The SEC Adopts Security-Based Swap Regulations Governing Capital, Margin and Collateral Segregation

June 24, 2019[1]

I. Introduction

The Securities and Exchange Commission ("**SEC**") has adopted rules under the Securities Exchange Act (the "**SEA**") establishing (i) capital and margin requirements applicable to broker-dealers entering into security-based swaps ("**SBS**") and to security-based swap dealers ("**SBSDs**") that are not banks and (ii) a collateral segregation regime for SBS customers transacting with broker-dealers and with SBSDs.[2] The Rules were first proposed in October 2012,[3] and the comment period was reopened in a substantial release in October 2018.[4]

The Rules will become effective 60 days after publication in the Federal Register. However, as discussed in further detail in Section X of this memorandum, the "compliance date" for the Rules is 18 months after the *later of*: (1) the effective date of the final rules establishing recordkeeping and reporting requirements for SBSDs and (2) the effective date of the final rules addressing the cross-border application of certain security-based swap requirements.

The Commodity Futures Trading Commission (the "**CFTC**") has yet to adopt capital rules applicable to nonbank swap dealers. Given that the CFTC's capital rules are, to a significant extent, based

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1 *The hyperlinks in the memorandum are generally to the Cadwalader Cabinet (www.FindKnowDo.com) and are in some cases password-protected for Cabinet subscribers. If you wish to sign up for our free daily newsletter, you may do so at the bottom of the www.FindKnowDo.com home page. Nonsubscribers interested in a demonstration or trial of the Cabinet may contact William Sadd at william.sadd@findknowdo.com. See some of our awards and honors: https://www.findknowdo.com/endorsements.*

2 *SEC Adopts Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Amends the Capital and Segregation Requirements for Broker-Dealers*, SEC Press Release No, 2019-105 (June 21, 2019); SEC Release No. 34-96175 (the "**Release**"; and the rules adopted therein, the "**Rules**").

3 SEC Release No. 34-68071 (Oct. 18, 2012), 77 Fed. Reg. 70213 (Nov. 23, 2012) (the "**Proposal**").

4 SEC Release No. 84409 (Oct. 11, 2018), 83 Fed. Reg. 53007 (Oct. 19, 2018). *See also* CWT C&F Memo, *Definitely Maybe? The SEC Returns to Security-Based Swap Dealer Regulation (Oct. 12, 2018).*

upon the SEC capital rules, it was necessary for the SEC to complete its rulemaking before the CFTC could do so. Presumably, the CFTC will now move forward relatively promptly.[5]

The structure of the remainder of this memorandum is as follows:

- Part II defines the different types of entities that are subject to variants of the Rules;
- Part III provides a very brief summary of the Rules;
- Part IV reviews the minimum regulatory capital requirements imposed by the Rules;
- Part V reviews the required haircuts from entering into SBS and swap transactions;
- Part VI summarizes the margin requirements that apply to SBS transactions;
- Part VII describes the segregation requirements applicable to SBS transactions and certain of the related insolvency issues;
- Part VIII discusses alternative compliance for CFTC swap dealers;
- Part IX discusses the cross-border aspect of the Rules;
- Part X discusses the compliance dates for the Rules; and
- Part XI discusses what is still to come and raises a few additional matters for regulators and firms to consider.

II. Entities Subject to the Rules

A relatively small number of SBSDs will be subject to the SEC SBSD margin and capital rules. The SEC only has capital and margin rule jurisdiction over SBSDs that are not regulated by a "prudential [bank] regulator" (the "**Prudential Regulators**").[6] The majority of SBSDs are banks and so are not subject to the SEC rules. Second, the Rules provide that the SEC may grant substituted compliance for non-U.S., non-bank SBSDs. In other words, the SEC can (and likely will) determine that many non-U.S., non-bank SBSDs can satisfy their SEC margin and capital requirements by complying with the requirements of their home countries. (The cross-border aspects of the rules are discussed in further detail in Part IX of this memorandum.)

All SBSDs (including those subject to a Prudential Regulator) are subject to the SEC segregation requirements as to customer collateral posted in respect of SBS transactions. However, the SEC provides for the potential for an exemption from these requirements for Bank SBSDs and Standalone SBSDs, with the result that most, if not all, of these firms will *not* be subject to the full requirements of the collateral segregation rules.

While the number of SBSDs that end up being required to comply with the Rules may be small, these entities and the entities that may benefit from one or more exemptions fall into a variety of different categories, as follows:

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[5] The CFTC originally had proposed capital rules in 2011. See 76 FR 27801. The CFTC then re-proposed its rules at the end of 2016. See 81 FR 91251 (Dec. 16, 2016). The comment period on the re-proposal was then reopened in 2017. See 82 FR 13971 (Mar. 16, 2017).

[6] *See* SEA § 15F(e). *See also* SEA § 3(a)(74) (defining "prudential regulator" by reference to CEA § 1a).

- broker-dealers that can execute trades in any securities and compute their capital using the standardized haircuts in SEA Rule 15c3-1 ("**Standardized Haircut Broker-Dealers**") and that may also register as SBSDs;
- broker-dealers that can execute trades in any securities and compute their capital using models that have been approved by the SEC (such firms are referred to as "**Alternative Net Capital Broker-Dealers**" or as "**ANC Broker-Dealers**") and that may also register as SBSDs;
- Standardized Haircut Broker-Dealers and ANC Broker-Dealers that have custody of customer assets are referred to collectively as "**Custodial Broker-Dealers**";
- SBSDs that either are not registered as broker-dealers at all or, if they are so registered, conduct only those activities allowed to "over-the-counter-derivatives dealers" (“**OTCDDs**”)[7] under SEA Rule 3b-12 (such firms are referred to as "**Standalone SBSDs**");
- standalone SBSDs that are organized and operate outside the United States, and are not subject to the requirements of the Prudential Regulators, will have a path to substituted compliance as to capital and margin requirements (such firms are referred to as "**Foreign Standalone SBSDs**");
- all of the above types of firms, *i.e.*, those firms that are not subject to the capital and margin rules of the Prudential Regulators, are referred to as "**Nonbank SBSDs**";
- SBSDs that are subject to the margin and capital rules of the Prudential Regulators are not subject to the SEC's margin and capital rules are referred to as "**Bank SBSDs**".

Broker-dealers that are not registered as SBSDs are also subject to many of the Rules to the extent that they enter into SBS or swaps or hold collateral in connection with SBS. By way of example, the position haircut requirements applicable to broker-dealers that register as SBSDs also will be applicable to broker-dealers that are not SBSDs should they transact in SBS or in swaps.

Although they are not directly subject to the Rules, customers of SBSDs will be very much impacted by them, directly by the margin and custodial requirements and indirectly by the capital requirements. Customers should also be aware of the different types of insolvency regimes that are applicable to different types of SBSDs. The interaction between these various requirements may determine the type of SBSD that is most attractive to a particular customer.

