess of 10% of its tentative net capital. Stand-alone SBSBs, including SBSBs operating as OTC derivatives dealers, are not subject to a portfolio concentration charge with respect to uncollateralized current exposure. However, all these entities (*i.e.*, ANC Broker-dealers, ANC broker-dealer SBSBs, stand-alone SBSBs, and stand-alone SBSBs that also are registered as OTC derivatives dealers) are subject to a concentration charge for large exposures to single a counterparty that is calculated using the existing methodology in Rule 15c3-1e.<sup>1111</sup>

Currently, dealing entities affiliated with ANC broker-dealers are among the largest in terms of level of trading activity in the security-based swap and swap markets.<sup>1112</sup> If these dealing entities are currently registered with the CFTC as swap dealers, major swap participants or FCMs, their market and credit risk exposures from certain legacy security-based swap and swap positions will have to be collateralized per CFTC's margin rules. However, these margin rules have exceptions such that not all exposures from legacy positions have to be collateralized (*e.g.*, security-based swaps and swaps with counterparties that are not a "covered swap entity" or "financial end user," as defined by the CFTC's margin rules).<sup>1113</sup> To the extent that these dealing entities will register as ANC broker-dealers or ANC broker-dealer SBSBs, the requirement to cap the use of the alternative credit risk charge for capital charges in lieu of margin to 10% of an ANC broker-dealer's tentative net capital as a portfolio concentration charge could impose costs on these broker-dealers. More generally, the 10% cap

requirement may impose additional costs on a dealer that has uncollateralized market risk exposure from legacy and new security-based swap and swap positions in excess of the 10% cap and that chooses to register as ANC broker-dealer or both ANC broker-dealer and SBSB rather than other forms of nonbank SBSB, including stand-alone SBSBs approved to use models. ANC broker-dealers may pass on a portion of these additional costs to their counterparties, and therefore, the requirement may increase the costs of transacting in security-based swaps and swaps for market participants that access these markets through ANC broker-dealers. However, competitive pressure may limit the extent to which ANC broker-dealers may be able to pass on these additional costs to their counterparties. For instance, stand-alone SBSBs that are not subject to this requirement may be able to offer better prices compared to ANC broker-dealers that are subject to this requirement. As a corollary, if a dealing entity expects the additional costs to be large, the requirement may reduce the entity's incentives to engage in security-based swap dealing activity that would trigger a requirement to register as an ANC broker-dealer SBSB.

As discussed above, the 10% cap requirement will limit the extent to which an ANC broker-dealer, including an ANC broker-dealer SBSB, can make use of the alternative credit risk charge in lieu of the 100% capital deduction. As a result, the capital buffer that an ANC broker-dealer will have to hold as a result of the 10% cap requirement is larger than the capital buffer that the ANC broker-dealer would hold, absent this requirement. Because a larger capital buffer allows ANC broker-dealers to better withstand potential losses from uncollateralized market risk exposures, the requirement is intended to enhance the safety and soundness of ANC broker-dealers and therefore benefit market participants.

#### vi. Risk Management Procedures

Nonbank SBSBs will be required to comply with Rule 15c3-4, which currently applies to OTC derivatives dealers and ANC broker-dealers. Rule 15c3-4 requires firms to, among other things, 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. These requirements may help nonbank SBSBs better monitor the risk of their operations, and it may help reduce the risk of significant

48% of the 100% capital deduction in lieu of margin, depending on the multiplication factor used to calculate the maximum potential exposure, which ranges between 3 and 4, and the credit risk weight of the counterparty. The lower end of the range (*i.e.*, 4.8%) is calculated as the product between the lowest multiplication factor (*i.e.*, 3), and a credit risk weight of 20%, and 8%. The upper end of the range (*i.e.*, 48%) is calculated as the product between the highest multiplication factor (*i.e.*, 4) and a credit risk weight of 150%, and 8%.

<sup>1111</sup> Stand-alone SBSBs (including firms that also are registered as OTC derivatives dealers) are subject to Rule 18a-1, which includes a counterparty concentration charge that parallels the existing in charge in Rule 15c3-1e.

<sup>1112</sup> See section VI.A.1. of this release.

<sup>1113</sup> See *CFTC Margin Adopting Release*, 81 FR 636. In certain cases, FCMs may have to take capital charges against uncollateralized security-based swap and swap positions. See section VI.A.4.c. of this release (discussing the capital requirements for FCMs).

losses from unmonitored positions.<sup>1114</sup> Nonbank SBSBs may incur costs in documenting their risk management procedures and updating their information technology systems to meet these requirements. These costs could vary significantly among nonbank SBSBs depending on their size, the degree to which their risk management systems are already documented, and the types of business they engage in.<sup>1115</sup>

### c. Alternatives Considered

The 2012 proposal discussed the benefits and the costs of the proposed net liquid assets test capital standard for nonbank SBSBs. A number of commenters suggested several other alternatives to this standard. In this section, the Commission discusses alternative capital standards that were either proposed or suggested by commenters.

#### i. Bank Standard

One commenter argued that the bank capital standard should be used for nonbank SBSBs, and was concerned that the proposed capital requirements for nonbank SBSBs were not comparable to those proposed by other U.S. regulators and that modeling the capital standards on the broker-dealer capital standard was not appropriate.<sup>1116</sup> As discussed above in section II.A.1. of this release, the Commission has made two significant modifications to the final capital rules for nonbank SBSBs that reduce some of the differences between the final capital rules for nonbank SBSBs and the capital rules of the prudential regulators (and the CFTC). First, as discussed above in section II.A.2.b.v. of this release, the Commission has modified Rule 18a–1 so that it no longer contains a portfolio concentration charge that is triggered when the aggregate current exposure of a stand-alone SBSB to its derivatives counterparties exceeds 50% of the firm's tentative net capital.<sup>1117</sup> This means that stand-alone SBSBs that have been authorized to use models will not be subject to this limit on applying the credit risk charges to uncollateralized current exposures related to derivatives transactions. This includes uncollateralized current exposures arising from electing not to collect variation margin for non-cleared security-based swap and swap

transactions under exceptions in the margin rules of the Commission and the CFTC (which is generally consistent with the margin rules of the prudential regulators). The credit risk charges are based on the creditworthiness of the counterparty and can result in charges that are substantially lower than deducting 100% of the amount of the uncollateralized current exposure.<sup>1118</sup> This approach to addressing credit risk arising from uncollateralized current exposures related to derivatives transactions is generally consistent with the treatment of such exposures under the capital rules for banking institutions.<sup>1119</sup>

The second significant modification is the alternative compliance mechanism. As discussed above in section II.D. of this release, the alternative compliance mechanism will permit a stand-alone SBSB that is registered as a swap dealer and that predominantly engages in a swaps business to comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of complying with the Commission's capital, margin, and segregation requirements.<sup>1120</sup> The CFTC's proposed capital rules for swap dealers that are FCMs would retain the existing capital framework for FCMs, which imposes a net liquid assets test similar to the existing capital requirements for broker-dealers.<sup>1121</sup> However, under the CFTC's proposed capital rules, swap dealers that are not FCMs would have the option of complying with: (1) A capital standard based on the capital rules for banks; (2) a capital standard based on the Commission's capital requirements in Rule 18a–1; or (3) if the swap dealer is predominantly engaged in non-financial activities, a capital standard based on a tangible net worth requirement.

Notwithstanding the modification to Rule 18a–1 described above, the rule continues to be modeled in large part on the broker-dealer capital rule. For example, as is the case with Rule 15c3–1, most unsecured receivables (aside from uncollateralized current exposure relating to derivatives transactions) will not count as allowable capital. Moreover, fixed assets and other illiquid assets will not count as allowable capital. Consequently, stand-alone SBSBs subject to Rule 18a–1 (*i.e.*, firms that do not operate under the alternative compliance mechanism) will remain

subject to certain requirements designed to promote their liquidity. Additionally, broker-dealer SBSBs will be subject to Rule 15c3–1 and the stricter (as compared to Rule 18a–1) net liquid assets test it imposes.

Several factors have influenced the Commission's decision not to use a bank capital standard for nonbank SBSBs. First, a nonbank SBSB's role of dealing in security-based swaps and performing market-making activity is fundamentally different from a bank's central role of making loans and taking deposits. Second, banks have access to sources of liquidity and support that nonbank SBSBs do not have access to, such as retail deposits and central bank support. Finally, like the bank standard, the net liquid test capital standard is also risk-based, as nonbank SBSBs will be required to take capital charges that are proportionate to the risk exposures from their trading activity, and the 2% margin factor for calculating the minimum net capital requirement is tied directly to the credit risk of the nonbank SBSB's exposures from trading activity.

The adopted capital standard has a number of similarities and differences compared to the bank capital standard. Under the current bank capital standard, bank SBSBs would also have to allocate capital for their exposures with other covered entities, including other dealers. The capital that supports a bank SBSB's dealing activities in the OTC markets is determined in accordance with the prudential regulators' rules on banks' capital adequacy. These rules require that bank SBSBs calculate a risk weight amount for each of their exposures, including exposures to non-cleared security-based swaps. Furthermore, the rules require that bank SBSBs calculate an additional risk weight amount for the exposure created through the posting of initial margin to collateralize a non-cleared security-based swap. However, both of these risk weight amounts are likely to be small. The dealer's exposure to a covered-entity counterparty is collateralized by the initial margin that the counterparty has to post with a third-party custodian (for the benefit of the dealer), and the risk weight of this exposure reflects almost entirely the risk weight of the collateral—usually minimal. Similarly, by posting initial margin, the dealer creates an exposure to the third-party custodian holding the collateral. Exposures to custodian banks usually have low risk weight.

The capital that bank SBSBs have to allocate for their non-cleared security-based swaps equals the sum of the two risk weight amounts calculated above multiplied by a factor—usually 8%.

<sup>1114</sup> See Barnard Letter.

<sup>1115</sup> See section VI.C. of this release.

<sup>1116</sup> See Morgan Stanley 2/22/2013 Letter.

<sup>1117</sup> See paragraph (e)(2) of Rule 18a–1, as adopted. See also *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70244 (proposing a portfolio concentration charge in Rule 18a–1 for stand-alone SBSBs).

<sup>1118</sup> See paragraph (e)(2) of Rule 18a–1, as adopted.

<sup>1119</sup> See *OTC Derivatives Dealers*, 63 FR at 59384–87.

<sup>1120</sup> See Rule 18a–10, as adopted.

<sup>1121</sup> See *CFTC Capital Proposing Release*, 81 FR 91252.

Thus, the capital that a bank SBSB would have to allocate to support a non-cleared security-based swap is relatively small, and likely of the same order of magnitude as the capital that a nonbank SBSB would have to allocate for a similar exposure. However, unlike the nonbank SBSB, the bank SBSB still has to post away the initial margin. The posting of collateral will “consume” the bank SBSB’s capital, and gives nonbank SBSB a comparative advantage in terms of capital efficiency, to the extent their counterparty is not an entity that is required to collect initial margin from them.

While collateral posting makes dealing under a bank SBSB structure costly, the cost of funding such collateral is likely smaller for these dealers compared to nonbank SBSBs. Unlike nonbank SBSBs, bank SBSBs may have access to less costly sources of collateral funding, including deposits and central bank mechanisms.

#### ii. Harmonization with the CFTC

As discussed above in section II.A.1. of this release, several commenters argued that the Commission should harmonize its rules with the CFTC and other regulatory bodies that have finalized their capital and/or margin rules.<sup>1122</sup> One commenter suggested that the Commission coordinate with the CFTC and, as appropriate, the prudential regulators to assure that each agency’s respective capital rules are harmonized and do not have the unintended effect of impairing the ability of broker-dealers that are dually registered as FCMs to provide clearing services for security-based swaps and swaps.<sup>1123</sup> Differences between these final capital rules and any final rules adopted by the CFTC could mean that nonbank SBSBs that are also registered with the CFTC as swap dealers would need to perform two different calculations to determine whether they satisfy their respective capital standards. The difficulties and inefficiencies associated with satisfying both standards could cause some firms to separate nonbank SBSBs from nonbank swap dealers. Thus, relative to the adopted rule, an approach that prioritized greater regulatory harmonization might have mitigated the costs borne by nonbank SBSBs.

Although the Commission has declined to fully harmonize its rules with the CFTC’s proposed approach to capital for the reasons described above,

the final rules eliminate or modify many of the provisions in the proposed rules that commenters identified as posing particular challenges to firms registered as both SBSBs and swap dealers. Moreover, the alternative compliance mechanism should achieve the same benefits as full harmonization for a subset of firms that will register as SBSBs by permitting those stand-alone SBSBs that are likely to be most affected by differences between the Commission’s rules and the CFTC’s rules to comply with the capital, margin, and segregation requirements of the CEA and the CFTC’s rules (if they meet certain conditions).

#### iii. Tangible Net Worth Test

Several commenters were concerned about the differences between the risk-based capital standards used for banks, and the transaction volume based broker-dealer capital standard.<sup>1124</sup> One commenter suggested that the Commission apply a tangible net worth test to nonbank SBSBs, claiming that it is “particularly appropriate for entities that have not been prudentially regulated before and effectively protects against any losses in the event of a potential liquidation.”<sup>1125</sup>

As mentioned in section II.A.1., the Commission believes that a tangible net worth test would give incentives to nonbank SBSBs to hold illiquid, higher yielding assets to meet the requirement, which would undermine the Commission’s goal of promoting liquidity for SBSBs. In addition, a nonbank SBSB will not also have the support of retail deposits or central bank support. Thus, the Commission is adopting the broker-dealer capital standard for nonbank SBSBs.

#### iv. Standardized Haircuts for Cleared Security-Based Swap and Swap Positions

The Commission proposed that the standardized haircuts for cleared and non-cleared security-based swaps be calculated the same way. The proposed standardized haircut for a CDS was determined using one of two maturity grids: one for a CDS that is a security-based swap and the other for a CDS that is a swap.<sup>1126</sup> For a security-based swap that is not a CDS, the proposed standardized haircuts required multiplying the notional amount of the security-based swap by the amount of the standardized haircut that applied to the underlying position pursuant to the

pre-existing provisions of Rule 15c3–1.<sup>1127</sup> In addition, under the proposal, firms authorized to use internal models were allowed to use model-based haircuts instead of the standardized haircuts.

The final capital rules differ from the proposed rules in terms of how broker-dealers and nonbank SBSBs must calculate standardized haircuts for cleared security-based swaps and swaps. Namely, the Commission is modifying the proposed standardized haircut requirements for cleared security-based swaps and swaps to require that the amount of the deduction will be the amount of margin required by the CCP where the position is cleared.<sup>1128</sup> However, an ANC broker-dealer and stand-alone SBSB authorized to use a model can calculate model-based haircuts instead of standardized haircuts for positions for which the firm has been approved to use the model.

As an alternative to the final capital rules, the Commission could have taken the proposed approach with respect to standardized haircuts for cleared security-based swaps and swaps. The Commission analyzes below the economic impact of this alternative. Requiring SBSBs to take the proposed standardized haircuts for cleared proprietary security-based swap and swap positions could create a larger capital buffer against the market risk of a cleared position if the proposed standardized haircuts were more conservative than the margin requirements of the CCPs. As a result, the proposed approach could increase the safety and soundness of SBSBs, which would benefit the market participants in the security-based swap and swap markets, all things being equal. At the same time, however, to the extent the proposed standardized haircuts were more conservative, generally, than the margin requirements of the CCPs, the proposed approach would have resulted in relatively higher capital requirements for cleared security-based swap and swap positions. This could have discouraged broker-dealers and nonbank SBSBs from engaging in cleared security-based swap and swap transactions if the firms believed their capital could be deployed more profitably. Alternatively, nonbank SBSBs would likely have passed the costs associated higher capital requirements under this alternative to

<sup>1127</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70234–36.

<sup>1128</sup> See paragraph (c)(2)(vi)(O) of Rule 15c3–1, as amended; paragraph (b)(1) of Rule 15c3–1b, as amended; paragraph (c)(1)(vi)(A) of Rule 18a–1, as adopted; paragraph (b)(1) of Rule 18a–1b, as adopted.

<sup>1122</sup> See Citadel 11/19/18 Letter; Financial Services Roundtable Letter; FIA 11/19/2018 Letter; Morgan Stanley 11/19/2018 Letter.

<sup>1123</sup> See FIA 11/19/2018 Letter.

<sup>1124</sup> See section II.A.1. of this release.

<sup>1125</sup> See Sutherland Letter.

<sup>1126</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70232–34, 70248–49.

their customers, increasing the relative costs of cleared transactions.

Adopting standardized haircuts based on clearing agency and DCO margin requirements is consistent with the treatment of futures products and potentially consistent with the standardized haircuts the CFTC ultimately will adopt. Differences in the capital treatment of these positions under the Commission's and the CFTC's rules could have caused broker-dealers and nonbank SBSDs to be subject to overlapping regulatory regimes if they were registered as FCMs or swap dealers in terms of calculating standardized haircuts for cleared security-based swaps and swaps. This could have imposed costs on broker-dealers and SBSDs if the proposed standardized haircuts were larger than the margin amount required by the CCP where the position is cleared. These costs could have further reduced the incentives of broker-dealers and nonbank SBSDs to clear security-based swap and swap positions.

Finally, cleared security-based swaps and swaps differ from non-cleared security-based swaps and swaps in ways that could have made the capital charges using the proposed standardized haircuts for cleared security-based swaps and swaps inappropriately high. In particular, as counterparties to cleared OTC derivatives contracts, CCPs must meet risk management standards that support the orderly liquidation of portfolios in the event of clearing member default and mitigate the risk of CCP default. In addition, regulatory standards as well as private incentives encourage CCPs to offer to clear products that are sufficiently liquid to enable CCPs to replace positions they hold against defaulting members without substantial price impact.

#### v. 1% Minimum Standardized Haircut for Interest Rate Swaps

Under the final rules being adopted today, the standardized haircuts for non-cleared interest rate swaps are determined using the maturity grid for U.S. government securities in paragraph (c)(2)(vi)(A) of Rule 15c3-1.<sup>1129</sup> Moreover, the standardized haircuts for non-cleared security-based swaps and swaps (other than CDS) being adopted today permit a broker-dealer and nonbank SBSD to reduce the deduction by an amount equal to any reduction recognized for a comparable long or short position in the reference security

under the standardized haircuts in Rule 15c3-1.<sup>1130</sup> The standardized haircuts in paragraph (c)(2)(vi)(A) of Rule 15c3-1 permit a broker-dealer to take a capital charge on the net long or short position in U.S. government securities that are in the same maturity categories in the rule. This treatment will apply to interest rate swaps. The standardized haircut for non-cleared interest rate swaps can be no less than  $\frac{1}{8}$  of 1% of a long position that is netted against a short position in the case of a non-cleared swap with a maturity of 3 months or more.<sup>1131</sup> The standardized haircuts in paragraph (c)(2)(vi)(A) of Rule 15c3-1 require a 0% haircut for the unhedged amount of U.S. government securities that have a maturity of less than 3 months. Therefore, the standardized haircuts for interest rate swaps will treat hedged and unhedged positions with maturities of less than 3 months identically in that there will be no haircut applied to the positions. The minimum standardized haircut for hedged interest rate swaps with a maturity of 3 months or more will be  $\frac{1}{8}$  of 1%.

The proposed haircut for interest rate swaps had a floor of 1% (whereas U.S. government securities with a maturity of less than 9 months are subject to haircuts of  $\frac{3}{4}$  of 1%,  $\frac{1}{2}$  of 1%, or 0% depending on the time to maturity). The proposed 1% floor is an alternative to the minimum standardized haircut for non-cleared interest rate swaps in the final rules. A commenter opposed the proposed 1% minimum standardized haircut for interest rate swaps as being too severe.<sup>1132</sup> Based on an analysis of sample positions, this commenter believed that the proposed 1% minimum standardized haircut would result in market risk charges that are nearly 35 times higher than charges without the 1% minimum.<sup>1133</sup>

The Commission is persuaded that the 1% minimum haircut was too conservative, particularly when applied to tightly hedged positions such as those in the commenter's examples. A minimum standardized haircut for non-cleared interest rate swaps that was too conservative could have unduly increased the transaction costs of broker-dealers and nonbank SBSDs that engage in these types of swaps. To the extent that these entities passed on

these increased costs to their customers in the form of higher prices to liquidity provision, the ability of their customers to use interest rate swaps for risk mitigation could have been impaired. In addition, by raising their prices for liquidity provision, broker-dealers and nonbank SBSDs could have become less competitive than other liquidity providers that are not subject to the Commission's capital rules.

However, the Commission continues to believe that a minimum haircut should be applied to non-cleared interest rate swaps. A minimum haircut for non-cleared interest rate swaps will help enhance the safety and soundness of broker-dealers and nonbank SBSDs by reducing their incentives to engage in excessive risk-taking, by increasing their ability to withstand losses from their trading activity, and by reducing the risk of sequential counterparty failure. It also will account for potential differences between the movement of interest rates on U.S. government securities and interest rates upon which the non-cleared interest rate swap payments are based. The Commission believes the final rules for standardized haircuts for non-cleared security-based swaps strike an appropriate balance in terms of addressing commenters' concerns that the proposed minimum was too conservative and the objective of enhancing the safety and soundness of nonbank SBSDs. Thus, the Commission believes that the adopted approach is preferable to the alternative.

#### vi. Same Control and Opinion of Counsel Conditions for Avoiding Capital Charge When Collateral is Held by an Independent Third-Party Custodian as Initial Margin

The Commission asked in the 2018 comment reopening whether there should be an exception to taking the deduction for initial margin collateral held by an independent third-party custodian pursuant to Section 3E(f) of the Act or Section 4s(l) of the CEA under conditions that promote the SBSD's ability to promptly access the collateral if needed.<sup>1134</sup> Specifically, the Commission sought comment on whether there should be such an exception under the following conditions: (1) The custodian is a bank; (2) the nonbank SBSD enters into an agreement with the custodian and the counterparty that provides the nonbank SBSD with the same control over the collateral as would be the case if the nonbank SBSD controlled the collateral

<sup>1129</sup> See paragraph (b)(2)(ii)(A)(3) of Rule 15c3-1b, as amended; paragraph (b)(2)(ii)(A)(3) of Rule 18a-1b, as adopted.

<sup>1130</sup> See paragraph (c)(2)(vi)(P)(2) of Rule 15c3-1, as amended; paragraph (b)(2)(ii)(B) of Rule 15c3-1b, as amended; paragraph (c)(1)(vi)(B)(2) of Rule 18a-1, as adopted; paragraph (b)(2)(ii)(B) of Rule 18a-1b, as adopted.

<sup>1131</sup> See paragraph (b)(2)(ii)(A)(3) of Rule 15c3-1b, as amended; paragraph (b)(2)(ii)(A)(3) of Rule 18a-1b, as adopted.

<sup>1132</sup> See SIFMA 2/22/2013 Letter.

<sup>1133</sup> See SIFMA 11/19/2018 Letter.

<sup>1134</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53011-12.

directly; and (3) an opinion of counsel deems the agreement enforceable.

As discussed above in section II.A.2.b.ii. of this release, the Commission agrees with commenters that the “same control” language could create practical obstacles that would make it difficult to execute an account control agreement that would be sufficient to avoid the capital charge when initial margin is held by a third-party custodian. Moreover, even if such an agreement could be executed, existing agreements that are in place in accordance with the third-party custodian and documentation requirements of the CFTC and the prudential regulators likely would need to be re-drafted to meet the requirements of the potential condition. Doing so would be a costly and burdensome process. Some commenters opposed the condition requiring a legal opinion of outside counsel on the basis of cost and impracticability, arguing it is inconsistent with market practice and operationally burdensome to implement. The Commission acknowledges that requiring an opinion of counsel could have been a costly burden. To the extent that the counterparties of nonbank SBSDs bore at least part of the costs associated with the re-drafting of account control agreements and the acquisition of an opinion of counsel, they would have incurred higher costs in transacting in the security-based swap market, which could have reduced their participation in this market. These effects could have been strengthened if the nonbank SBSDs bore part of the costs associated with the re-drafting of account control agreements and the acquisition of an opinion of counsel, and passed on those costs to their counterparties in the form of higher prices for liquidity provision. In light of these concerns, the Commission believes that the adopted approach is preferable to this alternative.

vii. Requiring a Nonbank SBSD To Take a Capital Deduction for the Margin Difference

The Commission proposed a deduction that applied if a nonbank SBSD collects margin 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.*, the collected margin was less than the amount of the standardized or model-based haircuts, as applicable).<sup>1135</sup> This proposed

requirement was designed to account for the risk of the counterparty defaulting by requiring the nonbank SBSD to maintain capital in the place of collateral in an amount that is no less than required for a proprietary position. It also was designed 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. In the 2018 comment reopening, the Commission asked whether this proposed rule change should be modified to include a risk-based threshold under which the deduction need not be taken, and provided modified rule text to apply the deduction to cleared swap transactions.<sup>1136</sup>

In light of comments received and for reasons discussed further below, the final rules will not require a nonbank SBSD to deduct the margin difference for each account it carries that holds cleared security-based swaps or swaps. Consequently, this approach is analyzed below as an alternative.

As discussed above in section II.A.2.b.ii. of this release, commenters raised a number of concerns with the proposed capital deduction for the difference between the haircuts and CCP margin requirements for cleared security-based swaps and swaps and with potential threshold discussed in the 2018 comment reopening. In light of these concerns, the Commission has supplemented the analysis of the capital deduction in the proposing release<sup>1137</sup> by analyzing the potential direct costs associated with the capital charge for the margin difference for each account carried by the nonbank SBSD that holds cleared security-based swaps or swaps. To estimate the capital charge under this alternative, Commission staff examined initial margin requirements<sup>1138</sup> for customer accounts carried by 11 registered broker-dealers<sup>1139</sup> that hold cleared security-

based swap and swap positions. The Commission staff also reviewed initial margin requirements for a range of hypothetical single-name and index CDS that were calculated using clearing agency initial margin methodology<sup>1140</sup> and ISDA’s SIMM™ model. Assuming that the SIMM™ model initial margin calculations reasonably approximate the initial margin requirements that would apply if the hypothetical security-based swap and swap positions were proprietary, the resulting margin difference—expressed as a ratio of the SIMM™ initial margin requirements to the clearing agency initial margin requirements—ranges from a minimum of 0.57 to a maximum of 2, depending on the direction of the hypothetical security-based swap and swap positions.<sup>1141</sup> Commission staff applied these ratios to the initial margin requirements for customer accounts to estimate an upper bound for the capital charge. At the maximum ratio of 2, the aggregate capital charge would be \$4,644.55 million<sup>1142</sup> or 422.23 million<sup>1143</sup> per broker-dealer.

Under this alternative, nonbank SBSDs would likely have passed on the costs associated with this capital charge to their clients, either in the form of higher prices or by demanding that clients post collateral in excess of the amounts set by the CCPs. As a result, the proposed capital charge may have increased the cost of clearing security-based swaps or swaps for market participants who wish to clear such transactions through nonbank SBSDs. Instead of passing on costs associated with the capital charge to clients, nonbank SBSDs may have chosen to limit their client clearing services to those security-based swap and swap products that are less likely to attract the capital charge. These responses from nonbank SBSDs may have reduced the incentive of market participants to engage in centrally cleared security-

are entities that will likely register as SBSDs or are affiliated with entities that will likely register as SBSDs.

<sup>1140</sup> This is the initial margin methodology of the clearing agency that provided the initial margin requirements examined by Commission staff.

<sup>1141</sup> A ratio of 0.57 for a position means that the associated SIMM™ initial margin requirement is 57% of the associated clearing agency initial margin requirement. Conversely, a ratio of 2 means that the SIMM™ initial margin requirement is 200% of the clearing agency initial margin requirement. When the ratio is greater than 1, there would be a capital charge under this alternative.

<sup>1142</sup> The aggregate capital charge is calculated as \$4,644.55 million (total initial margin requirements for customer accounts) × (2 – 1) = \$4,644.55 million.

<sup>1143</sup> The capital charge per registered broker-dealer is calculated as \$4,644.55 million / 11 registered broker-dealers = \$422.23 million.

<sup>1135</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 7045–47.

<sup>1136</sup> See *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53009. More specifically, the Commission requested comment on whether the rule should provide that the deduction need not be taken if the difference between the clearing agency margin amount and the haircut is less than 1% (or some other amount) of the SBSD’s tentative net capital, and less than 10% (or some other amount) of the counterparty’s net worth, and the aggregate difference across all counterparties is less than 25% (or some other amount) of the counterparty’s tentative net capital.

<sup>1137</sup> See *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70312–13.

<sup>1138</sup> These initial margin requirements were calculated as of October 2, 2017, based on clearing agency data.

<sup>1139</sup> These 11 registered broker-dealers are clearing members of a CCP. These broker-dealers

based swap or swap transactions.<sup>1144</sup> Further, CCPs are generally required to meet minimum margin standards under the rules of most jurisdictions. These minimum standards—to the extent they prohibit a “race to the bottom” by a CCP in terms of the margin it requires from clearing members—would limit the likelihood of a margin difference and the associated capital deduction.

While the proposed capital deduction would have imposed a cost on nonbank SBSBs and ultimately, their clients, the Commission acknowledges it could have enhanced the safety and soundness of nonbank SBSBs, and in turn promoted financial stability. Indeed, absent this proposed requirement, a nonbank SBSB may collect margin from the client that is just enough to satisfy the CCP’s margin requirements. This CCP-bound margin may not always adequately capture the risk of the position, relative to the margining standards of nonbank SBSBs. For example, if CCPs weaken their margin standards as a way to compete among themselves, and, if this competition turns into a “race to the bottom,” the initial margin that a CCP would assess at the outset of a trade would have to reflect, in part, this competitive pressure and, as a result, may not adequately capture the risk of the cleared position.<sup>1145</sup> Because the nonbank SBSB would have to fulfil any CCP-bound margin calls that the insolvent client was not able to fulfill, resulting in an unexpected draw on the nonbank SBSB’s capital, the proposed requirement was intended to provide a capital buffer (in the form of a capital

deduction for the margin difference) against such potential losses, potentially allowing the nonbank SBSB to better withstand a client default. The main beneficiaries of the enhanced safety and soundness of the nonbank SBSB as a result of the requirement would have been market participants, in particular those market participants that employ the services of the nonbank SBSB.

## 2. The Capital Rule for Nonbank MSBSPs—Rule 18a–2

As discussed above in section II.A.3. of this release, Rule 18a–2 will prescribe capital requirements for nonbank MSBSPs that are not also registered as broker-dealers and will require them to hold at all times positive tangible net worth. Nonbank MSBSPs are also required to comply with Rule 15c3–4 with respect to their security-based swap and swap activities.

### a. Benefits and Costs of the Capital Rule for Nonbank MSBSPs

The entities that are expected to register as nonbank MSBSPs typically engage in both security-based swap activities and other business activities. These other business activities could be commercial in nature (e.g., manufacturing, energy, transportation), and require that firms pre-commit capital in advance (i.e., capital that is generally not liquid). In contrast, security-based swap activities (like other securities activities) are more opportunistic in nature and require liquid capital.

The requirement that nonbank MSBSPs maintain positive tangible net worth will allow these entities to offset losses in their security-based swap positions with capital that is tied to other business activities. In particular, a nonbank MSBSP does not need to hold liquid capital beyond what is necessary to support its security-based swap activities. Since capital tied to other business activities counts toward regulatory capital, the requirement should result in more efficient use of capital, which would be a clear benefit for nonbank MSBSPs.

While the requirement may allow a nonbank MSBSP to engage in security-based swap activities without having to reallocate its capital inefficiently, it may also lead to situations where the nonbank MSBSP may fail to be compliant with the final margin rule and, thereby, create risk for counterparties that rule is designed to protect. Under Rule 18a–3, as adopted, a nonbank MSBSP is required to post collateral to cover current exposure of counterparties to the nonbank SBSB if the transaction is not subject to an

exception in the rule. Consider a situation where a nonbank MSBSP has losses on its non-cleared security-based swap positions (i.e., gains for the counterparty) that are in excess of its liquid capital. If its productive capital cannot be liquidated right away, then the nonbank MSBSP may not have collateral available to post to the counterparty to cover the counterparty’s current exposure to the nonbank SBSB. In this case, the nonbank SBSB would be in violation of Rule 18a–3, as adopted, and, as a consequence, the counterparty with the gains would be at risk.

However, as discussed above, Rule 18a–2, as adopted, has a provision that requires nonbank MSBSPs to comply with Rule 15c3–4. To the extent that a nonbank MSBSP has effective risk management controls in place, it should be able limit the number of situations where potential losses on its positions exceed its buffer of liquid capital.

### b. Alternatives Considered

An alternative to the positive tangible net worth standard is the net liquid assets test standard. The main difference between these two approaches is that under the former nonbank MSBSPs are allowed to count capital tied to other business activities towards regulatory capital, while under the latter they are not to the extent the capital is illiquid. Thus, the net liquid assets test standard is substantially more conservative as nonbank MSBSPs would now need to set aside more liquid capital to support their non-cleared security-based swap trading activities. To the extent that nonbank MSBSPs obtain their liquid capital by scaling down their business activities, the alternative leads to less efficient allocation of capital and imposes significant costs on nonbank MSBSPs.

## 3. The Margin Rule—Rule 18a–3

### a. Overview

As discussed above in section II.B.1. of this release, Rule 18a–3, as adopted, will establish margin requirements for nonbank SBSBs and nonbank MSBSPs with respect to transactions with counterparties in non-cleared security-based swaps.

### i. Nonbank SBSBs

Rule 18a–3 prescribes margin requirements for nonbank SBSBs with respect to non-cleared security-based swaps. The rule requires a nonbank SBSB to perform two calculations with respect to each account of a counterparty as of the close of business each day: (1) The amount of current exposure in the account of the

<sup>1144</sup> This reduction in the incentives to clear a security-based swap or a swap transaction may have been limited by a number of factors, including but not limited to: (1) Any mandatory clearing determinations for security-based swaps by the Commission under Section 763(a) of the Dodd-Frank Act; (2) any mandatory clearing determinations for swaps by the CFTC under Section 723(a) of the Dodd-Frank Act; (3) the margin requirements for non-cleared security-based swaps and swaps; (4) the segregation regime of initial margin posted by the customer to collateralize a non-cleared security-based swap or swap; and (5) the presence of financial market intermediaries that are clearing members and that are not directly subject to the requirements of the proposed capital rule and amendments (e.g., banks).

<sup>1145</sup> Market participants have often raised concerns about the adverse effects of a race to the bottom in initial margin standards among CCPs. See, e.g., Futures & Options World (FOW), *OTC Derivatives Clearing Roundtable*. There is also some preliminary evidence of the adverse effects of competition on margin standards among CCPs in the futures markets. See Nicole Abbruzzo and Yang-Ho Park, *An Empirical Analysis of Futures Margin Changes: Determinants and Policy Implications*, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board (2014–86), available at <https://www.federalreserve.gov/econresdata/feds/2014/files/201486pap.pdf>.

counterparty (also known as variation margin); and (2) the initial margin amount for the account of the counterparty (also known as potential future exposure or initial margin). Variation margin is calculated by marking the position to market. Initial margin must be calculated by applying the standardized haircuts prescribed in Rule 15c3-1 or Rule 18a-1 (as applicable). However, a nonbank SBSB may apply to the Commission for authorization to use a model (including an industry standard model) to calculate initial margin. Broker-dealer SBSBs must use the standardized haircuts (which include the option to use the more risk sensitive methodology in Appendix A to Rule 15c3-1) to compute initial margin for non-cleared equity security-based swaps (even if the firm is approved to use a model to calculate initial margin). Stand-alone SBSBs may use a model to calculate initial margin for non-cleared equity security-based swaps (and potentially equity swaps if portfolio margining is implemented by the Commission and CFTC), provided the account of the counterparty does not hold equity security positions other than equity security-based swaps (and potentially equity swaps).

Rule 18a-3 requires a nonbank SBSB to collect collateral from a counterparty to cover a variation and/or initial margin requirement. The rule also requires the nonbank SBSB to deliver collateral to the counterparty to cover a variation margin requirement. The collateral must be collected or delivered by the close of business on the next business day following the day of the calculation, except that the collateral can be collected or delivered by the close of business on the second business day following the day of the calculation if the counterparty is located in another country and more than four time zones away. Further, collateral to meet a margin requirement must consist of cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold. The fair market value of collateral used to meet a margin requirement must be reduced by the standardized haircuts in Rule 15c3-1 or 18a-1 (as applicable), or the nonbank SBSB can elect to apply the standardized haircuts prescribed in the CFTC's margin rules. The value of the collateral must meet or exceed the margin requirement after applying the standardized haircuts. In addition, collateral being used to meet a margin requirement must meet conditions specified in the rule, including, for example, that it must have a ready

market, be readily transferable, and not consist of securities issued by the nonbank SBSB or the counterparty.

There are exceptions in Rule 18a-3 to the requirements to collect initial and/or variation margin and to deliver variation margin. A nonbank SBSB need not collect variation or initial margin from (or deliver variation margin to) a counterparty that is a commercial end user, the BIS, the European Stability Mechanism, or a multilateral development bank identified in the rule. Similarly, a nonbank SBSB need not collect variation or initial margin (or deliver variation margin) with respect to a legacy account (*i.e.*, an account holding security-based swaps entered into prior to the compliance date of the rule). Further, a nonbank SBSB need not collect initial margin from a counterparty that is a financial market intermediary (*i.e.*, an SBSB, a swap dealer, a broker-dealer, an FCM, a bank, a foreign broker-dealer, or a foreign bank) or an affiliate. A nonbank SBSB also need not hold initial margin directly if the counterparty delivers the initial margin to an independent third-party custodian. Further, a nonbank SBSB need not collect initial margin from a counterparty that is a sovereign entity if the nonbank SBSB has determined that the counterparty has only a minimal amount of credit risk.

