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

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–68071; File No. S7–08–12]

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

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

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

DATES: Comments should be received on or before January 22, 2013.

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

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an email to *rule-comments@sec.gov*. Please include File Number S7–08–12 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

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

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

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

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Background
II. Proposed Rules and Rule Amendments
A. Capital
1. Introduction
2. Proposed Capital Rules for Nonbank SBSDs
a. Computing Required Minimum Net Capital
i. Stand-alone SBSDs Not Using Internal Models
ii. Broker-Dealer SBSDs Not Using Internal Models
iii. Stand-alone SBSDs Using Internal Models
iv. Broker-Dealer SBSDs Using Internal Models and ANC Broker-Dealers
b. Computing Net Capital
i. The Net Liquid Assets Test
ii. Standardized Haircuts for Security-Based Swaps
iii. VaR Models
iv. Credit Risk Charges
v. Capital Charge In Lieu of Margin Collateral
vi. Treatment of Swaps
c. Risk Management
d. Funding Liquidity Stress Test Requirement
e. Other Rule 15c3–1 Provisions Incorporated into Rule 18a–1
i. Debt-Equity Ratio Requirements
ii. Capital Withdrawal Requirements
iii. Appendix C
iv. Appendix D
3. Proposed Capital Rules for Nonbank MSBSPs
B. Margin
1. Introduction
2. Proposed Margin Requirements for Nonbank SBSDs and Nonbank MSBSPs
a. Scope of Rule 18a–3
b. Daily Calculations
i. Nonbank SBSDs
ii. Nonbank MSBSPs
c. Account Equity Requirements
i. Nonbank SBSDs
ii. Nonbank MSBSPs
d. $100,000 Minimum Transfer Amount
e. Risk Monitoring and Procedures
3. Specific Request for Comment to Limit the Use of Collateral
C. Segregation
1. Background
2. Proposed Rule 18a–4
a. Possession and Control of Excess Securities Collateral
b. Security-Based Swap Customer Reserve Account
c. Special Provisions for Non-cleared Security-Based Swap Counterparties
III. General Request for Comment
IV. Paperwork Reduction Act
A. Summary of Collections of Information Under the Proposed Rules and Rule Amendments
1. Proposed Rule 18a–1 and Amendments to Rule 15c3–1
2. Proposed Rule 18a–2
3. Proposed Rule 18a–3
4. Proposed Rule 18a–4
B. Proposed Use of Information
C. Respondents
D. Total Initial and Annual Recordkeeping and Reporting Burden
1. Proposed Rule 18a–1 and Amendments to Rule 15c3–1
2. Proposed Rule 18a–2
3. Proposed Rule 18a–3
4. Proposed Rule 18a–4
E. Collection Of Information Is Mandatory
F. Confidentiality
G. Retention Period For Recordkeeping Requirements
H. Request For Comment
V. Economic Analysis
A. Baseline Of Economic Analysis
1. Overview of the OTC Derivatives Markets—Baseline for Proposed Rules 18a–1 through 18a–4
2. Baseline for Amendments to Rule 15c3–1
B. Analysis of the Proposals and Alternatives
1. Overview—The Proposed Financial Responsibility Program
a. Nonbank SBSDs
b. Nonbank MSBSPs
2. The Proposed Capital Rules
a. Nonbank SBSDs and ANC Broker-dealers
i. Minimum Capital Requirements
ii. Standardized Haircuts
iii. Capital Charge in Lieu of Margin Collateral
iv. Credit Risk Charge
v. Funding Liquidity Stress Test Requirement
vi. Risk Management Procedures
b. Capital Requirements for MSBSPs
c. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation
3. The Proposed Margin Rule—Rule 18a–3

a. Calculation of Margin Amount
b. Account Equity Requirements
i. Commercial end users
ii. SBSDs—Alternatives A and B
c. Margin Requirements for Nonbank-MSBSPs
d. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation
4. Proposed Segregation Rule—Rule 18a–4
a. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation
C. Implementation Considerations
D. General Request for Comment
VI. Regulatory Flexibility Act Certification
VII. Statutory Basis and Text of the Proposed Amendments

I. Background

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

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

Section 4s(e)(1)(B) of the CEA provides that the CFTC shall prescribe capital and margin requirements for swap dealers and major swap participants for which there is not a prudential regulator (''nonbank swap dealers'' and ''nonbank swap participants'').[8] Section 15F(e)(1)(A) of the Exchange Act provides that the prudential regulators shall prescribe capital and margin requirements for bank SBSDs and bank MSBSPs, and section 4s(e)(1)(A) of the CEA provides that the prudential regulators shall prescribe capital and margin requirements for swap dealers and major swap participants for which there is a prudential regulator (''bank swap dealers'' and ''bank swap participants'').[9] The prudential regulators have proposed capital and margin requirements for bank swap dealers, bank SBSDs, bank swap participants, and bank MSBSPs.[10] The CFTC has proposed capital and margin requirements for nonbank swap dealers and nonbank major swap participants.[11] The CFTC also has adopted segregation requirements for cleared swaps and proposed segregation requirements for non-cleared swaps.[12]

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

Further, the proposals also would increase the minimum net capital

[1] *See* Public Law 111–203, 124 Stat. 1376 (2010).

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

[3] *See* Public Law 111–203 §§ 701–774.

[4] *See id.* § 764; 15 U.S.C. 78o–10.

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

[6] *See* Public Law 111–203 § 763; 15 U.S.C. 78c–5.

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

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

[9] *See* 15 U.S.C. 78o–10(e)(1)(A); 7 U.S.C. 6s(e)(1)(A).

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

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

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

[13] *See* 17 CFR 240.15c3–1; 17 CFR 240.15c3–3.

requirements and establish liquidity requirements for ANC broker-dealers.[14] An ANC broker-dealer is a broker-dealer that has been approved by the Commission to use internal value-at-risk (''VaR'') models to determine market risk charges for proprietary securities and derivatives positions and to take a credit risk charge in lieu of a 100% charge for unsecured receivables related to OTC derivatives transactions (hereinafter, collectively ''internal models''). The proposed amendments applicable to ANC broker-dealers are designed to account for their large size, the scale of their custodial activities, and the potential substantial leverage they may take on if they become more active in the security-based swap markets under the Dodd-Frank Act reforms, which, among other things, require dealers in security-based swaps to register with the Commission.[15] Finally, some of the proposed amendments to Rule 15c3–1 would apply to broker-dealers that are not registered as SBSDs. These proposed amendments are designed to maintain a consistent capital treatment for security-based swaps and swaps under Rule 15c3–1 and proposed new Rule 18a–1.

As discussed in detail below, the proposals for capital, margin, and segregation requirements for SBSDs and MSBSPs are based in large part on existing capital, margin, and segregation requirements for broker-dealers (''broker-dealer financial responsibility requirements'').[16] The broker-dealer financial responsibility requirements served as the model for the proposals because the financial markets in which SBSDs and MSBSPs are expected to operate are similar to the financial markets in which broker-dealers operate. In addition, as discussed below, the objectives of the broker-dealer financial responsibility requirements are similar to the objectives underlying the proposals. Moreover, the broker-dealer financial responsibility requirements have existed for many years and have facilitated the prudent operation of broker-dealers.[17] Consequently, they provide a reasonable template for building a financial responsibility program for SBSDs and MSBSPs. Furthermore, it is expected that some nonbank SBSDs also will register as broker-dealers in order to be able to offer customers a broader range of services than a nonbank SBSD not registered as a broker-dealer (''stand-alone SBSD'') would be permitted to engage in. Therefore, establishing consistent financial responsibility requirements would avoid potential competitive disparities between stand-alone SBSDs and broker-dealer SBSDs.

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

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

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

The Commission notes in this regard that the specific quantitative requirements included in this proposal have not been derived directly from econometric or mathematical models, nor has the Commission performed a detailed quantitative analysis of the likely economic consequences of the specific quantitative requirements being included in this proposal. As discussed in the economic analysis below, there are a number of challenges presented in conducting such a quantitative analysis in a robust fashion. Accordingly, the selection of a particular quantitative requirement proposed below reflects a qualitative assessment by the Commission regarding the appropriate financial standard for an identified issue. In making such assessments and in turn selecting proposed quantitative requirements, the Commission has drawn from its experiences in regulating broker-dealers and has frequently looked to comparable quantitative elements in the existing broker-dealer financial responsibility regime (*e.g.,* the current capital charges in the existing broker-dealer net capital rule) or, where appropriate, the existing or proposed regulations of the prudential regulators,

[14] *See* 17 CFR 240.15c3–1(a)(7); 17 CFR 240.15c3–1e.