III. Summary of the Final Rules

The Rules:

- establish minimum capital requirements for Nonbank SBSDs and increase the minimum net capital requirements for ANC firms (including for any ANC firms that do not also register as SBSDs);
- establish net capital "haircuts" for SBS and swap positions that will apply to all broker-dealers (even if they do not register as SBSDs and Nonbank SBSDs);

[7] These entities, of which only a handful are in operation, are sometimes referred to as "BD Lites."

- require that all Nonbank SBSDs adopt Internal Risk Management Control Systems (ANC Broker-Dealers and OTCDDs are already subject to this requirement);
- establish margin requirements for Nonbank SBSDs and for broker-dealers (even if not registered as SBSDs) entering into SBS;
- establish collateral segregation requirements for SBSDs and for broker-dealers (even if not registered as SBSDs) entering into SBS; and
- amend the SEC's existing cross-border SBS rule to provide a means to request substituted compliance with respect to the capital and margin requirements for foreign SBSDs, and provide guidance discussing how the SEC will evaluate requests for substituted compliance.

IV. Minimum Capital Requirements for Nonbank SBSDs and All ANC Broker-Dealers

Standardized Haircut Broker-Dealers and ANC Broker-Dealers will be subject to the amendments made to SEA Rule 15c3-1. Standalone SBSDs and OTCDDs (including those that will not register as SBSDs and which previously have been subject to SEA Rule 15c3-1) will become subject to SEA Rule 18a-1, which is very substantially modeled after Rule 15c3-1. See also Appendix 1 for a summary of these minimum capital requirements.[8]

A. Standardized Haircut Broker-Dealers (Firms Ineligible to Use Models)

For Standardized Haircut Broker-Dealers that are also registered as SBSDs, the minimum net requirement is raised from $100,000 to $20 million. While this amount may seem substantial, it is impossible to imagine that any firm could bear the expenses of being a registered SBSD unless it maintained net capital of well in excess of $20 million. (The real question is whether a standardized Haircut Broker Dealer can operate as an SBSD given the prohibition on it using models for capital purposes.)

In addition to increasing the minimum net capital requirements, the SEC also added another minimum capital measure: a firm must maintain net capital of at least 2% of the "risk margin amount," which percentage may be increased by the SEC to 4% or 8% as discussed below under Risk Margin Amount.

B. ANC Broker-Dealers (Firms Eligible to Use Models)

The various capital measures applicable to ANC Broker-Dealers have all been increased:

(i) the minimum tentative net capital requirement will be raised from $1 billion to $ 5 billion;

(ii) the minimum net capital requirement will be raised from $500 million to $1 billion; and

[8] A detailed discussion of current broker-dealer net capital requirements can be found in the Capital Requirements chapter of LOFCHIE'S GUIDE TO BROKER-DEALER REGULATION.

(iii) the "early warning requirement" (the level at which a firm must give notice to the SEC) from $ 5 billion in tentative net capital to $6 billion.

While some of these numbers seem to be dramatic increases, ANC Broker-Dealers have treated the $5 billion in tentative net capital, required to avoid providing notice to the SEC, as the "real" operative minimum capital requirement. Accordingly, while the increase to this number is substantial, it is much less by percentage than the other two numbers.

In addition to increasing the minimum tentative net capital and the net capital requirements, the SEC also added another minimum capital measure: a firm must maintain net capital of at least 2% of the "risk margin amount," which percentage may be increased by the SEC to 4% or 8% as discussed below under Risk Margin Amount.

C. Standalone SBSDs

A Standalone SBSD will be subject to the capital requirements of SEA Rule 18a-1, rather than SEA Rule 15c3-1.

The minimum capital requirement for Standalone SBSDs will be $20 million, and if the firm uses models to compute its capital, the firm also will be subject to a $100 million tentative net capital requirement. We expect that any firm registering as a Standalone SBSD would use models, given the significant capital advantages that models provide by comparison to the standardized haircuts, and thus would be subject to the $100 million tentative net capital requirement.

In addition, such a firm must maintain net capital of at least 2% of the "risk margin amount," which percentage may be increased by the SEC to 4% or 8% as discussed below under Risk Margin Amount Ratio.

D. Risk Margin Amount Ratio

All Nonbank SBSDs (whether they compute their capital by reference to the standardized haircuts or by reference to models, and whether they are also registered broker-dealers) will be subject to an additional measure of a minimum capital requirement, which will be set equal to, at first, 2% of the firm's "**Risk Margin Amount**." The Risk Margin Amount is the amount of margin required to be collected in respect of SBS. This amount is itself the sum of (i) the amount required to be collected by a clearing agency for cleared SBS and (ii) the amount required to be collected by the SEC Rules for uncleared SBS. (In the original Proposal regarding capital, firms would have been required to maintain minimum capital equal to 8% of the Risk Margin Amount.)

Although the SEC capital rules start with a 2% ratio, the SEC reserved the right to raise the ratio to 4% three years from the compliance date of the rule and again to 8% five years from the compliance date of the rule. Prior to raising the ratio, the SEC must publish a notice and an order (*i.e.*, the increase is not automatic). However, there is no minimum period specified between the time the SEC determines to publish an order and the order going effective, nor is there a maximum incremental rate set at which the ratio may be increased. This means that, under the rule as written, the SEC could effectively double or even quadruple an SBSD's minimum capital requirement with very little time for the firm to adjust by obtaining additional capital or winding down positions. We are confident that the SEC will, in practice, exercise this authority in a very controlled manner, and will give firms reasonable notice to adjust their positions, but it is nonetheless a bit of a worrisome authority as it is uncoupled from any minimum notice period.

V. Position Haircuts for Nonbank SBSDs and All Broker-Dealers

As a starting matter, it is stressed that Standardized Haircut Broker-Dealers are not eligible to use models to compute capital charges in connection with SBS and swap transactions. ANC Broker-Dealers and Standalone SBSDs are both eligible to use models, and we expect that they will both do so in preference to the standardized haircuts.

For broker-dealers, including those not registered as SBSDs, the capital rules are set out in SEA Rule 15c3-1. For Standalone SBSDs, the capital charges are set out in SEA Rule 18a-1.