The rule also has a threshold exception to the initial margin requirement. Under this exception, a nonbank SBSB need not collect initial margin to the extent that the initial margin amount when aggregated with other security-based swap and swap exposures of the nonbank SBSB and its affiliates to the counterparty and its affiliates does not exceed \$50 million. The rule also would permit an SBSB to defer collecting initial margin from a counterparty for two months after the month in which the counterparty does not qualify for the \$50 million threshold exception for the first time. Finally, the rule has a minimum transfer amount exception of \$500,000. Under this exception, if the combined amount of margin required to be collected from or delivered to a counterparty is equal to or less than \$500,000, the nonbank SBSB need not collect or deliver the margin. If the initial and variation margin requirements collectively or individually exceed \$500,000, collateral equal to the full amount of the margin requirement must be collected or delivered.

#### ii. Nonbank MSBSPs

Rule 18a-3 also prescribes margin requirements for nonbank MSBSPs with respect to non-cleared security-based

swaps. The rule requires a nonbank MSBSP to calculate variation margin for the account of each counterparty as of the close of each business day. The rule requires the nonbank MSBSP to collect collateral from (or deliver collateral to) a counterparty to cover a variation margin requirement. The collateral must be collected or delivered by the close of business on the next business day following the day of the calculation, except that the collateral can be collected or delivered by the close of business on the second business day following the day of the calculation if the counterparty is located in another country and more than four time zones away. Further, the variation margin must consist of cash, securities, money market instruments, a major foreign currency, the security of settlement of the non-cleared security-based swap, or gold. The rule has an exception pursuant to which the nonbank MSBSP need not collect variation margin if the counterparty is a commercial end user, the BIS, the European Stability Mechanism, or one of the multilateral development banks identified in the rule (there is no exception from delivering variation margin to these types of counterparties). The rule also has an exception pursuant to which the nonbank MSBSP need not collect or deliver variation margin with respect to a legacy account. There also is a \$500,000 minimum transfer amount exception to the collection and delivery requirements for nonbank MSBSPs.

#### b. Benefits and Costs of the Margin Rule

As noted earlier, the market for non-cleared security-based swaps as it exists today is fairly opaque. Market participants have little or no knowledge about a dealer's uncollateralized exposure to a failed counterparty and the dealer's ability to withstand potential losses from such exposure. When a dealer fails, uncertainty about the uncollateralized exposures of the surviving dealers to the failed dealer and their safety and soundness may discourage some market participants from entering transactions with the surviving dealers. In turn, this uncertainty may hinder the efficient allocation of capital in this market.

In the market for non-cleared security-based swaps and in the market for OTC derivatives generally, collateral is the means for mitigating counterparty credit risk.<sup>1146</sup> Counterparties can collateralize a transaction by exchanging variation and initial margin. The regular exchange of variation margin between counterparties limits the potential for

<sup>1146</sup> See section VI.A.5. of this release.



one party in an OTC derivative transaction to build up a large “current exposure” to the other. The current exposure of counterparty A to counterparty B is the amount that counterparty B would be obligated to pay counterparty A if all the OTC derivatives contracts between the two parties were terminated (*i.e.*, it is the net amount of the current receivable from counterparty B). A positive current exposure of counterparty A to counterparty B implies a zero current exposure of counterparty B to counterparty A. The exchange of variation margin between two parties represents the settlement of profits and losses resulting from some subset of derivative transactions between those parties.

In the absence of significant market frictions and under suitable conditions, requiring the exchange of variation margin at a suitably high frequency can limit the probability that a counterparty exposure grows beyond a set level.<sup>1147</sup> However, in many instances, this may not be the case. In particular, market frictions in the CDS market, especially in times of stress, can result in liquidity shortages that prevent timely replacement of defaulted CDS positions. Delays in the replacement of such defaulted positions or closing out the positions can lead to losses for the non-defaulting party. Moreover, the occurrence of unexpected credit-related events at the reference entity can precipitate a counterparty default. For example, a seller of credit protection may itself enter financial distress as a result of a downgrade of the reference entity. Under such conditions, the exchange of variation margin may—by itself—be inadequate at limiting counterparty credit risk as unexpected credit events at the reference entity can contribute to both the development of current exposures to a counterparty and its default.

Such concerns provide the economic rationale for requiring initial margin. The exchange of initial margin is intended to limit “potential future exposures” (*i.e.*, losses resulting from

the costs of replacing transactions with a failed counterparty). The potential future exposure of counterparty A to counterparty B is an estimate of the amount that the current exposure of counterparty A to counterparty B could increase before the position can be liquidated in the event of B’s default. Generally, both parties in an OTC derivatives transaction will have positive potential future exposures to each other. By collecting initial margin amounts to cover these potential future exposures, market participants can reduce the costs associated with re-establishing their positions with a failed counterparty.

However, initial margin may be less effective in circumstances where the prevalent market practice is to not exchange initial margin and where there is no regulatory requirement that market participants do so. If only a limited number of inter-dealer exposures are collateralized with initial margins, and absent a capital regime for dealers that is sufficiently conservative to cover losses from positions that are not collateralized with initial margin, the failure of one dealer may still trigger the sequential failure of other dealers. Uncertainty about the uncollateralized exposures of the surviving dealers to the failed dealer and their ability to withstand losses from such exposures may erode the confidence of market participants in the safety and soundness of the surviving dealers. In times of stress, this uncertainty may cause the market to break down; market participants may suddenly “run” on the surviving firms due to uncertainty about their uncollateralized exposure to the failed dealer.

Thus, if the exchange of initial margin is not an adopted market practice or is not mandated by regulation, or if capital requirements for dealers are not sufficiently conservative to cover losses from positions that are not collateralized with initial margin, market participants may face additional uncertainty about the safety and soundness of the surviving dealers, which, in times of stress, may lead to a market shutdown.

A number of commenters argue that an approach based on the exchange of initial margin may prevent an inappropriate build-up of systemic risk within the financial system, which they argue would be more consistent with the intent of the Dodd-Frank Act.<sup>1148</sup> A commenter argued that it would be inappropriate to allow a nonbank SBSD

to have non-cleared security-based swap exposure to another SBSD without any requirement to collect initial margin or to take a capital charge to recognize the risk in the non-cleared security-based swap and in the counterparty.<sup>1149</sup> Other commenters noted that the prudential regulators have explicitly required bank SBSDs to collect initial margin from other SBSDs and argued that the Commission should do so as well, and that the Commission should maximize harmonization with rules already implemented by the CFTC and the prudential regulators.<sup>1150</sup> Finally, one commenter criticized the Commission for making these proposals despite the fact that insufficient margin and capital were two of the triggers of the financial crisis.<sup>1151</sup>

The Commission agrees with the commenters that allowing dealers to enter non-cleared security-based swap exposures without having to collect initial margin or take a capital deduction for the credit risk of exposure may increase risk in the financial system, which may increase the risk of sequential dealer failure. This is why the final capital rules impose a capital deduction or credit risk charge when a nonbank SBSD elects not to collect initial margin under an exception in the Commission’s final margin rule or the margin rules of the CFTC. In addition, there is a trade-off in terms of the benefits of requiring a nonbank SBSD to collect initial margin from another financial market intermediary: Namely, the liquidity of the delivering firm is reduced by the amount of initial margin posted to the nonbank SBSD. Thus, while the initial margin collected by the nonbank SBSD enhances the firm’s safety and soundness, the delivery of liquid capital by the other financial market intermediary diminishes that firm’s safety and soundness because it cannot use the delivered liquid capital to protect itself from losses or to meet liquidity demands.

Moreover, the final margin rule is intended to enhance the safety and soundness of nonbank SBSDs in the market for non-cleared security-based swaps by reducing the uncertainty about uncollateralized exposures to a failed counterparty. The requirement to exchange variation margin is intended to reduce a nonbank SBSD’s potential losses stemming from uncollateralized market risk exposures, and the risk of nonbank SBSD failure as a result of

<sup>1147</sup> This follows under the assumption of, among other things, frictionless markets in which a defaulted position can be immediately replaced. In other words, if frequent exchange of variation margin guarantees that a market participant has collected enough margin to replace an outstanding position, markets for collateral assets are sufficiently liquid to permit sales with no price impact, and derivatives markets are sufficiently liquid to permit replacement of an outstanding position with no price impact, the market participant would be indifferent to whether her counterparty defaults or not, because she would be able to replace her outstanding position with the counterparty instantly without taking on any market risk.

<sup>1148</sup> See Americans for Financial Reform Education Letter; Barnard Letter; Citadel 11/19/2018 Letter; Council for Institutional Investors Letter.

<sup>1149</sup> See OneChicago 2/19/2013 Letter.

<sup>1150</sup> See Americans for Financial Reform Education Fund Letter; Citadel 11/19/2018 Letter; Rutkowski 11/20/2018 Letter.

<sup>1151</sup> See Better Markets 11/19/2018 Letter.

these potential losses. Further, the requirement that nonbank SBSBs collect initial margin from their counterparties that are not subject to an exception to the margin rule is intended to reduce a nonbank SBSB's potential losses stemming from uncollateralized credit risk exposures, and therefore reduce the risk of nonbank SBSB failure as a result of these potential losses.

However, the final margin rule includes a number of exceptions to the requirement that nonbank SBSBs collect variation and/or initial margin from counterparties, such as the exception from the requirement to collect variation or initial margin in transactions with commercial end users and the exception from the requirement to collect initial margin in transactions with other financial market intermediaries. The Commission acknowledges, however, as noted by a number of commenters, that financing additional collateral can also impose certain costs on parties in non-cleared security-based swap transactions, as well as potentially reduce liquidity in that market. In cases where an exception to the final margin rule applies and nonbank SBSBs have uncollateralized exposures from security-based swap transactions, the final capital rules and amendments require nonbank SBSBs to take capital deductions or credit risk charges against such uncollateralized exposures. While this approach may leave nonbank SBSBs with residual uncollateralized exposures, because capital deductions and credit risk charges against uncollateralized credit exposures can be much lower than the initial margin appropriate for such exposures, this approach may benefit nonbank SBSBs and market participants more generally, by supporting nonbank SBSB liquidity provision and promoting the liquidity and therefore the safety and soundness of nonbank SBSBs to the extent it relieves them from having to post initial margin to other nonbank SBSBs.

As described in the baseline, reliable information about counterparty exposures in the non-cleared security-based swap market is not currently publicly observable. Because market participants generally lack reliable information about their counterparty's exposure to a failed dealer or major participant, the failure of a dealer or major participant in these markets can lead to questions about the continued viability of other firms. It is generally not possible for market participants to reliably estimate the size of other participants' exposures to a failing firm. Uncertainty can cause market participants to cease trading with participants suspected of having had

large exposures to the failed entity. This can precipitate the demise of suspect firms. By constraining uncollateralized counterparty exposures, margin requirements reduce the likelihood of sequential dealer failure.

To reduce these exposures, the final rule requires nonbank SBSBs to collect variation margin on a daily basis from other financial market intermediaries, including other SBSBs. Under the baseline, non-cleared security-based swap transactions are typically covered by agreements outlining the rights of the parties to make margin calls; however, such agreements may not require the contracting parties to exchange variation margin on a daily basis.<sup>1152</sup> Therefore, dealers may defer making margin calls during relatively benign market conditions, and make margin demands only when conditions deteriorate or when doubts about specific counterparties surface. This can destabilize markets and lead to contagion. By requiring daily collection or delivery of variation margin in inter-dealer trades, the final rule will limit the buildup of uncollateralized inter-dealer exposures. This will help ensure that, at all times, the immediate losses of a nonbank SBSB resulting from its non-cleared security-based swap exposures to a failing financial market intermediary are limited to a one-day change in the value of its positions with the failing firm.<sup>1153</sup>

While the inter-dealer exchange of variation margin may reduce the immediate losses from exposure to a failed dealer, this form of collateralization is usually not enough to isolate a dealer against potential losses from re-establishing or closing out the positions with a failed dealer. As noted earlier, such losses are usually covered by initial margin. The final margin rule does not require nonbank SBSBs to collect initial margin from other financial market intermediaries, including other SBSBs. While the rule does not preclude nonbank SBSBs from collecting initial margin from other financial market intermediaries, in general, the Commission does not expect most inter-dealer transactions to be collateralized with initial margin. However, as discussed above in section II.A.2.b.ii. of this release, the final capital rules will require nonbank SBSBs to take a capital deduction or credit risk charge for these inter-dealer

uncollateralized exposures. In addition, the final capital rules require dealers to increase their minimum net capital by a factor proportional to the initial margin that would cover such exposures (when the margin factor amount equals or exceeds its fixed-dollar requirement). The additional capital that a surviving nonbank SBSB will have to allocate to support inter-dealer transactions that are not collateralized with initial margin will act as a buffer against potential losses from replacing or closing out the positions with a failed firm, and reduce the surviving nonbank SBSB's risk of default. To this end, while surviving nonbank SBSBs may still incur losses from replacing or closing out positions with defaulting counterparties that were not collateralized with initial margin, the final capital rules are designed to reduce the likelihood that such losses will lead to their failure. Thus, the final capital rules complement the margin requirements to limit the risk of sequential dealer failure in this market. By reducing the uncertainty about uncollateralized exposures to a failed dealer, and by reducing the risk of sequential dealer failure, the margin requirements together with the capital requirements should enhance the safety and soundness of the dealers in times of stress. Further, as discussed above, the exception from collecting initial margin from other financial market intermediaries involves a trade-off between the benefits that initial margin provides the collecting firm and the costs (including the loss of liquid capital) that such a requirement imposes on the delivering firm.

While the scale of the above benefits is difficult to quantify, it can be broadly characterized as a function of the size of the affected transactions and the degree to which a dealer's private incentives in those transactions may create uncollateralized exposures that reduce the stability of the market for security-based swaps. In the non-cleared security-based swap market, inter-dealer transactions represent a significant portion of transactions.<sup>1154</sup> Industry surveys indicate that on average, these transactions are partly collateralized (*i.e.*, margin for current or potential future exposure is not always collected).<sup>1155</sup> This collateralization practice, while limited, is consistent with major dealer defaults being rare and resulting from certain aggregate shocks. Dealer failures resulting from aggregate shocks could impose significant negative externalities on the financial system. If dealers were to fully

<sup>1152</sup> See, e.g., ISDA, *User's Guide to the ISDA 1994 Credit Support Annex*, 1994.

<sup>1153</sup> Although the immediate losses are limited to a one-day net change in the value of the positions, eventual losses may be more significant due to the surviving dealer's inability to replace defaulted positions in a timely manner.

<sup>1154</sup> See section VI.A.1.d of this release.

<sup>1155</sup> See section VI.A.2.d of this release.

margin their inter-dealer transactions, including collecting initial margin from other dealers, the negative externalities associated with a dealer failure would be significantly reduced, resulting in improvements to financial stability. However, fully-margining inter-dealer transactions would impose costs on dealers because delivering margin collateral may reduce a dealer's available liquid capital and, therefore, the extent to which the dealer can provide liquidity to the market. Improvements to financial stability, on one hand, and higher costs associated with liquidity provision on the other hand could have offsetting effects on the overall economy. While dealers may pass on some of these costs to other security-based swap market participants through increased spreads or reduced liquidity provision, these costs generally may reduce a dealer's incentives to fully-margin its transactions with other dealers. Thus, private incentives alone may be insufficient to result in margin arrangements that improve the stability of the market for security-based swaps and the benefit of regulations can be significant.

The requirement to collect variation and initial margin from non-expected counterparties is likely to generate qualitatively similar but quantitatively smaller benefits. The requirement should significantly limit the extent to which a nonbank SBSD can build a large uncollateralized exposure to a non-expected counterparty, and therefore, significantly reduce the likelihood of the SBSD's failure due to potential losses from such exposure. However, although defaults among certain non-expected counterparties may be more common, their defaults tend to be idiosyncratic and the negative externalities of these failures are less significant compared to those that result from a financial market intermediary's failure.

Margin requirements—initial margin requirements in particular—can also constrain risk-taking. As noted above, currently, nonbank dealers may collateralize some portion of the exposures created by their positions.<sup>1156</sup> In general, depending on the margin arrangements with the counterparties, a dealer may maintain a buffer of pledgeable assets to satisfy expected margin calls from the counterparties over a given period. In the absence of regulatory margin requirements, privately-negotiated margin requirements may be limited, resulting in small expected margin calls from the

counterparties.<sup>1157</sup> This may likely result in a buffer of pledgeable assets that is small relative to the size of the exposures created by the dealer's derivatives book. Conversely, regulatory margin requirements, by imposing more extensive margin requirements, increase expected margin calls; the increased expected margin calls necessitate a larger buffer of pledgeable assets to support the same derivatives book. As pledgeable collateral must be funded, margin requirements link the expansion of a firm's derivatives book, and therefore the amount of risk it takes, more closely to its ability to obtain funding. In particular, regulatory margin requirements may reduce a dealer's ability to create uncollateralized exposures, and, therefore, limit its ability to take on risk.

The margin rule should further contribute to financial stability by limiting effective leverage in the non-cleared security-based swap market. By requiring nonbank SBSDs to exchange variation margin and to collect initial margin from non-commercial counterparties when the amount exceeds the initial margin threshold, the rule increases the collateral required to support non-cleared security-based swap transactions, limiting the effective leverage of such transactions. One commenter noted that the economic analysis should consider the impact of the final rules on market participants' ability to build up leverage through non-cleared security-based swaps.<sup>1158</sup> Absent the need to post margin, financial entities such as dealers, hedge funds, insurance companies, and banks are relatively unconstrained in the size of their security-based swap exposures.<sup>1159</sup> Failure of a large financial entity or of a group of smaller financial entities with significant derivatives exposures could lead to large dealer losses, dealer failures, or

significant market dislocations. The rule limits the potential impact of financial entities' defaults by: (1) Reducing the probability of their occurrence; (2) reducing their scale; and (3) reducing losses to nonbank SBSDs from transaction with the defaulted counterparties. The first two effects follow from reductions in such firms' leverage. The third effect follows from a nonbank SBSD's ability to collateralize its exposures from the positions with a financial entity counterparty, prior to the default of the counterparty.

As noted above, under the final rule, a nonbank SBSD can defer collecting initial margin for up to two months following the month in which a counterparty no longer qualifies for the fixed-dollar \$50 million threshold exception for the first time. This one-time deferral is designed to provide the counterparty with sufficient time to take the steps necessary to begin posting initial margin pursuant to the final rule. Thus, the deferral should support the benefits of the initial margin requirement discussed above by ensuring that counterparties have enough time to execute agreements, establish processes for exchanging initial margin, and take other steps to comply with the initial margin requirement. A nonbank SBSD that chooses to use the one-time deferral will continue to take a capital deduction in lieu of margin or credit risk charge. As noted above, the requirement to take this capital deduction or charge may impose costs on SBSDs and may create benefits for market participants.<sup>1160</sup> These costs could be limited to the extent that the nonbank SBSD and its counterparty have an existing agreement and processes that can be readily modified to incorporate the \$50 million threshold and thus help shorten the deferral period.

Regulatory margin requirements on non-cleared transactions make them relatively less attractive vis-à-vis similar cleared transactions, and thereby encourage the use of cleared transactions. Cleared contracts significantly reduce the contagion risk inherent in bilateral contracts. When an OTC derivatives contract between two counterparties is submitted for clearing, it is replaced by two new contracts: Separate contracts between the CCP and each of the two original counterparties. At that point, the original counterparties no longer have credit risk exposures to each other. Instead, both are left with a

<sup>1157</sup> Although private incentives may be sufficient to require margin under certain circumstances, private incentives alone need not result in margin exchange policies that are optimal from a social perspective. In general, privately negotiated margin policies do not take account of the systemic risk externalities of uncollateralized counterparty exposures and are therefore expected to result in margin policies that require too little margin. See, e.g., Viral V. Acharya, Aaditya M. Iyer, and Rangarajan K. Sundaram, *Risk-Sharing and the Creation of Systemic Risk* (New York University Stern School of Business, Working Paper (2015), available at [http://pages.stern.nyu.edu/~sternfin/vacharya/public\\_html/pdfs/2015-01-23\\_SystemicRiskCreation.pdf](http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/pdfs/2015-01-23_SystemicRiskCreation.pdf)).

<sup>1158</sup> See Better Markets 11/19/2018 Letter.

<sup>1159</sup> For example, hedge funds are not generally subject to regulatory capital requirements. Therefore, in the absence of a requirement to post initial margin, the scale of their derivatives exposures is not directly constrained by available capital.

<sup>1156</sup> See section VI.A.2.d. of this release.

<sup>1160</sup> See section VI.B.1.b.iii. of this release.

credit risk exposure to the CCP.<sup>1161</sup> Structured and operated appropriately, CCPs can improve the management of counterparty risk, reduce uncertainty, and provide additional benefits such as multilateral netting of trades.<sup>1162</sup> However, prudent risk management at CCPs will generally take the form of requirements on participants to frequently post initial and variation margin and requirements to contribute to a general guarantee fund.<sup>1163</sup> These measures impose costs on counterparties to cleared transactions. These costs can be avoided through non-cleared transactions if regulatory margin requirements are absent or the costs of regulatory margin requirements are lower.

By imposing regulatory margin requirements on nonbank SBSBs for non-cleared security-based swap transactions that, in large part, mirror certain margin requirements imposed by a clearinghouse on its participants, namely to collect variation and initial margin, the rule decreases the cost advantage of non-cleared security-based swap transactions relative to central clearing. For parties that derive sufficiently large private benefits from their collateral and who generally prefer to transact with more limited use of margin, the rule's requirements may, at the margin, increase the costs of non-cleared security-based swap transactions relative to cleared security-based swap transactions, encouraging these parties to clear their security-based swap transactions. Insofar as the final margin rule causes previously non-cleared transactions to be cleared, an important net benefit of the rule is promoting central clearing.

The final margin rule should also improve the information set for regulatory oversight of nonbank SBSBs and MSBSPs. The rule requires nonbank SBSBs and MSBSPs to perform margin 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. Even if the counterparty is not required to deliver collateral, the calculations will 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.<sup>1164</sup>

The principal costs resulting from the final margin rule arise from the requirement on a nonbank SBSB to collect initial margin from non-excepted counterparties to which the SBSB has a significant exposure (*i.e.*, an exposure that is above the \$50 million initial margin threshold under the rule). As noted above, currently, nonbank dealers do not always collect initial margin from their counterparties on non-cleared security-based swap transactions.<sup>1165</sup> Thus, by requiring the collection of initial margin, absent an exception, the rule has the effect of increasing the demand for a market participant's unpledged collateral, and thereby raises the cost of engaging in non-cleared security-based swap transactions. This can reduce the efficiency of risk sharing through the non-cleared security-based swap market. The increased cost is also likely to lead to a reduction in the quantity of transactions. Reductions in the quantity of transactions can have negative implications for market liquidity, price discovery and on dealer profitability.<sup>1166</sup> Similarly, the additional margin required under the rule can reduce the availability of collateral for other transactions and limit the effective leverage of participants in the non-cleared security-based swap market. Finally, by reducing effective leverage, the requirements may reduce the profitability (*e.g.*, the expected returns) of investment strategies that currently take advantage of the leverage created by uncollateralized exposures in this market.

<sup>1164</sup> See *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers*, 79 FR at 25206.

<sup>1165</sup> See section VI.A.2.d. of this release.

<sup>1166</sup> Concerns with these costs were highlighted by several commenters. One commenter believed the proposed initial margin requirement would severely impact liquidity in the non-cleared security-based swap market and make non-cleared security-based swaps significantly more expensive because of the costs of initial margin. This commenter stated that these costs include not only the costs of the actual initial margin but also the operational burdens of complex daily posting and reconciliation of initial margin. This commenter stated that the OTC derivatives market is critical to the functioning of the overall economy and provided examples of non-clearable security-based swaps that the commenter believed are critical to key sectors of the global economy that would be harmed by the imposition of initial margin requirements. See ISDA 1/23/13 Letter.

Several commenters argued that initial margin is unnecessary, and potentially counterproductive.<sup>1167</sup> One commenter believed that in lieu of initial margin, systemic risk could be effectively mitigated by daily variation margining with zero thresholds, implementation of appropriate capital requirements, and mandatory clearing of liquid standardized security-based swaps.<sup>1168</sup> The Commission believes that while all of the aforementioned mechanisms can play an important role in maintaining financial stability, they do not fully address it. In particular, as noted earlier, due to various market frictions, variation margin alone does not offer adequate protection against unexpected counterparty defaults in times of stress when such defaults are precipitated by the counterparty's losses in the same positions, and liquidity is scarce.<sup>1169</sup>

Another commenter argued that the Commission should not accept claims that the full margining of security-based swap transactions will make it difficult to use them for hedging purposes, or will shrink the size of the global security based swap market.<sup>1170</sup> This commenter also argued that the use of uncollateralized or under-collateralized security-based swaps does not reduce risk, it increases it, even if users claim the security-based swaps are "hedged." This commenter also believed that to the degree the unregulated security-based swap market in place prior to the Dodd-Frank Act was overleveraged, it was also too large because full social costs of the market were not incorporated into user decisions.

Several comments raised concerns about certain technical aspects of the proposed initial margin calculation. Some commenters asked the

<sup>1167</sup> A commenter asserted that "VM, with daily collection (subject to limited exceptions for illiquid collateral) and zero thresholds, effectively protects against accumulated and unrealized losses in over-the-counter ("OTC") derivatives positions." See ISDA 1/23/2013 Letter. Another commenter stated that "[r]igorous variation margin requirements have the potential to significantly reduce systemic risk by eliminating the accumulation of uncollateralized current exposures while avoiding the potentially destabilizing and pro-cyclical effects of initial margin . . ." See SIFMA 2/23/2013 Letter.

<sup>1168</sup> See ISDA 1/23/13 Letter.

<sup>1169</sup> As discussed earlier in this section, liquidity shortages during times of market stress can prevent timely replacement of defaulted CDS positions, and delays in replacement can lead to losses for the non-defaulting counterparty. Moreover, the occurrence of unexpected credit-related events at the reference entity can precipitate a counterparty default. Under such conditions, the exchange of variation margin may—by itself—be inadequate at limiting counterparty credit risk as unexpected credit events at the reference entity can contribute to both the development of current exposures to a counterparty and its default.

<sup>1170</sup> See Americans for Financial Reform Letter.

<sup>1161</sup> See Stephen Cecchetti, Jacob Gyntelberg, and Mark Hollanders, *Central Counterparties for Over-the-counter Derivatives*, BIS Quarterly Review (Sept. 2009).

<sup>1162</sup> 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 market could economize both on margin and non-margin resources). See also *Process for Submissions of Security-Based Swaps*, 77 FR at 41602.

<sup>1163</sup> See *Standards for Covered Clearing Agencies*, 81 FR 70786.

Commission to revise the standardized haircuts (which would be used to calculate initial margin if the firm was not authorized to use a model) to better reflect the historical market volatility and losses given default associated with CDS positions. A few commenters argued that methods (*e.g.*, using a model) other than the Appendix A methodology should be permitted to calculate initial margin for equity security-based swaps.<sup>1171</sup> One commenter stated that the Appendix A methodology is inadequate and inefficient for a proper initial margin calculation and does not sufficiently recognize portfolio margining.<sup>1172</sup> This commenter also stated that the Appendix A methodology does not incorporate critical factors such as volatility, and, as a result, initial margin on equity security-based swaps would likely be insufficient in times of stressed markets (in contrast to a model-based approach). Another commenter raised concerns that applying the Appendix A methodology would result in initial margin requirements that are substantially less sensitive to the economic risks of a security-based swap portfolio than a model-based approach, and suggested the Commission permit a nonbank SBSB to use either the Appendix A methodology or an internal model to compute the initial margin amount for equity security-based swaps.<sup>1173</sup> Another commenter requested that the Commission permit the use of models for both debt and equity security-based swaps.<sup>1174</sup>

In response to commenters' concerns regarding the use of the Appendix A methodology to compute initial margin for equity security-based swaps, the Commission modified the final margin rule to permit a stand-alone SBSB to use a model to calculate initial margin for non-cleared equity-based security-based swaps, provided the account does not hold equity security positions other than equity security-based swaps and equity swaps.<sup>1175</sup> Permitting the model-based approach under these limited circumstances strikes an appropriate balance in terms of addressing commenters' concerns and maintaining regulatory parity between the cash equity and the equity security-based swap markets.

Broker-dealer SBSBs will not be permitted to use a model to compute initial margin for equity security-based

swaps. The Commission has also considered the objections of commenters to requiring the use of the Appendix A methodology to calculate the initial margin amount for non-cleared equity security-based swaps (rather than permitting a model).<sup>1176</sup> While the Commission agrees that the Appendix A methodology has certain limitations, particularly with respect to recognizing offsets arising from correlated positions, it notes that the use of models in this context is unlikely to address these limitations, and moreover, can introduce additional problems. Due to the volatility of equity returns, correlations in these returns are difficult to estimate without significant modeling assumptions. To the extent that parties in security-based swap transactions wish to minimize the total amount of initial margin devoted to such transactions, incentives to adopt optimistic assumptions can lead to models that overestimate negative correlations, underestimate positive correlations, and lead to inadequate margin levels. These are some of the reasons why the final capital and margin rules impose qualitative and quantitative requirements on the use of models and why the final capital rules impose higher capital requirements for (and increased monitoring of) nonbank SBSBs that use models.

In addition, the Commission recognizes the concerns commenters raised about the historical accuracy of the standardized haircuts. As discussed sections VI.A.7. and VI.B.1.iv. of this release, the Commission has provided an analysis that compares the standardized haircuts to the actual losses on credit default swap positions observed from historical data. In response to the commenters, the Commission notes that the standardized haircut grids for non-cleared CDS in the final rules are based on existing Rule 15c3-1 and, in part, on FINRA Rule 4240. The Commission further notes that in the analysis for CDS positions referencing single-name obligors, the maximum loss on a position scaled by its corresponding haircut—the so-called loss coverage ratio—exceeds 1 in all sample years. However, this is not always the case in the analysis for CDS positions referencing an index. These results suggest that the standardized haircuts in the final rules are generally

not set at the most conservative level, as losses on some positions exceed the corresponding standardized haircuts. In general, haircuts are intended to strike a balance between being sufficiently conservative to cover losses in most cases, including in stressed market conditions, and being sufficiently nimble to allow dealers to operate efficiently in all market conditions. Based on the results of the analysis, as described above, the Commission believes that the standardized haircuts in the final rules take into account this tradeoff.<sup>1177</sup>

Several commenters argued against the adoption of initial margin requirements for certain types of counterparties. One commenter believed that substantial initial margin requirements could impose significantly greater costs on life insurers and suggested that dealers and major participants in the security-based swap market have the flexibility to determine whether and to what extent life insurers should be required to pledge initial margin to financial firms.<sup>1178</sup> One commenter argued that, as proposed, the initial margin requirements will “severely challenge the resiliency of the financial system and will severely curtail the use of non-cleared swaps for hedging.”<sup>1179</sup> Another commenter believed that the initial margin requirement is a new and costly requirement for most financial end users, while the variation margin requirement may undermine the ability of an end-user to negotiate the best terms for a security-based swap.<sup>1180</sup> This commenter stated that a survey found that a 3% initial margin requirement on the S&P 500 companies could be expected to reduce capital spending by \$5.1 billion to \$6.7 billion, and that United States would lose 100,000 to 130,000 jobs from both direct and indirect effects. One commenter urged the Commission to except counterparties with material swaps exposure of less than \$8 billion from the margin requirements to be consistent with the margin rules adopted by the prudential regulators, the CFTC, and non-U.S. regulators.<sup>1181</sup> Other commenters opposed margin requirements for certain types of

<sup>1171</sup> See ISDA 1/23/2013 Letter; SIFMA 2/22/2013 Letter.

<sup>1172</sup> See ISDA 1/23/2013 Letter.

<sup>1173</sup> See SIFMA 2/22/2013 Letter.

<sup>1174</sup> See SIFMA AMG 2/22/2013 Letter.

<sup>1175</sup> See paragraph (d)(2)(ii) of Rule 18a-3, as adopted.

<sup>1176</sup> Nonbank SBSBs may also use the non-portfolio based standardized approach to calculate the haircut/margin for equity security-based swaps. In most cases, the deduction is the notional amount of the equity security-based swap multiplied by the deduction (haircut) that would apply to the underlying instrument referenced by the equity security-based swap.

<sup>1177</sup> As discussed above in section VI.B.1. of this release, a standardized haircut grid calibrated to historical volatilities and recoveries will generally not be accurate going forward, due to variation in volatilities and recoveries over time.

<sup>1178</sup> See American Council of Life Insurers 2/22/2013 Letter.

<sup>1179</sup> See ISDA 1/23/13 Letter.

<sup>1180</sup> See Coalition for Derivatives End-Users 2/22/2013 Letter.

<sup>1181</sup> See ICI 11/19/2018 Letter.

transactions. One commenter opposed margin requirements for inter-affiliate transactions and stated that this requirement would cause artificial and inefficient capital allocation for end-users, increase consumer costs, and undermine efficiencies that end-users currently realize through centralized treasury units.<sup>1182</sup> Another commenter argued that nonprofit sovereign institutions should be granted an exception to the posting of margin requirement because these institutions do not trade for profit-seeking reasons and they benefit from explicit or implicit guarantees from their sovereign governments.<sup>1183</sup> In addition, the commenter argued that the Commission's requirement to collect margin from this type of institution is not consistent with the margin requirements adopted by the CFTC and the prudential regulators.<sup>1184</sup>

Several commenters provided estimates of the additional collateral that would be required to satisfy the proposed rules.<sup>1185</sup> One commenter estimated that the potential impact of initial margin requirements assuming the use of models and a zero threshold, would be \$1.7 trillion for universal two-way margin and \$1.2 trillion for dealer only collection, as proposed by the Commission.<sup>1186</sup> This commenter also estimated that under proposed Alternative A (nonbank SBSBs exchange only variation margin) the total initial margin requirements would drop to \$500 billion, assuming full use of models.

This commenter stated that its member firms have estimated that the liquidity demands associated with mandatory initial margin requirements are likely to range between approximately \$1.1 trillion (if dealers are not required to collect initial margin from each other) to \$3 trillion (if dealers must collect initial margin from each other) to \$4.1 trillion (if dealers must

post initial margin to non-dealers).<sup>1187</sup> Moreover, in stressed conditions, the commenter estimated that initial margin amounts collected by firms that use internal models could increase by more than 400%. A final commenter requested that multilateral development banks be exempt from the Commission's regulatory margin requirements, noting specifically that the International Bank for Reconstruction "could face a potential posting requirement over the medium term of \$20–30 billion under plausible scenarios," with a "possible cost of carry in the range of \$40–90 million per year," which could be problematic, given that none of the multilateral development banks have access to a liquidity facility of last resort.<sup>1188</sup>

Estimates of the aggregate impact of the Commission's margin rule are subject to two major uncertainties. First, as discussed below in section VI.D.2. of this release, the aggregate impact of the Commission's margin rule will largely depend on the SBSB organizational structure chosen by the large banking groups that dominate security-based swap trading activity. To the extent that security-based swap trades continue to be conducted primarily through entities subject to the prudential regulators' supervision (*i.e.*, bank SBSBs), relatively few transactions will be subject to the Commission's margin rules. To the same extent, the additional collateral required, and the costs associated with this additional collateral will, in the aggregate, be minimal. If however, security-based swap trading migrates to nonbank affiliates (*i.e.*, nonbank SBSBs), the aggregate impact of the rule could be considerably larger to the extent it imposes requirements that differ from the requirements of the prudential regulators' margin rules. Second, as discussed below in section VI.B.4. of this release, the aggregate amount of collateral required to satisfy the final margin rule will also depend on counterparties' choices with respect to segregation. The Exchange Act provides counterparties of nonbank SBSBs a choice of several alternatives to the segregation of their initial margin, including the option to waive segregation (though only affiliated counterparties can waive segregation in

the case of a stand-alone broker-dealer or broker-dealer SBSB). As discussed below in section VI.B.4. of this release, when segregation is waived, the private costs associated with the requirement to collect initial margin can be significantly reduced as the SBSB collecting said initial margin would obtain the benefit of using the collected collateral in its operations.

One commenter<sup>1189</sup> suggested that the Commission estimate the additional collateral required to satisfy the margin requirements. However, as noted above, the collateral required to satisfy the Commission's rule will depend in large part on the business decisions of entities currently operating in the security-based swap market. To estimate the eventual collateral demand resulting from the Commission's new margin rule, the Commission would have to make significant assumptions about individual firms' ultimate organizational structure. In particular, the Commission would have to make assumptions about how much of U.S. security-based swap dealing activity would eventually be housed in nonbank SBSBs, rather than in bank SBSBs not subject to the Commission's margin rule; such assumptions would be highly speculative. Further, estimates of collateral demand resulting from the Commission's margin rule would also be significantly affected by market participant's contracting arrangements with respect to segregation of collateral. Because the Commission's new rules do not prevent re-hypothecation of collateral and permit the waiving of segregation, counterparties' choices in these areas will ultimately play a major role in determining the additional collateral demand; the Commission does not have information on the private contracting arrangements of counterparties or the preferences for particular segregation regimes that would allow for meaningful estimates of the use of segregation and re-hypothecation.