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

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

[17] For example, one of the objectives of the broker-dealer financial responsibility requirements is to protect customers from the consequences of the financial failure of a broker-dealer in terms of safeguarding customer securities and funds held by the broker-dealer. It should be noted that the Securities Investor Protection Corporation (''SIPC''), since its inception in 1971, has initiated customer protection proceedings for only 324 broker-dealers, which is less than 1% of the approximately 39,200 broker-dealers that have been members of SIPC during that timeframe. From 1971 through December 31, 2011, approximately 1% of the $117.5 billion of cash and securities distributed for accounts of customers came from the SIPC fund rather than debtors' estates. *See* SIPC, *Annual Report 2011,* available at *http://www.sipc.org/Portals/0/PDF/2011_Annual_Report.pdf* (''*SIPC 2011 Annual Report*'').

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

[19] *CFTC Capital Proposing Release,* 76 FR 27802.

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

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

FINRA, or the CFTC with respect to similar activities. For example, the Commission may propose using a specified haircut percentage (*e.g.,* 15%, as opposed to a percentage that is higher or lower) because it believes, based on its experience regulating markets, that such percentage should be sufficient to cover a severe market movement. The Commission has used these comparable quantitative requirements as a reasonable starting point for purposes of the various proposals because, as noted above, there are substantial similarities between the proposed rules and those other regimes in terms of the relevant markets, entities, and regulatory objectives, and because many nonbank SBSDs may also be subject to the existing broker-dealer financial responsibility requirements.

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

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

The capital, margin, and segregation requirements ultimately adopted, like other requirements established under the Dodd-Frank Act, could have a substantial impact on international commerce and the relative competitive position of intermediaries operating in various, or multiple, jurisdictions. In particular, intermediaries operating in the U.S. and in other jurisdictions could be advantaged or disadvantaged if corresponding requirements are not established in other jurisdictions or if the Commission's rules are substantially more or less stringent than corresponding requirements in other jurisdictions. This could, among other potential impacts, affect the ability of intermediaries and other market participants based in the U.S. to participate in non-U.S. markets, the ability of non-U.S.-based intermediaries and other market participants to participate in U.S. markets, and whether and how international firms make use of global ''booking entities'' to centralize risks related to security-based swaps. These issues have been the focus of numerous comments to the Commission and other regulators, Congressional inquiries, and other public dialogue.[24]

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

II. Proposed Rules and Rule Amendments

A. Capital

1. Introduction

Section 15F(e)(1)(B) of the Exchange Act requires that the Commission prescribe capital requirements for nonbank SBSDs and nonbank MSBSPs.[25] The Commission also has concurrent authority under section 15(c)(3) of the Exchange Act to prescribe capital requirements for broker-dealers.[26] The existing broker-dealer capital requirements are contained in

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

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

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

[25] 15 U.S.C. 78o–10(e)(1)(B).

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

Rule 15c3–1,[27] including seven appendices to Rule 15c3–1.[28] The minimum capital requirements for stand-alone SBSDs would be contained in proposed new Rule 18a–1,[29] and the minimum capital requirements for broker-dealer SBSDs would be contained in Rule 15c3–1, as proposed to be amended. Proposed Rule 18a–1 would be structured similarly to Rule 15c3–1 and would contain many provisions that correspond to those in Rule 15c3–1.[30]

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

In addition, the Dodd-Frank Act divided responsibility for SBSDs by providing the prudential regulators with authority to prescribe the capital and margin requirements for bank SBSDs and the Commission with authority to prescribe capital and margin requirements for nonbank SBSDs.[32] This division also suggests it may be appropriate to model the capital requirements for nonbank SBSDs on the capital standards for broker-dealers, while the capital requirements for bank SBSDs are modeled on capital standards for banks (as reflected in the proposal by the prudential regulators).[33] Certain operational, policy, and legal differences appear to support this distinction between nonbank SBSDs and bank SBSDs. First, based on the Commission staff's understanding of the activities of nonbank dealers in over-the counter (''OTC'') derivatives, nonbank SBSDs are expected to engage in a securities business with respect to security-based swaps that is more similar to the dealer activities of broker-dealers than to the activities of banks; indeed, some broker-dealers likely will be registered as nonbank SBSDs.[34] Second, existing capital standards for banks and broker-dealers reflect, in part, differences in their funding models and access to certain types of financial support, and those same differences also will exist between bank SBSDs and nonbank SBSDs. For example, banks obtain funding through customer deposits and can obtain liquidity through the Federal Reserve's discount window, whereas broker-dealers do not—and nonbank SBSDs will not—have access to these sources of funding and liquidity. Third, Rule 15c3–1 currently contains provisions designed to address dealing in OTC derivatives by broker-dealers and, therefore, to some extent already can accommodate this type of activity (although, as discussed below, proposed amendments to Rule 15c3–1 would be designed to more specifically address the risks of security-based swaps and the potential for increased involvement of broker-dealers in the security-based swaps markets).[35]

For these reasons, the proposed capital standard for nonbank SBSDs is a net liquid assets test modeled on the broker-dealer capital standard in Rule 15c3–1.[36] However, the Commission

[27] 17 CFR 240.15c3–1.

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

[29] *See* proposed new Rule 18a–1.

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

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

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

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

[34] *Id.*

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

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

recognizes that there may be alternative approaches to financial responsibility requirements that may be appropriate.[37] Accordingly, in the requests for comment below on the various capital standards, commenters are encouraged: (1) To consider alternative approaches to capital for nonbank SBSDs generally; (2) for nonbank SBSDs that are broker-dealers, to identify what, if any, specific amendments to Rule 15c3–1 and its appendices they believe would not be appropriate for broker-dealers; and (3) for stand-alone SBSDs, to identify what, if any, specific provisions in proposed new Rule 18a–1 and its appendices (including those modeled on provisions in Rule 15c3–1 and its appendices) they believe would not be appropriate for stand-alone SBSDs.

The capital standard in Rule 15c3–1—that serves as a model for the proposed capital standard for nonbank SBSDs—is a net liquid assets test. This standard is designed to promote liquidity; the rule allows a broker-dealer to engage in activities that are part of conducting a securities business (*e.g.,* taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (*e.g.,* money owed to customers, counterparties, and creditors).[38] For example, Rule 15c3–1 allows securities positions to count as allowable net capital, subject to standardized or internal model-based haircuts.[39] The rule, however, does not permit most unsecured receivables to count as allowable net capital.[40] This aspect of the rule severely limits the ability of broker-dealers to engage in activities, such as unsecured lending, that generate unsecured receivables. The rule also does not permit fixed assets or other illiquid assets to count as allowable net capital, which creates disincentives for broker-dealers to own real estate and other fixed assets that cannot be readily converted into cash. For these reasons, Rule 15c3–1 incentivizes broker-dealers to confine their business activities and devote capital to activities such as underwriting, market making, and advising on and facilitating customer securities transactions.

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

In computing net capital, the broker-dealer must, among other things, make certain adjustments to net worth such as deducting illiquid assets and taking other capital charges and adding qualifying subordinated loans.[45] The amount remaining after these deductions is defined as ''tentative net capital.''[46] The final step in computing net capital is to take prescribed percentage deductions (''standardized haircuts'') from the mark-to-market value of the proprietary positions (*e.g.,* securities, money market instruments, and commodities) that are included in its tentative net capital.[47] The standardized haircuts are designed to account for the market risk inherent in these positions and to create a buffer of liquidity to protect against other risks associated with the securities business.[48] ANC broker-dealers and a type of limited purpose broker-dealer that deals solely in OTC derivatives (''OTC derivative dealers'') are permitted, with Commission approval, to calculate net capital using internal models as the basis for taking market risk and credit risk charges in lieu of the standardized haircuts for classes of positions for which they have been approved to use models.[49] Rule 15c3–1 imposes substantially higher minimum capital requirements for ANC broker-dealers and OTC derivatives dealers, as compared to other types of broker-dealers, because, among other reasons, the use of internal models to compute net capital can substantially reduce the deductions for securities and money market positions as compared with the standardized haircuts.[50] Consequently, the higher minimum capital requirements are designed to account for risks that may not be addressed by the internal models. A broker-dealer must ensure that its net capital exceeds

able to more readily adhere to a net liquid assets test. In addition, many broker-dealers currently are affiliates within bank holding companies. Consequently, these broker-dealers are subject to Rule 15c3–1, while their bank affiliates are subject to bank capital standards.

[37] *CFTC Capital Proposing Release,* 76 FR 27802.

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

[39] *See* 17 CFR 240.15c3–1(c)(2)(vi); 17 CFR 240.15c3–1e; 17 CFR 240.15c3–1f.

[40] *See* 17 CFR 240.15c3–1(c)(2)(iv).

[41] *See* 17 CFR 240.15c3–1.

[42] *See* 17 CFR 240.15c3–1(a).

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

[44] *See* 17 CFR 240.15c3–1(a).

[45] *See* 17 CFR 240.15c3–1(c)(2)(i)–(xiii).

[46] *See* 17 CFR 240.15c3–1(c)(15).

[47] *See* 17 CFR 240.15c3–1(c)(2)(vi).