Subsection A sets out the credit charges for margin deficiencies. Subsections B-D describe the charges and haircuts applicable under the standard haircut methodology. Subsection E summarizes the SEC's comments as to the use of models in place of the standardized haircuts. The SEC has effectively acknowledged in the Release that the use of the standardized haircuts is punitive in comparison to the use of models and therefore it believes that "most nonbank SBSDs will seek approval to use model-based haircuts," which means that they will either conduct their SBSD activities out of a Standalone SBSD or out of ANC Broker-Dealer.[9]

A. Margin Deficiencies

The *amount of margin required to be collected* is discussed in Section VI of this memorandum. Firms that are eligible to use models may determine the amount of margin that they are required to collect by reference to their models. The *value of margin collected* is deemed to be equal to the market value of the relevant asset reduced by the haircut on that asset for net capital purposes as set out in SEA Rule 15c3-1 or SEA Rule 18c-1. By way of simple example, this means that a U.S.-listed equity having a market value of $100 would be deemed to have a value of $85 for margin purposes. A firm that did not collect margin would be required to take a dollar-for-dollar capital charge, whether the failure to collect was the result of a counterparty failure or because an SBSD that was eligible to do so relied on one of the elections that enabled it not to collect margin.[10]

Additionally, in the case of an ANC Broker-Dealer that uses models to determine credit risk charges and that elects not to collect certain margin amounts, it must take a capital charge (referred to as a "portfolio concentration charge") to the extent that its uncollateralized credit risk charges to current exposure to *all derivatives counterparties* is more than 10% of the firm's tentative net capital. ANC Firms and Standalone SBSDs, both of which have the authority to waive the collection of certain

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[9] Release at 90.

[10] This is particularly significant to keep in mind when considering the exceptions from margin requirements discussed in Section VI. For example, an SBSD transacting with a supra-national entity could avoid collecting VM, but would need to essentially put up the amount that would have been collected on its own.

margin amounts, are also subject to counterparty concentration charges if they have large exposure to a single counterparty.[11] See summary table in Appendix 2.

B. Standardized Haircuts on Non-Cleared Credit Default Swaps ("CDS")

(i) CDS Regulated by the SEC; Short Positions.

Where a broker-dealer or Nonbank SBSD has sold protection by entering into a CDS regulated by the SEC (typically a single name CDS) that is not cleared, the capital rules require the firm to take a capital charge that is based upon two factors: (i) the time to maturity of the CDS and (ii) the basis point spread on the CDS. The longer the time to maturity and the higher the basis point spread, the greater the required capital charge. The required capital charges are set out in a table (at page 610 of the Release and Appendix 4) and range from 1% of the notional of the CDS (where the time to maturity is less than one year and the basis point spread is not more than 100) to 50% of the notional (where the time to maturity is 10 years or more and the basis point spread is 700 or greater).

(ii) CDS Regulated by the CFTC; Short Positions.

Where a broker-dealer or Nonbank SBSD has sold protection by entering into a CDS regulated by the CFTC (typically an index CDS) that is not cleared, the firm would be required to take a capital charge determined, likewise pursuant to a table (see page 617 of the Release and Appendix 5), based on the maturity of the CDS and the basis point spread. The capital charges for index CDS are generally 2/3 of the capital charges for single-name CDS of the same maturity and basis point spread; the reduction in capital charges reflects the lesser risk of a diversified position.

(iii) CDS Regulated by the SEC or the CFTC; Long Positions.

Where a broker-dealer or Nonbank SBSD is long protection on a CDS (whether a single name or an index), the firm should (i) market value the long position and (ii) deduct from that market value 50% of the amount determined by the relevant SEC or CFTC table referenced above, depending on whether the CDS is regulated by the SEC or by the CFTC; provided, however, that the final net capital value of the protection will not be less than zero.

The net capital rule also provides for reduced charges where a broker-dealer or Nonbank SBSD has hedged long and short positions, whether in two CDS, or in a CDS and a cash market position; provided that the hedges must generally be in the same entity and must have a similar maturity.

C. Standardized Haircuts on Uncleared SBS and Swaps (Other than CDS)

In the case of a proprietary position in an uncleared SBS or swap, a broker-dealer or Nonbank SBSD would essentially treat the transaction as if it were a cash market position in the relevant asset; *i.e.,* it would take a deduction from its net capital equal to the notional value of the position

[11] *See* SEA Rule 15c3-1e.

multiplied by the haircut on the relevant asset specified by SEA Rule 15c3-1 or SEA Rule 18a-1, as the case may be.

D. Standardized Haircuts on Cleared SBS and Swaps

In the case of proprietary position in cleared SBS or swaps, a broker-dealer or Nonbank SBSD would take a capital charge equal to the margin requirement at the relevant clearing organization; provided that, in the case of a cleared swap on an equity index, the firm may take the capital charge required under SEA Rule 15c3-1a.

E. Use of Models

Instead of using standardized haircuts, Standalone SBSDs and ANC Broker-Dealers may apply to the SEC to use a model to calculate market and credit risk charges for its proprietary positions. The SEC already had developed a process of model approval that has implemented for OTCDDs and for ANC Broker-Dealers and the SEC stated in the Release that the model approval process for SBSDs should be very similar.[12]

The model approval process can take quite a long time and, even though the SEC has gained substantial experience in the process, the number of firms now needing to obtain model approval (or perhaps expansion of an existing model approval) is bound to tax the SEC staff. Further, once a model is approved, a firm still will have to ensure that its technology, recordkeeping, reporting and capital computations are consistent with the model. Given all that must be done, even two years likely will be insufficient for a number of firms to fully have completed the process with the SEC. Fortunately, the SEC has acknowledged the practical difficulties of completing all model approvals within the compliance date time frame and has allowed for the conditional approval of models that have been approved by other regulators. This conditional approval will be very significant to firms that have had a model approved by a bank regulator or by non-U.S. regulators the sufficiency of whose capital standards have been acknowledged by U.S. regulators.

F. Internal Risk Management Controls

SBSDs must comply with Rule 15c3-4 (with minor modifications that eliminate parts of that rule that are only relevant to OTCDDs), which will require them to establish, document and maintain a system of internal risk management controls. These controls are required to address market, credit,

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[12] *See* Rule 15c3-1e(a) as to ANC Broker-Dealers and Rule 18a-1(d) as to Standalone SBSDs. These provisions describe the information that must be submitted to the SEC and the process for filing.

The Release (at pp. 97-98) provides details as to the procedures for having a model approved:

SEC staff reviews the operation of the 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 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. The SEC 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.

Firms must apply for permission to the SEC before materially changing a model or an internal risk management control system.

The SEC also reserves the right to decide that a model is no longer functioning effectively.

leverage, liquidity, legal and operational risks. While being subject to the rule may require additional documentation or formalization of process, the substance of the requirements should not be an impediment to broker-dealers that wish to be registered as SBSDs.

VI. Margin Requirements for Nonbank SBSDs[13]

A. General Requirements

(i) Daily Calculation and Transfers.