Finally, to obtain estimates for the entire security-based swap market, the Commission would have to make significant assumptions about unobserved security-based swap activity (*i.e.*, those transactions that are not single-name CDS). Although the Commission has provided estimates of the scale of such activity, such broad estimates are generally inadequate for quantifying the collateral required to support this activity under the final margin rule: To do so with some degree of accuracy would require detail on the non-CDS positions at the counterparty

<sup>1182</sup> See Coalition for Derivatives End-Users 2/22/2013 Letter.

<sup>1183</sup> See KFW Bankengruppe Letter.

<sup>1184</sup> See *CFTC Margin Final Release*, 81 FR at 696 (providing that the term "financial end user" (meaning an entity from whom margin must be collected) does not generally include any counterparty that is: A sovereign entity, a multilateral development bank, the BIS, a captive finance company that qualifies for the exemption from clearing under Section 2(h)(7)(C)(iii) of the Commodity Exchange Act and implementing regulations, or a person that qualifies for the affiliate exemption from clearing pursuant to Section 2(h)(7)(D) of the Commodity Exchange Act or Section 3C(g)(4) of the Securities Exchange Act and implementing regulations). See also *Prudential Regulator Margin and Capital Final Release*, 80 FR at 74855.

<sup>1185</sup> See ISDA 1/23/2013 Letter; SIFMA 3/12/2014 Letter; SIFMA 2/22/2013 Letter.

<sup>1186</sup> See ISDA 1/23/13 Letter.

<sup>1187</sup> See SIFMA 2/22/2013 Letter.

<sup>1188</sup> See World Bank Letter. In response to these comments, in the final rule, the Commission is adopting additional exceptions from the margin rule for the BIS, European Stability Mechanism, multilateral development banks, sovereign entities that have minimal credit risk, and affiliates. See Rule 18a–3, as adopted. These modifications to the final rule should alleviate commenters' concerns to some extent regarding the overall impact of the rule.

<sup>1189</sup> See ISDA 1/23/13 Letter.

level of entities that will register as nonbank SBSBs.<sup>1190</sup> Because the Commission would have to make several layers of assumptions that cannot be rigorously justified with available data, the Commission does not believe that attempts to quantify the cost of the final margin rule would provide reliable estimates of the true collateral demand resulting from it.

The final rule's requirements for the collection and posting of variation margin by nonbank SBSBs and MSBSPs may also lead to additional collateral funding costs for participants in the non-cleared security-based swap market. These costs, however, are likely to be of a smaller magnitude. Unlike segregated initial margin, variation margin does not "consume" collateral: Variation margin posted by one party can be used to satisfy margin requirements of the party collecting it. Moreover, the amount of required variation margin reflects the receiving party's mark-to-market gain (receivable) and delivering party's mark-to-market loss (payable) on the transaction. The exchange of variation margin settles the daily mark-to-market change in the value of the position (*i.e.*, it settles the receivable and payable). However, to the extent that collateral other than U.S. dollars or short-term U.S. government securities is used to meet a variation margin requirement, the final margin rule requires haircuts to be applied to the collateral. These haircuts could impose an incremental need to hold additional collateral to meet variation margin requirements. The Commission expects that cash and U.S. government securities (which require no or minimal

haircuts) will predominantly be used to meet variation margin requirements and, therefore, the aggregate additional collateral required as a result of the haircuts should not be substantial.<sup>1191</sup> Thus, imposing variation margin requirements on security-based swap transactions where variation margin has not previously been collected may not significantly increase the overall amount of collateral required to support those transactions. However, the knowledge that variation margin must be posted on a daily basis can be expected to result in affected parties maintaining larger buffer stocks of unpledged collateral to ensure that margin calls can be satisfied.<sup>1192</sup> While this can indirectly increase the amount of collateral that is required to support such transactions and in so doing increase their cost, this effect is likely to be limited as the regular exchange of variation margin is a relatively common market practice under the baseline.

The impact of the Commission's margin rules on the non-cleared security-based swaps is expected to be qualitatively similar to the impact of the prudential regulators' margin rules for non-cleared security-based swaps and swaps and the CFTC's margin rules on non-cleared swaps. Quantitatively however, the scale of the impact will be much less significant. As of the end of 2017, non-cleared security-based swap positions represented less than 2% of the outstanding non-cleared swap positions.<sup>1193</sup> Nevertheless, if the Commission's final margin rule makes trading in the security-based swap market prohibitively expensive, the cost of this lost investment opportunity to market participants that currently are very active in the security-based swap market would be very significant.

The additional collateral funding costs resulting from the Commission's final margin rule are mitigated by the broad range of eligible collateral permitted by the rule, which may consist of cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold. 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,<sup>1194</sup> takes advantage of efficiencies that result from correlations between securities and security-based swaps.<sup>1195</sup> One commenter supported the use of a broad range of collateral noting that it is important that the Commission recognize that the proposed rules could impose significantly greater costs on life insurers due to the potential narrowing of the securities categories eligible to be used as margin.<sup>1196</sup> Another commenter supported the Commission's broad approach to permissible collateral, arguing that a narrower approach could increase costs and liquidity pressures on market participants by increasing demand for and placing undue pressure on the supply of such collateral.<sup>1197</sup> However, another commenter believed that the collateral requirements under the proposal would nonetheless significantly increase the cost of using non-cleared security-based swaps, penalizing end users, including the pension plans, mutual funds and other vehicles for which commenter serves as a fiduciary.<sup>1198</sup>

The final margin rule is generally modeled on broker-dealer margin rules in terms of establishing an "account equity" requirement; requiring nonbank SBSBs to collect collateral to meet the requirement; and allowing a range of securities for which there is a ready market to be used as collateral. This approach promotes consistency with existing rules, which will generally reduce the implementation costs for entities with affiliates already subject to the Commission's broker-dealer financial responsibility rules, and the broker-dealer margin rules. It also facilitates the ability to provide portfolio margining of security-based swaps with other types of securities, and in particular single-name CDS with bonds

<sup>1190</sup> In this and other Title VII releases, the Commission has stated its belief that single-name CDS data are sufficiently representative of the security-based swap market to directly inform the analysis of the current state of the market. Moreover, in prior releases, the Commission has used its estimate that single-name CDS represent 82% of the total security-based swap market to make inferences about unobserved security-based swap activity. See *Trade Acknowledgment and Verification of Security-Based Swap Transactions*, 81 FR 39808. In those cases, a specific regulatory requirement—as well as the cost of the requirement—did not depend on the nature of the particular security-based swap. For example, security-based swap entities must provide trade acknowledgments to their counterparties for all security-based swaps. The requirement does not vary with the type of security-based swap. In contrast, margin requirements vary across security-based swaps. For example, initial margin requirements for non-cleared CDS that reference a narrow-based security index vary with the maturity and credit spread of the contract, as well as whether the dealer is approved to use models. As another example, broker-dealer SBSBs are not permitted to use models to calculate initial margin requirements for equity security-based swaps. Thus, in contrast to previous releases, any estimate of collateral costs will depend greatly on the composition of unobserved activity.

<sup>1191</sup> See *ISDA Margin Survey 2012* at 8, Table 2.1.

<sup>1192</sup> See *Central Clearing and Collateral Demand*, Journal of Financial Economics 116, no. 2, 237–256.

<sup>1193</sup> This figure is based on global notional amounts of swaps outstanding. See BIS, *OTC derivatives outstanding*, Tables D5.1 and D5.2.

<sup>1194</sup> See 12 CFR 220.1 *et seq.* (Regulation T); FINRA Rule 4210 (SRO margin rule); CBOE Rule 12.3 (SRO margin rule).

<sup>1195</sup> An ISDA margin survey states, with regard to the types of assets used as collateral, that the use of cash and government securities as collateral remained predominant, constituting 90.4% of collateral received and 96.8% of collateral delivered. See *ISDA Margin Survey 2012* at 8, Table 2.1.

<sup>1196</sup> See American Council of Life Insurers 2/22/2013 Letter (arguing that "[n]arrow limits on the types of permitted collateral could greatly impair liquidity in the derivatives marketplace and thwart constructive risk management").

<sup>1197</sup> See SIFMA 2/22/2014 Letter.

<sup>1198</sup> See PIMCO Letter (suggesting two modifications to the proposed margin rule to mitigate costs: (1) Model-based margin calculations should be based on a shorter liquidation period; and (2) the required haircuts on collateral should be adjusted to expand the range of collateral that can effectively be used).



referenced by the CDS. This consistent approach can also reduce the potential for regulatory arbitrage and lead to simpler interpretation and enforcement of applicable regulatory requirements across U.S. securities markets.

Finally, the Commission has modified the final margin rule in response to commenters' concerns about the rule excluding collateral types that are permitted by the CFTC and the prudential regulators. As noted above, the final rule permits cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold to serve as eligible collateral.<sup>1199</sup> This will avoid the operational burdens of having different sets of collateral that may be used with respect to a counterparty depending on whether the nonbank SBSB is entering into a security-based swap (subject to the Commission's rule) or a swap (subject to the CFTC's rule) with the counterparty. It also will avoid potential unintended competitive effects of having different sets of collateral for non-cleared security-based swaps under the margin rules for nonbank SBSBs and bank SBSBs. Finally, by giving the option of aligning with the requirements of the CFTC and the prudential regulators, the final rule should avoid the necessity of amending existing collateral agreements that may specifically reference the forms of margin permitted by those requirements.

#### c. Alternatives Considered

##### i. Alternative B: Inter-Dealer margin

As discussed above in section II.B.2.b.i. of this release, the Commission proposed two alternatives (Alternatives A and B) with respect to inter-dealer margin requirements. Under Alternative A, a nonbank SBSB would need to collect variation margin but not initial margin from the other SBSB. Under alternative B, a nonbank SBSB would be required to collect variation and initial margin from the other SBSB and the initial margin needed to be held at a third-party custodian.

Alternative B was generally consistent with the recommendations in the BCBS/IOSCO Paper and the margin rules of the CFTC, prudential regulators, and European authorities in that it would have required nonbank SBSBs to exchange initial (in addition to variation margin). Further, it was consistent with the margin rules of the CFTC and the prudential regulators in that it would

have required that initial margin be held at an unaffiliated third-party custodian.<sup>1200</sup> The BCBS/IOSCO Paper recommends that "[i]nitial margin collected should be held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default, and (ii) the collected margin must be subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy."<sup>1201</sup> The EU's margin rule requires the collecting counterparty to provide the posting counterparty with the option to segregate its collateral from the assets of the other posting counterparties.<sup>1202</sup>

Alternatives A and B would have required nonbank SBSBs to collect variation *and* initial margin from non-expected counterparties. Therefore, both alternatives would protect nonbank SBSBs from the consequences of one of these counterparties defaulting. However, because Alternative B would have required a nonbank SBSB also to collect variation *and* initial margin from an SBSB counterparty and segregate it with an independent third-party custodian, this alternative would have provided greater protection to nonbank SBSBs from the consequences of one of these counterparties defaulting than Alternative A. By providing greater protection against the consequences of non-expected counterparties and SBSBs defaulting, Alternative B would have further reduced the likelihood of sequential dealer failure as a result of defaulting counterparties relative to Alternative A. This would have enhanced the safety and soundness of nonbank SBSBs in terms of this risk. As noted earlier in this release, most of the benefits of this enhancement would accrue to market participants that rely on nonbank SBSBs for liquidity

<sup>1200</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74863; *CFTC Margin Adopting Release*, 81 FR 636.

<sup>1201</sup> See BCBS/IOSCO Paper at 20 ("There are many different ways to protect provided margin, but each carries its own risk. For example, the use of third-party custodians is generally considered to offer the most robust protection, but there have been cases where access to assets held by third-party custodians has been limited or practically difficult. The level of protection would also be affected by the local bankruptcy regime, and would vary across jurisdictions.").

<sup>1202</sup> The margin rules of the European Union require that initial margin be segregated on the books and records of a third-party holder or custodian; or via other legally binding arrangements so that the initial margin is protected from the default or insolvency of the collecting counterparty. Where cash is collected as initial margin, it must be deposited with an unaffiliated third-party holder or custodian or with a central bank. Initial margin cannot be re-hypothecated.

provision in security-based swap market and other services.

However, Alternative B would likely impose more costs than Alternative A. As discussed above, there is a trade-off in terms of the benefits of requiring a nonbank SBSB to collect initial margin from another financial market intermediary: Namely, the liquidity of the delivering firm is reduced by the amount of initial margin posted to the nonbank SBSB. Thus, while the initial margin collected by the nonbank SBSB enhances the firm's safety and soundness, the delivery of liquid capital by the other financial market intermediary diminishes that firm's safety and soundness because it cannot use the delivered liquid capital to protect itself from losses or to meet liquidity demands. Thus, Alternative B would have reduced the safety and soundness of nonbank SBSBs in terms of this risk. In addition, the requirement that the initial margin be segregated at a third-party custodian could have contributed to the instability of the nonbank SBSB for whom the initial margin was posted if the initial margin was not immediately available to the nonbank SBSB upon the default of the SBSB counterparty.<sup>1203</sup> During periods of general market unrest, even a brief delay in access to liquid collateral, could increase instability.<sup>1204</sup> Further, Alternative B's negative impact on nonbank SBSBs' liquidity could have reduced their ability to trade in non-cleared security-based swaps. Nonbank SBSBs likely would have passed on these costs to other market participants who, in turn, may have had less of an incentive to trade in the security-based swap market.

In summary, although Alternative B would provide greater protection against a defaulting SBSB counterparty, it would also impose more costs on dealers and other market participants, relative to Alternative A.

##### ii. Third-Party Segregation Requirements

The final margin rules of the CFTC and the prudential regulators generally require that initial margin be held at a third-party custodian. The purpose of using a third-party custodian is to have

<sup>1203</sup> For example, the defaulting SBSB counterparty could claim that the secured nonbank SBSB is not entitled to access the initial margin held by the third-party custodian and bring a court action to bar such access. The resolution of this claim in court could substantially delay the secured nonbank SBSB's access to the collateral.

<sup>1204</sup> Importantly, as discussed below in section VI.B.4. of this release, the ultimate market effects will also depend on the approach adopted by market participants with regard to the segregation of initial margin.

<sup>1199</sup> See paragraph (c)(4)(i)(C) of Rule 18a-3, as adopted. The additional collateral requirements in the final rule are discussed below.

the initial margin held in a manner that is bankruptcy-remote from the secured party. The Commission's final margin rule does not require that initial margin posted by a counterparty to the nonbank SBSB be held at a third-party custodian. However, Section 3E(f) of the Exchange Act provides counterparties the right to elect to have the initial margin they post to a nonbank SBSB to be held at an independent third-party custodian. Given the limited use of third-party segregation under existing market practice in security-based swap transactions, the circumstances in which third-party segregation is elected may be limited.

As an alternative, the Commission's margin rule could have required that initial margin posted to nonbank SBSBs be held at a third-party custodian. This would have provided more counterparties (*i.e.*, ones that would not have otherwise elected to have their initial margin held at a third-party custodian) with the benefit of having their initial margin protected from the consequences of the nonbank SBSB's bankruptcy. The main benefit of such an approach would be that the return of the initial margin to the counterparty would not be subject to the delay caused by having to make a claim in a bankruptcy proceeding and the subsequent processing of that claim.

However, mandating (rather than permitting) initial margin to be held at a third-party custodian would entail costs. For example, under existing market practice, initial margin is not typically employed in inter-dealer transactions; rather, it is largely limited to dealer transactions with non-dealer counterparties, where the non-dealers are the parties posting initial margin.<sup>1205</sup> Non-dealer counterparties typically have not required that initial margin they post to dealers be held at a third-party custodian. This may reflect a preference for granting dealers more flexibility with respect to the use of their collateral over its safety, given the added costs associated with establishing and maintaining tri-party custodial arrangements and potentially imposed by dealers when they cannot directly hold the initial margin. Mandating that initial margin be held at a third-party custodian could increase these costs.

### iii. Eligible Collateral

The margin rules of the CFTC and the prudential regulators permit the following types of assets to serve as collateral: (1) Cash; (2) U.S. Treasury securities; (3) certain securities guaranteed by the U.S.; (4) certain

securities issued or guaranteed by the European Central Bank, a sovereign entity, or the BIS; (5) certain corporate debt securities; (6) certain equity securities contained in major indices; (7) certain redeemable government bond funds; (7) a major foreign currency; (8) the settlement currency of the non-cleared security-based swap or swap; or (9) gold.<sup>1206</sup> The Commission's final margin rule permits cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold. Consequently, unlike the margin rules of the CFTC and the prudential regulators, the Commission's final margin rule does not list the specific types of securities that can serve as eligible collateral. However, the Commission's final margin rule requires, among other things, that the collateral have a ready market.

In addition, the margin rules of the CFTC and the prudential regulators generally require that cash be used to meet a variation margin requirement in a transaction between dealers. The Commission's final margin rule does not place this limit on the collateral that must be used to meet a variation margin requirement.

As an alternative, the Commission could have specifically identified the types of securities that can serve as collateral and could have required that cash be used to meet a variation margin requirement of a financial market intermediary.

A benefit of this alternative is that with respect to the cash collateral requirement for variation margin in inter-dealer transactions it would limit the potential for losses resulting from liquidating non-cash collateral in times of stress, reduce the likelihood of fire-sale dynamics, and reduce uncertainty and disputes with respect to collateral valuation.<sup>1207</sup> A second benefit is that it would more closely align the Commission's margin rule with the margin rules of the CFTC and the prudential regulators. Commenters supported such consistency. One commenter urged consistency so that different rules would not apply to economically related transactions, or to transactions involving different types of counterparties, which could, in turn,

lead to increased costs for end users.<sup>1208</sup> Another commenter requested that the Commission develop a list of permissible collateral that is consistent across jurisdictions to "improve the efficiency of the derivatives market."<sup>1209</sup> These comments were aimed at the Commission's proposed margin rule. The Commission's final margin rule has been modified to permit the types of collateral that are eligible under the margin rules of the CFTC and the prudential regulators as discussed above in section II.B.2.b.i. of this release.

On the other hand, the alternative approach could increase demand for the types of securities enumerated in the margin rules of the CFTC and the prudential regulators and potentially cause shortages in their supply.<sup>1210</sup> Moreover, such forms of collateral may not be readily available to counterparties wishing to engage in non-cleared security-based swap transactions, significantly restricting their ability to engage in such transactions, and limiting the ability of these markets to facilitate risk transfer in the economy.

A commenter identified 3 adverse consequences of limiting collateral in the manner of the CFTC and the prudential regulators.<sup>1211</sup> First, the commenter argued that investors may be forced to hold unnecessarily low-yielding securities. Second, the commenter argued that the securities that investors will be forced to deliver as initial margin may be different from the transactions or portfolios hedged by the security-based swap, thereby creating undesirable basis risk and running counter to clients' desire to match benchmark composition. Third, the commenter argued that investors seeking to avoid this unnecessary cost or basis risk may look to "collateral transformation" approaches to convert holdings to assets that satisfy the posting requirements. The commenter argued that these collateral transformations will typically include haircuts on securities that will create additional costs for the funding component of the transformation.

The Commission broadly agrees with this commenter and believes that the alternative could unduly restrict the ability of entities to participate in the security-based swap market. It also could impede the ability to portfolio

<sup>1206</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR at 74870; *CFTC Margin Adopting Release*, 81 FR at 701–2.

<sup>1207</sup> See 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.

<sup>1208</sup> See SIFMA AMG 2/22/2013 Letter.

<sup>1209</sup> See ISDA 2/5/2014 Letter.

<sup>1210</sup> 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>.

<sup>1211</sup> See PIMCO Letter.

<sup>1205</sup> See section VI.A.2.d. of this release.

margin security-based positions with related securities positions. Further, by granting participants in security-based swap transactions the flexibility to post a wider range of securities, the Commission's final margin rule may reduce the collateral costs for participants in the security-based swap market. Finally, the ready market requirement and collateral haircuts are designed to ensure that the collateral adequately covers the credit exposures that variation and initial margin are designed to address.

#### iv. Excluding Certain Assets From List of Eligible Collateral

The Commission's proposed margin rule permitted cash, securities, and money market instruments to serve as collateral to meet variation and initial margin requirements. Therefore, unlike the margin rules of the CFTC and the prudential regulators, it did not permit a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold from serving as collateral. The margin rules of the CFTC and the prudential regulators permit major foreign currencies, the currency of settlement for the security-based swap, and gold to serve as eligible collateral. The Commission's final margin rule has been modified to permit the types of collateral that are eligible under the margin rules of the CFTC and the prudential regulators as discussed above in section II.B.2.b.i. of this release.

As an alternative, the Commission's margin rule could have continued to exclude a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold from serving as collateral. However, differences between the sets of permitted collateral under the margin rules of the Commission and the CFTC and the prudential regulators could have imposed operational burdens on a nonbank SBSB. For example, a nonbank SBSB that is registered as a swap dealer would have been required to adhere to a different set of permitted collateral depending on whether it was entering into a security-based swap (subject to the Commission's rule) or a swap (subject to the CFTC's rule) with the counterparty. In addition, the nonbank SBSB and its counterparties would likely have had to incur costs to amend existing collateral agreements that may specifically reference the forms of margin permitted by CFTC and prudential requirements.

Further, prudential regulators permitting major foreign currencies, the currency of settlement for the security-based swap, and gold to serve as collateral (while the Commission did

not) would have meant that a bank SBSB and its counterparties had more options when sourcing for permitted collateral compared to a nonbank SBSB. This greater range of options, in turn, could have allowed the bank SBSB to obtain eligible collateral at lower cost than a nonbank SBSB, even if both entities were entering into economically equivalent non-cleared security-based swap transactions. This could have allowed bank SBSBs to gain a competitive advantage over nonbank SBSBs.

In light of the operational burden, costs, and competitive disparity associated with the alternative, the Commission believes that final margin rule, which permits a major foreign currency, the settlement currency of the non-cleared security-based swap, and gold to serve as eligible collateral, is preferable to the alternative.

#### v. Not Permitting the Option To Use Collateral Haircuts Adopted by CFTC and Prudential Regulators

As discussed above in section II.B.2.b.i. of this release, the Commission's proposed margin rule provided that the fair market value of securities and money market instruments held in the account of a counterparty needed to be reduced by the amount of the standardized haircuts the nonbank SBSB would apply to the positions pursuant to the proposed capital rules for the purpose of determining whether the level of equity in the account met the minimum margin requirements. The proposed haircuts and the haircuts in the margin rules of the CFTC and the prudential regulators (which are based on the recommended standardized haircuts in the BCBS/IOSCO Paper) are largely comparable. However, there were differences. In order to promote greater harmonization with the margin rules of the CFTC and the prudential regulators, the Commission's final margin rule provides nonbank SBSBs with the option of choosing to use the standardized haircuts in the capital rules or the standardized haircuts in the CFTC's margin rule.

As an alternative, the Commission could have adopted the proposed requirement that did not provide the option to use the standardized haircuts in the CFTC's margin rule. However, this could have imposed operational burdens on nonbank SBSBs. For example, a nonbank SBSB that was also registered as a swap dealer would have been required to adhere to a different set of collateral haircuts depending on whether it was entering into a security-based swap (subject to the

Commission's rule) or a swap (subject to the CFTC's rule) with the counterparty. In addition, the nonbank SBSB and its counterparties would likely have had to incur costs to amend existing collateral agreements that may specifically reference the haircuts in the margin rules of the CFTC and the prudential regulators.

This alternative also could have resulted in competitive disparities between bank SBSBs and nonbank SBSBs. To the extent that the prudential regulators' collateral haircuts result in more favorable treatment of a counterparty's collateral, the counterparty might have preferred to trade with a bank SBSB rather than with a nonbank SBSB, even if both SBSBs are equally attractive liquidity providers in all other respects. Thus, the alternative could have allowed bank SBSBs to gain a competitive advantage over nonbank SBSBs.

The Commission believes that final margin rule, which provides nonbank SBSBs with the option of using the CFTC's collateral haircuts, is preferable to the alternative as it will avoid the operational burdens, costs, and competitive disparities discussed above.

#### vii. Risk-Based Threshold

In the 2018 comment reopening, the Commission requested comment on whether it would be appropriate to establish a risk-based threshold where a nonbank SBSB would not be required to collect initial margin from a counterparty to the extent the amount does not exceed the lesser of: (1) 1% of the SBSB's tentative net capital; or (2) 10% of the net worth of the counterparty.<sup>1212</sup> As an alternative, the Commission could have adopted this risk-based initial margin threshold instead of the fixed-dollar \$50 million initial margin threshold.

One commenter was concerned that, were the Commission to adopt an initial margin threshold tied to counterparty net worth, nonbank SBSBs would effectively be required to collect initial margin from all in-scope counterparties because they would be unable to confirm that the calculated initial margin amounts had not crossed the 10% net worth threshold. The commenter believed that such a requirement would put nonbank SBSBs at a significant competitive disadvantage relative to bank SBSBs and foreign SBSBs.<sup>1213</sup> The commenter also noted that the 1% tentative net capital threshold would effectively

<sup>1212</sup> *Capital, Margin, and Segregation Comment Reopening*, 83 FR at 53013.

<sup>1213</sup> See SIFMA 11/19/2018 Letter.

increase the prices offered by smaller nonbank SBSBs to counterparties relative to their competitors. Additionally, the commenter pointed out that the costs of overhauling systems and re-documenting initial margin agreements to incorporate the proposed thresholds would have a disproportionate impact on smaller firms, since such costs do not generally scale to a firm's size. These substantial disadvantages would likely reduce the ability of smaller nonbank SBSBs to attract counterparties, which would cause greater market concentration and less efficient pricing. A commenter argued that the Commission did not explain its views on why a counterparty-specific unsecured threshold (e.g., \$50 million) should be rejected in favor of a measure that would relate to a percentage of the nonbank SBSB's tentative net capital, which captures counterparty exposures only indirectly, or the counterparty's overall net worth unrelated to a specific counterparty relationship.<sup>1214</sup>

In response to the comments above, the Commission is adopting a fixed \$50 million initial margin threshold below which initial margin need not be collected.<sup>1215</sup> This fixed threshold is consistent with the threshold adopted by the prudential regulators. Having a more consistent threshold will minimize potential competitive disparities and address operational concerns raised by commenters. The Commission recognizes that a fixed-dollar threshold (as opposed to a scalable threshold) does not necessarily bear a relation to the financial condition of the nonbank SBSB and its counterparty. To address this consequence, as discussed above, and as suggested by a commenter, a nonbank SBSB will be required to take a capital deduction in lieu of margin or credit risk charge if it does not collect initial margin pursuant to the fixed-dollar \$50 million threshold exception. Furthermore, the nonbank SBSB will be required to establish, maintain, and document procedures and guidelines for monitoring counterparty risk. Consequently, the Commission does not believe the fixed-dollar \$50 million threshold exception will unduly increase systemic risk as suggested by a commenter.

#### 4. The Segregation Rules—Rules 15c3–3 and 18a–4

##### a. Overview

As discussed above in section II.C. of this release, Section 3E(b) of the Exchange Act provides that, for cleared security-based swaps, the money, securities, and property of a security-based swap customer shall be separately accounted for and shall not be commingled with the funds of the broker, dealer, or SBSB 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. However, Section 3E(c)(1) of the Exchange Act also provides that, for cleared security-based swaps, customers' money, securities, and property may, for convenience, be commingled and deposited in the same one or more accounts with any bank, trust company, or clearing agency. Section 3E(c)(2) further provides that, notwithstanding Section 3E(b), in accordance with such terms and conditions as the Commission may prescribe by rule, regulation, or order, any money, securities, or property of the security-based swaps customer of a broker, dealer, or security-based swap dealer described in Section 3E(b) may be commingled and deposited as provided in Section 3E with any other money, securities, or property received by the broker, dealer, or security-based swap dealer and required by the Commission to be separately accounted for and treated and dealt with as belonging to the security-based swaps customer of the broker, dealer, or security-based swap dealer.

Section 3E(f) of the Exchange Act establishes a program by which a counterparty to non-cleared security-based swaps with an SBSB or MSBSP can elect to have initial margin held at an independent third-party custodian (individual segregation). Section 3E(f)(4) provides that if the counterparty does not choose to require segregation of funds or other property, the SBSB or MSBSP shall send a report to the counterparty on a quarterly basis stating that the firm's back office procedures relating to margin and collateral requirements are in compliance with the agreement of the counterparties. The statutory provisions of Sections 3E(b) and (f) are self-executing.

The Commission is adopting omnibus segregation rules pursuant to which money, securities, and property of a security-based swap customer relating to cleared and non-cleared security-based swaps must be segregated but can be commingled with money, securities,

or property of other customers. The omnibus segregation requirements for stand-alone broker-dealers and broker-dealer SBSBs are codified in amendments to Rule 15c3–3. The omnibus segregation requirements for stand-alone SBSBs (including those also registered as OTC derivatives dealers) and bank SBSBs are codified in Rule 18a–4.

The omnibus segregation requirements are mandatory with respect to money, securities, or other property that is held by a stand-alone broker-dealer or SBSB and that relate to cleared security-based swap transaction (i.e., customers cannot waive segregation). With respect to non-cleared security-based swap transactions, the omnibus segregation requirements are an alternative to the statutory provisions discussed above pursuant to which a counterparty can elect to have initial margin individually segregated or waive segregation. With respect to non-cleared security-based swap transactions, the omnibus segregation requirements are an alternative to the statutory provisions discussed above pursuant to which a counterparty can elect to have initial margin individually segregated or waive segregation. However, under the final omnibus segregation rules for stand-alone broker-dealers and broker-dealer SBSBs codified in Rule 15c3–3, counterparties that are not an affiliate of the firm cannot waive segregation. Affiliated counterparties of a stand-alone broker-dealer or broker-dealer SBSB can waive segregation. Under Section 3E(f) of the Exchange Act and Rule 18a–4, all counterparties (affiliated and non-affiliated) to a non-cleared security-based swap transaction with a stand-alone or bank SBSB also can waive segregation. The omnibus segregation requirements are the “default” requirement if the counterparty does not elect individual segregation or to waive segregation (in the cases where a counterparty is permitted to waive segregation).

Under the final segregation rules, an SBSB or stand-alone broker-dealer must maintain a security-based swap customer reserve account to segregate cash and/or qualified securities in an amount equal to the net cash owed to security-based swap customers. The SBSB or stand-alone broker-dealer must at all times maintain, through deposits into the account, cash and/or qualified securities in amounts computed weekly in accordance with the formula set forth in the rules. In the case of a broker-dealer, this account must be separate from the reserve accounts it maintains

<sup>1214</sup> See Better Markets 11/19/2018 Letter.

<sup>1215</sup> See paragraph (c)(1)(iii)(G) of Rule 18a–3, as adopted.

for traditional securities customers and broker-dealers.

The formula in the final segregation rules requires the SBSD or stand-alone broker-dealer to add up various credit items (amounts owed to security-based swap customers) and debit items (amounts owed by security-based swap customers). If, under the formula, credit items exceed debit items, the SBSD or stand-alone broker-dealer must maintain cash and/or qualified securities in that net amount in the security-based swap customer reserve account. For purposes of the security-based swap reserve account requirement, qualified securities are: Obligations of the United States; obligations fully guaranteed as to principal and interest by the United States; and, subject to certain conditions and limitations, general obligations of any state or a political subdivision of a state that are not traded flat and are not in default, are part of an initial offering of \$500 million or greater, and are issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year end.

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. SBSDs and MSBSPs must provide this notice in writing to a duly authorized individual prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the compliance date of the rule. SBSDs also must obtain subordination agreements from a counterparty that affirmatively elects to have initial margin held at a third-party custodian or that waives segregation.

The final segregation rules modify the proposed definition of “excess securities collateral” to exclude securities collateral held in a “third-party custodial account” as that term is defined in the rules.<sup>1216</sup> The final segregation rules also incorporate the definition of “third-party custodial account” that was included in the 2018 comment reopening but with modifications suggested by the commenters to broaden the definition to include domestic registered clearing organizations and depositories and

foreign supervised banks, clearing organizations, and depositories.<sup>1217</sup> The final segregation rules also modify the proposed definition of “qualified registered security-based swap dealer account” to remove the limitation that the account be held at an unaffiliated SBSD.

MSBSPs collect initial margin from security-based swap counterparties under a house margin requirement are subject to Section 3E(f) of the Exchange Act under the baseline, which—as discussed above—establishes a program by which a counterparty to non-cleared security-based swaps with an MSBSP can elect to have initial margin held at an independent third-party custodian.

#### b. Benefits and Costs of the Segregation Rules

Under the baseline, the Section 3E(b) of the Exchange Act provides that, for cleared security-based swaps, the money, securities, and property of a security-based swap customer 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. Therefore, under the baseline, stand-alone broker-dealers and SBSDs must segregate collateral for cleared security-based swaps and, therefore, the benefits of segregation (*i.e.*, protecting initial margin) will accrue to market participants to the extent they clear security-based swaps through stand-alone broker-dealers and SBSDs. However, the Section 3E(c)(1) of the Exchange Act also provides that, for cleared security-based swaps, customers’ money, securities, and property may, for convenience, be commingled and deposited in the same one or more accounts with any bank, trust company, or clearing agency. The Commission’s final omnibus segregation rules will permit stand-alone broker-dealers and SBSDs to commingle customers’ initial margin for cleared security-based swaps. Therefore, these entities will benefit from the efficiencies and lower costs of treating initial margin for cleared security-based swaps in this manner as compared to individually segregating each customer’s initial margin. The benefits of these efficiencies and lower costs will accrue to market participants in the form of quicker executions of cleared security-

based swap transactions and lower transaction fees.

Stand-alone broker-dealers and SBSDs will incur costs to develop systems, controls, and procedures to comply with the omnibus segregation requirements and to operate those systems, controls, and procedures. These costs may be passed on to market participants to the extent they clear security-based swaps through stand-alone broker-dealers and SBSDs. However, these costs will be lower than the costs that would have been incurred under the baseline segregation requirement for cleared security-based swaps because it would not have permitted commingling of customers’ initial margin. Thus, under the baseline, the stand-alone broker-dealers and SBSDs would have needed to develop and operate systems, controls, and procedures to individually segregate each customer’s initial margin in separate accounts. This would have been a much more complex undertaking than it will be to develop and operate systems to comply with the omnibus segregation requirements where commingling customers’ initial margin in a single account is permitted.

With respect to non-cleared security-based swaps, the final omnibus segregation rules are not mandatory. Counterparties that are affiliates of the stand-alone broker-dealer or broker-dealer SBSD with whom they are transacting the non-cleared security-based swap can potentially elect individual segregation, omnibus segregation, or to waive segregation. Counterparties (regardless of whether they are affiliates) potentially can elect any of these alternatives if they are a counterparty to a non-cleared security-based transaction with a stand-alone or bank SBSD. Counterparties that are *not* affiliates of the stand-alone broker-dealer or broker-dealer SBSD with whom they are transacting the non-cleared security-based swap can potentially elect either individual segregation or omnibus segregation (they cannot waive segregation).

Therefore, the direct benefits and costs of the Commission’s final omnibus segregation rules as applied to non-cleared security-based swap transactions will depend, in large part, on the entities with whom counterparties choose to transact: Stand-alone broker-dealers and broker-dealer SBSDs (where the option to waive segregation is not available to non-affiliates) or stand-alone and bank SBSDs (where the option to waive segregation is potentially available to all counterparties and where the option for the stand-alone or bank SBSD to operate

<sup>1216</sup> See paragraph (p)(1)(ii)(B) of Rule 15c3–3, as amended; paragraph (a)(2)(ii) of Rule 18a–4, as adopted.

<sup>1217</sup> See paragraph (p)(1)(viii) of Rule 15c3–3, as amended; paragraph (a)(10) of Rule 18a–4, as adopted.

under the exemption from the omnibus segregation rules is available).

Because segregation (individual or omnibus) is mandatory when a non-affiliated counterparty enters into a non-cleared security-based swap with a stand-alone broker-dealer or broker-dealer SBSB, and because omnibus segregation is the default requirement for a stand-alone SBSB or bank SBSB, the final rules could incrementally increase the amount of collateral that is segregated for non-cleared security-based swaps. The amount of this increase will depend on whether counterparties elect individual segregation or, if permitted, to waive segregation. It also will depend on whether counterparties elect to transact with stand-alone or bank SBSBs operating under the exemption to the omnibus segregation requirements or with stand-alone SBSBs operating pursuant to the alternative compliance mechanism. If counterparties elect these alternatives to omnibus segregation, the final rules (themselves) will have a limited impact on the amount of collateral that is segregated. However, if they do increase the amount of collateral that is segregated, SBSBs may pass these costs to market participants.

However, these costs may be limited. In general, the Commission expects most non-cleared security-based swap dealing will be conducted by stand-alone and bank SBSBs (where waiver by non-affiliated counterparties will be permitted). This is because the Commission expects that dealers in non-cleared security-based swaps will organize themselves as stand-alone SBSBs to take advantage of the more favorable capital requirements applicable to stand-alone SBSBs under the final rules (*i.e.*, the absence of a portfolio concentration charge and the ability to use the alternative compliance mechanism).