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

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

[50] *See* 17 CFR 240.15c3–1(a)(5) and (a)(7).

its minimum net capital requirement at all times.[51]

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

Request for Comment

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

1. Will the entities that register as nonbank SBSDs engage in a securities business with respect to security-based swaps that is similar to the securities business conducted by broker-dealers? If not, describe how the securities activities of nonbank SBSDs will differ from the securities activities of broker-dealers.

2. Will some broker-dealers register as nonbank SBSDs? If so, which types of broker-dealers and which types of activities do these broker-dealers currently engage in?

3. Should there be different capital standards for nonbank SBSDs depending on whether they are registered as broker-dealers or affiliated with bank holding companies, or not registered as broker-dealers and not affiliated with bank holding companies? If so, explain why. If not, explain why not. For example, should stand-alone SBSDs be subject to a tangible net worth standard or, if affiliated with a bank holding company, the bank capital standard? Would different standards create competitive advantages? If so, explain why. If different capital standards would be appropriate, explain the appropriate capital standard that should apply to each of these classes of nonbank SBSDs.

4. Generally, is there a level of capital under which counterparties will not transact with a dealer in OTC derivatives because the counterparty credit risk is too great? If so, identify that level of capital.

5. Will stand-alone SBSDs seek to effect transactions in securities OTC derivatives products other than security-based swaps, such as OTC options, that would necessitate registration as a broker-dealer? If so, would registering as a limited purpose broker-dealer under the provisions applicable to OTC derivatives dealers provide a workable alternative to registering as a full-service broker-dealer? For example, would there be conflicts between the proposed capital, margin, and segregation requirements for SBSDs and the existing requirements for OTC derivatives dealers? If so, identify the conflicts.

6. Should the requirements for OTC derivatives dealers be amended (by exemptive relief or otherwise) to accommodate firms that want to deal in security-based swaps? If so, explain how the requirements should be amended and why.

7. Should the Commission exempt nonbank SBSDs engaged in activities with respect to securities OTC derivatives products other than security-based swaps from any requirements applicable to OTC derivatives dealers? Please identify which requirements and explain why.

8. As discussed below, the proposed minimum net capital requirements would differ substantially for stand-alone SBSDs that are approved to use models in computing net capital (*i.e.,* a $20 million fixed-dollar minimum net capital requirement and $100 million tentative net capital requirement) compared to broker-dealer SBSDs approved to use models (*i.e.,* a $1 billion fixed-dollar minimum net capital requirement and $5 billion tentative net capital requirement). In general, because the definition of ''security-based swap dealer'' in the Dodd-Frank Act does not include acting as a broker or agent in security-based swaps, entities engaging in brokerage activities with respect to security-based swaps could be required to register as broker-dealers. To the extent these broker-dealer SBSDs wanted to use models to compute net capital, they would be subject to the higher minimum net capital requirements. Accordingly, in order to avoid being subject to higher minimum net capital requirements applicable to broker-dealer SBSDs approved to use models to compute net capital, a stand-alone SBSD may need to limit the activity it could conduct on behalf of customers so that it does not fall within the definition of a ''broker'' under the Exchange Act and, thereby, need to register as a broker-dealer. Commenters are requested to address this issue, including any potential changes to the proposed capital requirements for stand-alone SBSDs and broker-dealer SBSDs discussed below. For example, should broker-dealer SBSDs approved to use internal models to compute net capital and that register as broker-dealers only in order to conduct brokerage activities with respect to security-based swaps, and that do not conduct a general business in securities with customers, be subject to the minimum net capital requirements applicable to stand-alone SBSDs approved to use internal models? If so, explain why. If not, explain why not. If different capital standards would be appropriate, explain the appropriate capital standard that should apply to this class of broker-dealer SBSDs and whether any limitations should apply, including with respect to the types of broker activities in which the nonbank SBSD may engage in order to qualify for a particular capital treatment. Alternatively, or in addition, should the Commission allow OTC derivatives dealers (which are subject to a $20 million fixed-dollar minimum net capital requirement and $100 million tentative net capital requirement) to be dually registered as nonbank SBSDs and/or amend the rules for OTC derivatives dealers to conduct a broader range of activities than are currently

[51] 17 CFR 240.15c3–1(a).

[52] *See* proposed new Rule 18a–2.

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

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

permitted? If the Commission took this action, should it also remove the exemption for OTC derivatives dealers from membership in a self-regulatory organization (''SRO'')?

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

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

2. Proposed Capital Rules for Nonbank SBSDs

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

a. Computing Required Minimum Net Capital

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

Proposed Minimum Capital Requirements

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

i. Stand-alone SBSDs Not Using Internal Models

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

The proposed $20 million fixed-dollar minimum requirement would be the same as the fixed-dollar minimum

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

[56] *See* 17 CFR 240.15c3–1(a).

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

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

[59] *See* paragraphs (a)(1) and (c)(6) of proposed new Rule 18a–1.

[60] *See* paragraph (a)(1) of proposed new Rule 18a–1.

requirement applicable to OTC derivatives dealers and already familiar to existing market participants.[61] OTC derivatives dealers are limited purpose broker-dealers that are authorized to trade in certain derivatives, including security-based swaps, and to use internal models to calculate net capital. They are required to maintain minimum tentative net capital of $100 million and minimum net capital of $20 million.[62] These current fixed-dollar minimums have been the minimum capital standards for OTC derivative dealers for over a decade, and are substantially lower than the fixed-dollar minimums in Rule 15c3–1 currently applicable to ANC broker-dealers, which use internal models to calculate net capital.[63] In addition, available data regarding the current population of broker-dealers suggests that these minimums would not prevent new entrants in the security-based swap market.[64] To date, there have been no indications that these minimums are not adequately meeting the objective of requiring OTC derivatives dealers to maintain sufficient levels of regulatory capital to account for the risks inherent in their activities.

At the same time, the proposed $20 million fixed-dollar minimum requirement for stand-alone SBSDs that do not use internal models to calculate net capital would be substantially higher than the fixed-dollar minimums in Rule 15c3–1 currently applicable to broker-dealers that do not use internal models (*i.e.,* that are not ANC broker-dealers or OTC derivatives dealers).[65] Under the proposals, stand-alone SBSDs that do not use models would not be able to avail themselves of such minimums and would be subject to the same $20 million minimum net capital requirement as OTC derivatives dealers, even though they would not be using models like such derivatives dealers. In other words, the same minimum net capital requirement will apply to stand-alone SBSDs regardless of whether or not they use models.

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

In addition, stand-alone SBSDs will not be subject to the same limitations that apply to OTC derivative dealers in effecting transactions with customers and engaging in dealing activities.[66] Therefore, the failure of a stand-alone SBSD could have a broader adverse impact on a larger number of market participants, including customers and counterparties.[67] The proposed capital requirements for this group of firms, in part, are meant to account for this potential broader impact on market participants.[68]

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

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

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

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

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

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

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

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

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

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

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

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

- The greater of the total margin required to be delivered by the stand-alone SBSD with respect to security-based swap transactions cleared for security-based swap customers at a clearing agency or the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to paragraph (c)(1)(vi) of Rule 18a–1;[70] and
- The total *margin* amount calculated by the stand-alone SBSD with respect to non-cleared security-based swaps pursuant to paragraph (c)(1)(i)(B) of proposed new Rule 18a–3.[71]

The total of these two amounts—*i.e.,* the risk margin amount—would be multiplied by 8% to determine the amount of the 8% margin factor, which, if greater than the $20 million fixed-dollar amount, would be the stand-alone SBSD's minimum net capital requirement.[72] This proposed 8% margin factor ratio requirement is similar to an existing requirement in the CFTC's net capital rule for FCMs.[73] Further, the CFTC has proposed a similar requirement for swap dealers and major swap participants registered as FCMs.[74] Under the CFTC's proposal, an FCM would be required to maintain adjusted net capital that is equal to or greater than 8% of the risk margin required for customer and non-customer exchange-traded futures and swaps positions that are cleared by a derivatives clearing organization (''DCO'').[75] The CFTC's proposed 8% of margin, or risk-based capital rule, ''is intended to require FCMs to maintain a minimum level of capital that is associated with the level of risk associated with the customer positions that the FCM carries.''[76] Based on Commission staff experience with dually-registered broker-dealer/FCMs, the Commission preliminarily believes that the 8% margin factor would serve as a reasonable measure to ensure that a firm's minimum capital requirement increases or decreases in tandem with the level of risk arising from customer futures transactions. Consequently, the 8% margin factor is being proposed to provide a similar adjustable minimum net capital requirement for nonbank SBSDs with respect to their security-based swap activity.[77]

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

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

as operational risk, leverage risk, and liquidity risk. Raising the minimum tentative net capital requirement to $1 billion and net capital requirement to $500 million is one way to ensure that firms that use the alternative capital computation maintain sufficient capital reserves to account for these other risks. In addition, based on our experience, firms must have this scale of operations in order to have developed internal risk management control systems necessary to support reliable VaR computations.'').