SEA Rule 18a-3 will require a Nonbank SBSD to calculate 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 (*i.e.*, variation margin or "**VM**") and (2) the initial margin ("**IM**") amount for the account. VM will be calculated by marking the position to market.[14] IM will be calculated by applying standardized haircuts or a margin model. In limited circumstances where there is extreme volatility or a firm is holding concentrated positions, the SBSD will also be required to calculate intra-day margin requirements.[15]

In contrast to the Proposal, a Nonbank SBSD will be required to post VM to its counterparties, although it remains the case that it will not be required to post IM. Posting and collection is generally required to be done on a T+1 basis, with a limited exception for when a counterparty is in a far-off time zone (discussed further below). SBSDs are permitted to apply a $500,000 minimum transfer amount to any transfer requirement. An SBSD is also permitted to apply a $50 million group-to-group threshold for IM requirements, with an SBSD only required to collect two months after a counterparty's IM requirement first exceeds the threshold.

(ii) Model Approval and Oversight.

A Nonbank SBSD may apply to the SEC for authorization to use a model (including an industry standard model) to calculate IM. The models are subject to quantitative and qualitative requirements and the firms' use of, and governance over, the models is subject to ongoing oversight. The general requirements of the models are substantially similar to those under the margin rules adopted by the Prudential Regulators (the "**PR Margin Rules**"),[16] including a 99% confidence interval over a 10-day period.

Broker-dealer SBSDs must use the standardized haircuts for determining margin on SBS referencing equity securities and indexes. This requirement is designed to maintain parity with the

[13] For a summary of VM and IM exceptions in Rule 18a-3 see Appendix 3.

[14] The SEC specifically declined to define "current exposure," saying it is "commonly used … when describing uncollateralized mark-to-market gains or losses." *See* Release at 139. This contrasts with CFTC rules, which require documentation to specify how transactions are valued and that the amount, "to the maximum extent practicable … be based on recently-executed transactions, valuations provided by independent third parties, or other objective criteria." *See* CFTC Rule 23.504(b)(4)(i). *See also* CFTC Rule 23.151 (definition of "variation margin" and "variation margin amount") and CFTC Rule 23.158 (margin-specific documentation requirements).

[15] The SEC indicated that this would not require *collection* of margin intra-day, but said that in designing internal controls under 15c3-4, an SBSD has to consider if there are circumstances where such collection would be necessary to effectively manage risk. *See* Release at 160.

[16] *See* generally *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74840 (Nov. 30, 2015).

margin rules for cash market equity positions (*e.g.*, exchange-traded equity securities and listed options). Broker-dealer SBSDs can use a margin model for other types of SBS (*e.g.*, CDS). Nonbank SBSDs may use a model to calculate IM for all types of SBS;[17] with respect to SBS referencing equity securities or indexes, the model can be used only if the account holds no other type of equity securities.[18]

(iii) Collateral Requirements.

The SEC rules permit collateral in the form of cash, securities, money market instruments, major foreign currencies, the settlement currency of the SBS or gold, *so long as* such collateral: (i) has a "ready market" and is (ii) "readily transferable."[19] The rules specifically exclude collateral issued by the SBSD, its counterparty or a "party related to" either such entity.[20] Haircuts on collateral are those specified in the relevant capital rule for the SBSD, *except* that an SBSD can apply the haircuts specified under the CFTC margin requirements so long as the SBSD applies those deductions consistently with respect to a particular counterparty (*i.e.*, the SEC does not want firms "cherry-picking" the lesser haircuts as between the SEC and the CFTC).

(iv) Counterparty Scope.

The margin collection requirements apply to all counterparties of a broker-dealer or SBSD, except no margin (VM or IM) need be collected from: (i) commercial end users that may rely on an exception from mandatory clearing; and (ii) certain specified supra-national entities. In addition, a number of entities can benefit from an exception from posting IM (though not VM), including: (i) the SBSD's affiliates; (ii) certain sovereigns; and (iii) other financial market intermediaries (including banks, CFTC-registered FCMs, other SEC-registered SBSDs and broker-dealers).

IM collection requirements rules apply broadly to an SBSD's customers otherwise, regardless of the level of transactions that counterparty engages in.[21] However, the SEC permits a $50 million threshold, on a group-to-group basis. The threshold effectively softens the effect of the SEC policy decision not to apply the "material swaps exposure" trigger for IM requirements used in the PR Margin Rules.[22] The threshold, combined with the fact that SBSDs are not required to collect IM from other financial market intermediaries, means that Nonbank SBSDs could have a very small number of counterparties that actually are subject to IM collection requirements.

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[17] The rules specifically contemplate that an SBSD could use an IM model that is different from its capital model and that it could use a model developed by a third party (with the SEC specifically noting the ISDA SIMM™). *See, e.g.*, Release at 134.

[18] This would include, *e.g.*, options on securities. For some firms, questions will need to be addressed, given that (i) OTC options are commonly booked under an ISDA Master Agreement and transacted like other derivatives, and (ii) while there is temporary relief in Europe, OTC options on securities are generally in-scope for derivatives rules in non-U.S. jurisdictions.

[19] The SEC noted that these conditions do not exist under the CFTC and PR Margin Rules, but argued that these requirements are consistent with the policy of those rules. *See* Release at n. 473.

[20] The rules do not define what "related" means in this context.

[21] The SEC did not adopt the "material swaps exposure" concept used by the CFTC and PR Margin Rules and part of the BCBS-IOSCO framework.

[22] It is likely the case that many firms that transact in amounts that create an IM requirement above the threshold would also have "material swaps exposure."

(v) Risk Management Procedures

An SBSD subject to the SEC rules is required to establish procedures to monitor the risks of SBS accounts. Review is required at “reasonable periodic intervals” and an SBSD must determine whether information and data to apply the procedures are accessible “on a timely basis” and if the systems established are appropriate to analyze risk. The rule specifies 8 particular required elements of the risk management program, including: (i) review of account documentation, (ii) determination of credit limits or limits on credit exposure, (iii) conducting of stress tests, (iv) management and monitoring of credit exposure, and (v) maintaining sufficient account equity to “protect against the largest individual potential future exposure” of an uncleared SBS in the account, as measured by computing the largest maximum possible loss that could result. Among other things, the risk management requirements make clear that, although the IM requirements of the margin rules will apply to a relatively small subset of counterparties, the SEC expects SBSDs to establish “house” margin requirements that will apply to all counterparties.

B. Comparison with the PR Margin Rules

The SEC rules are, in many ways, more similar to the PR Margin Rules than one might have expected based on the Proposal and certain of the indications coming from the SEC over the intervening years. The below section highlights the most significant distinctions that remain between the PR Margin Rules and the SEC rules.