Furthermore, the Commission expects that dealers in non-cleared security-based swaps will generally seek exemption from the omnibus segregation requirements in Rule 18a-4, which is available to stand-alone and bank SBSBs. While qualifying for the exemption means they will not be able to clear security-based swap transactions for others, the Commission does not believe that will discourage dealers in non-cleared security-based swaps from organizing as stand-alone or bank SBSBs to take advantage of the exemption.<sup>1218</sup> Moreover, the

Commission does not believe that an entity will register solely as an SBSB to clear security-based swap transactions for others, given the relative size of the cleared security-based swap market as compared to the cleared swap market. Therefore, entities that want to clear security-based swaps will also want to clear swaps and, therefore, need to register as FCMs. This creates a strong incentive to effect brokered cleared transactions through entities that are dually registered as broker-dealers and FCMs, and to deal in non-cleared transactions in stand-alone SBSBs and swap dealers.

Finally, based on FOCUS information, the Commission believes that the broker-dealers most active in dealing in non-cleared security-based swaps will trade mostly with affiliates that will be permitted to waive segregation under the final omnibus segregation rule for stand-alone broker-dealers and broker-dealer SBSBs. For these reasons, the Commission does not expect the limitation in Rule 15c3-3 that prohibits a non-affiliated counterparty from waiving segregation will significantly increase the amount of collateral segregated for non-cleared security-based swap transactions.

In the context of transactions where the waiver limitation does not apply, the benefits and costs of the final segregation rule will depend on whether counterparties elect individual segregation or to waive segregation under Section 3E(f) of the Exchange Act, or, alternatively, elect to have their initial margin held directly by the stand-alone broker-dealer or SBSB subject to the omnibus segregation requirements. Thus, in evaluating the costs and benefits of the final segregation rules, the Commission considers the implications of optionality on the segregation choices of market participants, and the impact of those choices on the costs and benefits of the rules. In this regard, available information suggests that customer assets related to security-based swap transactions are currently not consistently segregated from dealer proprietary assets. With respect to non-cleared security-based swaps, available information suggests that there is no uniform segregation practice but that collateral for most accounts is not

capital rule (Rule 15c3-1). Bank swap dealers in particular appear to avoid clearing swaps for customers (and limit their swap dealing activities to non-cleared swaps), as engaging in such business would subject them to the capital requirements for FCMs in addition to the capital requirements that would apply to them under the bank capital rules.

segregated.<sup>1219</sup> According to an ISDA margin survey, where independent amounts (initial margin) are collected, ISDA members reported that most (72%) was commingled with variation margin and not segregated, and less than 5% of the amount received was segregated with a third party-custodian.<sup>1220</sup>

As a general matter, more restrictive segregation regimes (*i.e.*, individual segregation, omnibus segregation, or similar privately negotiated arrangements) provide more protection to the posting party. However, they “lock up” collateral to varying degrees, restricting its use by the collecting party, and raise the overall cost of the transaction. Avoiding segregation can lower the costs of the transaction by permitting the recipient of collateral to obtain benefits from its use. However, collateral that is not segregated may be difficult to recover when the holder of the collateral is in distress. Thus, the absence of segregation can potentially contribute to instability in times of stress.

In response to the 2018 comment reopening, one commenter recommended that the Commission not impose the omnibus segregation requirements on bank SBSBs, foreign SBSBs, stand-alone SBSBs, and OTC derivatives dealers that do not clear for customers.<sup>1221</sup> This commenter argued that the proposed omnibus segregation requirements could conflict with bank liquidation or resolution, may cause jurisdictional disputes, and are not consistent with the Exchange Act. In addition, this commenter stated that omnibus segregation requirements would impair hedging and funding activities for stand-alone SBSBs and OTC derivatives dealers because the exclusions related to the use of excess securities collateral admit only a narrow range of hedging activities. In particular, the commenter was concerned that a failure to recognize hedging strategies using instruments other than security-based swaps would create undue regulatory incentives to transact using one type of instrument versus another.

<sup>1219</sup> See generally *ISDA Margin Survey 2012*. More recent ISDA margin surveys do not include the relevant statistics.

<sup>1220</sup> See *ISDA Margin Survey 2012*. The survey also notes that while the holding of the independent amounts and variation margin together continues to be the industry standard both contractually and operationally, the ability to segregate has been made increasingly available to counterparties over the past three years on a voluntary basis, and has led to adoption of 26% of independent amounts received and 27.8% of independent amounts delivered being segregated in some respects. See also ISDA, *Independent Amounts*, Release 2.0.

<sup>1221</sup> See SIFMA 11/19/2018 Letter.

<sup>1218</sup> In particular, to clear swaps for others, a swap dealer must be registered as an FCM under the CFTC's rules. The FCM capital rule prescribes a net liquid asset test similar to the broker-dealer net

As discussed above, the final segregation rule for stand-alone and bank SBSBs will exempt these entities from the requirements of the rule if the SBSB meets certain conditions, including that the SBSB does not clear security-based swap transactions for other persons, provides statutory notice to the counterparty regarding the right to segregate initial margin at an independent third-party custodian, and discloses in writing that any collateral received by the SBSB will not be subject to a segregation requirement and how a counterparty's claim on collateral would be treated in a bankruptcy or other formal liquidation proceeding of the SBSB. This modification from the proposed rule will lessen the costs imposed on stand-alone and bank SBSBs that do not clear security-based swaps for other persons by avoiding conflict with other regulations and minimizing the impact on hedging activity. As discussed above, the Commission expects these firms will not choose to clear security-based swaps for others because, from an economic perspective, it is more attractive to clear security-based swaps and swaps for others. Clearing swaps for others requires registration as an FCM and, therefore, compliance with the CFTC's capital requirements for FCMs.

However, the exemption to the final segregation rule may also impose costs on market-participants. A stand-alone or bank SBSB that is making use of this exemption would be able to commingle the collateral collected from counterparties with its own assets. In particular, the firm would be able to use a counterparty's collateral to collateralize a transaction with another counterparty (*i.e.*, collateral re-hypothecation). In the event of the stand-alone or bank SBSB's failure, counterparties may have difficulty recovering their collateral in a timely manner, or at all.

The omnibus segregation requirements are the default requirement for non-cleared security-based swaps if the counterparty does not affirmatively elect individual segregation or to waive segregation (and if the SBSB is not operating pursuant to the exemption for bank and stand-alone SBSBs). A large body of behavioral economics literature has documented the power of defaults in driving individual behavior.<sup>1222</sup> In addition, the final segregation rules require a foreign SBSB to disclose to a U.S. security-based swap customer the potential

treatment of the assets segregated by the SBSB pursuant to Section 3E of the Exchange Act, and the rules and regulations thereunder, in insolvency proceedings under U.S. bankruptcy law and applicable foreign insolvency laws. This requirement may cause SBSBs' customers to devote more attention to the choice of segregation regime and may potentially trigger greater reluctance to transact without segregation.<sup>1223</sup> Thus, the rule's requirement that omnibus segregation be the default approach for non-cleared security-based swaps could have the effect of increasing the use of some form of segregation in non-cleared security-based swap transactions. However, the Commission cannot determine the extent to which having omnibus segregation be the default requirement will increase the use of segregation. In particular, the Commission lacks information on the extent to which market participants prefer various segregation options, as well as data on the extent to which defaults determine the behavior of market participants active in the security-based swap market.<sup>1224</sup>

The Commission cannot predict the ultimate magnitude of the use of segregation by counterparties to non-cleared security-based swap transactions under the final rules. Counterparties to non-cleared security-based swap transactions may find it privately beneficial to waive segregation. For example, a hedge fund customer of a dealer may consider the risk of dealer insolvency to be too remote to warrant requiring the segregation of its initial margin if waiving segregation results in the dealer offering better terms, or providing other non-pecuniary benefits.<sup>1225</sup> Alternatively, two dealers with bilateral security-based swap exposures that require similar amounts of initial margin can reduce the total collateral required to support those exposures by

waiving segregation. Waiving segregation allows collateral posted by the first dealer to be used by the second dealer to satisfy its margin obligation to the first: the end result is similar to when initial margin is not required. In addition, other factors may contribute to a lower use of segregation. For example, a dealer's counterparties may not be fully aware of the implications of the lack of segregation,<sup>1226</sup> or have insufficient bargaining power to extract the desired segregation arrangements.<sup>1227</sup>

Importantly, parties that decide that it is privately optimal to waive segregation for non-cleared security-based swaps may not take into account the potential externalities of their decisions. If customers generally do not avail themselves of the option to segregate collateral for non-cleared security-based swaps, this will reduce the potential positive contribution of the final segregation rules to financial stability. For example, the emergence of doubts about a dealer can lead to sudden demands for segregation, which during times of market stress may be difficult for dealers to satisfy, precipitating distress or failure. Moreover, if a dealer fails, the likelihood that its counterparties can recover their collateral in a timely manner is decreased, raising questions about the financial condition of those counterparties. In addition, to the extent that actual insolvency contributes to the dealer's failure, counterparties' collateral may never be fully recovered. Delays in recovery of collateral, realized losses, and the potential of such losses, could potentially lead to contagion, and destabilizing runs.

Conversely, to the extent that the final segregation rules ultimately increase the use of segregation for non-cleared security-based swaps, they could impose costs on SBSBs (and their counterparties). These costs would primarily result from limitations on SBSBs' use of initial margin. As discussed above in section VI.A.5.a. of this release, margin requirements have been adopted by the CFTC, prudential regulators, and foreign regulators, but they are being phased-in over time. Further, current market practice (in the absence of regulatory requirements)

<sup>1223</sup> See Victor Stango and Jonathan Zinman, *Limited and varying consumer attention evidence from shocks to the salience of bank overdraft fees*, Review of Financial Studies (2014).

<sup>1224</sup> Broadly, the evidence for behavioral biases tends to be more limited in "professional" contexts. See, e.g., John A. List, *Does Market Experience Eliminate Market Anomalies?* Quarterly Journal of Economics (Feb. 2003); Zur Shapira and Itzhak Venezia, *Patterns of behavior of professionally managed and independent investors*, Journal of Banking & Finance 25.8 (2001): 1573–1587.

<sup>1225</sup> Similar concerns were raised by a commenter who argued that by not mandating individual segregation, "cost considerations will lead [SBSBs] to pressure counterparties not to elect segregation." See *PIMCO Letter*. Another commenter stated that the costs for imposing omnibus segregation on foreign SBSBs would be significant. See IIB 11/19/2018 Letter.

<sup>1222</sup> See William Samuelson and Richard Zeckhauser, *Status Quo Bias in Decision Making*, Journal of Risk and Uncertainty 7–59 (1988).

<sup>1226</sup> See Alarna Carlsson-Sweeny, *Trends in Prime Brokerage*, Practical Law: The Journal (Apr. 2010) ("Few US hedge funds fully comprehended the repercussions of allowing their assets to be transferred offshore" to avoid the Commission's segregation requirements.).

<sup>1227</sup> See *id.* ("Before Lehman's collapse, the relationship between hedge funds and prime brokers was one-sided, with prime brokers holding most of the bargaining power.").



does not generally involve posting initial margin. Therefore, the impact of any restrictions on the use of such collateral strictly relative to the baseline should be quite limited. More specifically, under the baseline scenario where the exchange of initial margin for non-cleared security-based swaps is largely voluntary, segregation requirements that impose restrictions on how SBSDs can use collateral posted by their counterparties should have minimal economic effect, as the final segregation rules would be unlikely to bind. However, the margin requirements of the CFTC, prudential regulators, and the Commission (as they come into full effect) are expected to increase the prevalence of initial margin in non-cleared security-based swap transactions, and the Commission believes it is meaningful to also analyze the interaction of the new margin and segregation requirements. In this context, the impact of the Commission's final segregation rules is likely to be more significant.<sup>1228</sup> If, as a result of the final margin and segregation rules, security-based swap counterparties increase demand for segregation of initial margin for non-cleared security-based swaps, dealers' costs of engaging in security-based swap transactions will increase. Having unhindered access to customers' collateral represents a significant benefit to a dealer. Such collateral can be used by the dealer in its hedging and proprietary trading activities. In its absence, the dealer will bear the cost of financing the collateral to support these activities. Depending on the level of segregation required by the dealer's counterparties, the collateral required to support current levels of security-based swap activity could be significantly greater than in a regime without segregation and no restrictions on re-hypothecation. To the extent that the provisions of the final segregation rules increase demand for segregation in non-cleared security-based swap transactions, a dealer's costs of hedging these transactions may be higher than under existing market practice. Similarly, increased use of segregation for non-cleared security-based swaps would reduce dealers' ability to otherwise benefit from the use of customers' collateral. Both of these factors could potentially lead to higher apparent transaction costs in the security-based swap market.<sup>1229</sup>

<sup>1228</sup> See section VI.B.3. of this release for estimates of the use of margin under the Commission's final margin rules.

<sup>1229</sup> In the absence of segregation, part of the consideration offered by the SBSB's counterparty to the SBSB in an OTC derivatives transaction is non-pecuniary: the right to make use of the

Additional operational and up-front costs resulting from the final rules as applied to cleared and non-cleared security-based swaps include costs of establishing qualifying bank accounts, costs of third-party custody services and associated legal fees, as well as costs of building systems to maintain custody of customer securities and to perform the required calculations.<sup>1230</sup> The final rules require that stand-alone broker-dealers and SBSBs compute the amount required to be maintained in the special reserve account for the exclusive benefit of security-based swap customers at least weekly. This requirement supports the benefits of segregation described above, by ensuring that the assets subject to segregation more accurately reflect the risks to the posting party in the event that the holder of collateral fails. The final rules permit more frequent computations. Such flexibility will be valuable to those broker-dealers and standalone SBSBs that have the operational capability and resources to perform daily computations. These entities may choose to perform daily computations if the benefits of doing so—for example, being able to more rapidly take advantage of investment opportunities using cash withdrawn from the reserve account—outweigh the costs associated with daily computations.

In cases of a broker-dealer SBSB, the costs of adapting existing systems to account for cleared and non-cleared security-based swap transactions may not be material in light of the similarities between the systems and procedures currently required by Rule 15c3-3 and those that will be required by final segregation rules. For bank and stand-alone SBSBs without such systems, the operational up-front costs could be higher. However, even in these cases it is likely that the entities in question will have access to similar systems and expertise from their broker-dealer affiliates.<sup>1231</sup>

As discussed above, the extent to which segregation will be used by market participants for non-cleared

counterparty's collateral. In the absence of this benefit, the SBSB can be expected to require additional (likely pecuniary) consideration from the counterparty. This would appear as higher transaction costs. It is important to note that there would be a corresponding benefit realized by security-based swap counterparties: increased collateral safety.

<sup>1230</sup> See Rule 15c3-3, as amended; Rule 18a-4, as adopted. See section VI.C. of this release (discussing implementation costs).

<sup>1231</sup> As discussed above in section VI.A. of this release, dealing activity in the security-based swap and swap market is concentrated in affiliates of large diversified bank holding companies. Such firms can be expected to have access to expertise and systems of their broker-dealer affiliates.

security-based swaps is unknown. In particular, the Commission lacks data on the preferences of current market participants for various segregation options, as well as the private benefits and costs described qualitatively above that may inform a market participant's choice of whether to use individual segregation or omnibus segregation, or to waive segregation. In the absence of a material increase in the use of segregation for non-cleared security-based swaps, the direct costs of the final segregation rules borne by counterparties to security-based swaps should be minimal. Moreover, for market participants electing omnibus segregation for non-cleared security-based swaps, the direct costs should be lower than counterparties that elect individual segregation where the stand-alone broker-dealer or SBSB will not hold the collateral directly and will not be able to use it for the limited purpose permitted in the final rules (*i.e.*, hedging the customer's transaction). Thus, firms running matched books that collect initial margin from end-users should not have to fund additional collateral to support hedging transactions with other SBSBs. For these reasons, the costs of omnibus segregation should be lower as compared with individual segregation.<sup>1232</sup>

### c. Alternatives Considered

#### i. Mandatory Individual Segregation

A potential alternative to the final rules would be to mandate individual segregation for non-cleared security-based swaps in a manner that is consistent with the margin rules of the CFTC and the prudential regulators.<sup>1233</sup> This alternative would not give an SBSB's counterparty to a non-cleared security-based swap the option to elect omnibus segregation or to waive segregation altogether (if such a waiver is permitted). Thus, the alternative is considerably more restrictive. As discussed above, the magnitude of the costs and benefits of segregation depends on the extent to which it is adopted by market participants. Under this alternative, individual segregation would be mandatory and thus universally practiced. As a result, it would be more costly to market participants primarily due to significant additional collateral funding costs,

<sup>1232</sup> In addition, and as noted by one commenter, individually segregated accounts impose increased administrative burdens and related costs. See MFA 2/22/2013 Letter.

<sup>1233</sup> See *CFTC Margin Adopting Release*, 81 FR 636; *Prudential Regulator Margin and Capital Adopting Release*, 80 FR 74840.

while also providing financial stability benefits.

Mandatory individual segregation would likely reduce the risk of contagion. Third-party segregation with no re-hypothecation minimizes the risk of delays and losses in the recovery of collateral for transactions involving an entity that enters into financial distress.<sup>1234</sup> Under such arrangements, the counterparties of the troubled entity can be confident in their ability to recover their collateral in the event of its default. This reduces the incentives for counterparties to “run” on the troubled entity. In addition, it increases market participants’ confidence in the financial condition of the troubled entity’s counterparties in the event of its default: in such an event counterparties can be expected to recover their collateral *and* the collateral posted by the defaulting party. Access to the latter compensates the surviving counterparties for losses incurred in replacing the defaulted transaction. Together, these effects can stabilize the market in times of stress. Relatedly, this alternative would restrict the implicit leverage in non-cleared security-based swap transactions. By preventing re-hypothecation, the alternative would tie growth in the gross notional amounts of non-cleared security-based swap activity to the amount of collateral devoted to this activity. Similar to other forms of leverage limits, this can contribute to financial stability. Finally, by increasing the collateral costs of non-cleared security-based swap transactions, this alternative would create incentives for central clearing. Together, the aforementioned benefits could further reduce the likelihood of sequential counterparty failure in the security-based swap market beyond the rules the Commission is adopting.

However, these benefits of mandatory individual segregation with no re-hypothecation come with a cost. The alternative would deprive the SBSB of the use of collected collateral for re-hypothecation in related transactions, or in support of its trading operations. As discussed in the prior section, the locking up of collateral would raise the SBSB’s costs of facilitating security-based swap transactions.

Aside from the additional collateral funding costs, this alternative may further increase costs by reducing the

SBSB’s access to defaulting counterparties’ collateral in typical default scenarios. A typical defaulting counterparty is not expected to be another SBSB, but rather an end-user who does not collect collateral from the SBSB. In such scenarios, third-party segregation can complicate the SBSB’s attempts to make use of the defaulting counterparty’s collateral: Rather than having immediate access to collateral in its possession or control, the SBSB would need to obtain the collateral from a third party. This could create delays that harm the SBSB’s ability to liquidate and reestablish the positions of the insolvent counterparty, and may cause the SBSB to incur losses.

The Commission has considered the costs and benefits of requiring segregation at a third-party custodian and prohibiting re-hypothecation. Based on its judgment and prior experience, the Commission determines that the potential benefits to financial stability do not justify the potentially considerable additional costs that would need to be borne by market participants under this alternative approach.

#### ii. Daily Computations To Determine Reserve Account Requirement

The proposed rule provided that the computations necessary to determine the amount required to be maintained in the SBS 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. A commenter requested that the Commission require a weekly computation rather than a daily computation.<sup>1235</sup> The commenter stated that calculating the reserve account formula is an onerous process that is operationally intensive and requires a significant commitment of resources. The commenter further stated that the Commission can achieve its objective of decreasing liquidity pressures on SBSBs while limiting operational burdens by requiring weekly computations and permitting daily computations. The Commission acknowledges that a daily reserve calculation will increase operational burdens as compared to a weekly computation. Therefore, in response to comments, the Commission is modifying the final rules to require a

weekly SBS Customer Reserve Account computation.<sup>1236</sup>

#### iii. Including Securities Collateral Held in a Third-Party Custodial Account in the Definition of “Excess Securities Collateral”

The proposed definition of “excess securities collateral” did not include securities collateral held in a third-party custodial account. As discussed above in section II.C.3.a.i. of this release, the proposed definition would have prevented a stand-alone broker-dealer or SBSB from posting a customer’s securities collateral to a third-party custodian in accordance with the requirements of the prudential regulators. This consequence could have increased the cost incurred by the stand-alone broker-dealer or nonbank SBSB to enter into a non-cleared security-based swap with another SBSB to hedge a non-cleared security-based swap with a customer under the conditions in the final segregation rules. Under the proposed definition of “excess securities collateral,” a broker-dealer or SBSB would have had to use proprietary securities or cash to enter into a hedging transaction with a bank SBSB. To the extent that the firm incurs a cost to obtain the proprietary securities or cash, that cost would add to the cost of entering into the hedging transaction with the bank SBSB and thus raise the overall cost of hedging the transaction with the customer. Alternatively, the broker-dealer or SBSB would have had to limit its hedging transactions to nonbank SBSBs and avoid trading with bank SBSBs. This approach would have avoided the need to use proprietary securities or cash to enter into a hedging transaction, as discussed above. However, by limiting itself to a smaller set of potential counterparties (*i.e.*, other SBSBs), the firm would have reduced the competition among potential counterparties to provide hedging services to the firm. If the reduced competition resulted in higher prices for liquidity provision, for example, wider bid-ask spreads, the broker-dealer or SBSB may have incurred a higher cost to enter into a hedging transaction. To the extent that the firm passed on the increased hedging cost to the customer by charging a higher price for providing liquidity to the customer, transaction costs in the security-based swap market could have risen, which may have discouraged participation in the security-based swap market and

<sup>1234</sup> These risks are not entirely eliminated. Delays may still occur due to legal disputes that prevent the third-party custodian from releasing the collateral. Similarly, losses may still occur if the third-party custodian suffers from financial distress. However, under individual segregation with no re-hypothecation, the potential for such delays and losses is expected to be relatively limited.

<sup>1235</sup> See SIFMA 2/22/2013 Letter.

<sup>1236</sup> See paragraphs (p)(3)(A) and (B) of Rule 15c3–3, as amended; paragraphs (c)(3)(i) and (ii) of Rule 18a–4, as adopted.

impeded the use of this market for hedging economic exposures. In light of this concern, the Commission believes that the definition of “excess securities collateral” in the final rules is preferable to this alternative.

iv. Including “Unaffiliated” in the Definition of “Qualified Registered Security-Based Swap Dealer Account”

The proposed definition of “qualified registered security-based swap dealer account” included the term “unaffiliated,” which meant that an affiliated SBSB would not fall within the scope of the proposed definition. As the Commission has discussed elsewhere, entities that engage in security-based swap dealing activities may lay off the risk associated with a security-based swap transaction to another affiliate via a back-to-back transaction or an assignment of the security-based swap.<sup>1237</sup> To the extent that a broker-dealer or SBSB enters into a non-cleared security-based swap with an affiliated SBSB to hedge a non-cleared security-based swap with a customer as part of its risk management, the proposed definition could impede the firm’s risk management because it could not use the counterparty’s initial to meet the margin requirement of the affiliated SBSB under the conditions of the final rules. As a consequence, the broker-dealer or SBSB could have incurred a higher cost to enter into a non-cleared security-based swap with an affiliated SBSB for hedging purposes as permitted under the conditions in the final rules. If the broker-dealer or SBSB chose to enter into a hedging transaction with an affiliated SBSB, it would had to use proprietary securities or cash to meet the affiliate SBSB’s margin requirement. To the extent that the nonbank SBSB incurred a cost to obtain the proprietary securities or cash, that cost would add to the cost of entering into the hedging transaction with the affiliated SBSB and thus raise the overall cost of hedging the firm’s transaction with the counterparty. Alternatively, the nonbank SBSB could enter into a hedging transaction with an unaffiliated SBSB that satisfies the proposed definition of “qualified registered security-based swap dealer account” so that it could use the counterparty’s initial margin to meet the margin requirement of the unaffiliated SBSB. However, the nonbank SBSB may have still incurred a higher cost to enter into the hedging transaction, if the

unaffiliated SBSB charges a higher price for providing liquidity than the affiliated SBSB. More generally, to the extent that cost efficiencies are realized through the use of the affiliated SBSB for risk management purposes, those efficiencies would be lost if the broker-dealer or SBSB enters into a hedging transaction with an unaffiliated SBSB, which would raise the overall cost of the hedging transaction. To the extent that the broker-dealer or SBSB passed on the increased hedging cost to the counterparty by charging a higher price for providing liquidity to the counterparty, transaction costs in the security-based swap market could have risen, which could have discouraged participation in the security-based swap market and impede the use of this market for hedging economic exposures. In light of this concern, the Commission believes that the definition of “qualified registered security-based swap dealer account” in the final rules is preferable to this alternative.

## 5. Cross-Border Application

### a. Overview

As the Commission has previously indicated, security-based swap market is global, and market data presented in the economic baseline demonstrates extensive cross-border participation in the market.<sup>1238</sup> For example, approximately half of price-forming North American corporate single-name CDS transactions from January 2008 to December 2015 were cross-border transactions between a U.S.-domiciled counterparty and a foreign-domiciled counterparty. Counterparties in the security-based swap market are highly interconnected; dealers transact with hundreds of counterparties, and most non-dealers transact with multiple dealers. The global scale of the security-based swap market allows counterparties to access liquidity across jurisdictional boundaries, providing market participants with opportunities to share these risks with counterparties around the world. Because dealers facilitate the great majority of security-based swap transactions, with bilateral relationships that extend to potentially thousands of counterparties spanning

multiple jurisdictions, the safety and soundness of non-U.S. dealers can have significant implications for U.S. financial stability.

As discussed above in section II.E.1. of this release, the Commission is treating the capital and margin requirements of the Exchange Act the final rules as entity-level requirements. The Commission also is amending Rule 3a71–6 to make a substituted compliance available with respect to the capital and margin requirements of Section 15F(e) of the Exchange Act and Rules 18a–1, 18a–2, and/or 18a–3.

The Commission is treating the segregation requirement as a transaction-level requirement. Further, substituted compliance is not available with respect to the final segregation requirements. However, the final segregation rule for stand-alone and bank SBSBs and MSBSPs has exceptions under which a foreign firm need not comply with the segregation requirements of Section 3E of the Exchange Act and Rule 18a–4 for certain transactions. The final rule also requires a foreign stand-alone or bank SBSB to make certain disclosures to a U.S. security-based swap customer relating to segregation and U.S. bankruptcy and foreign insolvency laws. There are no exceptions from the segregation rule for cross-border transactions of a broker-dealer SBSB or MSBSP.

### b. Benefits and Costs

In considering the economic effects of this cross-border approach, the Commission recognizes that the economic baseline reflects markets as they exist today, in which no population of registered SBSBs and MSBSPs exists and compliance with capital, margin, and segregation requirements for security-based swaps is not required. Therefore, these final rules will apply with respect to security-based swap transactions intermediated by entities where they currently do not.

Imposing the new capital and margin requirements on non-U.S. SBSBs and MSBSPs has the potential to significantly impact the willingness of foreign entities to transact with U.S. counterparties in the security-based swap market, especially firms for which the U.S. market represents a relatively small fraction of total security-based swap business. For such firms, the additional costs resulting from having to comply with the capital and margin requirements of the Exchange Act the Commission’s final rules in addition to corresponding regulations applicable in their own jurisdiction may not justify the benefits of conducting security-based swap transactions with U.S.

<sup>1238</sup> See, e.g., *Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities*; *Republication*, 79 FR at 47280; *Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected With a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent*, 80 FR at 27454; *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 81 FR 29960.

<sup>1237</sup> See *Proposed Guidance and Rule Amendments Addressing Cross-Border Application of Certain Security-Based Swap Requirements*, 84 FR 24206.

entities. The exit of foreign firms from the U.S. security-based swap market could potentially harm liquidity in these markets, and more importantly, would likely reduce valuable risk-sharing opportunities for U.S. counterparties.

However, as noted earlier, the global and inter-connected nature of the security-based swap market implies that the safety and soundness of non-U.S. firms operating in this market can have a significant impact on U.S. financial stability. Moreover, failing to apply capital and margin regulations to such foreign entities would potentially create incentives for regulatory arbitrage as participants in U.S. markets would seek to locate in jurisdictions with the most favorable capital and margin treatment.

With respect to capital requirements, the Commission believes that imposing the same entity-level requirements that are applicable to U.S. firms on non-U.S. entities with the opportunity for substituted compliance in cases where the foreign jurisdiction imposes comparable requirements reflects appropriate consideration of potential compliance costs and benefits to U.S. markets. By allowing non-U.S. entities to satisfy comparable requirements in foreign jurisdictions, the rule mitigates the compliance burden on these non-U.S. entities. At the same time, by requiring compliance with capital requirements at the entity level, the rule should reduce the likelihood that entities operating in the U.S. market will impose negative financial stability externalities on the U.S. market by locating in a foreign jurisdiction. The Commission did not receive comments addressing the proposed treatment of capital as an entity-level requirement.

Similar considerations apply to the Commission's approach in treating the final margin requirements as entity-level requirements. A number of commenters suggested that the Commission should apply margin requirements on a transaction-level basis instead of on an entity-level basis, with several arguing that this was necessary for consistency with other domestic and foreign regulators.<sup>1239</sup> Some of these

commenters also pointed to the costs and operational complications that could result from subjecting a foreign registrant to both Commission and home country margin requirements.<sup>1240</sup>

While there are potential consistency issues and operational complications to applying the Commission's margin requirements at the entity-level rather than at the transaction-level, these considerations have to be considered in the context of the economic function of margin requirements. The primary economic function of the Commission's final margin requirements is to enhance financial stability to help ensure the safety and soundness of nonbank SBSBs and nonbank MSBSPs. Permitting substantially different margin requirements based on the location of the counterparty would not be consistent with this objective and could undermine the stability of U.S. markets. Moreover, as above discussed in section VI.B.3. of this release, the Commission expects market participants to employ industry standard models in the calculation of initial margin amounts. It is reasonable to expect that such models will be designed in a manner to comply with the margin requirements of the key jurisdictions implementing margin regulations, thereby reducing the potential for significant discrepancies. Finally, minor differences in margin requirements across jurisdictions can be addressed through applications for substituted compliance.

While Commission's final capital and margin requirements primarily serve to ensure the safety and soundness of regulated entities and thereby enhance financial stability, a primary economic function of the Commission's final segregation requirements is to protect the assets of U.S. customers and counterparties in the event of an SBSB's insolvency and to align the final segregation requirements with U.S. insolvency laws. As such, the Commission proposed transaction-level requirements tailored to address the risks faced by U.S. customers of non-U.S. entities. The Commission did not receive comments addressing the transaction-level treatment of the segregation requirements. However, one commenter stated that it "support[s] the

Commission's overall proposal to distinguish between entity-level and transaction-level requirements" and that it "generally support[s] the Commission's proposed cross-border application of segregation requirements to foreign SBSBs."<sup>1241</sup> The main considerations in the design of the Commission's segregation requirements with respect to non-U.S. SBSBs and MSBSPs are of a legal rather than economic nature. They are discussed in section II.D.1. of this release.

## 6. Rule 18a–10

### a. Overview

As discussed above in section II.D. of this release, the final capital, margin, and segregation rules include an alternative compliance mechanism (codified in Rule 18a–10) pursuant to which a stand-alone SBSB that is registered as a swap dealer and predominantly engages in a swaps business may elect to comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules applicable to swap dealers instead of complying with Rules 18a–1, 18a–3, and 18a–4.<sup>1242</sup> In order to qualify for the alternative compliance mechanism, the firm must: (1) Be registered as an SBSB pursuant to Section 15F(b) of the Exchange Act and the rules thereunder; (2) be registered as a swap dealer pursuant to Section 4s of the Commodity Exchange Act and the rules thereunder; (3) not be registered as a broker-dealer pursuant to Section 15 of the Exchange Act or the rules thereunder; (4) meet the conditions to be exempt from Rule 18a–4 specified in paragraph (f) of that section; and (5) as of the most recently ended quarter of the fiscal year, have an aggregate gross notional amount of the security-based swap positions of the that do not exceed the lesser of the maximum fixed-dollar amount specified in paragraph (f) of the rule or 10 percent of the combined aggregate gross notional amount of the security-based swap and swap positions of the SBSB. The maximum fixed-dollar amount is set at a transitional level of \$250 billion for the first 3 years after the compliance date of the rule and then drops to \$50 billion thereafter unless the Commission issues an order: (1) Maintaining the \$250 billion maximum fixed-dollar amount for an additional period of time or indefinitely; or (2) lowering the maximum fixed-dollar

<sup>1239</sup> See *Better Markets* 8/21/2013 Letter (arguing that treating margin as a transaction-level requirement "is more consistent with the CFTC's cross-border guidance"); IIB 8/21/2013 Letter (stating that the Commission's divergence from the CFTC's rules and those envisioned by the EMIR would be "impracticable" and "could also lead to significant competitive distortions"); ISDA 1/23/2013 Letter (generally requesting that the Commission recognize local margin requirements for SBSBs outside the United States, and coordinate with the CFTC and other domestic and foreign regulators to achieve consistency in the treatment of swaps and security-based swaps involving

multiple jurisdictions); Japan SDA Letter (urging the Commission and the CFTC to align their rules to avoid "hamper[ing] efficient management of derivatives transactions").

<sup>1240</sup> See IIB 8/21/2013 Letter (stating that it would be "cost-intensive" to "negotiate and execute separate credit support documentation, make separate margin calculations and have separate operational procedures across its swap and [security-based swap] transactions"); Japan SDA Letter (inconsistent rules would "hamper efficient management of derivatives transactions").

<sup>1241</sup> See IIB 8/21/2013 Letter.

<sup>1242</sup> See Rule 18a–10. As discussed above in section II.D. of this release, while a bank SBSB could theoretically use the alternative compliance mechanism, the Commission does not expect such an entity will do so.

amount to an amount between \$250 billion and \$50 billion.

The rule further requires a stand-alone SBSB operating pursuant to the alternative compliance mechanism to provide a written disclosure to its counterparties before the first transaction with the counterparty after the firm begins operating pursuant to the mechanism notifying the counterparty that the firm is complying with the applicable capital, margin, segregation, recordkeeping, and reporting requirements of the CEA and the CFTC's rules in lieu of complying with Rules 18a-1, 18a-3, and 18a-4. The rule further requires, among other things, that the firm comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules applicable to swap dealers and treat security-based swaps and related collateral pursuant to those requirements to the extent the requirements do not specifically address security-based swaps and related collateral.

#### b. Benefits and Costs of Rule 18a-10

The final rule provides stand-alone SBSBs that are also registered as swap dealers and that engage predominantly in swap activity with flexibility to comply with a single set of requirements under the CEA and the CFTC's rules. The primary benefit of the alternative compliance mechanism is that it will avoid the costs of complying with two sets of capital, margin, and segregation requirements for a firm that is dually registered as a stand-alone SBSB and a swap dealer. This benefit is perhaps best illustrated through how it will permit a stand-alone SBSB to comply with the capital requirements of the CEA and the CFTC's rules exclusively rather than comply both with those requirements and with the capital requirements of the Commission's rules. For example, a stand-alone SBSB operating pursuant to the alternative compliance will not need to perform two capital computations and monitor its capital position and financial condition to ensure it is complying with the Commission's capital requirements (in addition to the capital requirements of the CEA and the CFTC's rules).

Moreover, as discussed above, the Commission's final capital rules impose certain requirements with respect to swap positions that are not imposed by the CFTC's proposed capital rules and that could have important economic implications for firms that engage in swap trading activity. These requirements include a requirement that a stand-alone SBSB will need to take a capital deduction if the firm posts initial

margin to a counterparty in a swap transaction pursuant to the margin rules of the CFTC. The Commission is providing guidance in this release as to how a firm could avoid this capital deduction. While some firms may be able to take advantage of this guidance, others may not. Thus, generally, the requirement may impose costs on those firms that cannot use the guidance.

In addition, stand-alone SBSBs also will be required to take a capital deduction in lieu of margin or credit risk charge for uncollateralized exposures from swap positions that are subject to an exception in the margin rules of the CFTC. For example, one such exception in the CFTC's margin rules is that swap dealers are not required to collect initial margin on swaps from counterparties that are not "covered swap entities" or "financial end users," as those terms are defined in the rules. Because reallocating capital from other activities to support the swap trading activity or raising capital is generally costly, the requirement may impose a cost on those firms that carry uncollateralized exposures from swap transactions.

Another requirement is that stand-alone SBSBs will be required to take a capital deduction or credit risk charge for margin collateral required of a counterparty pursuant to the CFTC's margin rule that is held at a third-party custodian. The final capital rules contain an exception from having to take this capital charge. The conditions for the exception are designed to recognize existing agreements entered into pursuant to the margin rules of the CFTC. However, to the extent firms cannot meet all the conditions for the exception, they may not be able to avoid taking the capital charges associated with this requirement, and therefore may incur potential costs.

The proposed capital rules of the CFTC do not include some requirements being adopted by the Commission, and therefore swap dealers that are not dually registered as SBSBs may not face the potential costs associated with these requirements. From this perspective, stand-alone SBSBs that can meet the conditions of the alternative compliance mechanism will have an incentive to take advantage of it. The larger the potential costs associated with the differences between the final capital rules of the CFTC (when adopted) and the Commission, the larger the potential impact of the overlapping regulatory regimes on the swap trading activity. The alternative compliance mechanism will reduce the potential impact of these costs on the swap trading activity of stand-alone SBSBs, which, in turn,

could benefit the swap market participants to the extent that stand-alone SBSBs that use the alternative compliance mechanism pass on the associated cost savings to their counterparties in the form of lower prices for liquidity provision.