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

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

[72] *See* paragraphs (a)(1) and (c)(6) of proposed new Rule 18a–1.

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

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

[75] *See CFTC Capital Proposing Release,* 76 FR 27802.

[76] *Id.* at 27807.

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

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

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

swaps, whereas margin requirements for cleared security-based swaps will vary over time and across different clearing agencies.

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

Request for Comment

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

1. Is the proposed $20 million minimum net capital requirement for stand-alone SBSDs not using internal models appropriate? If not, explain why not. What minimum amount would be more appropriate? For example, should the minimum fixed-dollar amount be greater than $20 million to account for the broader range of activities that stand-alone SBSDs will be able to engage in as compared with OTC derivatives dealers? If so, explain why. If it should be a greater amount, how much greater should it be (*e.g.,* $30 million, $50 million, $100 million, or some other amount)? Alternatively, should the minimum fixed-dollar amount be less than $20 million because these firms will not be using internal models to compute net capital? If so, explain why. If it should be a lower amount, how much lower (*e.g.,* $15 million, $10 million, $5 million, or some other amount)? If a greater or lesser alternative amount is recommended, explain why it would be more appropriate for broker-dealer SBSDs that are not approved to use internal models.

2. Is the proposed definition of *risk margin amount* appropriate? If not, explain why and suggest modifications to the definition. For example, are there modifications that could make the definition more accurately reflect the nonbank SBSD's risk exposure from dealing in security-based swaps? If so, describe the modifications and explain why they would achieve this result.

3. Is the component of the *risk margin amount* definition addressing margin delivered for cleared swaps appropriate? If not, explain why not. Would the definition be more appropriate if this component was dropped so that the first prong of the definition only incorporated the haircuts for cleared security-based swaps?

4. Should the proposed definition of *risk margin amount* only address cleared security-based swaps, consistent with the CFTC's proposal? If so, explain why, including how the risk of non-cleared security-based swap activities could be addressed through other measures.

5. Is the component of the *risk margin amount* definition addressing margin collected for non-cleared security-based swaps appropriate? If not, explain why not.

6. Is the 8% margin factor an appropriate metric for determining a nonbank SBSD's minimum net capital requirement in terms of increasing a nonbank SBSD's minimum net capital requirement as the risk of its security-based swap activities increases? If not, explain why not. For example, should the percentage be greater than 8% (*e.g.,* 10%, 12%, or some other percentage)? If so, identify the percentage and explain why it would be preferable. Should the percentage be less than 8% (*e.g.,* 6%, 4%, or some other percentage)? If so, identify the percentage and explain why it would be preferable.

7. Should the 8% multiplier be tiered as the amount of the risk margin amount increases? If so, explain why. For example, should the multiplier decrease from 8% to 6% for the amount of the risk margin amount that exceeds a certain threshold, such as $1 billion or $5 billion? If so, explain why. Should the amount of the multiplier increase from 8% to 10% for the amount of the risk margin amount that exceeds a certain threshold such as $1 billion or $5 billion? If so, explain why.

8. Should the 8% margin factor be an adjustable ratio (*e.g.,* increase to 10% or decrease to 6%)? For example, should the multiplier adjust periodically if certain conditions occur? If so, explain the conditions under which the 8% multiplier would adjust upward or downward and why having an adjustable ratio would be appropriate.

9. Would the 8% margin factor be a sufficient minimum net capital requirement without the $20 million fixed-dollar minimum? If so, explain why.

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

11. Would the 8% margin factor address the risk of extremely large nonbank SBSDs? If not, explain why not. For example, if the customer margin requirements for cleared and non-cleared security-based swaps carried by the nonbank SBSD were low because the positions were hedged or otherwise not high risk, the 8% margin

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

factor may not increase in tandem with the level of the nonbank SBSD's security-based swap activity. In this case, would the 8% margin factor adequately address the risk of the nonbank SBSD, particularly if it carried substantial security-based swap positions? If not, explain why not. Would the 8% margin factor be necessary for small nonbank SBSDs? If not, explain why not.

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

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

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

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

ii. Broker-Dealer SBSDs Not Using Internal Models

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

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

Moreover, the broker-dealer SBSD—as a broker-dealer—would be subject to the existing financial ratio requirements in Rule 15c3–1 and, therefore, would need to include the applicable financial ratio amount when determining the firm's minimum net capital requirement.[83] A broker-dealer's minimum net capital requirement is the greater of the applicable fixed-dollar amount and one of two alternative financial ratios. The first financial ratio requirement provides that a broker-dealer must not permit its aggregate indebtedness to all other persons to exceed 1500% of its net capital (*i.e.,* a 15-to-1 aggregate indebtedness to net capital requirement).[84] This is the default financial ratio requirement that all broker-dealers must apply unless they affirmatively elect to be subject to the second financial ratio requirement by notifying their designated examining authority of the election.[85] The second financial ratio requirement provides that a broker-dealer must not permit its net capital to be less than 2% of aggregate debit items (*i.e.,* customer-related obligations to the broker-dealer).[86]

The proposed amendments to Rule 15c3–1 would provide that a broker-dealer SBSD that is not approved to use internal models would be required to maintain a minimum net capital level of not less than the greater of: (1) $20 million or (2) the financial ratio amount required pursuant to paragraph (a)(1) of Rule 15c3–1 *plus* the 8% margin factor.[87] Thus, the proposed minimum net capital requirement for a broker-dealer SBSD would incorporate the requirement in Rule 15c3–1 that a broker-dealer maintain the greater of a fixed-dollar amount or one of the two financial ratio amounts, as applicable.[88] The financial ratio requirements in Rule 15c3–1 are designed to link the broker-dealer's minimum net capital requirement to the level of its securities activities. For example, the aggregate debit ratio requirement is designed for broker-dealers that carry customer securities and cash.[89] This provision increases the minimum net capital requirement for these broker-dealers as they increase their debit items by engaging in margin lending and facilitating of customer short-sale

[81] *See* proposed new paragraph (a)(10) of Rule 15c3–1.

[82] *Id.*

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

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

[85] *See* 17 CFR 240.15c3–1(a)(1)(i)–(ii).

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

[87] *See* proposed new paragraph (a)(10)(i) of Rule 15c3–1.

[88] *Id.*

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

transactions.[90] The proposal to combine the Rule 15c3–1 financial ratios with the 8% margin factor in a broker-dealer SBSD's computation of its minimum net capital requirement is designed to require the broker-dealer SBSD to maintain a capital cushion to support its traditional securities activities (*e.g.,* margin lending) and its security-based swap activities.

Request for Comment

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

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

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

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

iii. Stand-Alone SBSDs Using Internal Models

As discussed above, a stand-alone SBSD would be subject to the capital requirements in proposed new Rule 18a–1.[91] Rule 18a–1 would permit stand-alone SBSDs to apply to use internal models to compute net capital.[92] In terms of minimum capital requirements, a stand-alone SBSD that has been approved to use internal models would be required to maintain: (1) a minimum tentative net capital level of not less than $100 million; and (2) a minimum net capital level of not less than the greater of $20 million or the 8% margin factor.[93] The proposed minimum net capital requirement for stand-alone SBSDs using internal models (*i.e.,* the greater of $20 million or the 8% margin factor) is the same as the proposed minimum net capital requirement for stand-alone SBSDs and broker-dealer SBSDs not using internal models (though the latter would need to incorporate the Rule 15c3–1 financial ratio requirement into their minimum net capital computations).

A stand-alone SBSD approved to use internal models also would be subject to a minimum tentative net capital requirement of $100 million.[94] This proposed minimum tentative net capital requirement would be consistent with the current minimum tentative net capital requirement applicable to OTC derivatives dealers.[95] A minimum tentative net capital requirement is designed to operate as a prudential control on the use of internal models for regulatory capital purposes.[96] Tentative net capital is the amount of net capital maintained by a broker-dealer before applying the standardized haircuts or using internal models to determine deductions on the mark-to-market value of proprietary positions to arrive at the broker-dealer's amount of net capital.[97] OTC derivatives dealers, therefore, compute tentative net capital before using internal VaR models to take the market risk deductions. The minimum tentative net capital requirement is designed to account for the fact that VaR models, while more risk sensitive than standardized haircuts, tend to substantially reduce the amount of the deductions to tentative net capital in comparison to the standardized haircuts because the models recognize more offsets between related positions (*i.e.,* positions that show historical correlations) than the standardized haircuts.[98] In addition, VaR models may

[90] *See* 17 CFR 240.15c3–1(a)(1)(ii); 17 CFR 240.15c3–3a.

[91] *See* proposed new Rule 18a–1.

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

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

[94] *See* paragraph (a)(2) of proposed new Rule 18a–1.