- Scope of Customers.
  - Unlike the PR Margin Rules there is no general carve out in the SEC rules for counterparties that are not "financial end users." This distinction is most relevant for VM purposes. Very few counterparties will be out of scope for VM requirements.
  - The SEC did adopt an exception for "commercial end users" (as it was required to do under the statute),[23] however this exception requires an entity to satisfy the terms for an exception from mandatory clearing – including that the transaction is for "hedging" purposes and that the entity (generally) is not a "financial entity." The exception is likely to be of very limited use in the SBS markets, given that the majority of hedging in SBS will be done by financial entities.
  - In addition, the SEC adopted explicit carve-outs from margin requirements for transactions with specified supranational entities (IM *and* VM) and sovereigns (IM only).[24]
- No Third-Party Custodian Requirement. Unlike the PR Margin Rules, the SEC did not impose a requirement that IM be posted to an independent third-party custodian. However, the rules do permit this method and specifically contemplate the situations in which an SBSD: (1) posts collateral to an independent third-party custodian for the benefit of a counterparty (in which case the SBSD is *not* required to take a capital charge, so long as certain conditions are met) or (2) allows a counterparty to post collateral to an independent

[23] SEA § 15F(e)(4) (as added by Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015).

[24] The SEC specifically stated that the sovereign exception applies to the U.S. government. This is an odd choice, given that a swap with the U.S. government is not actually a "swap" for U.S. legal purposes. *See* CEA § 1a(47)(B)(ix) and SEA § 3(a)(68)(A)(i).

third-party custodian for the benefit of the SBSD (in which case certain exceptions to the segregation rules may apply, so long as conditions are met).

- No SBSD IM Posting. While VM requirements are two-way, as with the PR Margin Rules, the SEC did not impose a requirement on an SBSD to *post* IM to a customer, although it is not prohibited from doing so. This distinction significantly reduces the cost of SBS transactions for SBSDs subject to the SEC rules rather than the PR Margin Rule.[25]

- No IM Requirements with Other Regulated Intermediaries. The SEC imposes no IM requirement on transactions between an SBSD and any of (i) SBSDs, (ii) swap dealers, (iii) broker-dealers, (iv) FCMs, (v) banks, (vi) foreign banks and (vii) foreign broker-dealers. This exception will significantly reduce the cost of entering into SBS for entities subject to the SEC rules rather than the PR Margin Rules. A question that will come up is how this exception will be handled for relationships between an SEC-regulated SBSD and a derivatives dealer subject to the CFTC or PR Margin Rules (or similar non-U.S. rules). Those rules generally impose IM collection requirements.[26] In certain cases, an SEC-regulated SBSD could be in a situation where the other party requires it to post IM but the SEC-regulated SBSD is not required to collect IM. [27]

- No Inter-Affiliate IM. The SEC imposed no inter-affiliate IM requirements. This is consistent with the CFTC margin requirements for swaps, but differs from the PR Margin Rules. It is also consistent with a recent push by industry groups for regulators to eliminate inter-affiliate margin posting requirements.[28] This is a fairly significant decision by the SEC, which generally has viewed inter-affiliate transactions as requiring more oversight than independent third-party transactions.

- Transfer Timing. The SEC took a slightly different approach to transfer timing than the PR Margin Rules. Under those rules, transfer is generally required on a T+1 basis, with limited exception provided through the definition of "business day" which recognizes that time zones may make same-day transfer impracticable. The SEC also generally requires T+1 margin transfer, but has an exception if a customer is in another country and more than four time zones away.[29] In that case, margin is required on a T+2 basis.

- Thresholds. The SEC rules permit a $50 million IM threshold that applies on a group-to-group basis (*i.e.*, all SBSD affiliates and all of the counterparty's affiliates), consistent with the PR Margin Rules. In a wrinkle – and perhaps responding to recent guidance from

[25] The SEC took essentially the opposite policy view on this point as the Prudential Regulators did. The Prudential Regulators viewed a posting requirement as a way to "reduce overall risk to the financial system." 80 Fed. Reg. at 74863 & n. 133. In contrast, the SEC viewed a dealer posting requirement as posing an unnecessary liquidity constraint on the SBSD. *See* Release at 186. In essence, the SEC – as it has historically – took a view of systemic risk that is driven by protection of the intermediaries, whereas bank regulators took the view that the intermediaries would be better served by a constraint that would limit their risk-taking.

[26] The PR Margin Rules do not impose a posting requirement on dealer-to-dealer transactions, on the theory that such a requirement is effectively imposed by the other dealer also being required to collect.

[27] Note, for example, that industry-standard documentation for IM published by ISDA contains numerous references to amounts and *requirements* for IM under relevant regulatory regimes.

[28] *See* Nihal Patel, *Trade Associations Ask Prudential Regulators to Drop Inter-Affiliate IM Requirements* (May 15, 2019).

[29] Query what this means for SBS users in Guam?

BCBS-IOSCO and industry requests – the SEC provided a two-month period before IM requirements apply after a counterparty (group) *first* hits the threshold.

- Legacy Transactions. The SEC rules are similar to the PR Margin Rules with respect to SBS entered into before the compliance date for the SEC margin rules. Such transactions are not subject to margin requirements so long as they are in a separate *account* from those SBS subject to the rules. This differs from the "netting set" concept used in the PR Margin Rules, but presumably the SEC intends that it would apply similarly. It does, however, put the control for "legacy" status entirely with the SBSD – "account" is essentially a dealer determination, whereas netting set tends to speak more to how the transactions are documented.

C. Comparison with Broker-Dealer Margin Rules

While the SEC took certain steps to create margin parity between cash-market securities transactions and SBS, it is nonetheless possible, to some extent, for customers to obtain greater leveraged exposure to equity securities via SBS rather than via borrowing on margin.[30] The standardized schedule for SBS IM requirements is substantially similar to the requirements under Regulation T and FINRA Rule 4210. In addition, SBSDs and broker-dealers engaging in non-SBS securities transactions are required to apply those margin requirements rather than models. However, it is almost certainly the case that those firms eligible to use models to calculate margin (ANC Broker-Dealers and Standalone SBSDs) will determine margin requirements to be less under models than under the standardized schedule. A lower margin requirement would typically apply for an SBSD using models financing an equity position via SBS than a broker-dealer financing the same equity position via SBS or a margin loan.

Note, in this regard, that Standardized Haircut Broker-Dealers cannot use models. Also Standalone SBSDs would not be permitted to make margin loans, as that would require generally require broker-dealer registration and is not a permitted activity for an OTCDD.

VII. Segregation Requirements for Broker-Dealers and SBSDs

A. The Rules

The segregation requirements for Custodial Broker-Dealers are codified in new paragraph (p) of Rule 15c3-3 (sometimes known as the "customer protection rule") and new Appendix B to Rule 15c3-3. The segregation requirements for Standalone SBSDs, OTCDDs and bank SBSDs are codified in Rule 18a-4. While much of SEA Rule 18a-4 is closely modeled on Rule 15c3-3, Rule 18a-4 also provides for exemptions that should allow most of the firms subject to that Rule to rely on an exemption from much of the substantive requirements.