Firms that face potential costs associated with differences between the capital, margin, and segregation requirements of the Commission's rules and the CFTC's rules may be at a competitive disadvantage relative to firms that are subject to the CFTC's rules only, and, as a result, the latter category of firms may be able to offer better prices to swap market participants. Therefore, the primary benefit of the alternative compliance mechanism is that it will avoid these costs and the corresponding competitive impact of them.

However, using the alternative compliance mechanism will also impose costs on stand-alone SBSBs. In particular, the requirement to provide written disclosure to all counterparties prior to the first transaction that would be subject to the alternative compliance mechanism will impose costs. These implementation costs are discussed in more detail in section VI.C. below.

The maximum fixed-dollar amount is set at a transitional level of \$250 billion for the first 3 years after the compliance date of the rule and then drops to \$50 billion thereafter unless the Commission issues an order: (1) Maintaining the \$250 billion maximum fixed-dollar amount for an additional period of time or indefinitely; or (2) lowering the maximum fixed-dollar amount to an amount between \$250 billion and \$50 billion.

Analysis by Commission staff indicates that the 10% threshold likely will be the greater of the two thresholds for stand-alone SBSBs that are also registered as swap dealers. Thus, the following discussion focuses on the maximum fixed-dollar threshold. Commission staff estimates that up to seven stand-alone SBSBs that are also registered as swap dealers have aggregate gross notional amount of single-name CDS positions that fall under the \$250 billion threshold. Out of these 7 stand-alone SBSBs that are also swap dealers, Commission staff estimates that between 1 and 4<sup>1243</sup> may engage in levels of security-based swap activity such that the aggregate gross notional amount of their single-name CDS positions may fall under the \$50 billion threshold.

<sup>1243</sup> The upper bound estimate of 4 accounts for data limitations and measurement errors.

To the extent that the aggregate gross notional amount of these stand-alone SBSBs' single-name CDS positions remains unchanged, the lowering of the maximum fixed-dollar amount from \$250 billion to \$50 billion could impose costs on certain stand-alone SBSBs that may seek to use the alternative compliance mechanism. In particular, stand-alone SBSBs with aggregate gross notional amount of less than \$250 billion but above \$50 billion will be able to use alternative compliance mechanism in the first 3 years and benefit from the associated cost savings discussed above. If the maximum fixed-dollar amount is lowered to \$50 billion after 3 years, these stand-alone SBSBs would not be able to use alternative compliance mechanism and would begin to incur the costs described above. To the extent that these stand-alone SBSBs have to incur higher costs in order to operate their dealing businesses, they may be at a competitive disadvantage relative to dealers that are subject to CFTC requirements. In addition, to the extent that differences between Commission and CFTC capital, margin, and segregation requirements result in different implementation requirements (e.g., different information technology infrastructures) these stand-alone SBSBs may have to incur costs to modify their existing systems and operations to support compliance with the Commission's capital, margin, and segregation requirements. However, the Commission believes these costs would be mitigated by the fact the final rules adopted today are harmonized with those of the CFTC to the maximum extent practicable. Moreover, if the Commission lowers the maximum fixed-dollar amount to a level that is between \$250 billion and \$50 billion, some of the firms with aggregate gross notional amount of single-name CDS positions may be able to continue to use the alternative compliance mechanism.

### C. Implementation Costs

As discussed above, Rules 18a–1 through 18a–4, and 18a–10, as well as the amendments to Rules 15c3–1 and 15c3–3, will impose certain implementation costs on SBSBs and MSBSPs. The Commission expects that the highest economic cost impact as a result of the final rules will likely result from the additional capital that nonbank SBSBs and MSBSPs may need to hold as a result of the capital rules, and the additional margin that nonbank SBSBs and MSBSPs, and other market participants may need to post and/or collect as a result of the Commission's margin requirements.

Other costs may include start-up costs, including personnel and other costs, such as technology costs, to comply with the final rules. As discussed above in section IV.D. of this release, the Commission has estimated the burdens and related costs of these implementation requirements for SBSBs and MSBSPs.<sup>1244</sup> These costs are summarized below.

A stand-alone SBSB that applies to use internal models will be required under Rule 18a–1 to create and compile various documents to be included with the application, including documents related to the development of its models, and to provide additional documentation to, and respond to questions from, Commission staff throughout the application process.<sup>1245</sup> These firms also will 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 \$1.34 million<sup>1246</sup> and \$6.6 million,<sup>1247</sup> respectively. It is also estimated that these firms will incur initial technology costs of \$32 million<sup>1248</sup> in the aggregate.

Rule 18a–1 also will require stand-alone SBSBs 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.<sup>1249</sup> This requirement will impose one-time and annual costs in the aggregate of \$6.1 million<sup>1250</sup> and \$606,000,<sup>1251</sup> respectively. These firms also may incur aggregate initial and ongoing information technology costs of \$192,000 and \$246,000, respectively.<sup>1252</sup>

As discussed above, the Commission staff estimates that 4 broker-dealer SBSBs and 2 standalone SBSBs not authorized to use models will utilize the CDS haircut provisions under the amendments to Rules 15c3–1 and 18a–1, respectively. Consequently, these firms will use an industry sector classification system that is documented for the credit default swap reference

obligors. The Commission staff estimates that nonbank SBSBs not using models will incur an aggregate annual cost of \$2,226<sup>1253</sup> to document these industry sectors.

Under paragraph (h) of Rule 18a–1, a nonbank SBSB is required to file certain notices with the Commission relating to the withdrawal of equity capital. The Commission staff estimates that stand-alone SBSBs will incur an aggregate annual cost of \$2,226<sup>1254</sup> to file such notices.

Under Rule 18a–1d, a nonbank SBSB is required to file a proposed subordinated loan agreement with the Commission (including nonconforming subordinated loan agreements). In connection with this provision, the Commission staff estimates that stand-alone SBSBs will incur aggregate one-time and annual costs of \$50,640 and \$25,320, respectively.<sup>1255</sup>

Rule 18a–1, as adopted, and Rule 15c3–1, as amended, will also require the execution of an account control agreement by nonbank SBSBs. This will require firms to execute each account control agreement internally, and they may engage outside counsel to review the account control agreement and potentially to draft and review an opinion that an account control agreement is (or a set of account control agreements are) legally valid, binding, and enforceable in all material respects. These requirements are estimated to impose one-time and annual costs in the aggregate of approximately \$345,620<sup>1256</sup> and \$1.86 million,<sup>1257</sup> respectively.

Rule 18a–2 also will 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 and update these controls.<sup>1258</sup> This requirement is estimated to impose one-time and annual costs in the aggregate of \$2.77 million<sup>1259</sup> and \$252,500<sup>1260</sup> for nonbank MSBSPs, respectively. These nonbank MSBSPs also may incur initial and ongoing information

<sup>1244</sup> See section IV.D. of this release (discussing the total initial and annual recordkeeping and reporting burdens of the new rules and rule amendments).

<sup>1245</sup> See section IV.A.1. of this release.

<sup>1246</sup> This consists of external costs of \$400,000, plus internal costs of \$938,000. See section IV.D.1. of this release.

<sup>1247</sup> This consists of external costs of \$2.496 million, plus internal costs of \$4.12 million. See section IV.D.1. of this release.

<sup>1248</sup> See section IV.D.1. of this release.

<sup>1249</sup> See section IV.A.1. of this release.

<sup>1250</sup> See section IV.D.1. of this release.

<sup>1251</sup> See *id.*

<sup>1252</sup> See *id.*

<sup>1253</sup> See *id.*

<sup>1254</sup> See *id.*

<sup>1255</sup> See *id.*

<sup>1256</sup> Calculated as \$176,000 (outside counsel to draft and review account control agreement) + \$88,000 (opinion of counsel) + \$81,620 (written 'in-house' analysis) = \$345,620. See section IV.D.1. of this release.

<sup>1257</sup> This is the estimated industry-wide annual burden of \$1,856,800. See section IV.D.1. of this release.

<sup>1258</sup> See section IV.A.2. of this release.

<sup>1259</sup> This consists of external costs of \$400,000, plus internal costs of \$2.37 million. See section IV.D.2. of this release.

<sup>1260</sup> See section IV.D.2. of this release.

technology costs of \$80,000 and \$102,500, respectively.<sup>1261</sup>

Rule 18a–3 will require nonbank SBSBs to establish a written risk analysis methodology, which will need to be reviewed and updated.<sup>1262</sup> This requirement is estimated to impose one-time and annual costs in the aggregate of \$1.62 million<sup>1263</sup> and \$489,720,<sup>1264</sup> respectively.

Rule 18a–3, as adopted will require nonbank SBSBs to seek Commission approval to use an internal model to calculate initial margin.<sup>1265</sup> This requirement is estimated to impose one-time and annual costs in the aggregate of \$464,200 and \$1,575,750, respectively.<sup>1266</sup>

SBSBs and MSBSPs will incur various one-time and ongoing costs in the aggregate in order to comply with the segregation and notification requirements of Rule 18a–4 and the amendments to Rule 15c3–3.<sup>1267</sup> Each SBSB will incur one-time and annual costs in establishing special bank accounts required by the rule. This requirement is estimated to impose one-time and annual costs of \$2.9 million<sup>1268</sup> and \$367,290<sup>1269</sup> in the aggregate on SBSBs, respectively. In addition, SBSBs will be required to perform a reserve computation required by Exhibit A to Rule 18a–4 or Exhibit B to Rule 15c3–3, which is estimated to impose on these firms annual costs in the aggregate of approximately \$1.69 million.<sup>1270</sup>

In addition, both SBSBs and MSBSPs will be required to prepare and send to their counterparties segregation-related notices pursuant to Section 3E(f) of the Exchange Act.<sup>1271</sup> This requirement is estimated to impose one-time and annual costs in the aggregate to SBSBs and MSBSPs of \$870,857<sup>1272</sup> and \$130,143,<sup>1273</sup> respectively.

Rule 15c3–3, as amended, and Rule 18a–4, as adopted, will require each SBSB to draft, prepare, and enter into subordination agreements with certain counterparties.<sup>1274</sup> This requirement is

estimated to impose on these firms one-time and annual costs in the aggregate of \$43.7 million<sup>1275</sup> and \$8.4 million,<sup>1276</sup> respectively.

Rule 15c3–3, as amended, and Rule 18a–4, as adopted, will require registered foreign SBSBs to provide disclosures to their U.S. counterparties. This requirement is estimated to impose on these firms one-time and annual costs in the aggregate of \$6,034,600<sup>1277</sup> and \$46,420,<sup>1278</sup> respectively.

The Commission estimates that 31 SBSBs (25 bank SBSBs and 6 stand-alone SBSBs) will incur costs in connection with the disclosure condition under paragraph (f)(3) of Rule 18a–4. These SBSBs are estimated to incur one-time and annual costs in the aggregate of \$130,885,410,<sup>1279</sup> and \$65,410,<sup>1280</sup> respectively.

Rule 18a–10 prescribes an alternative compliance mechanism pursuant to which a stand-alone that is registered as a swap dealer and predominantly engages in a swaps business may elect to comply with the capital, margin, and segregation requirements of the CEA and the CFTC’s rules in lieu of complying with Rules 18a–1, 18a–3, and 18a–4 (as applicable). As discussed above, the Commission estimates that 3 stand-alone SBSBs will elect to operate under Rule 18a–10. In connection with the disclosure requirements under paragraph (b)(2) of Rule 18a–10, these stand-alone SBSBs are estimated to incur one-time and annual costs in the aggregate of \$12,666,330,<sup>1281</sup> and

\$6,300,<sup>1282</sup> respectively. The Commission estimates that the notice requirement of paragraph (b)(3) of Rule 18a–10 will impose an aggregate annual cost of \$185.50.<sup>1283</sup>

Rule 3a71–6 gives firms the option of applying for substituted compliance with regard to the final capital and margin rules. This requirement is estimated to impose on these firms a one-time cost in the aggregate of \$341,280.<sup>1284</sup>

#### *D. Effects on Efficiency, Competition, and Capital Formation*

The OTC swaps and security-based swap market is characterized by complex bilateral exposure networks. Currently, such networks are opaque. Consequently, it is not possible for market participants to accurately ascertain counterparty exposures to other market participants. During times of market stress, market participants’ uncertainty about the financial condition of their OTC derivative counterparties can lead markets to become illiquid. Distress at dealers or at other major participants is a particular source of concern. The lack of information about individual market participants’ exposures to such troubled firms can lead to widespread “contagion” which may lead markets to break down. Disruptions to the OTC derivative markets can shut down critical risk-transfer mechanisms and further exacerbate concerns about the exposures of important financial intermediaries. This, in turn, can lead to disruptions in credit provision to the real economy. Moreover, the opacity of these markets can foster excessive risk taking, which can both instigate and exacerbate the breakdown of these markets.

The final capital, margin, and segregation rules work together to help improve the stability of the security-based swap market, and in so doing mitigate the inefficiencies in these markets arising from the existence of default risk of derivative counterparties. The final capital and margin rules will reduce a nonbank SBSB’s

<sup>1275</sup> See section IV.D.4. of this release. Calculated as \$1,603,600 (drafting and preparation of subordination agreements) + \$152,000 (review by outside counsel) + \$41,990,000 (entering into subordination agreements with counterparties) = \$43,745,600.

<sup>1276</sup> See section IV.D.4 of this release (estimating that 19 SBSBs will incur an industry-wide annual burden of \$8,398,000 in connection with establishing account relationships with new counterparties per year).

<sup>1277</sup> This consists of 3,300 hours of in-house attorney time in addition to 11,000 of in-house counsel hours required to create and incorporate disclosure language in trading documentation, at a rate of \$422 per hour. See section IV.D.4. of this release.

<sup>1278</sup> This consists of 110 hours of in-house attorney time multiplied by \$422 per hour. See section IV.D.4. of this release.

<sup>1279</sup> Calculated as cost of developing new disclosure language (155 in-house counsel hours × \$422 per hour = \$65,410) + cost of incorporating new disclosure language into trading documentation (310,000 in-house counsel hours × \$422 per hour = \$130,820,222) = \$130,885,410. See section IV.D.4. of this release.

<sup>1280</sup> Calculated as 155 in-house counsel hours × \$422 per hour = \$65,410. See section IV.D.4. of this release.

<sup>1281</sup> Calculated as cost of developing new disclosure language (15 in-house counsel hours × \$422 per hour = \$6,330) + cost of incorporating new disclosure language into trading documentation (30,000 in-house counsel hours × \$422 per hour =

\$12,660,000) = \$12,666,300. See section IV.D.5. of this release.

<sup>1282</sup> Calculated as 15 in-house counsel hours × \$422 per hour = \$6,330. See section IV.D.5. of this release.

<sup>1283</sup> See section IV.D.5. of this release estimating that an internal compliance attorney of one stand-alone SBSB will take 30 minutes to file one notice annually with the Commission. Therefore, the estimated cost = 30 minutes at \$371 per hour = \$185.50.

<sup>1284</sup> This consists of 240 initial burden hours times \$422 an hour for in-house attorney (\$101,280), in addition to the \$240,000 estimated costs for outside counsel. See section IV.D.6. of this release.

<sup>1261</sup> See *id.*

<sup>1262</sup> See section IV.A.3. of this release.

<sup>1263</sup> See section IV.D.3. of this release. This consists of external costs of \$12,000, plus internal costs of \$1.61 million.

<sup>1264</sup> See *id.*

<sup>1265</sup> See section IV.A.3. of this release.

<sup>1266</sup> See section IV.D.3. of this release.

<sup>1267</sup> See section IV.A.4. of this release.

<sup>1268</sup> See section IV.D.4. of this release.

<sup>1269</sup> See *id.*

<sup>1270</sup> See *id.*

<sup>1271</sup> See section IV.A.4. of this release.

<sup>1272</sup> See section IV.D.4. of this release. This consists of external costs of \$220,000, plus internal costs of \$650,857.

<sup>1273</sup> See section IV.D.4. of this release.

<sup>1274</sup> See section IV.A.4. of this release.



uncollateralized derivative exposures and require firms to hold additional capital to address uncollateralized exposures. This will reduce potential losses from these exposures in the event of a counterparty default. In cases where nonbank SBSBs are not required to collect margin or where the collected margin is not under the SBSB's control, the final capital rules require nonbank SBSBs to allocate capital to reduce the potential losses from uncollateralized counterparty exposure. In this way, the capital rules complement the margin rule to reduce a nonbank SBSB's probability of default, reduce incentives for excessive risk-taking, and reduce the probability of sequential counterparty failure. Finally, the capital requirements for nonbank MSBSPs should reduce the likelihood of a MSBSP's failure and the potential losses to nonbank SBSB counterparties in the event of MSBSP's failure. In this way, the capital and margin rules are designed to reduce the risk that the failure of one entity propagates to its counterparties.

Furthermore, the margin rule will reduce a nonbank SBSB's incentive for excessive risk taking and will restrict the amount of implicit leverage that market participants can achieve through non-cleared security-based swaps. In addition, the margin rule will also reduce the potential cost advantages of non-cleared transactions relative to cleared transactions, and thereby encourage the clearing of such transactions. While the final margin rule provides protection for the margin collector against the default of the margin poster, it simultaneously exposes the poster of initial margin to additional risk. The Commission's final segregation rules, however, are designed to complement the margin rule by ensuring that posted margin is adequately protected.

Through the aforementioned channels, the Commission's capital, margin, and segregation rules are expected to have a generally positive effect on economic efficiency, and capital formation. However, because of the complex, overlapping regulatory environment of the security-based swap market, the final rules' effects on competition are more uncertain. In this section, the Commission considers each of these effects in turn.

#### 1. Efficiency and Capital Formation

In principle, the security-based swap market improves efficiency by facilitating risk transfer in the economy. In addition, by mitigating market imperfections in underlying securities markets (such as limited liquidity), it can help improve price discovery with

attendant positive effects on firms' borrowing costs. However, the extent to which the security-based swap market improves efficiency is limited due to counterparty credit risk. Specifically, the imperfection in the security-based swap market resulting from counterparty default can facilitate excessive and opaque risk-taking and have negative effects on the stability of this market.<sup>1285</sup> The final capital, margin, and segregation rules help address these market imperfections.

Excessive risk-taking by dealers and other major participants in the security-based swap market can arise from misaligned incentives of the firms' manager-owners and those of other investors due to limited liability.<sup>1286</sup> More generally, contracting frictions can cause similar incentive misalignments between managers and shareholders, other investors, counterparties, and customers. Because the costs of monitoring large financial intermediaries are significant, the creditors and customers of such firms are generally not in a position to monitor their management. This lack of monitoring can lead financial firms to pursue inefficient risk management policies.

Even absent these incentive conflicts and monitoring limitations, firms may choose to engage in trading activity that, while privately optimal, reduces overall financial stability. Unexpected losses on derivatives positions at one firm can threaten the financial viability of its counterparties, with the potential to precipitate sequential counterparty failures. Moreover, due to the opacity of financial firms, market fears of such contagion can lead to anticipatory "runs" on financial institutions, further undermining financial stability. Importantly, the costs associated with the reductions in financial stability that result from a given firm's policies and strategies are not fully internalized by the firm.<sup>1287</sup> The final capital, margin, and segregation rules help to mitigate the inefficiencies resulting from this negative externality.

The final capital, margin, and segregation rules for participants in the security-based swap market being adopted by the Commission can improve efficiency by addressing the

aforementioned market failures. By imposing a set of minimum risk management standards on affected entities, these requirements reduce the scope for incentive conflicts that may arise among these entities, their investors, counterparties, and customers, which can lead to more efficient investment policies. In addition, these new requirements can reduce the degree to which an individual firm's risk-taking imposes negative externalities on the market as a whole by: (1) Reducing uncertainty about exposures to non-cleared security-based swaps and the resulting potential for contagion; (2) reducing the ability of entities to engage in excessive risk taking; (3) promoting central clearing of sufficiently standardized products; and (4) promoting a uniform set of standards across regulatory agencies that limit opportunities for regulatory arbitrage. By improving financial stability in these ways, the final capital, margin, and segregation rules may also facilitate capital formation. In particular, because financial crises are typically associated with large reductions in the supply of aggregate capital, financial instability and financial crises resulting from such instability can have large negative economic consequences, including significant harm to capital formation. By reducing the likelihood of such crises, the Commission expects the capital, margin, and segregation rules will enhance capital formation.

The Commission acknowledges that nonbank SBSBs might pass on a portion of the costs incurred as a result of the capital, margin, and segregation rules to end users. To the extent that end users bear these costs, they might reduce investments. This potential impact on investment depends in part on the degree of competition among SBSBs. In particular, robust competition among SBSBs would limit their ability to pass on costs to end users and in turn mitigate any adverse impact on investment.

As acknowledged in section VI.C. of this release, the degree to which the aforementioned benefits improve efficiency depends on the costs imposed by these measures. These costs include the costs of funding additional collateral to meet margin requirements, the costs of additional capital, and the costs of implementation and compliance. In isolation, these additional costs would be expected to increase transaction costs of security-based swap trading, suppressing trading, and liquidity. Insofar as the benefits of the regulations do not counteract these effects, price discovery may be harmed and opportunities for risk sharing may be

<sup>1285</sup> See BCBS/IOSCO Paper.

<sup>1286</sup> See Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, *Journal of Financial Economics* (Oct. 1976).

<sup>1287</sup> One commenter noted that the dollar cost of the financial collapse will exceed \$12.8 trillion, and argued that Congress's resolve to prevent another massively costly financial crisis overrides any industry-claimed cost concerns under the Dodd-Frank Act. See Better Markets 2/22/2013 Letter.

reduced. This, in turn, can potentially reduce the supply of credit to the real economy.

Although data limitations discussed above prevent the Commission from quantifying efficiency gains or losses from the rules being adopted, based on its judgment and experience, the Commission believes that the final rules will have a positive contribution to the overall efficiency of the market. The final rules work together to help improve the financial stability of participants in security-based swap market, and in so doing help address the market failures resulting from the possibility of counterparty defaults. By imposing margin requirements on nonbank SBSDs, the final margin rules reduce counterparty exposures and the expected costs borne by non-defaulting counterparties in the event of a counterparty default. While these new margin requirements provide protection for the margin collector against the default of the margin poster, they could simultaneously expose the poster of initial margin to additional credit risk. To address this risk, the Commission's segregation rules help ensure that posted initial margin is adequately protected. Finally, by imposing capital requirements on nonbank SBSDs and MSBSPs, the capital rules help reduce the probability of their default and moreover, increase the likelihood of recoveries in the event of default.

As mentioned earlier, several commenters urged the Commission to harmonize with other regulatory regimes when developing these rules. One commenter cited impacts on efficiency, competition, and capital formation, while another was concerned about the loss of netting and risk management efficiencies caused by fragmentation of trading activities.<sup>1288</sup> In developing its rules on capital, margin, and segregation for SBSDs and MSBSPs, the Commission has sought to minimize costs to the affected entities and other participants in the security-based swap market while still achieving the broader economic objective of enhancing financial stability. One key feature of the Commission's approach has been maintaining consistency with existing regulations applicable to broker-dealers. This consistency reduces compliance costs for entities with affiliates already subject to the Commission's broker-dealer financial responsibility rules. This consistent approach to regulation across firms subject to the Commission's rules can also reduce the potential for regulatory

arbitrage and lead to simpler interpretation and enforcement of applicable regulatory requirements across U.S. securities markets. Moreover, the final rules reflect the Commission's consideration of rules promulgated by the CFTC and the prudential regulators. For example, Rule 18a-3, while modeled on the broker-dealer margin rule, includes significant modifications that further harmonize it with the final margin rules of the CFTC and the prudential regulators.<sup>1289</sup>

For entities that choose to consolidate security-based swap dealing under a broker-dealer, the Commission's approach helps to simplify and streamline risk management, allows for the more efficient use of capital, and creates operational efficiencies such as avoiding the need for multiple netting and other agreements. It also facilitates the ability to provide portfolio margining of security-based swaps with other types of securities, and in particular single-name CDS along with bonds that serve as reference obligations for the CDS. This can yield additional efficiencies for clients conducting business in securities and security-based swaps, including netting benefits,<sup>1290</sup> a reduction in the number of account relationships required with affiliated entities, and a reduction in the number of governing agreements.

The final rules also offer various flexibilities that aim to minimize compliance burdens without subverting the objectives of the rules, such as allowing counterparties the flexibility to post a variety of collateral types to meet margin requirements, providing a \$50 million initial margin threshold, and permitting the use of third-party models in margin calculations. Similarly, the omnibus segregation requirements of Rule 15c3-3, as amended, and Rule 18a-4, as adopted, provide a less expensive segregation alternative to individual segregation.<sup>1291</sup>

## 2. Competition

The final capital, margin, and segregation rules significantly alter the regulatory environment for registered nonbank SBSDs and MSBSPs, and in the case of the segregation requirements, all SBSDs and MSBSPs participating in the U.S. security-based swap market. Thus, these new regulations are likely to have direct implications for competition among SBSDs and MSBSPs subject to the Commission's jurisdiction. As discussed in this section and elsewhere

in this release, and notwithstanding uncertainties about potential effects on competition, the Commission believes that the final rules and amendments are appropriate because they achieve the purposes of the Exchange Act, including by improving financial stability. Because the Commission does not have sole rulemaking authority for all SBSDs and MSBSPs in the U.S. security-based swap market, and because the security-based swap market is global with competition across jurisdictional boundaries, consideration of the effects of the Commission's rules on competition is not limited to entities directly affected by the Commission's rules. In particular, U.S. banks operating in these markets are subject to capital and margin regulations already adopted by the prudential regulators.<sup>1292</sup> These entities may compete in the security-based swap market with entities regulated by the Commission. Similarly, foreign banking entities subject to foreign capital, margin, and segregation requirements may actively compete with these same entities. In the following subsection the Commission considers the impact of its rules on competition in these various contexts.

### a. Nonbank SBSDs

The rules and amendments being adopted by the Commission are expected to have a significant impact on the regulatory environment for nonbank SBSDs; namely, stand-alone SBSDs and broker-dealer SBSDs. Under the baseline, stand-alone SBSDs are largely unregulated and hence not subject to capital or margin requirements on security-based swap transactions. Generally speaking, broker-dealers have historically not engaged in security-based swap transactions due to—among other factors—the relatively high capital costs of such transactions and the segregation requirements under existing broker-dealer capital and segregation rules. Thus, security-based swap dealing activity has been concentrated in stand-alone SBSDs and banks, which were not subject to the Commission's rules.<sup>1293</sup> The new rules and amendments create a harmonized regulatory environment

<sup>1292</sup> See *Prudential Regulator Margin and Capital Adopting Release*, 80 FR 74840.

<sup>1293</sup> The references to the historical activities of "nonbank SBSDs" in this discussion is somewhat imprecise as it refers to entities that operated prior to the Commission's adoption of security-based swap entity definitions and registration requirements. Such references should be interpreted to refer to entities that would have been required to register as SBSDs had the Commission's security-based swap entity registration requirements been in effect at the time. See *Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants*, 80 FR 48964.

<sup>1289</sup> See section II.B. of this release.

<sup>1290</sup> See, e.g., paragraph (c)(5) of Rule 18a-3, as adopted. See MFA 2/22/2013 Letter.

<sup>1291</sup> See 15 U.S.C. 78c(f)(1)(B).

<sup>1288</sup> See MFA/AIMA 11/19/2018 Letter; Mizuho/ING Letter.

for all nonbank SBSBs. By improving the financial stability of nonbank SBSBs, the final capital, margin, and segregation rules are likely to promote trade between nonbank SBSBs and a wide range of non-dealer counterparties, with potential benefits to competition. However, as discussed in more detail below, a harmonized set of rules for both stand-alone and broker-dealer SBSBs may also provide broker-dealers certain economies of scale and scope. These economies of scale and scope may provide incentives for market participants to migrate their security-based swap transaction activity away from stand-alone SBSBs. The Commission acknowledges that such migration could lead to further concentration in dealing activity.

Under the baseline, security-based swap dealing activity is dominated by a few large financial firms, reflecting in part the counterparty credit risk concerns of counterparties. The Commission's capital, margin, and segregation rules are expected to enhance the financial stability of entities subject to its rules, namely stand-alone and broker-dealer SBSBs. This may, in turn, favorably increase the views of market participants about the creditworthiness of nonbank SBSBs, increasing the amount of trade with these dealers and attracting new entrants to the industry. However, prospective new entrants will have to evaluate the costs of establishing and maintaining compliance with the Commission's new rules against the value of dealing in security-based swaps. As discussed above in sections VI.B.1. and VI.B.3. of this release, nonbank SBSBs will be subject to capital and margin requirements that vary depending on whether the nonbank SBSB obtains approval to use internal models. Although the costs of obtaining approval to use such models would likely not be large for the five ANC broker-dealers currently using models to compute net capital, for prospective dealers that are not ANC broker-dealers these costs could be large and place the nonbank SBSB at a competitive disadvantage relative to those nonbank SBSBs already are authorized to use internal models. In particular, a nonbank SBSB authorized to use internal models can make more efficient use of its capital and pass on some of the benefits to customers in the form of competitive pricing. Therefore, the success of a new entrant to attract order flow in the security-based swap business would also depend on the extent to which the entrant would be able to obtain the Commission's

approval to use internal models.<sup>1294</sup> As several commenters observed, nonbank SBSBs lacking such approvals will generally find it difficult to compete with SBSBs that have obtained approvals.<sup>1295</sup> However, as discussed above, the use of models for capital purposes is standard in financial market regulation. Indeed, the prudential regulators' rules for bank SBSBs and bank swap dealers, as well as the Commission's own rules for ANC broker-dealers, permit the use of internal models for capital purposes. Furthermore, the CFTC has proposed permitting nonbank swap dealers to use models for capital purposes. While the Commission acknowledges the potential competitive advantage identified by commenters, the Commission believes it is appropriate to promote consistency with these other regulatory approaches.

As noted above, while the Commission's rules may encourage competition in the security-based swap market by increasing the safety and soundness of nonbank SBSBs (and thereby favorably increasing market participants' views about the creditworthiness of these dealers), they may also incentivize migration of dealing activities to broker-dealer SBSBs. Aggregating security-based swaps business with other securities businesses in a single entity, such as a broker-dealer SBSB, can help simplify and streamline risk management, allow more efficient use of capital, and avoid the need for multiple netting and other agreements. This increase in operating flexibility may yield efficiencies for clients conducting business in securities and security-based swaps, including netting benefits, portfolio margining, a reduction in the number of account relationships required with affiliated entities, and a reduction in the number of governing agreements. In particular, broker-dealer SBSBs could gain a competitive edge over stand-alone SBSBs by passing on some of the benefits from the added operating flexibility to their customers. Similar considerations may make it relatively costly for customers to transact through multiple dealers. To the extent that

<sup>1294</sup> See, e.g., *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, 69 FR at 34455 (stating that the "major benefit for the broker-dealer" of using an internal model "will be lower deductions from net capital for market and credit risk"). See also *OTC Derivatives Dealer Release*, 63 FR 59362. Given the significant benefits of using models in reducing the capital required for security-based swap positions, it is likely that for new entrants to capture substantial volume in security-based swaps they will need to use models.

<sup>1295</sup> See CFA Institute Letter; Systemic Risk Council Letter; SIFMA 11/19/2018 Letter.

customers consolidate their positions with a single dealer, opportunities for smaller, more specialized dealers may be diminished. Moreover, customers consolidating their positions at a single and more efficient broker-dealer SBSB may find it more operationally difficult to change SBSBs in the future.

On the other hand, the less restrictive capital requirements applicable to stand-alone SBSBs could result in lower costs to these firms and, in turn, lower fees for their security-based swap customers. This could draw business away from broker-dealer SBSBs in the favor of stand-alone SBSBs.

The Commission acknowledges the various aforementioned competitive impacts, including the potential advantages held by broker-dealer and stand-alone SBSBs approved to use models over entities that must use standardized haircuts. However, overall, the Commission does not expect these competitive impacts to have a major net effect on competition among entities currently operating as nonbank SBSBs or those likely to do so in the immediate future. As noted in the baseline discussion above, security-based swap dealing activity is highly concentrated in a few entities affiliated with large national and international banking groups. This concentrated market structure reflects the importance of counterparty credit quality, scale, and financial sophistication to operating in the security-based swap market. The importance of these factors is not expected to be materially affected by the Commission's rules, nor are the rules expected to have significant disproportionate impacts on particular subsets of entities that currently operate as dealers in the security-based swap market.

#### b. Nonbank SBSBs and Bank SBSBs

The final margin, capital, and segregation rules have the potential to affect domestic competition in the security-based swap market significantly due to differences in the regulation of bank and nonbank SBSBs. As discussed above in sections I and II of this release, the rules adopted by the prudential regulators were considered in developing the Commission's capital, margin, and segregation requirements for SBSBs and MSBSPs. Nevertheless, the Commission's final rules differ in certain respects from the rules adopted by the prudential regulators. While some differences are based on differences in the activities of securities firms and banks, other differences reflect an alternative approach to balancing relevant policy choices and considerations.

Large national and international banking groups that dominate dealing activity in the security-based swap market enjoy considerable flexibility in organizing their operations. Such entities can be expected to minimize the private compliance costs of participating in the security-based swap market by organizing their activities to take advantage of differences in regulators' policy choices. Prior to the passage of the Dodd-Frank Act and subsequent rulemaking, these entities have been able to conduct security-based swap dealing from either their prudentially regulated bank affiliates or affiliated nonbank entities. In either case, they were not subject to margin requirements. Following the passage of Dodd-Frank, these entities will have to reconsider the costs and benefits of these alternative organizational structures taking into consideration differences in capital, margin, and segregation requirements applicable to the different types of entities.

An SBSB's choice between these competing regulatory regimes will likely be driven by the relative costs arising from differences in the two regimes. The most significant of these differences are: (1) Initial margin requirements for inter-dealer transactions; (2) segregation requirements; (3) capital treatment of security-based swaps; and (4) availability of collateral financing.

The Commission's margin requirements on inter-dealer transactions are not consistent with the prudential regulators' rules. Under the Commission's final margin rule, nonbank SBSBs are not required to collect initial margin from financial market intermediaries, including other SBSBs. In contrast, under the prudential regulators' rules, covered entities, including SBSBs, are required to exchange initial margin on inter-dealer transactions. Furthermore, covered entities are required to segregate the initial margin at an independent third-party custodian.

The prudential regulators' approach to collateralizing inter-dealer transactions puts significant strain on dealers' capital. Under this approach, dealers "consume" their own capital every time they enter a transaction with other dealers. As a result, market-making activities, such as book-matching transactions with end users, become very capital intensive. While bank SBSBs may have access to alternative ways of funding collateral relative to nonbank SBSBs, the sheer amount of collateral needed to intermediate non-cleared security based swaps under the prudential regulators' margin rule will make it expensive for

bank SBSBs to conduct business in this market.

The Commission's approach does not require that nonbank SBSBs collect initial margin from financial market intermediaries, but it does require them to take capital deductions in lieu of margin or credit risk charges with respect to uncollateralized potential futures exposures. They also will need to increase their net capital by a factor proportional to the initial margin that would cover this exposure when the amount of the 2% margin factor reaches or exceeds their minimum fixed-dollar net capital requirement. However, this additional capital is not likely to exceed the initial margin for the exposure, which means that for a given inter-dealer exposure, a nonbank SBSB will likely allocate less capital than a bank SBSB. Furthermore, unlike the prudential regulators' margin rules, the additional capital that nonbank SBSBs have to allocate to inter-dealer exposures is always under the firm's control. In addition, while bank SBSBs are not subject to a requirement to deduct 100% of the value of initial margin posted to a counterparty, nonbank SBSBs may avoid this deduction using the guidance in section II.A.2.b.i. of this release.

These considerations suggest that nonbank SBSBs may have a competitive advantage over bank SBSBs in the market for non-cleared security-based swaps. In particular, a bank holding company may determine to structure its dealing activities into a nonbank SBSB. However, this competitive advantage may be muted given the advantages bank SBSBs have over nonbank SBSBs in terms of access to low cost sources of funding (*i.e.*, deposits) and central bank support mechanisms.

A counterparty posting initial margin to an SBSB for a non-cleared security-based swap transaction may elect individual segregation or to waive segregation (if permitted to waive segregation) under section 3E(f) of the Exchange Act, or elect that the initial margin be held directly by the SBSB subject to the omnibus segregation requirements of the Commission's final segregation rule. Under the margin rule of the prudential regulators, initial margin must be segregated in an individual account at an independent third-party custodian.

Individual segregation of collateral is expensive because it prevents the re-hypothecation of collateral along intermediation chains. With individual segregation, the amount of initial margin required to support the transfer of risk from party A to party B depends on the length of the intermediation chain

linking party A to party B (*i.e.*, the number of SBSBs with matched books standing between the initial transaction by party A and the final transaction with party B): Each SBSB in the chain may require initial margin to be "locked up" at the custodian. In contrast, when individual segregation is not used, the amount of collateral required to support the transfer of risk from party A to party B does not depend on the length of the intermediation chain linking party A to party B; at each non-terminal link in the chain initial margin that is collected by an SBSB can be delivered to the SBSB that is the next link in the chain (*i.e.*, the initial margin can be re-hypothecated).