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

[96] *OTC Derivatives Dealers,* 63 FR at 59384 (''The final rule contains the minimum requirements of $100 million in tentative net capital and $20 million in net capital. The minimum tentative net capital and net capital requirements are necessary to ensure against excessive leverage and risks other than credit or market risk, all of which are now factored into the current haircuts. Further, while the mathematical assumptions underlying VaR may be useful in projecting possible daily trading losses under 'normal' market conditions, VaR may not help firms measure losses that fall outside of normal conditions, such as during steep market declines. Accordingly, the minimum capital requirements provide additional safeguards to account for possible extraordinary losses or decreases in liquidity during times of stress which are not incorporated into VaR calculations.''). *See also Alternative Net Capital Requirements Adopting Release,* 69 FR at 34431 (''The current haircut structure [use of the standardized haircuts] seeks to ensure that broker-dealers maintain a sufficient capital base to account for operational, leverage, and liquidity risk, in addition to market and credit risk. We expect that use of the alternative net capital computation [internal models] will reduce deductions for market and credit risk substantially for broker-dealers that use that method. Moreover, inclusion in net capital of unsecured receivables and securities that do not have a ready market under the current net capital rule will reduce the liquidity standards of Rule 15c3–1. Thus, the alternative method of computing net capital and, in particular, its requirements that broker-dealers using the alternative method of computing [*sic*] maintain minimum tentative net capital of at least $1 billion, maintain net capital of at least $500 million, notify the Commission that same day if their tentative net capital falls below $5 billion, and comply with Rule 15c3–4 are intended to provide broker-dealers with sufficient capital reserves to account for market, credit, operational, and other risks.'') (Text in brackets added).

[97] *See* 17 CFR 240.15c3–1(c)(10).

[98] *See OTC Derivatives Dealers,* 63 FR 53962. *See Net Capital Rule,* Exchange Act Release No. 39456 (Dec. 17, 1997), 62 FR 68011 (Dec. 30, 1997) (concept release considering the extent to which statistical models should be used in setting the capital requirements for a broker-dealer's proprietary positions) (''For example, the current method of calculating net capital by deducting fixed percentages from the market value of securities can allow only limited types of hedges without becoming unreasonably complicated. Accordingly, the net capital rule recognizes only certain specified hedging activities, and the Rule does not account

not capture all risks and, therefore, having a minimum tentative net capital requirement (*i.e.,* one that is not derived using the VaR model) is designed to require that capital be sufficient to withstand events that the model may not take into account (*e.g.,* extraordinary losses or decreases in liquidity during times of stress that are not incorporated into VaR calculations).[99] Consequently, the proposed $100 million minimum tentative net capital requirement is designed to provide a sufficient liquid capital cushion for stand-alone SBSDs that use models, just as it has done in practice for entities registered as OTC derivatives dealers.[100]

Request for Comment

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

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

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

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

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

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

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

Under the proposed amendments, the current net capital requirements for ANC broker-dealers in Rule 15c3–1 would be enhanced to account for the firms' large size, the scale of their custodial activities, and the potential that they may become substantially more active in the security-based swap markets under the Dodd-Frank Act's OTC derivatives reforms. As discussed in more detail below, the proposed enhancements would include increasing the minimum tentative net capital and minimum net capital requirements; increasing the ''early warning'' notice threshold; narrowing the types of unsecured receivables for which ANC broker-dealers may take a credit risk charge in lieu of a 100% deduction; and requiring ANC broker-dealers to comply with a new liquidity requirement.[103]

Currently, an ANC broker-dealer must maintain minimum tentative net capital of at least $1 billion and minimum net capital of at least $500 million.[104] In addition, an ANC broker-dealer must provide the Commission with an ''early warning'' notice when its tentative net capital falls below $5 billion.[105] These relatively high minimum capital requirements (as compared with the requirements for other types of broker-

for historical correlations between foreign securities and U.S. securities or between equity securities and debt securities. By failing to recognize offsets from these correlations between and within asset classes, the fixed percentage haircut method may cause firms with large, diverse portfolios to reserve capital that actually overcompensates for market risk.'' *Id.* ''The primary advantage of incorporating models into the net capital rule is that a firm would be able to recognize, to a greater extent, the correlations and hedges in its securities portfolio and have a comparatively smaller capital charge for market risk.'').

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

[100] *OTC Derivatives Dealers,* 63 FR 59362.

[101] *See* 17 CFR 240.15c3–1e.

[102] *Id.*

[103] *See* proposed amendments to 17 CFR 240.15c3–1; 17 CFR 240.15c3–1e.

[104] *See* 17 CFR 240.15c3–1(a)(7)(i).

[105] *See* 17 CFR 240.15c3–1(a)(7)(ii).

dealers) reflect the substantial and diverse range of business activities engaged in by ANC broker-dealers and their importance as intermediaries in the securities markets.[106] Further, the heightened capital requirements reflect the fact that, as noted above, VaR models are more risk sensitive but also may not capture all risks and generally permit substantially reduced deductions to tentative net capital as compared to the standardized haircuts.[107]

The proposals to strengthen the requirements for ANC broker-dealers are made in response to issues that arose during the 2008 financial crisis, recognizing the large size of these firms, and the scale of their custodial responsibilities. The proposals also are based on the Commission staff's experience supervising the ANC broker-dealers. The financial crisis demonstrated the risks to financial firms when market conditions are stressed and how the failure of a large firm can accelerate the further deterioration of market conditions.[108] The proposals are designed to bolster the ANC broker-dealer net capital rules to ensure that these firms continue to maintain sufficient capital reserves to account for market, credit, operational, and other risks.[109] While the rationale for these enhancements exists irrespective of whether the ANC broker-dealers ultimately register as SBSDs, the proposed increased capital requirements also are designed to account for increased security-based swap activities by these firms. FOCUS Report data and the Commission staff's supervision of the ANC broker-dealers indicate that these firms currently do not engage in a substantial business in security-based swaps.[110] It is expected, however, that they may increase their security-based swap activities after the Dodd-Frank Act's OTC derivatives reforms are implemented and become effective because security-based swap activities will need to be conducted in regulated entities.[111] Consequently, financial institutions that currently deal in security-based swaps will need to register as an SBSD or register one or more affiliates as an SBSD. To the extent they want to offer securities products and services beyond those related to security-based swaps, they also will need to be registered as broker-dealers. Using an existing broker-dealer—particularly an ANC broker-dealer that already is capitalized and has risk management systems and personnel in place—could provide efficiencies that create incentives to register the same entity as a nonbank SBSD.

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

As indicated above, the proposed amendments to Rule 15c3–1 would require an ANC broker-dealer to incorporate the 8% margin factor into its net capital calculation.[115] Consequently, an ANC broker-dealer would be required at all times to maintain tentative net capital of not less than $5 billion and net capital of not less than the greater of $1 billion or the sum of the ratio requirement under paragraph (a)(1) of Rule 15c3–1 and eight percent (8%) of the risk margin amount for security-based swaps carried by the ANC broker-dealer.[116]

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

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

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

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

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

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

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

[112] *See* proposed amendments to paragraph (a)(7)(i) of Rule 15c3–1.

[113] *See* 17 CFR 240.15c3–1(a)(7)(i).

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

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

[116] *See* proposed amendments to paragraph (a)(7)(i) of Rule 15c3–1.

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

[118] *See* 17 CFR 240.17a–11(c)(3).

requirement for OTC derivatives dealers.

The rules applicable to ANC broker-dealers provide that the Commission may impose additional conditions on an ANC broker-dealer under certain circumstances.[119] In particular, paragraph (e) of Appendix E to Rule 15c3–1 establishes a non-exclusive list of circumstances under which the Commission may restrict the business of an ANC broker-dealer, including when the firm's tentative net capital falls below the early warning threshold.[120] In this event, the Commission—if it finds it is necessary or appropriate in the public interest or for the protection of investors—may impose additional conditions on the firm, including requiring the firm to submit to the Commission a plan to increase its tentative net capital (to an amount above the early warning level).[121] Additional restrictions could include restricting the ANC broker-dealer's business on a product-specific, category-specific, or general basis; requiring the firm to file more frequent reports with the Commission; modifying the firm's internal risk management controls or procedures; requiring the firm to compute deductions for market and credit risk using standardized haircuts; or imposing any other additional conditions, if the Commission finds that imposition of other conditions is necessary or appropriate in the public interest or for the protection of investors.[122]

Request for Comment

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

1. Is the proposed increased minimum net capital requirement from $500 million to $1 billion for ANC broker-dealers appropriate? If not, explain why not. What minimum amount would be preferable? For example, should the minimum fixed-dollar amount be greater than $1 billion to account for the large size of these firms and the scale of their custodial activities? If so, explain why. If it should be a greater amount, how much greater should it be (*e.g.,* $1.5 billion, $2 billion, $3 billion, or some other amount)? Alternatively, should the minimum fixed-dollar amount be less than $1 billion? If so, explain why. If it should be a lower amount, how much lower (*e.g.,* $950 million, $900 million, $850 million, $800 million, $750 million, or some other amount)? If a greater or lesser alternative amount is recommended, explain why it would be preferable.