Generally speaking, the segregation requirements and reserve account requirements that will apply to SBS under new paragraph (p) and new Appendix B largely track the requirements that apply to securities positions under Rule 15c3-3 and Appendix A as they currently stand. The interesting aspect of the SEC's approach is that, for Custodial Broker-Dealers, it requires the calculations of

[30] To a significant extent, this is already the case, since market participants can get exposure to securities on SBS from a bank (or a non-U.S. firm), without being required to post IM, given that the BCBS-IOSCO framework (and the PR Margin Rules) do not turn IM requirements on except for counterparties with a specified amount of derivatives activities.

the segregation and reserve account requirements for SBS positions to be done separately from the calculations for securities positions. However, the results of these two calculations can be summed, and the total amount of securities and cash required to be segregated or deposited can be commingled. (Standalone SBSDs would not be permitted to hold customer collateral other than that related to derivatives, so the two-calculation approach is not relevant to them.)

This approach serves two policy aims of the SEC. First, the separation of the calculation ensures that collateral provided by customers to broker-dealer in respect of cash market securities positions cannot be used to fund the positions of SBS customers. Second, the commingling of the actual collateral serves, as a practical matter, to ensure that SBS customers should obtain the benefits of a SIPA liquidation proceeding.

B. Omnibus Segregation Requirements for SEA Rule 15c3-3 Firms

The SBS segregation requirement for firms that are subject to Rule 15c3-3 builds off of the existing requirements of the rule.[31] In fact, assets that are segregated for SBS customers *can* be commingled with assets that are segregated for regular securities customers.

(i) Segregation and Reserve Account Requirement.

The amount of customer collateral that a firm is required to segregate will be effectively increased to include the sum of (i) any IM that a firm collects in respect of an SBS and (ii) any additional margin that the firm collects beyond required VM, *i.e.,* beyond the amount that the broker-dealer or SBSD is in the money.

Generally, the determination of the amount required to be segregated is based on the "market value" of any collateral provided, not on its value after haircuts. Thus, if a firm is required to collect $85 of VM, and the counterparty were to meet the margin call by posting $100 of equity securities (having a margin value of $85 after haircuts), the broker-dealer would be required to segregate $15 of the securities. However, there are two important exceptions to the segregation requirement:

- securities and money market instruments posted to an SEC-registered clearing agency in respect of a customer's cleared SBS margin requirements (and that meets certain operational conditions) are not included in the calculation of collateral required to be segregated;
- securities and money market instruments posted by the broker-dealer or SBSD to an SEC-registered SBSD or an independent third party bank custodial account, where the collateral has been posted to offset the risk of an SBD with a customer are not included in the segregation calculation (again, subject to various operational conditions).

(ii) Waiver of Segregation.

The omnibus segregation requirements are mandatory with respect to collateral held by an SBSD or broker-dealer relating to a cleared SBS (*i.e.,* customers cannot waive segregation). With respect to non-cleared security-based swap transactions, only affiliates of the broker-dealer can waive

[31] Notably, the SEC rejected the idea of providing any option for individual segregation of customer collateral.

segregation and do so entering into an approved subordination agreement. The SEC did not permit individual customer IM segregation. Further, under the final omnibus segregation rules for broker-dealer, counterparties that are not affiliates of the broker-dealer cannot waive segregation.

Under the omnibus segregation requirements, an SBSD or broker-dealer must maintain: (1) possession or control over excess securities collateral (*i.e.*, securities and money market instruments that are not being used to meet a VM requirement of the counterparty); and (2) an SBS customer reserve account to segregate cash and/or qualified securities in an amount equal to the net cash owed to SBS customers, calculated on a weekly basis.

(iii) Collateral Held Away.

Historically, the SEC has required that, to the extent that a broker-dealer is required to collect margin from customers in respect of credit transactions, that broker-dealer must hold the collateral itself or in account in the name of the broker-dealer. In connection with collateral required to be collected in respect of SBS and swaps, the SEC will permit the broker-dealer to allow the use of tri-party collateral accounts, subject to the following conditions:

- the custodian is a U.S. bank or clearing organization, except that it is permissible to use a foreign bank or clearing organization to hold foreign securities or currency;
- the custodian cannot be an affiliate of the counterparty;
- there must be in place a legally enforcement control agreement requiring the release of the collateral in the event of either the counterparty's insolvency or failure to satisfy the conditions of its agreement with the firm; and
- the broker-dealer must maintain "written documentation of its analysis" that the account control agreement is "legal, valid, banking and enforceable" including in the event of the counterparty's insolvency.

(iv) Bank SBSDs.

One oddity (or glitch) in the SBS provisions in Title VII is that, while the Prudential Regulators have authority over the margin required by a bank dealer in SBS, and bank insolvency is governed by a scheme that is wholly separate from the SIPA insolvency scheme that is overseen by the SEC, it is the SEC (rather than the Prudential Regulators) that has authority to establish requirements as to the manner in which bank dealers hold or segregate collateral. In the rulemaking, the SEC effectively jettisons this authority as to bank SBSDs, provided that the bank does not clear swaps for others (which, as a practical matter, a bank would never do because it would then become subject to CFTC capital requirements), a bank is exempted from the SEC segregation requirements as long as the bank:

- provides notice to its counterparty that it has a right to segregate its IM at an independent third-party custodian;[32]

[32] The SEC did not have the option to waive this requirement for bank SBSDs. *See* SEA § 3E(f).

- discloses to the counterparty that any margin it provides the bank is not subject to a segregation requirement; and
- provides information as to how a counterparty claim for the return of its collateral will be treated in bankruptcy.

(v) Standalone SBSDs Including OTCDDs.

Firms have long been permitted to establish an OTCDD that may engage in a very limited set of OTC derivative transactions with customers, and may agree with its customers that it will not segregate their collateral or establish a reserve account. The Release extends this concept to SBSDs that either are not broker-dealers registered under SEA Section 15 or else act only as OTCDDs.

The custodial requirement that is applicable to Standalone SBSDs, SEA Rule 18a-4 and related Appendix A to that Rule, essentially track new paragraph (p) to Rule 15c3-3 and new Appendix B. However, in contrast to Rule 15c3-3, customers are permitted to waive their right to segregate their IM. The general expectation in the market is that Standalone SBSDs will not segregate IM for clients; either the clients will waive their segregation rights or they will deposit IM with a third party.

In order for a customer to waive its segregation rights, the Standalone SBSD must:

- not effect transactions in cleared SBS or hold collateral for another in connection with such transactions;
- provide the customer the writing required by SEA Section 3E(f)(1)(A) (notifying the counterparty of the SBSD at the beginning of an SBS transaction that the counterparty has the right to require segregation of the funds of other property supplied to margin, or guarantee or secure the obligations of the counterparty);
- disclose to the counterparty that any margin it provides the bank is not subject to a segregation requirement; and
- provide information as to how a counterparty claim for the return of its collateral will be treated in bankruptcy.

VIII. Alternative Compliance for SBSDs that are Swap Dealers

Rule 18a-10 provides that an SBSD that is not a broker-dealer and is registered as a swap dealer and predominantly engages in a swaps business may elect to comply with the capital, margin and segregation requirements established by the CFTC under Commodity Exchange Act instead of complying with the capital, margin and segregation rules of the SEC if certain conditions are met.