Thus, operating as a nonbank SBSB could provide a potential cost advantage. Specifically, if the parties along an intermediation chain are willing to rely on the default omnibus segregation regime, or agree to waive segregation entirely (when this is permitted), then the amount of collateral necessary to support the transaction can be considerably smaller than under third-party segregation. For example, a CDS transaction involving 3 dealers where dealer A purchases protection from dealer B who in turn purchases this protection from dealer C requires approximately two units of initial margin under third-party segregation: Dealer C provides one unit collateral to the third-party custodian for the benefit of dealer B, while dealer B provides another unit of collateral to the third-party custodian for the benefit of dealer A. Conversely, under omnibus segregation or waived segregation, only one unit of collateral is required: The collateral posted by dealer C is received by dealer B, who may then use the collateral received to satisfy his posting obligation to dealer A.

As noted earlier, nonbank SBSBs will be required to allocate capital for their dealing activities in the market for non-cleared security-based swaps. Importantly, uncollateralized exposures from inter-dealer transactions require that these entities scale up their minimum net capital by a factor proportional to the initial margin of the exposure if the amount of the 2% margin factor equals or exceeds the firm's fixed-dollar minimum net capital requirement. Furthermore, dealers are required to take a capital deduction in lieu of margin or credit risk charge for the uncollateralized inter-dealer potential future exposures.

Similarly, bank SBSBs will also have to allocate capital for their exposures with other covered entities, including other dealers. The capital that supports a bank SBSB's dealing activities in the

OTC markets is determined in accordance with the prudential regulators' capital rules. These rules require that bank SBSBs calculate a risk weight amount for each of their exposures, including exposure to non-cleared security-based swaps. Furthermore, the rules require that bank SBSBs calculate an additional risk weight amount for the exposure created through the posting of initial margin to collateralize a non-cleared security-based swap. However, both of these risk weight amounts are likely to be small. The dealer's exposure to a covered-entity counterparty is collateralized by the initial margin that the counterparty has to post with a third-party custodian (for the benefit of the dealer), and the risk weight of this exposure reflects almost entirely the risk weight of the collateral—usually minimal. Similarly, by posting initial margin, the dealer creates an exposure to the third-party custodian holding the collateral. Custodian banks usually have low risk weights.

The capital that bank SBSBs have to allocate for their non-cleared security-based swaps equals the sum of the two risk weight amounts calculated above multiplied by a factor—usually 8%. Thus, the capital that a bank SBSB has to allocate to support a non-cleared security-based swap is relatively small, and likely of the same order of magnitude as the capital that a nonbank SBSB would have to allocate for a similar exposure. However, the bank SBSB must deliver initial margin to certain counterparties. The posting of collateral will “consume” the bank SBSB's capital, and gives nonbank SBSB a comparative advantage in terms of capital efficiency. However, this advantage will not exist if a nonbank SBSB transacts with a bank SBSB because in this scenario the bank SBSB will be required to collect initial margin from the nonbank SBSB. It also will not exist if a counterparty demands initial margin from the nonbank SBSB under the terms of an agreement between the two parties. While collateral posting makes dealing under a bank SBSB structure costly, the cost of funding such collateral is likely smaller for these dealers compared to nonbank SBSBs. Unlike nonbank SBSBs, bank SBSB may have access to low cost sources of collateral funding, including deposits or a discount window with a central bank.

Several commenters addressed the impact of the final rules on competition between bank and nonbank SBSBs. One commenter stated that the Commission's proposal would make nonbank SBSBs uncompetitive, and that consistency with the CFTC's margin and capital

rules is also necessary for nonbank SBSBs to be competitive with bank SBSBs.<sup>1296</sup> This commenter noted that bank SBSBs will be subject to a single set of capital and margin rules for security-based swaps and swaps, but that nonbank SBSBs that are also registered with the CFTC as swap dealers would be subject to two sets of requirements with respect to these instruments. This commenter believed that the proposal's inconsistencies with other regulators' regimes would increase costs. Another commenter stated that the proposed capital requirements would result in a very different approach to capital for bank holding company subsidiaries that are swap dealers (based on the CFTC's proposal to apply the bank capital standard to these entities) and for such subsidiaries that are SBSBs, again potentially preventing the establishment of dually registered entities.<sup>1297</sup> Similarly, other commenters noted that the Commission's capital and margin rules would increase costs and reduce efficiency due to their potential inconsistency with the BCBS/IOSCO Paper, foreign requirements, and other domestic regulators' rules.<sup>1298</sup> One commenter argued that several components of the proposed margin rules differ from the recommended framework in the BCBS/IOSCO Paper and would generally make nonbank SBSBs uncompetitive with bank SBSBs and foreign SBSBs.<sup>1299</sup> The commenter argued that the Commission could best address these differences by permitting OTC derivatives dealers and stand-alone SBSBs to collect and maintain margin in a manner consistent with the recommendations of the BCBS/IOSCO Paper.

As discussed above in section II.A. of this release, the Commission has made two significant modifications to the final capital rules for nonbank SBSBs that should mitigate some of these concerns raised by commenters. First, as discussed above in section II.A.2.b.v. of this release, the Commission has modified Rule 18a–1 so that it no longer contains a portfolio concentration charge that is triggered when the aggregate current exposure of the stand-alone SBSB to its derivatives counterparties exceeds 50% of the firm's tentative net capital.<sup>1300</sup> This

means that stand-alone SBSBs that have been authorized to use models will not be subject to this limit on applying the credit risk charges to uncollateralized current exposures related to derivatives transactions. This includes uncollateralized current exposures arising from electing not to collect variation margin for non-cleared security-based swap and swap transactions under exceptions in the margin rules of the Commission and the CFTC. The credit risk charges are based on the creditworthiness of the counterparty and can result in charges that are substantially lower than deducting 100% of the amount of the uncollateralized current exposure.<sup>1301</sup> This approach to addressing credit risk arising from uncollateralized current exposures related to derivatives transactions is generally consistent with the treatment of such exposures under the capital rules for banking institutions.<sup>1302</sup>

The second significant modification is an alternative compliance mechanism. As discussed above in section II.D. of this release, the alternative compliance mechanism will permit a stand-alone SBSB that is registered as a swap dealer and that predominantly engages in a swaps business to comply with the capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of complying with the Commission's capital, margin, and segregation requirements.<sup>1303</sup> The CFTC's proposed capital rules for swap dealers that are FCMs would retain the existing capital framework for FCMs, which imposes a net liquid assets test similar to the existing capital requirements for broker-dealers.<sup>1304</sup> However, under the CFTC's proposed capital rules, swap dealers that are not FCMs would have the option of complying with: (1) A capital standard based on the capital rules for banks; (2)

portfolio concentration charge in Rule 18a–1 for stand-alone SBSBs).

<sup>1301</sup> See paragraph (e)(2) of Rule 18a–1, as adopted.

<sup>1302</sup> See *OTC Derivatives Dealers*, 63 FR at 59384–87 (“[T]he Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the “U.S. Banking Agencies”) have adopted rules implementing the Capital Accord for U.S. banks and bank holding companies. Appendix F is generally consistent with the U.S. Banking Agencies' rules, and incorporates the qualitative and quantitative conditions imposed on banking institutions. The use of models to compute market risk charges in lieu of the standardized haircuts (as nonbank SBSBs will be permitted to do under Rules 15c3–1 and 18a–1) also is generally consistent with the capital rules for banking institutions. *Id.*”).

<sup>1303</sup> See Rule 18a–10, as adopted.

<sup>1304</sup> See *CFTC Capital Proposing Release*, 81 FR 91252.

<sup>1296</sup> See SIFMA 2/22/2013 Letter.

<sup>1297</sup> See Financial Services Roundtable Letter.

<sup>1298</sup> See CFA Institute Letter; ISDA 1/23/2013 Letter; KfW Bankengruppe Letter; Morgan 10/29/2014 Stanley Letter; SIFMA 2/22/2013 Letter.

<sup>1299</sup> See SIFMA 11/19/2018 Letter.

<sup>1300</sup> See paragraph (e)(2) of Rule 18a–1, as adopted. See also *Capital, Margin, and Segregation Proposing Release*, 77 FR at 70244 (proposing a

a capital standard based on the Commission's capital requirements in Rule 18a-1; or (3) if the swap dealer is predominantly engaged in non-financial activities, a capital standard based on a tangible net worth requirement.

In addition, as discussed above in section II.B. of this release, the Commission has made a number of modifications to the final margin rule to more closely align the rule with the margin rules of the CFTC and the prudential regulators.

Nevertheless, to the extent that regulatory requirements differ across regimes, the Commission acknowledges the potential for registrants subject to more than one regulatory regime to face an increased compliance burden, even if capital and margin requirements are no more binding for dually-registered SBSBs than bank SBSBs. In particular, the Commission acknowledges that dual registrants may need to devote more resources towards compliance and regulatory monitoring. Because of the similarity between single-name and index CDS, the Commission expects that participants active in one market are likely to be active in the other, and dual registrants may need to devote more resources to ensure that the appropriate rules are applied to security-based swap and swap transactions than a bank SBSB.

However, as described above, the Commission expects that nonbank SBSBs will 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 lending and deposit-taking activities of commercial banks. Therefore, the Commission has modeled its capital, margin, and segregation regime on the existing rules for broker-dealers, rather than the rules of the CFTC and the prudential regulators. However, as discussed throughout this release, the Commission has modified its final rules in an effort to harmonize them, where appropriate, with the rules of the CFTC and the prudential regulators.

#### c. Domestic and Foreign SBSBs

The market for security-based swaps is a global market that transcends traditional jurisdiction boundaries. As discussed above in section VI.A.1. of this release, it is quite common for counterparties to a security-based swap transaction to not be based in the same jurisdiction. The specific regulatory requirements applicable in a dealer's jurisdictions can create competitive advantages and disadvantages for that dealer vis-à-vis dealers operating in other jurisdictions. There exists the possibility that differences in the

capital, margin, and segregation rules eventually adopted by foreign regulators and those of the Commission may create advantages or disadvantages for U.S. registrants participating in this global market.

The potential disadvantages to U.S. registrants were pointed out by commenters. One commenter argued that because U.S. registrants must structure their activities so as to margin non-cleared security-based swaps and swaps separately from other non-centrally cleared derivatives, U.S. registrants would be at a significant competitive disadvantage to foreign competitors.<sup>1305</sup> The commenter argued that several components of the proposed margin rules differ from the recommended framework in the BCBS/IOSCO Paper and would generally make nonbank SBSBs uncompetitive with bank SBSBs and foreign SBSBs.<sup>1306</sup> The commenter argued that the Commission could best address these differences by permitting OTC derivatives dealers and stand-alone SBSBs to collect and maintain margin in a manner consistent with the recommendations of the BCBS/IOSCO Paper. Another commenter stated that requiring the use of the Appendix A methodology (rather than internal models) for initial margin calculations on non-cleared equity security-based swaps would place U.S.-based nonbank SBSBs at a competitive disadvantage in the market.<sup>1307</sup> For example, the technical standards published by the European regulators do not include similar provisions precluding the use of internal models in the calculation of initial margin for equity swaps. As discussed above in section VI.B.3. of this release, while the Commission acknowledges that the Appendix A methodology has certain limitations, the Commission believes that permitting the use of internal models for equity swaps could lead to inadequate margin levels in comparison to the broker-dealer margin rules. However, the Commission has modified the final rule to permit nonbank SBSBs that are not broker-dealers to apply to the Commission to use internal models to compute initial margin for equity-based security-based swaps.

Based on a review of proposals by European regulators, the Commission does not believe that its capital, margin, and segregation rules will place U.S. firms at a significant competitive disadvantage in the security-based swap market. Although certain aspects of the Commission's rules—such as the

required use of Appendix A methodology for calculating initial margin for equity security-based swaps for broker-dealer SBSBs—are more restrictive than the corresponding aspects of the European rules, other aspects are less restrictive. In addition, foreign entities transacting with U.S. counterparties will, absent Commission approval for substituted compliance (with respect to capital and margin requirements) or transaction-based exceptions (with respect to segregation requirements), be subject to the Commission's rules. Thus, differences in foreign regulatory regimes are expected to have only limited impact in terms of competition for the business of domestic end users.

#### d. Nonbank MSBSPs

Some of the considerations outlined above for SBSBs apply to the analysis of the competitive effects on nonbank MSBSPs, although here the impact on competition is likely to be even more limited. The key characteristic distinguishing nonbank MSBSPs from nonbank SBSBs is that the former do not engage in dealing activity. Thus, the population of MSBSPs will likely consist of large financial non-dealing entities that maintain significant non-cleared security-based swap exposures. Under the final capital, margin, and segregation rules, such entities are subject to less extensive requirements than nonbank SBSBs, and consequently, the costs of compliance with these requirements is—other things being equal—expected to be less significant.

That said, the Commission acknowledges that some (non-dealing) market participants' internal systems and processes may not be designed to handle the new requirements. For example, under the new rules, nonbank MSBSPs will in most cases be required to post and collect variation margin on a daily basis. This requires back-office systems and procedures capable of handling the daily exchange of collateral. For certain participants in the non-cleared security-based swap market, such a capability may be absent or inadequate. Similarly, under the new capital provisions, nonbank MSBSPs will be required to ensure that tangible net worth is positive at all times; again, certain non-cleared security-based swap market participants may not currently possess systems or procedures for tracking tangible net worth on a real-time basis.<sup>1308</sup>

<sup>1305</sup> See SIFMA 3/12/2014 Letter.

<sup>1306</sup> See SIFMA 11/19/2018 Letter.

<sup>1307</sup> See ISDA 1/23/2013 Letter.

<sup>1308</sup> In determining net worth, all long and short positions in security-based swaps, swaps, and related positions must be marked to their market value. See Rule 18a-2, as adopted.

Disparities in the ease with which potential nonbank MSBSPs could comply with the Commission's new rules could rearrange the relative competitive positions of these entities. However, the Commission believes the registration thresholds for nonbank MSBSPs that the Commission has previously adopted are sufficiently high to minimize such disruptions. As discussed above in section VI.A. of this release, the Commission expects that between zero and five entities will initially register as MSBSPs, and that these entities will be operating at a scale where prudent risk management practices already include much of the infrastructure necessary to implement systems and procedures that can satisfy the Commission's new requirements.

## VII. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")<sup>1309</sup> requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Pursuant to Section 605(b) of the RFA,<sup>1310</sup> the Commission certified in the proposing release and the cross-border proposing release that proposed new Rules 3a71–6 and 18a–1 through 18a–4, and the proposed amendments to Rules 15c3–1 and 15c3–3 would not have a significant economic impact on any "small entity"<sup>1311</sup> for purposes of the RFA.<sup>1312</sup> The Commission is also adopting Rule 18a–10 today.

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,<sup>1313</sup> 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 paragraph (d) of Rule 17a–5,<sup>1314</sup> 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.<sup>1315</sup> 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,<sup>1316</sup> firms with \$175 million or less in assets; (2) for non-depository credit intermediation and certain other activities,<sup>1317</sup> firms with \$7 million or less in annual receipts; (3) for entities in financial investments and related activities,<sup>1318</sup> firms with \$7 million or less in annual receipts; (4) for insurance carriers and entities in related activities,<sup>1319</sup> firms with \$7 million or less in annual receipts; and (5) for funds, trusts, and other financial vehicles,<sup>1320</sup> firms with \$7 million or less in annual receipts.<sup>1321</sup>

With respect to nonbank SBSDs and MSBSPs, based on feedback from market participants and the Commission's information about the security-based swap market, the Commission continues to believe that: (1) The types of entities that would engage in more than a *de minimis* level

<sup>1314</sup> See 17 CFR 240.17a–5(d).

<sup>1315</sup> See 17 CFR 240.0–10(c).

<sup>1316</sup> 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.

<sup>1317</sup> 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.

<sup>1318</sup> 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.

<sup>1319</sup> 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.

<sup>1320</sup> 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.

<sup>1321</sup> See 13 CFR 121.201.

of dealing activity involving security-based swaps—which generally would be large financial institutions—would not be "small entities" for purposes of the RFA; and (2) the types of entities that may have security-based swap positions above the level required to register as "major security-based swap participants" would not be "small entities" for purposes of the RFA. Thus, it is unlikely that Rules 18a–1 through 18a–4, Rule 18a–10, and the amendments to Rules 15c3–1, 15c3–3, and 3a71–6 will have a significant economic impact on any small entity.

The Commission estimates that as of December 31, 2018, there were approximately 996 broker-dealers that were "small" for the purposes Rule 0–10. While certain amendments to Rules 15c3–1 and 15c3–3 will apply to stand-alone broker-dealers, these amendments will not have any impact on "small" broker-dealers, since few, if any, of these firms engage in security-based swaps activities.<sup>1322</sup>

For the foregoing reasons, the Commission certifies that new Rules 18a–1 through 18a–4, new Rule 18a–10, and the amendments to Rules 3a71–6, 15c3–1, and 15c3–3 will not have a significant economic impact on a substantial number of small entities for purposes of the RFA.

## VIII. Statutory Basis

Pursuant to the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly, Sections 3(b), 3E, 15, 15F, and 23(a) (15 U.S.C. 78c(b), 78c–5, 78o, 78o–10, and 78w(a)), thereof, the Commission is amending §§ 200.30–3, 240.3a71–6, 240.15c3–1, 240.15c3–1a, 240.15c3–1b, 240.15c3–1d, 240.15c3–1e, and 240.15c3–3, and adopting §§ 240.15c3–3b, 240.18a–1, 240.18a–1a, 240.18a–1b, 240.18a–1c, 240.18a–1d, 240.18a–2, 240.18a–3, 240.18a–4, 240.18a–4a, and 240.18a–10 under the Exchange Act.<sup>1323</sup>

## List of Subjects

### 17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies), Civil rights, Classified information, Conflicts of interest, Environmental impact statements, Equal employment

<sup>1322</sup> The amendments are discussed in detail in sections I, II, and III of this release. The Commission discusses the economic impact, including the compliance costs and burdens, of the amendments in section IV (PRA) and section VI (Economic Analysis) of this release.

<sup>1323</sup> If any of the provisions of these rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

<sup>1309</sup> See 5 U.S.C. 601 *et seq.*

<sup>1310</sup> See 5 U.S.C. 605(b).

<sup>1311</sup> 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 rulemaking, are set forth in 17 CFR 240.0–10 ("Rule 0–10"). See *Statement of Management on Internal Accounting Control*, Exchange Act Release No. 18451, (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982).

<sup>1312</sup> See *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*; *Proposed Rule*, 77 FR at 70328–70329; *Cross-Border Proposing Release*, 78 FR at 31204–31205.

<sup>1313</sup> See 17 CFR 240.0–10(a).



opportunity, Federal buildings and facilities, Freedom of information, Government securities, Organization and functions (Government agencies), Privacy, Reporting and recordkeeping requirements, Sunshine Act.

#### 17 CFR Part 240

Brokers, Confidential business information, Fraud, Reporting and recordkeeping requirements, Securities.

#### Text of Rules and Rule Amendments

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

### PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

#### Subpart A—Organization and Program Management

■ 1. The authority citation for part 200, subpart A, continues to read in part as follows:

**Authority:** 15 U.S.C. 77c, 77o, 77s, 77z–3, 77sss, 78d, 78d–1, 78d–2, 78o–4, 78w, 78ll(d), 78mm, 80a–37, 80b–11, 7202, and 7211 *et seq.*, unless otherwise noted.

\* \* \* \* \*

Section 200.30–3 is also issued under 15 U.S.C. 78b, 78d, 78f, 78k–1, 78q, 78s, and 78eee.

\* \* \* \* \*

■ 2. Section 200.30–3 is amended by revising paragraphs (a)(7) introductory text, (a)(7)(i) and (iv), (a)(7)(vi)(A) and (C) through (F), (a)(7)(vii) and (a)(10)(i) to read as follows:

#### § 200.30–3 Delegation of authority to Director of Division of Trading and Markets.

\* \* \* \* \*

(a) \* \* \*

(7) Pursuant to Rule 15c3–1 (§ 240.15c3–1 of this chapter) and Rule 18a–1 (§ 240.18a–1 of this chapter):

(i) To approve lesser equity requirements in specialist or market maker accounts pursuant to Rule 15c3–1(a)(6)(iii)(B) (§ 240.15c3–1(a)(6)(iii)(B) of this chapter);

\* \* \* \* \*

(iv) To approve a change in election of the alternative capital requirement pursuant to Rule 15c3–1(a)(1)(ii) (§ 240.15c3–1(a)(1)(ii) of this chapter);

\* \* \* \* \*

(vi)(A) To review amendments to applications of brokers or dealers and security-based swap dealers filed pursuant to §§ 240.15c3–1e, 240.15c3–1g, and 240.18a–1(d) of this chapter and to approve such amendments, unconditionally or subject to specified terms and conditions;

\* \* \* \* \*

(C) To impose additional conditions, pursuant to §§ 240.15c3–1e(e) and 240.18a–1(d)(9)(iii) of this chapter, on a broker or dealer that computes certain of its net capital deductions pursuant to § 240.15c3–1e of this chapter, or on an ultimate holding company of the broker or dealer that is not an ultimate holding company that has a principal regulator, as defined in § 240.15c3–1(c)(13)(ii) of this chapter, or on a security-based swap dealer that computes certain of its net capital deductions pursuant to § 240.18a–1(d) of this chapter;

(D) To require that a broker or dealer, or the ultimate holding company of the broker or dealer, or a security-based swap dealer provide information to the Commission pursuant to §§ 240.15c3–1e(a)(1)(viii)(G), 240.15c3–1e(a)(1)(ix)(C) and (a)(4), 240.18a–1(d)(2), and 240.15c3–1g(b)(1)(i)(H), and (b)(2)(i)(C) of this chapter;

(E) To determine, pursuant to §§ 240.15c3–1e(a)(10)(ii) and 240.18a–1(d)(7)(ii), that the notice that a broker or dealer and security-based swap dealer must provide to the Commission pursuant to §§ 240.15c3–1e(a)(10)(i) and 240.18a–1(d)(7)(i) of this chapter will become effective for a shorter or longer period of time; and

(F) To approve, pursuant to §§ 240.15c3–1e(a)(7)(ii) and 240.18a–1(d)(5)(ii) of this chapter, the temporary use of a provisional model, in whole or in part, unconditionally or subject to any conditions or limitations;

(vii)(A) To approve the prepayments of a subordinated loan agreement of a security-based swap dealer pursuant to § 240.18a–1d(b)(6) of this chapter;

(B) To approve a prepayment of a revolving subordinated loan agreement of a security-based swap dealer pursuant to § 240.18a–1d(c)(4) of this chapter; and

(C) To examine a proposed subordinated loan agreement filed by a security-based swap dealer and to find it acceptable pursuant to § 240.18a–1d(c)(5) of this chapter.

\* \* \* \* \*

(10)(i) Pursuant to Rule 15c3–3 (§ 240.15c3–3 of this chapter) and Rule 18a–4 (§ 240.18a–4 of this chapter) to find and designate as control locations for purposes of Rule 15c3–3(c)(7) (§ 240.15c3–3(c)(7) of this chapter), Rule 15c3–3(p)(2)(ii)(E) (§ 240.15c3–3(p)(2)(ii)(E) of this chapter), and Rule 18a–4(b)(2)(v) (§ 240.18a–4(b)(2)(v) of this chapter), certain broker-dealer and security-based swap accounts which are adequate for the protection of customer securities.

\* \* \* \* \*

### PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 3. The general authority citation for part 240 is revised, the sectional authorities for §§ 240.15c3–1 and 240.15c3–3 are revised, adding 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–4, 78o–10, 78p, 78q, 78q–1, 78s, 78u–5, 78w, 78x, 78dd, 78ll, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*, and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; Pub. L. 111–203, 939A, 124 Stat. 1376 (2010); and Pub. L. 112–106, sec. 503 and 602, 126 Stat. 326 (2012), 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, 240.18a–3, and 240.18a–10 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).

\* \* \* \* \*

■ 4. Section 240.3a71–6 is amended by adding paragraphs (d)(4) and (5) to read as follows:

#### § 240.3a71–6 Substituted compliance for security-based swap dealers and major security-based swap participants.

\* \* \* \* \*

(d) \* \* \*

(4) *Capital*—(i) *Security-based swap dealers*. The capital requirements of section 15F(e) of the Act (15 U.S.C. 78o–10(e)) and § 240.18a–1; provided, however, that prior to making such substituted compliance determination, the Commission intends to consider (in addition to any conditions imposed) whether the capital requirements of the foreign financial regulatory system are designed to help ensure the safety and soundness of registrants in a manner that is comparable to the applicable provisions arising under the Act and its rules and regulations.

(ii) *Major security-based swap participants*. The capital requirements of section 15F(e) of the Act (15 U.S.C. 78o–10(e)) and § 240.18a–2; provided,

however, that prior to making such substituted compliance determination, the Commission intends to consider (in addition to any conditions imposed) whether the capital requirements of the foreign financial regulatory system are comparable to the applicable provisions arising under the Act and its rules and regulations.

(5) *Margin*—(i) *Security-based swap dealers*. The margin requirements of section 15F(e) of the Act (15 U.S.C. 78o–10(e)) and § 240.18a–3; provided, however, that prior to making such substituted compliance determination, the Commission intends to consider (in addition to any conditions imposed) whether the foreign financial regulatory system requires registrants to adequately cover their current and potential future exposure to over-the-counter derivatives counterparties, and ensures registrants' safety and soundness, in a manner comparable to the applicable provisions arising under the Act and its rules and regulations.

(ii) *Major security-based swap participants*. The margin requirements of section 15F(e) of the Act (15 U.S.C. 78o–10(e)) and § 240.18a–3; provided, however, that prior to making such substituted compliance determination, the Commission intends to consider (in addition to any conditions imposed) whether the foreign financial regulatory system requires registrants to adequately cover their current exposure to over-the-counter derivatives counterparties, and ensures registrants' safety and soundness, in a manner comparable to the applicable provisions arising under the Act and its rules and regulations.

- 5. Section 240.15c3–1 is amended by:
- a. Redesignating paragraph (a)(5) as paragraph (a)(5)(i) and adding paragraph (a)(5)(ii);
- b. Revising paragraph (a)(7)(i) and (ii) and the undesignated center heading above paragraph (a)(7);
- c. Adding paragraph (a)(10) with an undesignated center heading above it;
- d. Revising paragraph (c)(2)(iv)(E);
- e. Adding paragraphs (c)(2)(vi)(O) and (P);
- f. Redesignating paragraph (c)(2)(xii) as paragraph (c)(2)(xii)(A) and adding paragraph (c)(2)(xii)(B);
- g. Adding paragraph (c)(2)(xv); and
- h. Adding paragraph (c)(17).

The revisions and additions read as follows:

**§ 240.15c3–1 Net capital requirements for brokers or dealers.**

\* \* \* \* \*

- (a) \* \* \*
- (5) \* \* \*

(ii) An OTC derivatives dealer that is also registered as a security-based swap

dealer under section 15F of the Act (15 U.S.C. 78o–10) is subject to the capital requirements in §§ 240.18a–1, 240.18a–1a, 240.18a–1b, 240.18a–1c and 240.18a–1d instead of the capital requirements of this section and its appendices.

\* \* \* \* \*

**Alternative Net Capital Computation for Broker-Dealers Authorized to Use Models**

(7) In accordance with § 240.15c3–1e, the Commission may approve, in whole or in part, an application or an amendment to an application by a broker or dealer to calculate net capital using the market risk standards of § 240.15c3–1e to compute a deduction for market risk on some or all of its positions, instead of the provisions of paragraphs (c)(2)(vi) and (vii) of this section, and § 240.15c3–1b, and using the credit risk standards of § 240.15c3–1e to compute a deduction for credit risk on certain credit exposures arising from transactions in derivatives instruments, instead of the provisions of paragraphs (c)(2)(iv) and (c)(2)(xv)(A) and (B) of this section, subject to any conditions or limitations on the broker or dealer the Commission may require as necessary or appropriate in the public interest or for the protection of investors. A broker or dealer that has been approved to calculate its net capital under § 240.15c3–1e must:

(i)(A) 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:

- (1) Two percent of the risk margin amount; or
- (2) Four percent or less of the risk margin amount if the Commission issues an order raising the requirement to four percent or less on or after the third anniversary of this section's compliance date; or
- (3) Eight percent or less of the risk margin amount if the Commission issues an order raising the requirement to eight percent or less on or after the fifth anniversary of this section's compliance date and the Commission had previously issued an order raising the requirement under paragraph (a)(7)(i)(B) of this section;

(B) If, after considering the capital and leverage levels of brokers or dealers subject to paragraph (a)(7) of this section, as well as the risks of their security-based swap positions, the Commission determines that it may be appropriate to change the percentage pursuant to paragraph (a)(7)(i)(A)(2) or (3) of this section, the Commission will

publish a notice of the potential change and subsequently will issue an order regarding any such change.

(ii) Provide notice that same day in accordance with § 240.17a–11(g) if the broker's or dealer's tentative net capital is less than \$6 billion. The Commission may, upon written application, lower the threshold at which notification is necessary under this paragraph (a)(7)(ii), either unconditionally or on specified terms and conditions, if a broker or dealer satisfies the Commission that notification at the \$6 billion threshold is unnecessary because of, among other factors, the special nature of its business, its financial position, its internal risk management system, or its compliance history; and

\* \* \* \* \*

**Broker-Dealers Registered as Security-Based Swap Dealers**

(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 paragraph (a)(7) of this section, must:

(i)(A) 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:

- (1) Two percent of the risk margin amount; or
- (2) Four percent or less of the risk margin amount if the Commission issues an order raising the requirement to four percent or less on or after the third anniversary of this section's compliance date; or
- (3) Eight percent or less of the risk margin amount if the Commission issues an order raising the requirement to eight percent or less on or after the fifth anniversary of this section's compliance date and the Commission had previously issued an order raising the requirement under paragraph (a)(10)(i)(B) of this section;

(B) If, after considering the capital and leverage levels of brokers or dealers subject to paragraph (a)(10) of this section, as well as the risks of their security-based swap positions, the Commission determines that it may be appropriate to change the percentage pursuant to paragraph (a)(10)(i)(A)(2) or (3) of this section, the Commission will publish a notice of the potential change and subsequently will issue an order regarding any such change; 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) and (xiv), and (d)(8) and (9) of § 240.15c3–4 shall not apply.

\* \* \* \* \*

- (c) \* \* \*
- (2) \* \* \*
- (iv) \* \* \*

(E) *Other deductions.* All other unsecured receivables; all assets doubtful of collection less any reserves established therefor; the amount by which the market value of securities failed to receive outstanding longer than 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 the following need not be deducted:

(1) Any amounts deposited in a Customer Reserve Bank Account or PAB Reserve Bank Account pursuant to § 240.15c3-3(e) or in the "special reserve account for the exclusive benefit of security-based swap customers" established pursuant to § 240.15c3-3(p)(3),

(2) Cash and securities held in a securities account at a carrying broker or dealer (except where the account has been subordinated to the claims of creditors of the carrying broker or dealer), and

(3) Clearing deposits.

\* \* \* \* \*

(vi) \* \* \*

(O) *Cleared security-based swaps.* In the case of a cleared security-based swap held in a proprietary account of the broker or dealer, deducting the amount of the applicable margin requirement of the clearing agency or, if the security-based swap references an equity security, the broker or dealer may take a deduction using the method specified in § 240.15c3-1a.

(P) *Non-cleared security-based swaps—(1) Credit default swaps—(i) Short positions (selling protection).* In the case of a non-cleared 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 table 1 to § 240.15c3-1(c)(2)(vi)(P)(1)(i):

TABLE 1 TO § 240.15c3-1(c)(2)(vi)(P)(1)(i)

Length of time to maturity of credit default swap contract	Basis point spread					
	100 or less %	101–300 %	301–400 %	401–500 %	501–699 %	700 or more %
Less than 12 months .....	1.00	2.00	5.00	7.50	10.00	15.00
12 months but less than 24 months .....	1.50	3.50	7.50	10.00	12.50	17.50
24 months but less than 36 months .....	2.00	5.00	10.00	12.50	15.00	20.00
36 months but less than 48 months .....	3.00	6.00	12.50	15.00	17.50	22.50
48 months but less than 60 months .....	4.00	7.00	15.00	17.50	20.00	25.00
60 months but less than 72 months .....	5.50	8.50	17.50	20.00	22.50	27.50
72 months but less than 84 months .....	7.00	10.00	20.00	22.50	25.00	30.00
84 months but less than 120 months .....	8.50	15.00	22.50	25.00	27.50	40.00
120 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 non-cleared security-based swap that is a long credit default swap, deducting 50 percent of the deduction that would be required by paragraph (c)(2)(vi)(P)(1)(i) of this section if the non-cleared security-based swap was a short credit default swap, each such deduction not to exceed the current market value of the long position.

(iii) *Long and short credit default swaps.* In the case of non-cleared security-based swaps that are long and short credit default swaps referencing the same entity (in the case of non-cleared credit default swap security-based swaps referencing a corporate entity) or obligation (in the case of non-cleared credit default swap security-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 paragraph (c)(2)(vi)(P)(1)(i) or (ii) on the excess of the long or short position. In the case of non-cleared 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)(P)(1)(i) of this section, deducting 50 percent of the amount required by paragraph (c)(2)(vi)(P)(1)(i) of this section on the short position plus the deduction required by paragraph (c)(2)(vi)(P)(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 or dealer must document the industry sector classification system used pursuant to this section.

(iv) *Long security and long credit default swap.* In the case of a non-cleared 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 percent of the amount specified in paragraph (c)(2)(vi) or (vii) of this section for the debt security, 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.

(v) *Short security and short credit default swap.* In the case of a non-cleared security-based swap that is a short credit default swap referencing a debt security or a corporate entity, and the broker or dealer is short the debt security or a debt security issued by the corporate entity, deducting the amount specified in paragraph (c)(2)(vi) or (vii) of this section for the debt security. In the case of a non-cleared 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 (vii)

of this section for the asset-backed security.

(2) *Non-cleared security-based swaps that are not credit default swaps.* In the case of a non-cleared 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)(P)(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 and swap customer to meet the margin requirements of a clearing agency, Examining Authority, the Commission, derivatives clearing organization, or the Commodity Futures Trading Commission, as applicable, after application of calls for margin, marks to the market, or other required deposits which are outstanding within the required time frame to collect the margin, mark to the market, or other required deposits.

\* \* \* \*

(xv) *Deduction from net worth in lieu of collecting collateral for non-cleared security-based swap and swap transactions—(A) Security-based swaps.* Deducting the initial margin amount calculated pursuant to § 240.18a-3(c)(1)(i)(B) for the account of a counterparty at the broker or dealer that is subject to a margin exception set forth in § 240.18a-3(c)(1)(iii), less the margin value of collateral held in the account.

(B) *Swaps.* Deducting the initial margin amount calculated pursuant to the margin rules of the Commodity Futures Trading Commission in the account of a counterparty at the broker or dealer that is subject to a margin exception in those rules, less the margin value of collateral held in the account.

(C) *Treatment of collateral held at a third-party custodian.* For the purposes of the deductions required pursuant to paragraphs (c)(2)(xv)(A) and (B) of this section, collateral held by an independent third-party custodian as initial margin may be treated as collateral held in the account of the counterparty at the broker or dealer if:

(1) The independent third-party custodian is a bank as defined in section

3(a)(6) of the Act or a registered U.S. clearing organization or depository that is not affiliated with the counterparty or, if the collateral consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that is not affiliated with the counterparty and that customarily maintains custody of such foreign securities or currencies;

(2) The broker or dealer, the independent third-party custodian, and the counterparty that delivered the collateral to the custodian have executed an account control agreement governing the terms under which the custodian holds and releases collateral pledged by the counterparty as initial margin that is a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency, or a similar proceeding of any of the parties to the agreement, and that provides the broker or dealer with the right to access the collateral to satisfy the counterparty's obligations to the broker or dealer arising from transactions in the account of the counterparty; and

(3) The broker or dealer maintains written documentation of its analysis that in the event of a legal challenge the relevant court or administrative authorities would find the account control agreement to be legal, valid, binding, and enforceable under the applicable law, including in the event of the receivership, conservatorship, insolvency, liquidation, or a similar proceeding of any of the parties to the agreement.

\* \* \* \*

(17) The term *risk margin amount* means the sum of:

(i) The total initial margin required to be maintained by the broker or dealer at each clearing agency with respect to security-based swap transactions cleared for security-based swap customers; and

(ii) The total initial 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).

\* \* \* \*

■ 6. Section 240.15c3-1a is amended by revising paragraphs (a)(3) and (4) and (b)(1)(v)(C)(3) and (4) and adding paragraph (b)(1)(v)(C)(5) to read as follows:

**§ 240.15c3-1a Options (Appendix A to 17 CFR 240.15c3-1)**

(a) \* \* \*

(3) The term *related instrument* within an option class or product group

refers to futures contracts, options on futures contracts, security-based swaps on a narrow-based security index, and swaps 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 other than a security-based swap on a narrow-based security index, 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 section, the broker or 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, security-based swaps on a narrow-based security index, qualified stock baskets, unlisted instruments, or swaps.

\* \* \* \*

(b) \* \* \*

(1) \* \* \*

(v) \* \* \*

(C) \* \* \*

(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 percent of the market value of the qualified stock basket for high-capitalization diversified and narrow-based indexes;

(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 ½ percent of the market value of the qualified stock basket for non-high-capitalization diversified indexes; and

(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 percent times the multiplier for each security future and equity option.

\* \* \* \*

■ 7. Section 240.15c3-1b is amended:

- a. In paragraph (a)(3)(iii)(C) by adding the phrase “cleared swap transactions or,” before the phrase “commodity futures or options transactions”; and
- b. By adding paragraph (b).