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

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

4. Is it appropriate to require broker-dealer SBSDs to become ANC broker-dealers in order to use internal models? For example, would it be appropriate to permit broker-dealer SBSDs to use internal models but subject them to lesser minimum capital requirements than the ANC broker-dealers? If so, explain why. In addition, provide suggested alternative minimum capital requirements.

5. Is combining the 8% margin factor requirement with the applicable Rule 15c3–1 financial ratio requirement an appropriate way to determine a minimum net capital requirement for ANC broker-dealers? If not, explain why not.

6. Would the 8% margin factor provide an appropriate and workable restraint on the amount of leverage incurred by ANC broker-dealers? If not, explain why not. Is there another measure that would more accurately and effectively address the leverage risk of these firms? If so, identify the measure and explain why it would be more accurate and effective.

Additional Request for Comment on VaR-Based Capital Charges

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

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

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

[119] *See* 17 CFR 240.15c3–1e(e)(1).

[120] *Id.*

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

[122] *See* 17 CFR 240.15c3–1e(e).

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

procyclicality in the existing market risk capital requirement for banks.

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

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

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

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

b. Computing Net Capital

i. The Net Liquid Assets Test

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

The net liquid assets test is imposed through the mechanics of how a broker-dealer is required to compute net capital pursuant to Rule 15c3–1. These requirements are set forth in paragraph (c)(2) of Rule 15c3–1, which defines the term ''net capital.''[125] The first step is to compute the broker-dealer's net worth under GAAP.[126] Next, the broker-dealer must make certain adjustments to its net worth to calculate net capital.[127] These adjustments are designed to leave the firm in a position where each dollar of unsubordinated liabilities is matched by more than a dollar of highly liquid assets.[128] There are thirteen categories of net worth adjustments required by the rule.[129] The most significant adjustments are briefly discussed below.

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

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

The third adjustment is that the broker-dealer must deduct from net worth any asset that is not readily convertible into cash.[134] This means the broker-dealer must deduct the following types of assets (among others): real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and other expenses; goodwill; and most unsecured receivables.[135] An additional adjustment is that the broker-dealer must deduct 100% of the carrying value of securities for which there is no ''ready market'' or which cannot be publicly offered or sold because of statutory, regulatory, or contractual arrangements or other restrictions.[136]

[124] *See* 17 CFR 240.15c3–1e; 17 CFR 240.15c3–1f.

[125] *See* 17 CFR 240.15c3–1(c)(2).

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

[127] *See* 17 CFR 240.15c3–1(c)(2).

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

[129] *See* 17 CFR 240.15c3–1(c)(2)(i)–(xiii).

[130] *See* 17 CFR 240.15c3–1(c)(2)(ii); 17 CFR 240.15c3–1d.

[131] *See* 17 CFR 240.15c3–1d(b).

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

[133] *See* 17 CFR 240.15c3–1(c)(2)(i).

[134] *See* 17 CFR 240.15c3–1(c)(2)(iv).

[135] *Id.*

[136] *See* 17 CFR 240.15c3–1(c)(2)(vii). Rule 15c3–1 defines *ready market* to include a recognized established securities market in which there exists

After making these and other adjustments and taking charges required under Appendix B to Rule 15c3–1,[137] the broker-dealer is left with an amount of adjusted net worth that is defined in the rule as ''tentative net capital.'' [138]

As discussed in more detail below, the final step in the process of computing net capital is to take deductions from tentative net capital to account for the market risk inherent in the proprietary positions of the broker-dealer and to create a buffer of extra liquidity to protect against other risks associated with the securities business.[139] Most broker-dealers use the standardized haircuts prescribed in Rule 15c3–1 to determine the amount of the deductions they must take from tentative net capital. ANC broker-dealers and OTC derivatives dealers may use internal VaR models to determine the amount of the deductions for positions for which they have been approved to use VaR models.[140] For all other types of positions, they must use standardized haircuts. The standardized haircuts prescribe deductions in amounts that are based on the type of security or money market instrument and, in the case of certain debt instruments, the time-to-maturity of the bond.[141] Under the VaR model approach, the amount of the deductions is based on an estimate of the maximum potential loss the portfolio of securities would be expected to incur over a fixed time period at a certain probability level.

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

ii. Standardized Haircuts for Security-Based Swaps

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

Nonbank SBSDs would be required to apply the standardized haircuts currently set forth in Rule 15c3–1 for securities positions for which they have not been approved to use internal models.[146] The standardized haircuts in Rule 15c3–1 prescribe differing deduction amounts for a variety of classes of securities, including, for example: securities guaranteed as to principal or interest by the government of the United States (''U.S. government securities'');[147] certain municipal securities;[148] Canadian debt obligations;[149] certain types of mutual funds;[150] certain types of commercial paper, bankers acceptances, and certificates of deposit;[151] certain nonconvertible debt securities;[152] certain convertible debt securities;[153]

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

[137] 17 CFR 240.15c3–1b.

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

[139] *See, e.g., Uniform Net Capital Rule,* 42 FR 31778 (''[Haircuts] are intended to enable net capital computations to reflect the market risk inherent in the positioning of the particular types of securities enumerated in [the rule]''); *Net Capital Rule,* 50 FR 42961 (''These percentage deductions, or 'haircuts', take into account elements of market and credit risk that the broker-dealer is exposed to when holding a particular position.''); *Net Capital Rule,* 62 FR 67996 (''Reducing the value of securities owned by broker-dealers for net capital purposes provides a capital cushion against adverse market movements and other risks faced by the firms, including liquidity and operational risks.'') (footnote omitted).

[140] *See* 17 CFR 240.15c3–1e; 17 CFR 240.15c3–1f.

[141] *See* 17 CFR 240.15c3–1(c)(2)(vi).

[142] *See* proposed new Rule 18a–1.

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

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

[145] *See* section II.A.1. of this release.

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

[147] *See* 17 CFR 240.15c3–1(c)(2)(vi)(A).

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

[149] *See* 17 CFR 240.15c3–1(c)(2)(vi)(C).

[150] *See* 17 CFR 240.15c3–1(c)(2)(vi)(D).

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

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

[153] *See* 17 CFR 240.15c3–1(c)(2)(vi)(G).

certain cumulative, nonconvertible preferred stock;[154] and certain options.[155] The rule also contains catchall provisions to account for securities that are not included in these specific classes of securities.[156] Generally, the catchall provisions impose higher deductions than the deductions in the specifically identified classes of securities.[157] Further, as discussed above in section II.A.2.b.i. of this release, if a security does not have a ''ready market,'' it is subject to the 100% deduction from net worth.[158]

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

The proposals would establish two separate sets of standardized haircuts for security-based swaps: one applicable to security-based swaps that are credit default swaps and one applicable to other security-based swaps.[163]

Credit Default Swaps

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

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

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

[155] *See* 17 CFR 240.15c3–1(c)(2)(vi); 17 CFR 240.15c3–1a.

[156] *See* 17 CFR 240.15c3–1(c)(2)(vi)(J)–(K).

[157] *Compare* 17 CFR 240.15c3–1(c)(2)(vi)(A)–(H), *with* 17 CFR 240.15c3–1(c)(2)(vi)(J)–(K).

[158] *See* 17 CFR 240.15c3–1(c)(2)(vii).

[159] *See* 17 CFR 240.15c3–1(c)(2)(vi).

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

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

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

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

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

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

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

[167] *Id.* at 48267, note 682.

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

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

well as the market's assessment of the size of that payment. The greater the estimated risk that a credit event will occur (or the greater the expected payment contingent upon a credit event occurring), the higher the spread (*i.e.,* the cost of buying the protection).