Specifically, a firm electing to operate under this alternative compliance mechanism must meet the following requirements: (i) the firm must be registered as a Standalone SBSD and registered with the CFTC as a swap dealer; (ii) the firm must be exempt from the segregation requirements of Rule 18a-4 (a Standalone or Bank SBSD will be exempt from omnibus segregation requirements if it meets certain conditions);[33] and (iii) the aggregate gross notional amount of the firm's outstanding

[33] Release at 262 ("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 IM 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

security-based swap positions measured as of the most recently ended quarter of the firm's fiscal year must not exceed the lesser of (a) the maximum fixed-dollar gross notional amount of open SBS specified in paragraph (f) of the rule ("maximum fixed-dollar threshold") or (b) 10% of the combined aggregate gross notional amount of the firm's open SBS and swap positions.[34]

IX. Cross-Border Application

A. Capital and Margin

The Rules treat capital and margin requirements as entity-level requirements that are applicable to the entirety of the business of an SBSD. Foreign SBSDs[35] may be able to avail themselves of substituted compliance to satisfy the capital and margin requirements. As the CFTC did, it is significant that the SEC, at least in theory, makes substituted compliance available even when a foreign SBSD transacts with a U.S. person. This is in contrast to the "territorial" approach in broker-dealer regulation, and it also creates opportunities for rule distinctions to result in competitive imbalances. For example, will the SEC, as the CFTC has done, permit European SBSDs to apply the entity and product scope definitions used under local rules?[36] Doing so could provide an incentive for some U.S.-based customers to transact with European firms, given that EMIR imposes thresholds before even VM requirements are triggered. This is particularly significant given that the SEC rules, unlike the CFTC and PR Margin Rules, contain significant deviations from the BCBS-IOSCO derivatives margin framework.

Generally, substituted compliance may be available to a foreign SBSD after the SEC makes a determination with respect to a foreign financial regulatory system that compliance with specified requirements under that foreign financial system by a registered SBSD may satisfy the corresponding SEC requirements.[37] In making such determination, the SEC will take into consideration the effectiveness of the supervisory compliance program administered, risk mitigation requirements, and the enforcement authority exercised by the foreign regulatory authority, which the SEC states will be a fact-specific analysis rather than a "blanket approach."[38]

B. Segregation

Unlike the capital and margin rules, segregation requirements are deemed “transaction-level” requirements and substituted compliance is not available. However, there are certain exceptions to Rule 18a-4 for foreign Standalone or bank SBSD engaging in certain transactions. However, there

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a segregation requirement. Consequently, a stand-alone SBSD 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.").

34 "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 maintaining the $250 billion threshold indefinitely, or lowers it to an amount less than $250 billion but greater than $50 billion. Release at 264-265.

35 Though the preferred nomenclature is "non-U.S." rather than "foreign," the term "foreign SBSD" is defined in SEA Rule 3a71-3(a)(7) (as an SBSD that is not a U.S. person) and cross-referenced in Rule 18a-4.

36 *E.g.*, the FC / NFC framework under EMIR and the definition of "OTC derivative" rather than "swap" or "SBS."

37 Release at 277 & n. 732.

38 Release at 279-280. The Release also notes that the SEC will look to whether the capital and prudential requirements of the foreign jurisdiction look to ensure safety and soundness of registrants in a comparable manner to the SEA.

are no exceptions from the segregation requirements for cross-border transactions of a U.S. Standalone broker-dealer or a broker-dealer SBSD.

The segregation requirements apply to all registered SBSDs.[39] The SEC analogized this to the broker-dealer segregation requirements: "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 SBSD or MSBSP."[40] However, Rule 18a-4 contains exceptions pursuant to which foreign SBSDs subject to its requirements need not comply with the segregation requirements for certain transactions.[41]

The exceptions relating to segregation requirements reflect SEC concerns about foreign liquidation regimes.[42] The segregation requirements apply to a foreign bank SBSD: (1) in respect of SBS transactions that it enters into with a U.S. person, or (2) in respect of SBS transactions for which it holds SBS related collateral in the U.S. (even if that collateral is not held for a U.S. customer).[43] This accounts for foreign bank SBSDs that do not have a U.S. branch and for foreign customers who transact with a U.S. branch of a foreign bank SBSD and, therefore, may be protected by U.S. ring fencing laws along with U.S. customers.

For non-bank non-U.S. Standalone SBSDs, the segregation requirements apply to all cleared SBS transactions, if the foreign Standalone SBSD holds collateral for even one U.S. person in respect of a cleared swap transaction. Further, for non-bank non-U.S. Standalone SBSDs, the segregation requirements apply as to any individual transaction with a U.S. person. If the segregation requirements apply, the SBSD must disclose to any U.S. customer the potential treatment of the

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[39] Release at 717.

[40] Release at 292. Though the policy argument may have merit, the SEC reasoning is somewhat specious, since there are very few broker-dealers that are not organized in the United States.

[41] Note that the exemptions to the application of the segregation requirements is the same whether the relevant entity is U.S. or Foreign.

[42] *See* Release at 285:

> [T]he [SEC] 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 US 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 US persons in all circumstances, and with respect to security-based swap customers regardless of US 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.")

See also Release at 287:

> A foreign bank SBSD that has a branch or agency in the United States should not be eligible to be a debtor under the US stockbroker liquidation scheme. Instead, the foreign bank's US 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 US branches or agencies. With respect to a foreign bank SBSD 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 US customers in such a liquidation is unknown because it depends on the laws of the jurisdiction where the foreign SBSD is liquidated. However, many jurisdictions' laws provide for ring fencing similar to US bank liquidation laws.

[43] Release at 288.

customer's collateral under both U.S. and foreign law, in the event of the foreign SBSD's bankruptcy.