The addition reads as follows:

**§ 240.15c3-1b Adjustments to net worth and aggregate indebtedness for certain commodities transactions (Appendix B to 17 CFR 240.15c3-1).**

\* \* \* \* \*

(b) Every broker or dealer in computing net capital pursuant to § 240.15c3-1 must comply with the following:

(1) *Cleared swaps*. In the case of a cleared swap held in a proprietary

account of the broker or dealer, deducting the amount of the applicable margin requirement of the derivatives clearing organization or, if the swap references an equity security index, the broker or dealer may take a deduction using the method specified in § 240.15c3-1a.

(2) *Non-cleared swaps*—(i) *Credit default swaps referencing broad-based security indices*. In the case of a non-cleared credit default swap for which

the deductions in § 240.15c3-1e do not apply:

(A) *Short positions (selling protection)*. In the case of a non-cleared swap that is a short credit default swap referencing a broad-based security 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 table 1 to § 240.15c3-1a(b)(2)(i)(A):

TABLE 1 TO § 240.15c3-1a(b)(2)(i)(A)

Length of time to maturity of credit default swap contract	Basis point spread					
	100 or less (%)	101–300 (%)	301–400 (%)	401–500 (%)	501–699 (%)	700 or more (%)
Less than 12 months .....	0.67	1.33	3.33	5.00	6.67	10.00
12 months but less than 24 months .....	1.00	2.33	5.00	6.67	8.33	11.67
24 months but less than 36 months .....	1.33	3.33	6.67	8.33	10.00	13.33
36 months but less than 48 months .....	2.00	4.00	8.33	10.00	11.67	15.00
48 months but less than 60 months .....	2.67	4.67	10.00	11.67	13.33	16.67
60 months but less than 72 months .....	3.67	5.67	11.67	13.33	15.00	18.33
72 months but less than 84 months .....	4.67	6.67	13.33	15.00	16.67	20.00
84 months but less than 120 months .....	5.67	10.00	15.00	16.67	18.33	26.67
120 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 non-cleared swap that is a long credit default swap referencing a broad-based security index, deducting 50 percent of the deduction that would be required by paragraph (b)(2)(i)(A) of this section if the non-cleared swap was a short credit default swap, each such deduction not to exceed the current market value of the long position.

(C) *Long and short credit default swaps*. In the case of non-cleared 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)(2)(i)(A) or (B) of this section on the excess of the long or short position.

(D) *Long basket of obligors and long credit default swap*. In the case of a non-cleared swap that is a long credit default swap referencing a broad-based security index and the broker or dealer is long a basket of debt securities comprising all of the components of the security index,

deducting 50 percent 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.

(E) *Short basket of obligors and short credit default swap*. In the case of a non-cleared swap that is a short credit default swap referencing a broad-based security index and the broker or dealer is short a basket of debt securities comprising all of the components of the security index, deducting the amount specified in § 240.15c3-1(c)(2)(vi) for the component securities.

(ii) *All other swaps*. (A) In the case of a non-cleared swap that is not a credit default swap for which the deductions in § 240.15c3-1e do not apply, deducting the amount calculated by multiplying the notional value of the swap by the percentage specified in:

(1) Section 240.15c3-1 applicable to the reference asset if § 240.15c3-1 specifies a percentage deduction for the type of asset;

(2) 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

(3) In the case of non-cleared 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 one eighth of 1

percent of the amount of a long position that is netted against a short position in the case of a non-cleared swap with a maturity of three months or more.

(B) A broker or dealer may reduce the deduction under paragraph (b)(2)(ii)(A) 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.

\* \* \* \* \*

■ 8. Section 240.15c3-1d is amended by revising paragraphs (b)(7) and (8), (b)(10)(ii)(B), (c)(2), and (c)(5)(i)(B) to read as follows:

**§ 240.15c3-1d Satisfactory subordination agreements (Appendix D to 17 CFR 240.15c3-1).**

\* \* \* \* \*

(b) \* \* \*

(7) A broker or dealer at its option but not at the option of the lender may, if the subordination 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 subordination agreement became effective. This restriction shall not apply to temporary subordination agreements that comply with the provisions of paragraph (c)(5) of this section. No Prepayment shall be made, if, after

giving effect thereto (and to all Payments of Payment Obligations under any other subordinated 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 broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 1000 percent of its net capital or its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1 or, in the case of a broker or dealer operating pursuant to § 240.15c3-1(a)(1)(ii), its net capital would be less than 5 percent of its aggregate debit items computed in accordance with § 240.15c3-3a, or if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1(a)(1)(ii), or if, in the case of a broker or dealer operating pursuant to § 240.15c3-1(a)(10), its net capital would be less than 120 percent of its minimum requirement.

(8)(i) The Payment Obligation of the broker or dealer in respect of any subordination 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 broker or dealer under any other subordination agreement(s) then outstanding that are scheduled to mature on or before such Payment Obligation) either:

(A) The aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital, or in the case of a broker or dealer operating pursuant to § 240.15c3-1(a)(1)(ii), its net capital would be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3-3a or, if registered as a futures commission merchant, 6 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the

rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or, in the case of a broker or dealer operating pursuant to § 240.15c3-1(a)(10), its net capital would be less than 120 percent of its minimum requirement; or

(B) Its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1 including paragraph (a)(1)(ii), if applicable. The subordination agreement may provide that if the Payment Obligation of the broker or dealer thereunder does not mature and is suspended as a result of the requirement of this paragraph (b)(8) for a period of not less than six months, the broker or 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 §§ 240.15c3-1 and 240.15c3-1d.

(ii) [Reserved]

\* \* \* \* \*

(10) \* \* \*

(ii) \* \* \*

(B) The aggregate indebtedness of the broker or dealer exceeding 1500 percent of its net capital or, in the case of a broker or dealer that has elected to operate under § 240.15c3-1(a)(1)(ii), its net capital computed in accordance therewith is less than two percent of its aggregate debit items computed in accordance with § 240.15c3-3a or, if registered as a futures commission merchant, four percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or, in the case of a broker or dealer operating pursuant to § 240.15c3-1(a)(10), its net capital is less than its minimum requirement, throughout a period of 15 consecutive business days, commencing on the day the broker or dealer first determines and notifies the Examining Authority for the broker or dealer, or the Examining Authority or the Commission first determines and notifies the broker or dealer of such fact;

\* \* \* \* \*

(c) \* \* \*

(2) Every broker or dealer shall immediately notify the Examining Authority for such broker or dealer if, after giving effect to all Payments of Payment Obligations under

subordination agreements then outstanding that are then due or mature within the following six months without reference to any projected profit or loss of the broker or dealer either the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital or its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1, or, in the case of a broker or dealer operating pursuant to § 240.15c3-1(a)(1)(ii), its net capital would be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3-3a, or, if registered as a futures commission merchant, 6 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or less than 120 percent of the minimum dollar amount required by § 240.15c3-1(a)(1)(ii), or, in the case of a broker or dealer operating pursuant to § 240.15c3-1(a)(10), its net capital would be less than 120 percent of its minimum requirement.

\* \* \* \* \*

(5)(i) \* \* \*

(B) In the case of a broker or dealer operating pursuant to § 240.15c3-1(a)(1)(ii), its net capital is less than 5 percent of aggregate debits computed in accordance with § 240.15c3-1, or, if registered as a futures commission merchant, less than 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of this section, or, in the case of a broker or dealer operating pursuant to § 240.15c3-1(a)(10), its net capital would be less than 120 percent of its minimum requirement, or

\* \* \* \* \*

■ 9. Section 240.15c3-1e is amended by:

■ a. Redesignating the Preliminary Note as introductory text and revising it;

■ b. Revising paragraph (a) introductory text;

■ c. Redesignating paragraph (a)(7) as paragraph (a)(7)(i) and adding paragraph (a)(7)(ii);

- d. Revising paragraph (c)(3);
- e. Adding paragraphs (c)(4)(v)(B)(1) and (2);
- f. Removing paragraph (c)(4)(v)(D) and redesignating paragraphs (c)(4)(v)(E) through (H) as paragraphs (c)(4)(v)(D) through (G);
- g. In paragraph (e) introductory text by removing the phrase “§ 240.15c3–1(c)(2)(vi), (c)(2)(vii), and (c)(2)(iv), as appropriate” and adding in its place “§ 240.15c3–1(c)(2)(iv), (vi), and (vii), (c)(2)(xv)(A) and (B), as appropriate, and § 240.15c–1b, as appropriate”; and
- h. Revising paragraph (e)(1).

The revisions read as follows:

**§ 240.15c3–1e Deductions for market and credit risk for certain brokers or dealers (Appendix E to 17 CFR 240.15c3–1).**

Sections 240.15c3–1e and 240.15c3–1g set forth a program that allows a broker or dealer to use an alternative approach to computing net capital deductions, subject to the conditions described in §§ 240.15c3–1e and 240.15c3–1g, including supervision of the broker's or dealer's ultimate holding company under the program. The program is designed to reduce the likelihood that financial and operational weakness in the holding company will destabilize the broker or dealer, or the broader financial system. The focus of this supervision of the ultimate holding company is its financial and operational condition and its risk management controls and methodologies.

(a) A broker or dealer may apply to the Commission for authorization to compute deductions for market risk pursuant to this section in lieu of computing deductions pursuant to §§ 240.15c3–1(c)(2)(vi) and (vii) and 240.15c3–1b, and to compute deductions for credit risk pursuant to this section on credit exposures arising from transactions in derivatives instruments (if this section is used to calculate deductions for market risk on these instruments) in lieu of computing deductions pursuant to § 240.15c3–1(c)(2)(iv) and (c)(2)(xv)(A) and (B):

(7) \* \* \*

(ii) The Commission may approve the temporary use of a provisional model in whole or in part, subject to any conditions or limitations the Commission may require, if:

(A) The broker or dealer has a complete application pending under this section;

(B) The use of the provisional model has been approved by:

- (1) A prudential regulator;
- (2) The Commodity Futures Trading Commission or a futures association registered with the Commodity Futures

Trading Commission under section 17 of the Commodity Exchange Act;

(3) A foreign financial regulatory authority that administers a foreign financial regulatory system with capital requirements that the Commission has found are eligible for substituted compliance under § 240.3a71–6 if the provisional model is used for the purposes of calculating net capital;

(4) A foreign financial regulatory authority that administers a foreign financial regulatory system with margin requirements that the Commission has found are eligible for substituted compliance under § 240.3a71–6 if the provisional model is used for the purposes of calculating initial margin pursuant to § 240.18a–3; or

(5) Any other foreign supervisory authority that the Commission finds has approved and monitored the use of the provisional model through a process comparable to the process set forth in this section.

\* \* \*

(c) \* \* \*

(3) A portfolio concentration charge of 100 percent of the amount of the broker's or dealer's aggregate current exposure for all counterparties in excess of 10 percent of the tentative net capital of the broker or dealer;

(4) \* \* \*

(v) \* \* \*

(B) \* \* \*

(1) The collateral is subject to the broker's or dealer's physical possession or control and may be liquidated promptly by the firm without intervention by any other party; or

(2) The collateral is held by an independent third-party custodian that is a bank as defined in section 3(a)(6) of the Act or a registered U.S. clearing organization or depository that is not affiliated with the counterparty or, if the collateral consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that is not affiliated with the counterparty and that customarily maintains custody of such foreign securities or currencies;

\* \* \*

(e) \* \* \*

(1) The broker or dealer is required by § 240.15c3–1(a)(7)(ii) to provide notice to the Commission that the broker's or dealer's tentative net capital is less than \$6 billion;

\* \* \*

■ 10. Section 240.15c3–3 is amended by adding introductory text and paragraph (p) to read as follows:

**§ 240.15c3–3 Customer protection—reserves and custody of securities.**

Except where otherwise noted, § 240.15c3–3 applies to a broker or

dealer registered under section 15(b) of the Act (15 U.S.C. 78o(b)), including a broker or dealer also registered as a security-based swap dealer or major security-based swap participant under section 15F(b) of the Act (15 U.S.C. 78o–10(b)). A security-based swap dealer or major security-based swap participant registered under section 15F(b) of the Act that is not also registered as a broker or dealer under section 15(b) of the Act is subject to the requirements under § 240.18a–4.

\* \* \*

(p) *Segregation requirements for security-based swaps.* The following requirements apply to the security-based swap activities of a broker or dealer.

(1) *Definitions.* For the purposes of this paragraph:

(i) The term *cleared security-based swap* means 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 Act (15 U.S.C. 78q–1);

(ii) 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 broker or dealer (after reducing the current exposure by the amount of cash in the account) to the security-based swap customer, excluding:

(A) 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 security-based swap customer; and

(B) Securities and money market instruments held in a qualified registered security-based swap dealer account or in a third-party custodial account but only to the extent the securities and money market instruments are being used to meet a regulatory margin requirement of a security-based swap dealer resulting from the broker or dealer entering into a non-cleared security-based swap transaction with the security-based swap dealer to offset the risk of a non-cleared security-based swap transaction between the broker or dealer and the security-based swap customer;

(iii) The term *qualified clearing agency account* means an account of a broker or dealer at a clearing agency registered with the Commission pursuant to section 17A of the Act (15



U.S.C. 78q-1) that holds funds and other property in order to margin, guarantee, or secure cleared security-based swap transactions for the security-based swap customers of the broker or dealer that meets the following conditions:

(A) The account is designated "Special Clearing Account for the Exclusive Benefit of the Cleared Security-Based Swap Customers of [name of broker or dealer]";

(B) The clearing agency has acknowledged in a written notice provided to and retained by the broker or 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 broker or dealer in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the broker or dealer with the clearing agency; and

(C) The account is subject to a written contract between the broker or 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.

(iv) The term *qualified registered security-based swap dealer account* means an account at a security-based swap dealer that is registered with the Commission pursuant to section 15F of the Act that meets the following conditions:

(A) The account is designated "Special Reserve Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of broker or dealer]";

(B) The security-based swap dealer has acknowledged in a written notice provided to and retained by the broker or dealer that the funds and other property held in the account are being held by the security-based swap dealer for the exclusive benefit of the security-based swap customers of the broker or dealer in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the broker or dealer with the security-based swap dealer;

(C) The account is subject to a written contract between the broker or dealer and the 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 security-based swap dealer or any person claiming through the 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

(D) The account and the assets in the account are not subject to any type of subordination agreement between the broker or dealer and the security-based swap dealer.

(v) The term *qualified security* means:

(A) Obligations of the United States;

(B) Obligations fully guaranteed as to principal and interest by the United States; and

(C) General obligations of any State or a political subdivision of a State that:

(1) Are not traded flat and are not in default;

(2) Were part of an initial offering of \$500 million or greater; and

(3) Were issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year end.

(vi) The term *security-based swap customer* means any person from whom or on whose behalf the broker or 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 broker or dealer or, in the case of an affiliate of the broker or dealer, is subordinated to all claims of customers (including PAB customers) and security-based swap customers of the broker or dealer.

(vii) The term *special reserve account for the exclusive benefit of security-based swap customers* means an account at a bank that meets the following conditions:

(A) The account is designated "Special Reserve Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of broker or dealer]";

(B) The account is subject to a written acknowledgement by the bank provided to and retained by the broker or 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 broker or dealer in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the broker or dealer with the bank; and

(C) The account is subject to a written contract between the broker or 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 broker or 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.

(viii) The term *third-party custodial account* means an account carried by an independent third-party custodian that meets the following conditions:

(A) The account is established for the purposes of meeting regulatory margin requirements of another security-based swap dealer;

(B) The account is carried by a bank as defined in section 3(a)(6) of the Act or a registered U.S. clearing organization or depository or, if the collateral to be held in the account consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that customarily maintains custody of such foreign securities or currencies;

(C) The account is designated for and on behalf of the broker or dealer for the benefit of its security-based swap customers and the account is subject to a written acknowledgement by the bank, clearing organization, or depository provided to and retained by the broker or dealer that the funds and other property held in the account are being held by the bank, clearing organization, or depository for the exclusive benefit of the security-based swap customers of the broker or dealer and are being kept separate from any other accounts maintained by the broker or dealer with the bank, clearing organization, or depository; and

(D) The account is subject to a written contract between the broker or dealer and the bank, clearing organization, or depository 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, clearing organization, or depository and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing organization, or depository or any person claiming through the bank, clearing organization, or depository.

(2) *Physical possession or control of excess securities collateral.* (i) A broker or dealer must promptly obtain and thereafter maintain physical possession or control of all excess securities collateral carried for the security-based

swap accounts of security-based swap customers.

(ii) A broker or dealer has *control* of excess securities collateral only if the securities and money market instruments:

(A) 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 broker or dealer does not require the payment of money or value, and if the books or records of the broker or 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;

(B) 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 broker or dealer to the issuer or its transfer agent, new certificates conforming to the instructions of the broker or dealer have not been received by the broker or dealer, the broker or 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 broker or dealer has not obtained a revalidation of a window ticket from a transfer agent with respect to the certificate delivered for transfer;

(C) 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 broker or 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;

(D)(1) Are held in or are in transit between offices of the broker or dealer; or

(2) Are held by a corporate subsidiary if the broker or 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 broker or 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

(E) Are held in such other locations as the Commission shall upon application from a broker or dealer find and designate to be adequate for the protection of security-based swap customer securities.

(iii) Each business day the broker or dealer must determine from its books and records the quantity of excess securities collateral in its possession or control as of the close of the previous business day and the quantity of excess securities collateral not in its possession or control as of the previous business day. If the broker or 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:

(A) Securities or money market instruments subject to a lien securing an obligation of the broker or dealer, then the broker or 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;

(B) Securities or money market instruments held in a qualified clearing agency account, then the broker or 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;

(C) Securities or money market instruments held in a qualified registered security-based swap dealer account maintained by another security-based swap dealer or in a third-party custodial account, then the broker or 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 security-based swap dealer or the third-party custodian and must obtain physical possession or control of the securities or

money market instruments within two business days following the date of the instructions;

(D) Securities or money market instruments loaned by the broker or dealer, then the broker or 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;

(E) Securities or money market instruments failed to receive more than 30 calendar days, then the broker or 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;

(F) Securities or money market instruments receivable by the broker or dealer as a security dividend, stock split or similar distribution for more than 45 calendar days, then the broker or 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

(G) Securities or money market instruments included on the broker's or dealer's books or records that allocate to a short position of the broker or dealer or a short position for another person, for more than 30 calendar days, then the broker or 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.

(3) *Deposit requirement for special reserve account for the exclusive benefit of security-based swap customers.* (i) A broker or dealer must maintain a special reserve account for the exclusive benefit of security-based swap customers that is separate from any other bank account of the broker or dealer. The broker or dealer must at all times maintain in the special reserve 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 § 240.15c3–3b. In determining the amount maintained in a special reserve account for the exclusive benefit of security-based swap customers, the broker or dealer must deduct:

(A) The percentage of the value of a general obligation of a State or a political subdivision of a State specified in § 240.15c3–1(c)(2)(vi);

(B) The aggregate value of general obligations of a State or a political subdivision of a State to the extent the amount of the obligations of a single issuer (after applying the deduction in paragraph (p)(3)(i)(A) of this section) exceeds two percent of the amount required to be maintained in the special reserve account for the exclusive benefit of security-based swap customers;

(C) The aggregate value of all general obligations of States or political subdivisions of States to the extent the amount of the obligations (after applying the deduction in paragraph (p)(3)(i)(A) of this section) exceeds 10 percent of the amount required to be maintained in the special reserve account for the exclusive benefit of security-based swap customers;

(D) The amount of cash deposited with a single non-affiliated bank to the extent the amount exceeds 15 percent of the equity capital of the bank as reported by the bank in its most recent Call Report or any successor form the bank is required to file by its appropriate federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); and

(E) The total amount of cash deposited with an affiliated bank.

(ii) A broker or dealer must not accept or use credits identified in the items of the formula set forth in § 240.15c3–3b except for the specified purposes indicated under items comprising Total Debits under the formula, and, to the extent Total Credits exceed Total Debits, at least the net amount thereof must be maintained in the Special Reserve Account pursuant to paragraph (p)(3)(i) of this section.

(iii)(A) The computations necessary to determine the amount required to be

maintained in the special reserve account for the exclusive benefit of security-based swap customers must be made weekly as of the close of the last business day of the week and any deposit required to be made into the account must be made no later than one hour after the opening of banking business on the second following business day. The broker or dealer may make a withdrawal from the special reserve 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 (p)(3) of this section.

(ii) (B) Computations in addition to the computations required pursuant to paragraph (p)(3)(iii)(A) of this section may be made as of the close of any business day, and deposits so computed must be made no later than one hour after the open of banking business on the second following business day.

(iv) A broker or dealer must promptly deposit into a special reserve account for the exclusive benefit of security-based swap customers cash and/or qualified securities of the broker or dealer if the amount of cash and/or qualified securities in one or more special reserve accounts for the exclusive benefit of security-based swap customers falls below the amount required to be maintained pursuant to this section.

(4) *Requirements for non-cleared security-based swaps*—(i) *Notice*. A broker or dealer registered under section 15F(b) of the Act (15 U.S.C. 78o–10(b)) as a security-based swap dealer or 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)) in writing to a duly authorized individual prior to the execution of the first non-cleared security-based swap

transaction with the counterparty occurring after the compliance date of this section.

(ii) *Subordination*—(A) *Counterparty that elects to have individual segregation at an independent third-party custodian*. A broker or dealer must obtain an agreement from a counterparty whose funds or other property to meet a margin requirement of the broker or dealer are held at a third-party custodian in which the counterparty agrees to subordinate its claims against the broker or dealer for the funds or other property held at the third-party custodian to the claims of customers (including PAB customers) and security-based swap customers of the broker or 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 or *customer property* as defined in 15 U.S.C. 78lll(4) in a liquidation of the broker or dealer.

(B) *Counterparty that elects to have no segregation*. A broker or dealer registered under section 15F(b) of the Act as a security-based swap dealer must obtain an agreement from a counterparty that is an affiliate of the broker or dealer that affirmatively chooses not 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 broker or dealer to the claims of customers (including PAB customers) and security-based swap customers of the broker or dealer.

■ 11. Section 240.15c3–3b is added to read as follows:

**§ 240.15c3–3b Exhibit B—Formula for determination of security-based swap customer reserve requirements of brokers and dealers under § 240.15c3–3.**

	Credits	Debits
1. Free credit balances and other credit balances in the accounts carried for security-based swap customers (See Note A) .....	\$ .....	.....
2. Monies borrowed collateralized by securities in accounts carried for security-based swap customers (See Note B) .....	\$ .....	.....
3. Monies payable against security-based swap customers' securities loaned (See Note C) .....	\$ .....	.....
4. Security-based swap customers' securities failed to receive (See Note D) .....	\$ .....	.....
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 (See Note E) .....	.....	\$ .....
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 .....	.....	\$ .....

	Credits	Debits
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 (See Note F) .....	.....	\$ .....
14. Margin related to security futures 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) (See Note G) .....	.....	\$ .....
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 a security-based swap dealer or at a third-party custodial account .....	.....	\$ .....
Total Credits .....	\$ .....	.....
Total Debits .....	.....	\$ .....
Excess of Credits over Debits .....	\$ .....	.....

Note A. Item 1 must include all outstanding drafts payable to security-based swap customers which have been applied against free credit balances or other credit balances and must also include checks drawn in excess of bank balances per the records of the broker or dealer.

Note B. Item 2 must 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 must include in addition to monies payable against security-based swap customers' 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 must 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 carried for security-based swap customers must 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 must 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 a security-based swap dealer, must be reduced by any deficits in such accounts (or if a credit, such credit must 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 must 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 broker or dealer and debit balances in accounts of affiliated persons of a broker or dealer must be excluded from the reserve formula, unless the broker or 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) must be reduced by the amount by which any single security-based swap customer's debit balance exceeds 25 percent (to the extent such amount is greater than \$50,000) of the broker's or dealer's tentative net capital (i.e., net capital prior to securities haircuts) unless the broker or 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) will be deemed to be a single security-based swap customer's account for purposes of this provision.

If the registered national securities exchange or the registered national securities association having responsibility for examining the broker or dealer ("designated examining authority") 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 such designated examining authority 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 that include both assets of a person who would be excluded from the definition of security-based swap customer ("non-security-based swap customer") and assets of a person or persons includible in the definition of security-based swap customer must 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 must be excluded from the formula unless the broker or 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 must be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula.

Note F. Item 13 must 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 must 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 will apply only if the broker or 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 broker or dealer, that the broker or 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 will 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 will provide that such funds and/or securities will 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 will 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, will 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 or 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 will apply only if a broker or dealer determines, at least annually, that the registered clearing agency or derivatives clearing organization with which the broker or dealer has on deposit margin related to security futures products meets the conditions of this Note G.

■ 12. An undesignated center heading and § 240.18a–1 are added to read as follows:

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

**§ 240.18a–1 Net capital requirements for security-based swap dealers for which there is not a prudential regulator.**

Sections 240.18a–1, 240.18a–1a, 240.18a–1b, 240.18a–1c, and 240.18a–1d apply to a security-based swap dealer registered under section 15F of the Act (15 U.S.C. 78o–10), including a security-based swap dealer that is an *OTC derivatives dealer* as that term is defined in § 240.3b–12. A security-based swap dealer registered under section 15F of the Act (15 U.S.C. 78o–10) that is also a broker or dealer registered under section 15 of the Act (15 U.S.C. 78o), other than an OTC derivatives dealer, is subject to the net capital requirements in § 240.15c3–1 and its appendices. A security-based swap dealer registered under section 15F of the Act that has a prudential regulator is not subject to § 240.18a–1, 240.18a–1a, 240.18a–1b, 240.18a–1c, and 240.18a–1d.

(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 paragraph (a)(1) or (2) of this section, and tentative net capital no less than the minimum requirement under paragraph (a)(2) of this section.

(1)(i) A security-based swap dealer must at all times maintain net capital of not less than the greater of \$20 million or:

(A) Two percent of the risk margin amount; or

(B) Four percent or less of the risk margin amount if the Commission issues an order raising the requirement to four percent or less on or after the third anniversary of this section's compliance date; or

(C) Eight percent or less of the risk margin amount if the Commission issues an order raising the requirement to eight percent or less on or after the fifth anniversary of this section's compliance date and the Commission had previously issued an order raising the requirement under paragraph (a)(1)(ii) of this section;

(ii) If, after considering the capital and leverage levels of security-based swap dealers subject to this paragraph (a)(1), as well as the risks of their security-based swap positions, the Commission determines that it may be appropriate to change the percentage pursuant to paragraph (a)(1)(i)(B) or (C) of this section, the Commission will publish a notice of the potential change and subsequently will issue an order regarding any such change.

(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), (vi), and (vii) of this section, and § 240.18a–1b, and using the credit risk standards of paragraph (d) to compute a deduction for credit risk on certain credit exposures arising from transactions in derivatives instruments, instead of the provisions of paragraphs (c)(1)(iii) and (c)(1)(ix)(A) and (B) 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:

(i)(A) Two percent of the risk margin amount;

(B) Four percent or less of the risk margin amount if the Commission issues an order raising the requirement to four percent or less on or after the third anniversary of this section's compliance date; or

(C) Eight percent or less of the risk margin amount if the Commission issues an order raising the requirement to eight percent or less on or after the fifth anniversary of this section's compliance date and the Commission had previously issued an order raising the requirement under paragraph (a)(2)(ii) of this section;

(ii) If, after considering the capital and leverage levels of security-based swap dealers subject to this paragraph (a)(2), as well as the risks of their security-based swap positions, the Commission determines that it may be appropriate to change the percentage pursuant to paragraph (a)(2)(i)(B) or (C) of this section, the Commission will publish a notice of the potential change and subsequently will issue an order regarding any such change; 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 (2) of this section, as applicable, in an amount equal to 10 percent of:

(1) 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;

(2) 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

(3) 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) *Net capital.* 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 paragraphs (c)(1)(i)(C)(1) through (3) of this section, or the sum of paragraphs (c)(1)(i)(C)(1), (2), and (3) of this section;

(1) The aggregate amount resulting from applying to the amount of the deductions computed in accordance with paragraphs (c)(1)(vi) and (vii) 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 § 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 the required time frame to collect the margin, marks to the market, or other required deposits; 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 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 longer than 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 reserve account for the exclusive benefit of the security-based swap customers" established pursuant to § 240.18a-4 and clearing deposits shall not be so deducted.

(E) *Repurchase agreements.* (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 this paragraph (c)(1)(iii)(E)(1), 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: Any margin or other deposits held

by the security-based swap dealer on account of the reverse repurchase agreement; 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; 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 calls for margin, marks to the market, or other required deposits that are outstanding one business day or less.

(3) In the case of repurchase agreements, the deduction shall be:

(i) 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

(ii) 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)(vi) and (vii) of this section (less any deduction taken with respect to repurchase agreements with that party under paragraph (c)(1)(iii)(E)(3)(i) of this section) or, if greater; 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)(vi) and (vii) of this section.

(iii) In determining the required deduction under paragraphs (c)(1)(iii)(E)(3)(i) and (ii) of this section, the security-based swap dealer may reduce a repurchase agreement by 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; 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 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) *Affiliate receivables and collateral*. 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)(A) *Cleared security-based swaps*. In the case of a cleared security-based swap held in a proprietary account of the security-based swap dealer, deducting the amount of the applicable margin requirement of the clearing agency or, if the security-based swap references an equity security, the security-based swap dealer may take a deduction using the method specified in § 240.18a-1a.

(B) *Non-cleared security-based swaps—(1) Credit default swaps—(i) Short positions (selling protection)*. In the case of a non-cleared 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 table 1 to § 240.18a-1(c)(1)(vi)(B)(1)(i):

TABLE 1 TO § 240.18A-1(C)(1)(vi)(B)(1)(i)

Length of time to maturity of credit default swap contract	Basis point spread					
	100 or less (%)	101–300 (%)	301–400 (%)	401–500 (%)	501–699 (%)	700 or more (%)
Less than 12 months .....	1.00	2.00	5.00	7.50	10.00	15.00
12 months but less than 24 months .....	1.50	3.50	7.50	10.00	12.50	17.50
24 months but less than 36 months .....	2.00	5.00	10.00	12.50	15.00	20.00
36 months but less than 48 months .....	3.00	6.00	12.50	15.00	17.50	22.50
48 months but less than 60 months .....	4.00	7.00	15.00	17.50	20.00	25.00
60 months but less than 72 months .....	5.50	8.50	17.50	20.00	22.50	27.50



TABLE 1 TO § 240.18A–1(C)(1)(vi)(B)(1)(i)—Continued

Length of time to maturity of credit default swap contract	Basis point spread					
	100 or less (%)	101–300 (%)	301–400 (%)	401–500 (%)	501–699 (%)	700 or more (%)
72 months but less than 84 months .....	7.00	10.00	20.00	22.50	25.00	30.00
84 months but less than 120 months .....	8.50	15.00	22.50	25.00	27.50	40.00
120 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 non-cleared security-based swap that is a long credit default swap, deducting 50 percent of the deduction that would be required by paragraph (c)(1)(vi)(B)(1)(i) of this section if the non-cleared security-based swap was a short credit default swap, each such deduction not to exceed the current market value of the long position.

(iii) *Long and short credit default swaps*. In the case of non-cleared security-based swaps that are long and short credit default swaps referencing the same entity (in the case of non-cleared credit default swap security-based swaps referencing a corporate entity) or obligation (in the case of non-cleared credit default swap security-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 paragraph (c)(1)(vi)(B)(1)(i) or (ii) on the excess of the long or short position. In the case of non-cleared 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)(1)(vi)(B)(1)(i) of this section, deducting 50 percent of the amount required by paragraph (c)(1)(vi)(B)(1)(i) of this section on the short position plus the deduction required by paragraph (c)(1)(vi)(B)(1)(ii) 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 the security-based swap dealer must

document the industry sector classification system used pursuant to this section.

(iv) *Long security and long credit default swap*. In the case of a non-cleared 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 percent of the amount specified in § 240.15c3–1(c)(2)(vi) or (vii) for the debt security, provided that the security-based swap dealer can deliver the debt security to satisfy the obligation of the security-based swap dealer on the credit default swap.

(v) *Short security and short credit default swap*. In the case of a non-cleared security-based swap that is a short credit default swap referencing a debt security or a corporate entity, and the security-based swap dealer is short the debt security or a debt security issued by the corporate entity, deducting the amount specified in § 240.15c3–1(c)(2)(vi) or (vii) for the debt security. In the case of a non-cleared 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.

(2) *All other security-based swaps*. In the case of a non-cleared 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)(2) 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 for certain undermargined accounts*. Deducting the amount of cash required in the account of each security-based swap and swap customer to meet the margin requirements of a clearing agency, the Commission, derivatives clearing organization, or the Commodity Futures Trading Commission, as applicable, after application of calls for margin, marks to the market, or other required deposits which are outstanding within the required time frame to collect the margin, mark to the market, or other required deposits.

(ix) *Deduction from net worth in lieu of collecting collateral for non-cleared security-based swap and swap transactions—(A) Security-based swaps*. Deducting the initial margin amount calculated pursuant to § 240.18a–3(c)(1)(i)(B) for the account of a counterparty at the security-based swap dealer that is subject to a margin exception set forth in § 240.18a–3(c)(1)(iii), less the margin value of collateral held in the account.

(B) *Swaps*. Deducting the initial margin amount calculated pursuant to the margin rules of the Commodity Futures Trading Commission in the account of a counterparty at the security-based swap dealer that is subject to a margin exception in those rules, less the margin value of collateral held in the account.

(C) *Treatment of collateral held at a third-party custodian*. For the purposes of the deductions required pursuant to paragraphs (c)(1)(ix)(A) and (B) of this section, collateral held by an independent third-party custodian as initial margin may be treated as collateral held in the account of the counterparty at the security-based swap dealer if:

(1) The independent third-party custodian is a bank as defined in section 3(a)(6) of the Act or a registered U.S. clearing organization or depository that is not affiliated with the counterparty or, if the collateral consists of foreign securities or currencies, a supervised

foreign bank, clearing organization, or depository that is not affiliated with the counterparty and that customarily maintains custody of such foreign securities or currencies;

(2) The security-based swap dealer, the independent third-party custodian, and the counterparty that delivered the collateral to the custodian have executed an account control agreement governing the terms under which the custodian holds and releases collateral pledged by the counterparty as initial margin that is a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency, or a similar proceeding of any of the parties to the agreement, and that provides the security-based swap dealer with the right to access the collateral to satisfy the counterparty's obligations to the security-based swap dealer arising from transactions in the account of the counterparty; and

(3) The security-based swap dealer maintains written documentation of its analysis that in the event of a legal challenge the relevant court or administrative authorities would find the account control agreement to be legal, valid, binding, and enforceable under the applicable law, including in the event of the receivership, conservatorship, insolvency, liquidation, or a similar proceeding of any of the parties to the agreement.

(x)(A) Deducting the market value of all short securities differences (which shall include securities positions reflected on the securities record which are not susceptible to either count or confirmation) unresolved after discovery in accordance with the schedule in table 2 to § 240.18a–1(c)(1)(x)(A):

TABLE 2 TO § 240.18a–1(c)(1)(x)(A)

Differences <sup>1</sup>	Number of business days after discovery
25 percent .....	7
50 percent .....	14
75 percent .....	21
100 percent .....	28

<sup>1</sup> Percentage of market value of short securities differences.

(B) Deducting the market value of any long securities differences, where such securities have been sold by the security-based swap dealer before they are adequately resolved, less any reserves established therefor;

(C) The Commission may extend the periods in paragraph (c)(1)(x)(A) of this section for up to 10 business days if it

finds that exceptional circumstances warrant an extension.

(2) The term *exempted securities* shall mean those securities deemed exempted securities by section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) 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 exist 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 paragraph (d) of this section or paragraphs (c)(1)(vi) and (vii) of this section, if applicable, and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in derivative instruments which would otherwise be deducted pursuant to paragraph (c)(1)(iii) of this section. 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 total initial margin required to be maintained by the security-based swap dealer at each clearing agency with respect to security-based swap transactions cleared for security-based swap customers; and

(ii) The total initial 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), (vi), and (vii) of this section, and § 240.18a–1b, 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 paragraphs (c)(1)(iii) and (c)(1)(ix)(A) and (B) 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.

(ii) [Reserved].

(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, DC. 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)(i) 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;

(ii) The Commission may approve the temporary use of a provisional model in whole or in part, subject to any conditions or limitations the Commission may require, if:

(A) The security-based swap dealer has a complete application pending under this section;

(B) The use of the provisional model has been approved by:

(1) A prudential regulator;

(2) The Commodity Futures Trading Commission or a futures association registered with the Commodity Futures Trading Commission under section 17 of the Commodity Exchange Act;

(3) A foreign financial regulatory authority that administers a foreign financial regulatory system with capital requirements that the Commission has found are eligible for substituted compliance under § 240.3a71-6 if the provisional model is used for the purposes of calculating net capital;

(4) A foreign financial regulatory authority that administers a foreign financial regulatory system with margin requirements that the Commission has found are eligible for substituted compliance under § 240.3a71-6 if the provisional model is used for the purposes of calculating initial margin pursuant to § 240.18a-3; or

(5) Any other foreign supervisory authority that the Commission finds has

approved and monitored the use of the provisional model through a process comparable to the process set forth in this section.