The proposed standardized haircuts for CDS security-based swaps would be based on a ''maturity grid'' approach.[170] Rule 15c3–1 currently uses maturity grids to prescribe standardized haircuts for various classes of debt instruments.[171] The grids impose a sliding scale of haircuts with the largest deductions applying to bonds with the longest period of time-to-maturity.[172] The grids also permit broker-dealers to completely or partially net long and short positions in these classes of debt instruments when the maturities of long and short positions are in the same category, subcategory, or, in some cases, between certain adjacent categories.[173] The permitted netting allows the broker-dealer to reduce its required deductions.[174]

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

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

The horizontal ''spread'' axis is designed to address the specific credit risk associated with the obligor or obligation referenced in the contract. As noted above, the spread increases as the protection seller's estimation of the likelihood of a credit event occurring increases. Therefore, the net capital deduction—which is designed to address the risk inherent in the instrument—should increase as the spread increases. Combining the two components (maturity and spread) in the grid results in the smallest deduction (1% of notional) required for a short CDS security-based swap with a maturity of 12 months or less and a spread of 100 basis points or below and the largest deduction (50% of notional) required for a short CDS security-based swap with a maturity of 121 months or longer and a spread of 700 basis points or more. The deduction for an un-hedged short position in a CDS security-based swap (*i.e.,* when the nonbank SBSD is the seller of protection) would be the applicable percentage specified in the grid. The deduction for an un-hedged long position in a CDS security-based swap (*i.e.,* when the nonbank SBSD is the buyer of protection) would be 50% of the applicable deduction in the grid.[180]

The proposed deduction requirements for CDS security-based swaps would permit a nonbank SBSD to net long and short positions where the credit default swaps reference the same entity (in the case of CDS securities-based swaps referencing a corporate entity) or

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

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

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

Time to Maturity and Deduction

Less than 1 year—2.0%

1 year but less than 2 years—3.0%

2 years but less than 3 years—5.0%

3 years but less than 5 years—6.0%

5 years but less than 10 years—7.0%

10 years but less than 15 years—7.5%

15 years but less than 20 years—8.0%

20 years but less than 25 years—8.5%

25 years or more—9%

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

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

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

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

[177] *Id.*

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

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

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

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

A reduced deduction also could be taken for long and short CDS security-based swap positions in the same maturity and spread categories and that reference corporate entities in the same industry sector.[183] In this case, the market risk of the offsetting positions is mitigated to the extent that macroeconomic factors similarly impact companies in a particular industry sector, because corporate entities in the same industry sector would likely be similarly impacted by market events affecting that specific industry. The proposed rule would not identify a specific source for determining industry sector classifications in order to provide firms flexibility and to avoid requiring firms to rely on a specific commercial entity to comply with the rule. Instead, a nonbank SBSD would need to use an industry sector classification system that is reasonable in terms of grouping types of companies with similar business activities and risk characteristics, and document the industry sector classification system used for the purposes of the rule.[184] A nonbank SBSD could use a third-party's classification system or develop its own classification system, subject to these limitations. The nonbank SBSD would need to be able to demonstrate the reasonableness of the system it uses.

Reduced deductions also would apply for strategies where the firm is long (short) a bond or asset-backed security and long (short) protection through a CDS security-based swap referencing the same underlying bond or asset-backed security. In the case where the nonbank SBSD is long a bond or an asset-backed security and long protection through a credit default swap, the nonbank SBSD would be required to take 50% of the deduction required on the bond (*i.e.,* no deduction would be required with respect to the CDS security-based swap and a lesser deduction would apply to the bond than would be the case if it were not paired with a CDS security-based swap).[185] In other words, the deduction the nonbank SBSD would take if it held the bond in isolation would be reduced by one-half to account for the protection provided by the CDS security-based swap referencing the bond. This reduced deduction for the long bond position reflects the risk-reducing effects of the protection provided by the long CDS security-based swap position. If the nonbank SBSD is short a bond or asset-backed security and short protection through a credit default swap, the nonbank SBSD would be required to take the deduction required on the bond or asset-backed security (*i.e.,* no deduction would be required with respect to the CDS security-based swap).[186]

Non-Credit Default Swaps

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

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

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

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

[183] *Id.*

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

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

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

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

[188] *See id.* at 48264.

[189] *Id.*

[190] *Id.* The total return swap is designed to put the buyer in the position of having exposure to the reference security without actually owning it. Thus, the seller pays the buyer appreciation (*i.e.,* gains) and any interest or income on the security and the buyer pays the seller any depreciation (*i.e.,* loss) on the reference security plus a variable interest rate.

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

[192] *See* 17 CFR 240.15c3–1(c)(2)(vi)(J).

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

[194] *See* 17 CFR 240.15c3–1(c)(2)(vi)(F)(*1*)(*v*).

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

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

The examples above reflect the proposed standardized haircuts for a single non-CDS security-based swap treated in isolation. It is expected that nonbank SBSDs will maintain portfolios of multiple non-CDS security-based swaps with offsetting long and short positions to hedge their risk. Under the proposed standardized haircuts for non-CDS security-based swaps, nonbank SBSDs would be able to recognize the offsets currently permitted under Rule 15c3–1.[200] In particular, as discussed below, nonbank SBSDs would be permitted to treat a non-CDS security-based swap that references an equity security (''equity security-based swap'') under the provisions of Appendix A to Rule 15c3–1, which produces a single haircut for portfolios of equity options and related positions.[201] Similarly, nonbank SBSDs would be permitted to treat a non-CDS security-based swap that references a debt instrument (''debt security-based swap'') in the same manner as debt instruments are treated in the Rule 15c3–1 grids in terms of allowing offsets between long and short positions where the instruments are in the same maturity categories, subcategories, and in some cases, adjacent categories for the purposes of computing haircuts for debt security-based swaps.[202]

Appendix A to Rule 15c3–1 prescribes a standardized theoretical pricing model to determine a potential loss for a portfolio of equity positions involving the same equity security to establish a single haircut for the group of positions (''Appendix A methodology'').[203] Proposed amendments to Appendix A to Rule 15c3–1 would permit equity security-based swaps to be included in portfolios of equity positions for which the Appendix A methodology is used to compute a portfolio haircut.[204] Under these proposed amendments, broker-dealer SBSDs and broker-dealers that are not registered as SBSDs would be able to include equity security-based swaps in portfolios of equity positions for purposes of the Appendix A methodology. In addition, proposed new Rule 18a–1 would permit stand-alone SBSDs to use the Appendix A methodology as well.[205] By permitting equity security-based swaps to be included in portfolios of related equity positions, broker-dealer SBSDs and broker-dealers that are not registered as SBSDs would be able to employ a more sensitive measure of the risk when computing net capital than would be the case if the positions were treated in isolation.

Under the Appendix A methodology (as proposed to be amended), a nonbank SBSD could group equity security-based swaps, options, security futures, long securities positions, and short securities positions involving the same underlying security (*e.g.,* XYZ Company common stock) and stress the current market price for each position at ten equidistant points along a range of positive and negative potential future market movements, using an approved theoretical option pricing model that satisfies certain conditions specified in the rule.[206] For equity security-based swaps, the ten stress points for a portfolio of related positions would span a range from −15% to +15% (*i.e.,* −15%, −12%, −9%, −6%, −3%, +3%, +6%, +9%, +12%, +15%).[207] The gains and losses of each position (*e.g.,* a security-based swap, option, and a security future referencing XYZ Company and a long position and short position in XYZ Company stock) in the portfolio would be allowed to offset each other to yield a net gain or loss at each stress point.[208] The stress point

[196] *See Net Capital Rule,* 58 FR at 27490.

[197] *See* 17 CFR 240.15c3–1(c)(2)(vi)(J).

[198] *See* 17 CFR 240.15c3–1(c)(2)(vi)(F)(*1*).

[199] *See, e.g., Net Capital Rule,* Exchange Act Release No. 39456 (Dec. 17, 1997), 62 FR 68011 (Dec. 30, 1997) (''[A] broker-dealer's haircut for equity securities is equal to 15 percent of the market value of the greater of the long or short equity position plus 15 percent of the market value of the lesser position, but only to the extent this position exceeds 25 percent of the greater position. In contrast to the uniform haircut for equity securities, the haircuts for several types of interest rate sensitive securities, such as government securities, are directly related to the time remaining until the particular security matures.'').

[200] *See* proposed new paragraph (c)(2)(vi)(O)(*2*) of Rule 15c3–1; paragraph (c)(1)(vi)(B) of proposed new Rule 18a–1.

[201] *See* 17 CFR 240.15c3–1a; Appendix A to proposed new Rule 18a–1.

[202] *See* 17 CFR 240.15c3–1(c)(2)(vi).

[203] *See* 17 CFR 240.15c3–1a; Appendix A to proposed new Rule 18a–1.

[204] Specifically, Appendix A to Rule 15c3–1 would be amended to include equity security-based swaps within the definition of the term ''underlying instrument'' in paragraph (a)(4) of Appendix A. This would allow these positions to be included in portfolios of equity positions involving the same equity security for purposes of the Appendix A methodology. In addition, the proposals would include security futures on single stocks within the definition of the term ''underlying instrument,'' which would permit these positions to be included in portfolios of positions involving the same underlying security for purposes of the Appendix A methodology, subject to a minimum charge. This proposal is made in response to legislative and regulatory developments that have occurred since the Appendix A methodology was adopted in 1997. *See Net Capital Rule,* Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997). When the Appendix A methodology was adopted, security futures trading was prohibited in the U.S. This prohibition was repealed by the Commodity Futures Modernization Act of 2000, which established a framework for the joint regulation of security futures products by the Commission and the CFTC. Public Law 106–554, 114 Stat. 2763 (2000). Because security futures contracts on individual stocks generally track the price of the underlying stock, and, at expiration, the price of the security futures contract equals the price of the underlying stock, the proposed amendments would treat a security future on an underlying stock as if it were the underlying stock. Appendix A to Rule 18a–1 similarly would include equity security-based swaps and security futures products in the definition of ''underlying instrument.'' *See* paragraph (a)(4) of proposed new Rule 18a–1a. *See also* letter from Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, Commission, to Timothy H. Thompson, Senior Vice President and Chief Regulatory Officer, Chicago Board Options Exchange, Incorporated (''CBOE''), and Grace B. Vogel, Executive Vice President, Member Regulation, Risk Oversight and Operational Regulation, FINRA (May 4, 2012) (no-action letter permitting broker-dealers when calculating net capital using a theoretical pricing model pursuant to Appendix A to Rule 15c3–1 to group U.S.-listed security futures contracts on individual stocks with equity options on, and positions in, the same underlying instrument under paragraph (b)(1)(ii)(A) of Appendix A).