X. Compliance Dates

As noted before, the SEC withdrew its previous schedule for compliance with SBSD rules and adopted a new schedule in this release. In particular, the compliance date for registration and for the new Rules (and external business conduct requirements) is 18 months after the *later of*: (1) the effective date of the final rules establishing recordkeeping and reporting requirements for SBSDs;[44] or (2) the effective date of the final rules addressing the cross-border application of certain security-based swap requirements.[45] (This is a complicated way of the SEC saying that these SBSD substantive requirements are applicable upon registration.) The SEC does not explicitly state in this release that the registration compliance date is the date entities will be required to count transactions towards the registration threshold, but presumably that is the intent.[46]

In the Release, the SEC also extended certain temporary exemptions relating to financial responsibility requirements, segregation and CDS portfolio margin programs. Each of the extensions are now tied to the compliance dates for the new rules.[47]

XI. What is to Come, Issues and Suggestions

A. What's Next for Title VII Rulemaking

- The SEC must adopt recordkeeping and reporting requirements. Although these rules may be thought of as non-substantive, they are essential to both the firms (so that they can demonstrate compliance with the capital, margin and segregation rules) and to the SEC (so that it can monitor compliance). Further, the rules may impose significant technology builds.
- The SEC must adopt (the last portion of) its cross-border rules. The final version of these rules will potentially influence which firms determine to register and how firms structure their activities.
- The CFTC must adopt capital rules. As stated above, the CFTC capital rules are built, in part, on the SEC rules, and, therefore, the CFTC could not finalize until the SEC did so.
- The SEC determined not to adopt liquidity requirements applicable to Nonbank SBSDs. Given that FINRA last year proposed liquidity reporting requirements for broker-dealers,[48] there is certainly the possibility of such rules being proposed or adopted. Even in the absence of rules, regulators generally are monitoring firm liquidity. (The last version of the

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44 These rules were first proposed in 2014. *See* 79 Fed. Reg. 25193 (May 2, 2014).

45 These rules were proposed last month. *See* 84 Fed. Reg. 24206 (May 24, 2019). *See* CWT memorandum, *Security-Based Swaps Meet Rule 15a-6* (June 3, 2019).

46 This would effectively add an additional two plus months, given that registration is required two months after the end of the month in which the *de minimis* threshold is crossed. *See* SEA Rule 3a71-2(b).

47 *See* Release at 303.

48 FINRA Reg. Notice 18-02.

CFTC proposed capital rules contained a liquidity requirement, though we would expect (or hope) that it would be tabled as part of consistency with the SEC requirements.)

B. Issues for Regulators to Consider

- While the SEC is unlikely to raise the Risk Margin Amount as precipitously as the rules permit it to do, it would be reasonable for the SEC to establish a schedule of increase that it would not exceed.
- Neither the SEC nor the CFTC has authority over the capital or margin requirements of bank SBSDs. The SEC now has effectively exempted bank SBSDs from its collateral segregation requirements. However, the SEC and CFTC have authority to establish recordkeeping and reporting requirements for bank SBSDs. With that said, it makes little sense for them to impose such requirements as to topics over which they have no substantive authority. In contrast to aspects of the CFTC rules, the SEC should limit the recordkeeping and reporting requirements on aspects of oversight for which it does not have substantive authority.[49]
- FINRA has put on temporary hold its margin requirements for TBA transactions under Rule 4210. While these rules have been under consideration for a long time, it would nonetheless be sensible for FINRA to delay them further so that it can better integrate the TBA rules with the SBS margin rules. At a minimum, FINRA should align the margin collection period under its rules with the SEC's rules. Consideration also should be given to including the margin calculation on TBA transactions as part of the margin calculations on SBS transactions, at least for ANC Broker-Dealers.
- FINRA also should consider to what extent its existing rules governing margin for OTC options should be amended consistent with the margin rules adopted by the SEC for SBS.
- The CFTC should, and hopefully will, consider lowering its minimum capital requirement based on 8% of margin from 8% to 2% with a right to escalate in the future, in order to make such requirements consistent with the rules adopted by the SEC (which reduced the minimum capital requirement from the proposed 8% of a firm's "risk margin amount" to 2% with a right to escalate in the future).

C. Issues for Firms to Consider

- <u>Model approval</u>. The compliance time frame is not actually that long, given everything that goes into getting models approved by the SEC. Firms that are seeking conditional approval of a model based on the approval of another regulator should seek early affirmation from the SEC that it is comfortable with the model (and the other regulator).
- <u>Parallel Systems</u>. It will be necessary for Custodial Broker-Dealers (at least for ANC Broker-Dealers) to build a parallel, but not identical, set of margin and custody computation requirements for their SBS activities. The timing of delivery requirements may not be identical under the SBS and the security rules. Firms will have to consider processes by which any particular item of margin may be allocated to a securities position or to an SBS

[49] For example, the CFTC, indirectly through the National Futures Association, has imposed financial, operational and risk management reporting requirements on swap dealers, including bank swap dealers. *See* NFA Notice I-17-10.

position. Further, the allocation of any individual item may be required to change, even on a daily basis, as customers enter into securities and SBS transactions.

- Timing. Even though the "compliance date" of the rules is some time away, SEC-registered broker-dealers are currently subject to capital requirements as to SBS positions. Accordingly, firms should consider the extent to which they able to look to the SEC rules for guidance even before the effective date.
- Organizational Structure. Financial institutions with multiple SBSDs will be required to consider whether it remains worthwhile to do so, as substantial minimum capital charges are imposed. In addition, the cost of maintaining separate systems and processes for each registrant will likely prove meaningful. Once the CFTC publishes its capital rules, firms should be positioned to make a judgement as to the most rational manner in which to structure their U.S. SBS and swaps activities.
- No Models, No Way. Will any Standardized Haircut Broker-Dealer register as an SBSD? An SBSD that cannot use models to compute its capital is not likely to be able to compete with firms that can use models.

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APPENDIX 1

Type of Registrant	Rule	Tentative Net Capital	Net Capital	
			Fixed-Dollar	**Financial Ratio**
Stand-alone SBSD (not using internal models)	18a-1	N/A	$20 million	2% margin factor
Stand-alone SBSD (using internal models)[1]	18a-1	$100 million	$20 million	2% margin factor
Broker-dealer SBSD (not using internal models)	15c3-1	N/A	$20 million	2% margin factor + Rule 15c3-1 ratio
Broker-dealer SBSD (using internal models)	15c3-1	$5 billion	$1 billion	2% margin factor + Rule 15c3-1 ratio

[1] Includes a stand-alone SBSD that also is an OTC derivatives dealer.

APPENDIX 2

Entity Type (Must Be Approved to Use Models)	**10% TNC Portfolio Concentration Charge**	**Counterparty Concentration Charge**
ANC broker-dealer	Yes	Yes
ANC broker-dealer SBSD	Yes	Yes
Stand-alone SBSD	No	Yes
Stand-alone SBSD/OTC derivatives dealer	No	Yes

APPENDIX 3

Exceptions in Rule 18a-3 Regarding VM and IM Collection and Delivery	Required to Collect Margin?		Required to Deliver VM?
	VM	IM	
Commercial End User	No	No	No
BIS or European Stability Mechanism	No	No	No
Multilateral Development Bank	No	No	No
Financial Market Intermediary	Yes	No	Yes
Affiliate	Yes	No	Yes
Sovereign with Minimal Credit Risk	Yes	No	Yes
Legacy Account	No	No	No
IM Below $50 Million Threshold	Yes	No	Yes
Minimum Transfer Amount	No	No	No

APPENDIX 4

(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 the following table:[50]

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%

[50] Note that the CDS Basis Point Spread tables are identical under Rules 15c3-1 and 18a-1.

APPENDIX 5

(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 the following table:

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%