(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) 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, 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 3 to § 240.18a–1(d)(9)(i)(C)(3) in determining its market risk until it obtains the next quarter's backtesting results;

TABLE 3 TO § 240.18a–1(d)(9)(i)(C)(3)—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' underlying rates and prices;

(2) Empirical correlations with and across risk factors or, alternatively, risk factors sufficient 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.* 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)(iii), (iv), (vi), (vii), and (c)(1)(ix)(A) and (B), as appropriate, and § 240.18a–1b, 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:

(A)–(B) [Reserved];

(C) 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;

(D) The security-based swap dealer fails to comply with this paragraph (d); or

(E) 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 may compute a deduction for credit risk on transactions in derivatives instruments (if this paragraph (e) is used to calculate a deduction for market risk on those positions) in an amount equal to the sum of the following:

(i) *Counterparty exposure charge*. 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)(iii)(A) of this

section, multiplied by the credit risk weight of the counterparty, as determined in accordance with paragraph (e)(2)(iii)(F) of this section, multiplied by eight percent; and

(ii) *Counterparty concentration charge*. 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 percent or less, 5 percent of the amount of the current exposure to the counterparty in excess of 5 percent of the tentative net capital of the security-based swap dealer;

(B) For each counterparty with a credit risk weight of greater than 20 percent but less than 50 percent, 20 percent of the amount of the current exposure to the counterparty in excess of 5 percent 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 percent, 50 percent of the amount of the current exposure to the counterparty in excess of 5 percent of the tentative net capital of the security-based swap dealer;

(iii) *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)(iii)(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)(iii)(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)(iii)(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)(iii)(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)(iii)(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)(iii)(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)(i) The collateral is subject to the security-based swap dealer's physical possession or control and may be liquidated promptly by the firm without intervention by any other party; or

(ii) The collateral is held by an independent third-party custodian that is a bank as defined in section 3(a)(6) of the Act or a registered U.S. clearing organization or depository that is not affiliated with the counterparty or, if the collateral consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that is not affiliated with the counterparty and that customarily maintains custody of such foreign securities or currencies;

(3) The collateral is liquid and transferable;

(4) The collateral agreement is legally enforceable by the security-based swap dealer against the counterparty and any other parties to the agreement;

(5) 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;

(6) 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

(7) 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 this paragraph (e)(2) shall apply a credit risk weight for transactions with a counterparty of either 20 percent, 50 percent, or 150 percent 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 percent, 50 percent, or 150 percent 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) *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 § 240.15c3-4(c)(5)(xiii) and (xiv) and (d)(8) and (9) shall not apply.

(g) *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 (g) 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 (h) 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 (g) if:

(1) It does not have any of the provisions for accelerated maturity provided for by paragraph (b)(8)(i) or (b)(9)(i) or (ii) of § 240.18a-1d and is maintained as capital subject to the provisions restricting the withdrawal thereof required by paragraph (h) of this section; or

(2) The partnership agreement provides that capital contributed pursuant to a satisfactory subordination agreement as defined in § 240.18a-1d shall in all respects be partnership capital subject to the provisions restricting the withdrawal thereof required by paragraph (h) of this section.

(h) *Provisions relating to the withdrawal of equity capital*—(1) *Notice provisions relating to limitations on the withdrawal of equity capital*. No equity capital of the security-based swap dealer or a subsidiary or affiliate consolidated pursuant to § 240.18a-1c 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 (h)(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 (h)(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 (h)(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, DC, 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) *Limitations on withdrawal of equity capital.* No equity capital of the security-based swap dealer or a subsidiary or affiliate consolidated pursuant to § 240.18a-1c 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 § 240.18a-1d) 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; or

(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 § 240.18a-1c (other than such agreements which qualify as equity under paragraph (g) of this section) would exceed 70 percent of the debt-equity total as defined in paragraph (g) 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 (h)(1) and (2) of this section, a security-based swap dealer may use the amount of excess net capital and deductions required under paragraphs (c)(1)(vi) and (vii) and § 240.18a-1a reported in its most recently required filed Part II of Form X-17A-5 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 Part II of Form X-17A-5 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 (h)(1) and (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 (h)(1) and (2) of this section.

(iv) For the purpose of this paragraph (h), 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.

■ 13. Section 240.18a-1a is added to read as follows:

#### § 240.18a-1a Options.

(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, options on futures contracts, security-based swaps on a narrow-based security index, and swaps 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 other than a security-based swap on a narrow-based security index, 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 broker or 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, security-based swaps on a narrow-based security index, qualified stock baskets, unlisted instruments, or 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 paragraph (b)(1)(iv)(C) of this section.

(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 percent 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 percent of the capitalization for such narrow-based index.

(ii) With respect to positions involving listed options 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 percent for equity securities with a ready market, narrow-based indexes, and non-high-capitalization diversified indexes;
- (B)  $+( - )$  6 percent for major market foreign currencies;
- (C)  $+( - )$  20 percent for all other currencies; and
- (D)  $+( - )$  10 percent 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 percent 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 percent, 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 percent 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 percent 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 percent 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 percent 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 percent 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 percent of the market value of the qualified stock basket for high-capitalization diversified and narrow-based indexes;

(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 7½ percent of the market value of the qualified stock basket for non-high-capitalization diversified indexes; and

(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 percent times the multiplier for each security-future and equity option.

■ 14. Section 240.18a–1b is added to read as follows:

**§ 240.18a–1b Adjustments to net worth for certain commodities transactions.**

(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 (c) of § 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 section. Where a commodity related asset or liability, including 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 § 240.18a–1 or this section, 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 § 240.18a–1(c)(1), the net worth of a security-based swap dealer shall be adjusted as follows with respect to commodity-related transactions:

(i)(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 cleared swap transactions or, commodity futures or option transactions, except those specifically excluded under paragraph (a)(2)(ii) of this section.

(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 percent of the market value.

(C) Inventory which is not covered—20 percent 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 percent 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 percent 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 section, 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 the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or the market

value of such asset after application of the percentage deductions specified in paragraph (a)(2)(ix) of this section or, where appropriate, specified in § 240.18a-1(c)(1)(iv), (vi), or (vii) of this part;

(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 section 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 the account, the value attributable to such asset for purposes of this paragraph shall be the lesser of the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or the market value of such asset after application of the percentage deductions specified in paragraph (a)(2)(ix) of this section or, where appropriate, specified in § 240.18a-1(c)(1)(iv), (vi), or (vii) of this part;

(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 percent 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 percent 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 percent 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) of this section, 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 section 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 section; 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 section shall mean cover as defined in 17 CFR 1.17(j).

(xvii) The term *customer* for purposes of this section shall mean customer as defined in 17 CFR 1.17(b)(2). The term *non-customer* for purposes of this section 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) *Cleared swaps*. In the case of a cleared swap held in a proprietary

account of the security-based swap dealer, deducting the amount of the applicable margin requirement of the derivatives clearing organization or, if the swap references an equity security index, the security-based swap dealer may take a deduction using the method specified in § 240.18a–1a.

(2) *Non-cleared swaps*—(i) *Credit default swaps referencing broad-based security indices*. In the case of a non-cleared credit default swap for which

the deductions in § 240.18a–1(e) do not apply:

(A) *Short positions (selling protection)*. In the case of a non-cleared swap that is a short credit default swap referencing a broad-based security 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 table 1 to § 240.18a–1b(2)(i)(A):

TABLE 1 TO § 240.18a–1b(2)(i)(A)

Length of time to maturity of credit default swap contract	Basis point spread					
	100 or less (%)	101–300 (%)	301–400 (%)	401–500 (%)	501–699 (%)	700 or more (%)
Less than 12 months .....	0.67	1.33	3.33	5.00	6.67	10.00
12 months but less than 24 months .....	1.00	2.33	5.00	6.67	8.33	11.67
24 months but less than 36 months .....	1.33	3.33	6.67	8.33	10.00	13.33
36 months but less than 48 months .....	2.00	4.00	8.33	10.00	11.67	15.00
48 months but less than 60 months .....	2.67	4.67	10.00	11.67	13.33	16.67
60 months but less than 72 months .....	3.67	5.67	11.67	13.33	15.00	18.33
72 months but less than 84 months .....	4.67	6.67	13.33	15.00	16.67	20.00
84 months but less than 120 months .....	5.67	10.00	15.00	16.67	18.33	26.67
120 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 non-cleared swap that is a long credit default swap referencing a broad-based security index, deducting 50 percent of the deduction that would be required by paragraph (b)(2)(i)(A) of this section if the non-cleared swap was a short credit default swap, each such deduction not to exceed the current market value of the long position.

(C) *Long and short credit default swaps*. In the case of non-cleared 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)(2)(i)(A) or (B) of this section on the excess of the long or short position.

(D) *Long basket of obligors and long credit default swap*. In the case of a non-cleared swap that is a long credit default swap referencing a broad-based security index and the security-based swap dealer is long a basket of debt securities comprising all of the components of the

security index, deducting 50 percent of the amount specified in § 240.15c3–1(c)(2)(vi) for the component securities, provided the security-based swap dealer can deliver the component securities to satisfy the obligation of the security-based swap dealer on the credit default swap.

(E) *Short basket of obligors and short credit default swap*. In the case of a non-cleared swap that is a short credit default swap referencing a broad-based security index and the security-based swap dealer is short a basket of debt securities comprising all of the components of the security index, deducting the amount specified in § 240.15c3–1(c)(2)(vi) for the component securities.

(ii) *All other swaps*. (A) In the case of any non-cleared swap that is not a credit default swap for which the deductions in § 240.18a–1(e) do not apply, deducting the amount calculated by multiplying the notional value of the swap by the percentage specified in:

(1) Section 240.15c3–1 applicable to the reference asset if § 240.15c3–1 specifies a percentage deduction for the type of asset;

(2) 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

(3) In the case of a non-cleared 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 one eighth of 1 percent of the amount of a long position that is netted against a short position in the case of a non-cleared swap with a maturity of three months or more.

(B) A security-based swap dealer may reduce the deduction under paragraph (b)(2)(ii) of this section 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.

■ 15. 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.**

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.

■ 16. Section 240.18a–1d is added to read as follows:

**§ 240.18a–1d Satisfactory Subordinated Loan Agreements.**

(a) *Introduction*—(1) *Minimum requirements*. This section 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 section.

(2) *Certain definitions.* For purposes of § 240.18a–1 and this section:

(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) Subordinated loan agreement.* 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 has a minimum term of one year, and 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 section.

(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 120 percent of its minimum requirement 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 percent of the minimum requirement. 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 120 percent of its minimum requirement 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 percent of the minimum requirement. 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 section, 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 section, 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 section and liquidation of the security-based swap dealer has not commenced on or prior to such accelerated maturity date, then notwithstanding paragraph (b)(7) 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 section. 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;

(7) 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 section, 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 section. 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 its minimum requirement 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 the minimum requirement, 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 paragraph (b)(8)(i) of this section.

(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) *Notification.* 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 120 percent of its minimum requirement 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 percent of the minimum requirement.

(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 120 percent of its minimum requirement 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 percent of the minimum requirement; or

(ii) Pre-tax losses during the latest three-month period equaled more than 15 percent 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 section. Any such subordinated loan agreement shall not be considered equity for purposes of § 240.18a-1(g), 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.

■ 17. 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 and is not registered as a broker or dealer pursuant to section 15(b) of the Act (15 U.S.C. 78o(b)) 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 § 240.15c3-4(c)(5)(xiii) and (xiv) and (d)(8) and (9) shall not apply.

■ 18. 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 that holds one or more non-cleared security-based swaps for a counterparty.

(2) The term *commercial end user* means a counterparty that qualifies for an exception from clearing under section 3C(g)(1) of the Act (15 U.S.C. 78o-3(g)(1)) and implementing regulations or satisfies the criteria in section 3C(g)(4) of the Act (15 U.S.C. 78o-3(g)(4)) and implementing regulations.

(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 *initial margin amount* means the amount calculated pursuant to paragraph (d) of this section.

(5) The term *non-cleared security-based swap* means a security-based swap that is not, directly or indirectly, submitted to and cleared by a clearing agency registered pursuant to section 17A of the Act (15 U.S.C. 78q-1) or by a clearing agency that the Commission has exempted from registration by rule or order pursuant to section 17A of the Act (15 U.S.C. 78q-1).

(6) The term *security-based swap legacy account* means an account that holds no security-based swaps entered into after the compliance date of this section and that only is used to hold one or more security-based swaps entered into prior to the compliance 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 the current exposure in the account of the counterparty; and

(B) The initial margin amount for the account of the counterparty.

(ii) *Account equity requirements.* Except as provided in paragraph (c)(1)(iii) of this section, a security-based swap dealer must take an action required in paragraph (c)(1)(ii)(A) or (B) of this section by no later than the close of business of the first business day following the day of the calculation required under paragraph (c)(1)(i) of this section or, if the counterparty is located in another country and more than four time zones away, the second business day following the day of the calculation required under paragraph (c)(1)(i) of this section:

(A)(1) Collect from the counterparty collateral in an amount equal to the current exposure that the security-based swap dealer has to the counterparty; or

(2) Deliver to the counterparty collateral in an amount equal to the current exposure that the counterparty has to the security-based swap dealer, provided that such amount does not include the initial margin amount collected from the counterparty under paragraph (c)(1)(ii)(B) of this section; and

(B) Collect from the counterparty collateral in an amount equal to the initial margin amount.

(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.

(B) *Counterparties that are financial market intermediaries.* 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, swap dealer, broker or dealer, futures commission merchant, bank, foreign bank, or foreign broker or dealer.

(C) *Counterparties that use third-party custodians.* The requirements of paragraph (c)(1)(ii)(B) of this section do not apply to an account of a counterparty that delivers the collateral to meet the initial margin amount to an independent third-party custodian.

(D) *Security-based swap legacy accounts.* The requirements of paragraph (c)(1)(ii) of this section do not apply to a security-based swap legacy account.

(E) *Bank for International Settlements, European Stability Mechanism, and Multilateral development banks.* The requirements of paragraph (c)(1)(ii) of this section do not apply to an account of a counterparty that is the Bank for International Settlements or the European Stability Mechanism, or is the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, or any other multilateral development bank that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member.

(F) *Sovereign entities.* The requirements of paragraph (c)(1)(ii)(B) of this section do not apply to an account of a counterparty that is a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government if the security-based swap dealer has determined that the counterparty has only a minimal amount of credit risk pursuant to policies and procedures or credit risk models established pursuant to § 240.15c3-1 or § 240.18a-1 (as applicable).

(G) *Affiliates.* The requirements of paragraph (c)(1)(ii)(B) of this section do

not apply to an account of a counterparty that is an affiliate of the security-based swap dealer.

(H) *Threshold amount.* (1) A security-based swap dealer may elect not to collect the initial margin amount required under paragraph (c)(1)(ii)(B) of this section to the extent that the sum of that amount plus all other credit exposures resulting from non-cleared swaps and non-cleared security-based swaps of the security-based swap dealer and its affiliates with the counterparty and its affiliates does not exceed \$50 million. For purposes of this calculation, a security-based swap dealer need not include any exposures arising from non-cleared security based swap transactions with a counterparty that is a commercial end user, and non-cleared swap transactions with a counterparty that qualifies for an exception from margin requirements pursuant to section 4s(e)(4) of the Commodity Exchange Act (7 U.S.C. 6s(e)(4)).

(2) *One-time deferral.* Notwithstanding paragraph (c)(1)(iii)(H)(1) of this section, a security-based swap dealer may defer collecting the initial margin amount required under paragraph (c)(1)(ii)(B) of this section for up to two months following the month in which a counterparty no longer qualifies for this threshold exception for the first time.

(I) *Minimum transfer amount.* Notwithstanding any other provision of this rule, a security-based swap dealer is not required to collect or deliver collateral pursuant to this section with respect to a particular counterparty unless and until the total amount of collateral that is required to be collected or delivered, and has not yet been collected or delivered, with respect to the counterparty is greater than \$500,000.

(2) *Major security-based swap participants*—(i) *Calculation required.* A major security-based swap participant must with respect to each account of a counterparty calculate as of the close of each business day the amount of the current exposure in the account of the counterparty.

(ii) *Account equity requirements.* Except as provided in paragraph (c)(2)(iii) of this section, a major security-based swap participant must take an action required in paragraph (c)(2)(ii)(A) or (B) of this section by no later than the close of business of the first business day following the day of the calculation required under paragraph (c)(2)(i) or, if the counterparty is located in another country and more than four time zones away, the second business day following the day of the

calculation required under paragraph (c)(2)(i) of this section:

(A) Collect from the counterparty collateral in an amount equal to the current exposure that the major security-based swap participant has to the counterparty; or

(B) Deliver to the counterparty collateral in an amount equal to the current exposure that the counterparty has to the major security-based swap participant.

(iii) *Exceptions*—(A) *Commercial end users.* The requirements of paragraph (c)(2)(ii)(A) of this section do not apply to an account of a counterparty that is a commercial end user.

(B) *Security-based swap legacy accounts.* The requirements of paragraph (c)(2)(ii) of this section do not apply to a security-based swap legacy account.

(C) *Bank for International Settlements, European Stability Mechanism, and Multilateral development banks.* The requirements of paragraph (c)(2)(ii)(A) of this section do not apply to an account of a counterparty that is the Bank for International Settlements or the European Stability Mechanism, or is the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, or any other multilateral development bank that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member.

(D) *Minimum transfer amount.* Notwithstanding any other provision of this rule, a major security-based swap participant is not required to collect or deliver collateral pursuant to this section with respect to a particular counterparty unless and until the total amount of collateral that is required to be collected or delivered, and has not yet been collected or delivered, with respect to the counterparty is greater than \$500,000.

(3) *Deductions for collateral.* (i) The fair market value of collateral delivered by a counterparty or the security-based swap dealer must be reduced by the amount of the standardized deductions the security-based swap dealer would apply to the collateral pursuant to

§ 240.15c3–1 or § 240.18a–1, as applicable, for the purpose of paragraph (c)(1)(ii) of this section.

(ii) Notwithstanding paragraph (c)(3)(i) of this section, the fair market value of assets delivered as collateral by a counterparty or the security-based swap dealer may be reduced by the amount of the standardized deductions prescribed in 17 CFR 23.156 if the security-based swap dealer applies these standardized deductions consistently with respect to the particular counterparty.

(4) *Collateral requirements.* A security-based swap dealer or a major security-based swap participant when calculating the amounts under paragraphs (c)(1) and (2) of this section may take into account the fair market value of collateral delivered by a counterparty provided:

(i) The collateral:

(A) Has a ready market;

(B) Is readily transferable;

(C) Consists of cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold;

(D) Does not consist of securities and/or money market instruments issued by the counterparty or a party related to the security-based swap dealer, the major security-based swap participant, or the counterparty; and

(E) Is subject to an agreement between the security-based swap dealer or the major security-based swap participant and the counterparty that 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; and

(ii) The collateral is either:

(A) Subject to the physical possession or control of the security-based swap dealer or the major security-based swap participant and may be liquidated promptly by the security-based swap dealer or the major security-based swap participant without intervention by any other party; or

(B) The collateral is carried by an independent third-party custodian that is a bank as defined in section 3(a)(6) of the Act or a registered U.S. clearing organization or depository that is not affiliated with the counterparty or, if the collateral consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that is not affiliated with the counterparty and that customarily maintains custody of such foreign securities or currencies.

(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 paragraphs (c)(1)(i) and (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) *Frequency of calculations increased.* The calculations required pursuant to paragraphs (c)(1)(i) and (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.

(7) *Liquidation.* A security-based swap dealer or major security-based swap participant must take prompt steps to liquidate positions in an account that does not meet the margin requirements of this section to the extent necessary to eliminate the margin deficiency.

(d) *Calculating initial margin amount.* A security-based swap dealer must calculate the initial 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)(B)(1) 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)(P)(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)(2) 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)(P)(2).

(2) *Model approach.* (i) For security-based swaps other than equity security-based swaps, a security-based swap dealer may apply to the Commission for authorization to use and be responsible for a model to calculate the initial margin amount required by paragraph

(c)(1)(i)(B) of this section subject to the application process in § 240.15c3–1e or § 240.18a–1(d), as applicable. The model must use a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices, and must use risk factors sufficient to cover all the material price risks inherent in the positions for which the initial margin amount is being calculated, including foreign exchange or interest rate risk, credit risk, equity risk, and commodity risk, as appropriate. Empirical correlations may be recognized by the model within each broad risk category, but not across broad risk categories.

(ii) Notwithstanding paragraph (d)(2)(i) of this section, a security-based swap dealer that is not registered as a broker or dealer pursuant to Section 15(b) of the Act (15 U.S.C. 78o(b)), other than as an OTC derivatives dealer, may apply to the Commission for authorization to use a model to calculate the initial margin amount required by paragraph (c)(1)(i)(B) of this section for equity security-based swaps, subject to the application process and model requirements of paragraph (d)(2)(i) of this section; provided, however, the account of the counterparty subject to the requirements of this paragraph may not hold equity security positions other than equity security-based swaps and equity swaps.

(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.

■ 19. 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.**

Section 240.18a-4 applies to a security-based swap dealer or major security-based swap participant registered under section 15F(b) of the Act (15 U.S.C. 78o-10(b)), including a security-based swap dealer that is an *OTC derivatives dealer* as that term is defined in § 240.3b-12. A security-based swap dealer registered under section 15F of the Act (15 U.S.C. 78o-10) that is also a broker or dealer registered under section 15 of the Act (15 U.S.C. 78o), other than an *OTC derivatives dealer*, is subject to the customer protection requirements under § 240.15c3-3, including paragraph (p) of that rule with respect to its security-based swap activity.

(a) *Definitions.* For the purposes of this section:

(1) The term *cleared security-based swap* means 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 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 (after reducing the current exposure by the amount of cash in the account) to the security-based swap 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 security-based swap customer; and

(ii) Securities and money market instruments held in a qualified registered security-based swap dealer account or in a third-party custodial account but only to the extent the securities and money market instruments are being used to meet a regulatory margin requirement of another 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 security-based swap customer.

(3) The term *foreign major security-based swap participant* has the meaning set forth in § 240.3a67-10(a)(6).

(4) The term *foreign security-based swap dealer* has the meaning set forth in § 240.3a71-3(a)(7).

(5) The term *qualified clearing agency account* means an account of a security-based swap dealer at a clearing agency registered with the Commission pursuant to section 17A of the Act (15 U.S.C. 78q-1) that holds funds and other property in order to margin, guarantee, or secure 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.

(6) 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 meets the following conditions:

(i) The account is designated "Special Reserve Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of security-based swap dealer]";

(ii) The other security-based swap dealer has acknowledged in a written notice 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.

(7) 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 a political 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.

(8) 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.

(9) The term *special reserve account for the exclusive benefit of security-based swap customers* means an account at a bank that meets the following conditions:

(i) The account is designated “Special Reserve 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.

(10) The term *third-party custodial account* means an account carried by an independent third-party custodian that meets the following conditions:

(i) The account is established for the purposes of meeting regulatory margin requirements of another security-based swap dealer;

(ii) The account is carried by a bank as defined in section 3(a)(6) of the Act or a registered U.S. clearing organization or depository or, if the collateral to be held in the account consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that customarily maintains custody of such foreign securities or currencies;

(iii) The account is designated for and on behalf of the security-based swap dealer for the benefit of its security-based swap customers and the account is subject to a written acknowledgement by the bank, clearing organization, or depository 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, clearing organization, or depository for the exclusive benefit of the security-based swap customers of the security-based swap dealer and are being kept separate from any other accounts maintained by the security-based swap dealer with the bank, clearing organization, or depository; and

(iv) The account is subject to a written contract between the security-based swap dealer and the bank, clearing organization, or depository 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, clearing organization, or depository and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing organization, or depository or any person claiming through the bank, clearing organization, or depository.

(11) The term *U.S. person* has the meaning set forth in § 240.3a71–3(a)(4).

(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 security-based swap 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 security-based swap 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 or control as of the close of the previous business day and the quantity of excess securities collateral not in its possession or 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 or in a third-party custodial 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 other security-based swap dealer or by the third-party custodian 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 for 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 security-based swap dealer's books or records that allocate to a short position of the security-based swap dealer or a short position for another person, for more than 30 calendar days, 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 reserve account for the exclusive benefit of security-based swap customers.* (1) A security-based swap dealer must maintain a special reserve 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 reserve 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.

(i) In determining the amount maintained in a special reserve account for the exclusive benefit of security-based swap customers, the security-based swap dealer must deduct:

(A) The percentage of the value of a general obligation of a State or a political subdivision of a State specified in § 240.15c3-1(c)(2)(vi);

(B) The aggregate value of general obligations of a State or a political subdivision of a State to the extent the amount of the obligations of a single issuer (after applying the deduction in paragraph (c)(1)(i)(A) of this section) exceeds two percent of the amount required to be maintained in the special reserve account for the exclusive benefit of security-based swap customers;

(C) The aggregate value of all general obligations of States or political subdivisions of States to the extent the amount of the obligations (after applying the deduction in paragraph (c)(1)(i)(A) of this section) exceeds 10 percent of the amount required to be maintained in the special reserve account for the exclusive benefit of security-based swap customers;

(D) The amount of cash deposited with a single non-affiliated bank to the extent the amount exceeds 15 percent of the equity capital of the bank as reported by the bank in its most recent Call Report or any successor form the bank is required to file by its appropriate federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); and

(E) The total amount of cash deposited with an affiliated bank.

(ii) *Exception.* A security-based swap dealer for which there is a prudential regulator need not take the deduction specified in paragraph (c)(1)(i)(D) of this section if it maintains the special reserve account for the exclusive benefit of security-based swap customers itself rather than at an affiliated or non-affiliated bank.

(2) A security-based swap dealer must not accept or use credits identified in the items of the formula set forth in § 240.18a-4a except for the specified purposes indicated under items comprising Total Debits under the formula, and, to the extent Total Credits exceed Total Debits, at least the net amount thereof must be maintained in the Special Reserve Account pursuant to paragraph (c)(1) of this section.

(3)(i) The computations necessary to determine the amount required to be maintained in the special reserve account for the exclusive benefit of security-based swap customers must be made weekly as of the close of the last business day of the week and any

deposit required to be made into the account must be made no later than one hour after the opening of banking business on the second following business day. The security-based swap dealer may make a withdrawal from the special reserve 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.

(ii) Computations in addition to the computations required pursuant to paragraph (c)(3)(i) of this section may be made as of the close of any business day, and deposits so computed must be made no later than one hour after the open of banking business on the second following business day.

(4) A security-based swap dealer must promptly deposit into a special reserve account for the exclusive benefit of security-based swap customers cash and/or qualified securities of the security-based swap dealer if the amount of cash and/or qualified securities in one or more special reserve 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 swap 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)) in writing to a duly authorized individual prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the compliance 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 whose funds or other property to meet a margin requirement of the security-based swap dealer are held at a third-party custodian in which the counterparty agrees to subordinate its claims against the security-based swap dealer for the funds or other property held at the third-party custodian 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 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 affirmatively chooses not 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.

(e) *Segregation and disclosure requirements for foreign security-based swap dealers and foreign major security-based swap participants*—(1) *Segregation requirements for foreign security-based swap dealers*—(i) *Foreign bank*. Section 3E of the Act (15 U.S.C. 78c-5) and this section thereunder apply to a foreign security-based swap dealer registered under section 15F of the Act (15 U.S.C. 78o-10) that is a foreign bank, foreign savings bank, foreign cooperative bank, foreign savings and loan association, foreign building and loan association, or foreign credit union:

(A) With respect to a security-based swap customer that is a U.S. person, and

(B) With respect to a security-based swap customer that is not a U.S. person if the foreign security-based swap dealer holds funds or other property arising out of a transaction had by such person with a branch or agency (as defined in section 1(b) of the International Banking Act of 1978) in the United States of such foreign security-based swap dealer.

(ii) *Not a foreign bank*. Section 3E of the Act (15 U.S.C. 78c-5) and this section thereunder apply to a foreign security-based swap dealer registered under section 15F of the Act (15 U.S.C. 78o-10) that is not a foreign bank, foreign savings bank, foreign cooperative bank, foreign savings and loan association, foreign building and loan association, or foreign credit union:

(A) *Cleared security-based swaps*. With respect to all cleared security-based swap transactions, if such foreign security-based swap dealer has received or acquired or holds funds or other property for at least one security-based swap customer that is a U.S. person with respect to a cleared security-based swap transaction with such U.S. person, and

(B) *Non-cleared security-based swaps*. With respect to funds or other property such foreign security-based swap dealer has received or acquired or holds for a security-based swap customer that is a U.S. person with respect to a non-cleared security-based swap transaction with such U.S. person.

(2) *Segregation requirements for foreign major security-based swap*

*participants*. Section 3E of the Act (15 U.S.C. 78c-5) and this section thereunder apply to a foreign major security-based swap participant registered under section 15F of the Act (15 U.S.C. 78o-10), with respect to a counterparty that is a U.S. person.

(3) *Disclosure requirements for foreign security-based swap dealers*. A foreign security-based swap dealer registered under section 15F of the Act (15 U.S.C. 78o-10) must disclose in writing to a security-based swap customer that is a U.S. person, prior to receiving, acquiring, or holding funds or other property for such security-based swap customer with respect to a security-based swap transaction, the potential treatment of the funds or other property segregated by such foreign security-based swap dealer pursuant to section 3E of the Act (15 U.S.C. 78c-5), and the rules and regulations thereunder, in insolvency proceedings under U.S. bankruptcy law and any applicable foreign insolvency laws. Such disclosure must include whether the foreign security-based swap dealer is subject to the segregation requirement set forth in section 3E of the Act (15 U.S.C. 78c-5), and the rules and regulations thereunder, with respect to the funds or other property received, acquired, or held for the security-based swap customer that will receive the disclosure, whether the foreign security-based swap dealer could be subject to the stockbroker liquidation provisions in the U.S. Bankruptcy Code, whether the segregated funds or other property could be afforded customer property treatment under U.S. bankruptcy law, and any other relevant considerations that may affect the treatment of the funds or other property segregated under section 3E of the Act (15 U.S.C. 78c-5), and the rules and regulations thereunder, in insolvency proceedings of the foreign security-based swap dealer.

(f) *Exemption*. The requirements of this section do not apply if the following conditions are met:

(1) The security-based swap dealer does not:

(i) Effect transactions in cleared security-based swaps for or on behalf of another person;

(ii) Have any open transactions in cleared security-based swaps executed for or on behalf of another person; and

(iii) Hold or control any money, securities, or other property to margin, guarantee, or secure a cleared security-based swap transaction executed for or on behalf of another person (including money, securities, or other property accruing to another person as a result of

a cleared security-based swap transaction);

(2) The security-based swap dealer provides the notice required pursuant to section 3E(f)(1)(A) of the Act (15 U.S.C. 78c-5(f)(1)(A)) in writing to a duly authorized individual prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the compliance date of this section; and

(3) The security-based swap dealer discloses in writing to a counterparty before engaging in the first non-cleared security-based swap transaction with the counterparty that any margin collateral received and held by the security-based swap dealer will not be subject to a segregation requirement and how a claim of a counterparty for the collateral would be treated in a

bankruptcy or other formal liquidation proceeding of the security-based swap dealer.

■ 20. Section 240.18a-4a is added to read as follows:

**§ 240.18a-4a Exhibit A—Formula for determination of security-based swap customer reserve requirements under § 240.18a-4.**

	Credits	Debits
1. Free credit balances and other credit balances in the accounts carried for security-based swap customers (See Note A) .....	\$ .....	.....
2. Monies borrowed collateralized by securities in accounts carried for security-based swap customers (See Note B) .....	\$ .....	.....
3. Security-based swap customers' securities failed to receive (See Note C) .....	\$ .....	.....
4. Credit balances in firm accounts which are attributable to principal sales to security-based swap customers .....	\$ .....	.....
5. Market value of stock dividends, stock splits and similar distributions receivable outstanding over 30 calendar days .....	\$ .....	.....
6. Market value of short security count differences over 30 calendar days old .....	\$ .....	.....
7. Market value of short securities and credits (not to be offset by longs or by debits) in all suspense accounts over 30 calendar days .....	\$ .....	.....
8. 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 .....	.....	\$ .....
9. 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 .....	.....	\$ .....
10. Failed to deliver of security-based swap customers' securities not older than 30 calendar days .....	.....	\$ .....
11. 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 (See Note D) .....	.....	\$ .....
12. Margin related to security futures 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) (See Note E) .....	.....	\$ .....
13. 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) .....	.....	\$ .....
14. 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 or at a third-party custodial account .....	.....	\$ .....
Total Credits .....	\$ .....	.....
Total Debits .....	.....	\$ .....
Excess of Credits over Debits .....	\$ .....	.....

Note A. Item 1 must include all outstanding drafts payable to security-based swap customers which have been applied against free credit balances or other credit balances and must 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 must 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 D. Item 11 must 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 E. (a) Item 12 must 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 12 will 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 E 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 E, 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 will 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 will provide that such funds and/or securities will 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 will 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, will 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 security-based swap 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 E. (b)(1) through (3).

(c) Item 12 will 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 E.

■ 21. Section 240.18a-10 is added to read as follows:

**§ 240.18a-10 Alternative compliance mechanism for security-based swap dealers that are registered as swap dealers and have limited security-based swap activities.**

(a) A security-based swap dealer may comply with capital, margin, and segregation requirements of the Commodity Exchange Act and chapter I of title 17 of the Code of Federal Regulations applicable to swap dealers in lieu of complying with §§ 240.18a-1, 240.18a-3, and 240.18a-4 if:

(1) The security-based swap dealer is registered as such pursuant to section 15F(b) of the Act and the rules thereunder;

(2) The security-based swap dealer is registered as a swap dealer pursuant to section 4s of the Commodity Exchange Act and the rules thereunder;

(3) The security-based swap dealer is not registered as a broker or dealer pursuant to section 15 of the Act or the rules thereunder;

(4) The security-based swap dealer meets the conditions to be exempt from § 240.18a-4 specified in paragraph (f) of that section; and

(5) As of the most recently ended quarter of the fiscal year of the security-based swap dealer, the aggregate gross notional amount of the outstanding security-based swap positions of the security-based swap dealer did not exceed the lesser of the maximum fixed-dollar amount specified in paragraph (f) of this section or 10 percent of the combined aggregate gross notional amount of the security-based swap and swap positions of the security-based swap dealer.

(b) A security-based swap dealer operating under this section must:

(1) Comply with the capital, margin, and segregation requirements of the Commodity Exchange Act and chapter I of title 17 of the Code of Federal Regulations applicable to swap dealers and treat security-based swaps and related collateral pursuant to those requirements to the extent the requirements do not specifically address security-based swaps and related collateral;

(2) Disclose in writing to each counterparty to a security-based swap before entering into the first transaction with the counterparty after the date the security-based swap dealer begins operating under this section that the security-based swap dealer is operating under this section and is therefore complying with the applicable capital, margin, and segregation requirements of the Commodity Exchange Act and the rules promulgated by the Commodity Futures Trading Commission thereunder in lieu of complying with the capital, margin, and segregation requirements promulgated by the Commission in §§ 240.18a-1, 240.18a-3, and 240.18a-4; and

(3) Immediately notify the Commission and the Commodity Futures Trading Commission in writing if the security-based swap dealer fails to meet a condition specified in paragraph (a) of this section.

(c) A security-based swap dealer that fails to meet one or more of the conditions specified in paragraph (a) of this section must begin complying with §§ 240.18a-1, 240.18a-3, and 240.18a-4 no later than:

(1) Two months after the end of the month in which the security-based swap dealer fails to meet a condition in paragraph (a) of this section; or

(2) A longer period of time as granted by the Commission by order subject to any conditions imposed by the Commission.

(d)(1) A person applying to register as a security-based swap dealer that intends to operate under this section beginning on the date of its registration must provide prior written notice to the Commission and the Commodity Futures Trading Commission of its intent to operate under the conditions of this section.

(2) A security-based swap dealer that elects to operate under this section beginning on a date after the date of its registration as a security-based swap dealer must:

(i) Provide prior written notice to the Commission and the Commodity Futures Trading Commission of its intent to operate under the conditions of this section; and

(ii) Continue to comply with §§ 240.18a-1, 240.18a-3, and 240.18a-4 for at least:

(A) Two months after the end of the month in which the security-based swap dealer provides the notice; or

(B) A shorter period of time as granted by the Commission by order subject to any conditions imposed by the Commission.

(e) The notices required by this section must be sent by facsimile transmission to the principal office of the Commission and the regional office of the Commission for the region in which the security-based swap dealer has its principal place of business or to an email address to be specified separately, and to the principal office of the Commodity Futures Trading Commission in a manner consistent with the notification requirements of the Commodity Futures Trading

Commission. The notice must include a brief summary of the reason for the notice and the contact information of an individual who can provide further information about the matter that is the subject of the notice.

(f)(1) The maximum fixed-dollar amount is \$250 billion until the three-year anniversary of the compliance date of this section at which time the maximum fixed-dollar amount is \$50 billion unless the Commission issues an order to:

(i) Maintain the maximum fixed-dollar amount at \$250 billion for an additional period of time or indefinitely; or

(ii) Lower the maximum fixed-dollar amount to an amount that is less than \$250 billion but greater than \$50 billion.

(2) If, after considering the levels of security-based swap activity of security-based swap dealers operating under this section, the Commission determines that it may be appropriate to change the maximum fixed-dollar amount pursuant

paragraph (f)(1)(i) or (ii) of this section, the Commission will publish a notice of the potential change and subsequently will issue an order regarding any such change.

By the Commission.

Dated: June 21, 2019.

**Jill M. Peterson,**

*Assistant Secretary.*

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