[205] *See* proposed new Rule 18a–1a.

[206] *See* 17 CFR 240.15c3–1a(b)(1); paragraph (b)(1) of proposed new Rule18a–1a. Presently, there is only one theoretical options pricing model that has been approved for this purpose.

[207] This range of price movements (±) 15% is consistent with the prescribed 15% haircut for most equity securities. *See* 17 CFR 240.15c3–1(c)(2)(vi)(J).

[208] For example, at the −6% stress point, XYZ Company stock long positions would experience a 6% loss, short positions would experience a 6% gain, and XYZ Company options would experience gains or losses depending on the features of the options. These gains and losses are added up resulting in a net gain or loss at that point.

that yields the largest potential net loss for the portfolio would be used to calculate the aggregate haircut for all the positions in the portfolio.[209] This method would permit a nonbank SBSD to compute deductions for a portfolio of equity security-based swaps in a more risk sensitive manner by accounting for the risk of the entire portfolio, rather than the risk of each position within the portfolio.

With respect to portfolios of debt security-based swaps, a nonbank SBSD could use the offsets permitted in the debt-maturity grids in Rule 15c3–1.[210] The debt-maturity grids permit the broker-dealer to reduce the amount of the deductions when long debt security positions are offset by short debt security positions. For example, as discussed above, the maturity grid for nonconvertible debt securities has nine maturity categories.[211] In each category, the broker-dealer is required to take the specified deduction on the greater of the long or short positions in the category.[212] Consequently, the broker-dealer need not take a deduction on the gross amount of these positions (*i.e.,* the broker-dealer need not take a deduction for the long *and* short positions). In addition, the rule permits the broker-dealer to exclude nonconvertible debt securities from the maturity categories if they are hedged by other similar nonconvertible debt securities or government securities or futures on government securities.[213] The excluded positions are subject to a separate maturity grid that imposes lower deductions.[214] The proposed amendments to Rule 15c3–1 and proposed new Rule 18a–1 would permit broker-dealer SBSDs and stand-alone SBSDs, respectively, to treat debt security-based swaps in the same manner as the debt instruments they reference are treated for the purposes of determining haircuts. Consequently, nonbank SBSDs could recognize the offsets and hedges that those provisions permit to reduce the deductions on portfolios of debt security-based swaps.

Request for Comment

The Commission generally requests comment on the proposed standardized haircuts for calculating deductions for security-based swaps. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is the proposed maturity/spread grid approach for CDS security-based swaps appropriate in terms of addressing the risk of these positions? If not, explain why not. How could the proposed maturity/spread grid approach be modified to better address the risk of these positions?

2. Do broker-dealers currently use the spread/maturity grid in FINRA Rule 4240 to determine capital charges for credit default swaps? If so, what has been the experience of broker-dealers in using the grid? If not, what potential practical issues does the maturity/spread grid raise? Are there ways these practical issues could be addressed through modifications to the proposed maturity/spread grid?

3. Is there an alternative maturity/spread grid approach that would be a preferable model for the standardized haircuts? If so, identify the model and explain why it would be preferable. For example, should the standardized haircut for a CDS security-based swap that references an obligation be based on the standardized haircut that would apply to the obligation under paragraph (c)(2)(vi) of Rule 15c3–1? If so, explain why. If not, explain why not. How could a CDS security-based swap that references an obligor as an entity be addressed under such a standardized haircut approach? For example, could the standardized haircut that would apply to obligations (*e.g.,* bonds) issued by the obligor be used as a proxy for the standardized haircut that would apply to the CDS security-based swap referencing the obligor? If so, explain why.

4. Are the proposed spread categories for the CDS security-based swap grid appropriate? If not, explain why not. For example, should there be more spread categories? If so, specify the total number of recommended spread categories and the basis point ranges that should be in each category, and explain why the recommended modifications would be preferable. Should there be fewer spread categories? If so, specify the total number of recommended spread categories and the basis point ranges that should be in each category, and explain why the recommended modifications would be preferable.

5. Would there always be an observable current offered basis point spread for purposes of determining the applicable spread category for a CDS security-based swap? If it could be the case that a CDS security-based swap does not have an observable current offered spread, how should the spread category be determined and how should the rule be modified to require the use of the determined spread category? For example, should the rule require that the nonbank SBSD apply the greatest percentage deduction applicable to the CDS security-based swap based on its maturity (*i.e.,* the deduction prescribed in ''700 or more'' basis points spread category) or another deduction amount?

6. Are the proposed maturity categories for the CDS security-based swap grid appropriate? If not, explain why not. For example, should there be more maturity categories? If so, specify the total number of recommended maturity categories and the time ranges that should be in each category, and explain why the recommended modifications would be preferable. Should there be fewer maturity categories? If so, specify the total number of recommended maturity categories and the time ranges that should be in each category, and explain why the recommended modifications would be preferable.

7. Are the proposed percentage deductions in the CDS security-based swap grid appropriate? If not, explain why not. For example, should the percentage deductions be greater? If so, specify the greater deductions and explain why they would be preferable. Should the percentage deductions be lesser? If so, specify the lesser deductions and explain why it would be preferable.

8. Is the proposed 50% reduced deduction for long CDS security-based swaps appropriate? If not, explain why not. For example, should the amount of the reduced deduction be greater? If so, specify the amount and explain why it would be preferable. Should the amount of the reduced deduction be lesser? If so, specify the lesser amount and explain why it would be preferable.

9. Is the proposed offset and corresponding reduced deduction for net long and short positions where the CDS security-based swaps reference the same obligor or obligation and are in the

[209] Because options are part of the portfolio, the greatest portfolio loss (or gain) would not necessarily occur at the largest potential market move stress points (±) 15%. This is because a portfolio that holds derivative positions that are far out of the money would potentially realize large gains at the greatest market move points as these positions come into the money. Thus, the greatest net loss for a portfolio conceivably could be at any market move stress point. In addition, the Appendix A methodology imposes a minimum charge based on the number of options contracts in a portfolio that applies if the minimum charge is greater than the largest stress point charge. *See* 17 CFR 240.15c3–1a(b)(1)(v)(C)(*2*); paragraph (b)(1)(iv)(C)(*2*) of proposed new Rule 18a–1a. This minimum charge is designed to address issues such as leverage and liquidity risk that may exist even if the market risk of the portfolio is very low as a result of closely-correlated hedging.

[210] *See* proposed new paragraph (c)(2)(vi)(O)(*2*) of Rule 15c3–1; paragraph (c)(1)(vi)(B) of proposed new Rule 18a–1 (incorporating by reference the standardized haircuts in Rule 15c3–1).

[211] *See* 17 CFR 240.15c3–1(c)(2)(vi)(F)(*1*).

[212] *Id.*

[213] *See* 17 CFR 240.15c3–1(c)(2)(vi)(F)(*2*).

[214] *See* 17 CFR 240.15c3–1(c)(2)(vi)(F)(*3*).

same maturity and spread categories appropriate? If not, explain why not.

10. Is the proposed offset and corresponding reduced deduction for net long and short positions where the CDS security-based swaps reference the same obligor or obligation, are in the same spread category, and are in an adjacent maturity category and have maturities within three months of the other maturity category appropriate? If not, explain why not.

11. Is the proposed offset and corresponding reduced deduction for long and short CDS security-based swap positions in the same maturity and spread categories and that reference obligors or obligations of obligors in the same industry sector appropriate? If not, explain why not.

12. Should the rule specify an industry sector classification system? If so, specify the recommended industry sector classification system and explain why it would be useful for the purposes of the standardized haircuts for CDS security-based swaps.

13. If a nonbank SBSD uses its own industry sector classification system, what factors would be relevant in evaluating whether the system is reasonable?

14. Should there be a concentration charge that would apply when the notional amount of the long and short CDS security-based swap positions in the same maturity and spread categories and that reference obligors or obligations of obligors in the same industry sector exceed a certain threshold to account for the potential that long and short positions may not directly offset each other? If so, explain why. If not, explain why not.

15. Is the proposed deduction for a position where a nonbank SBDS is long a bond and long a CDS security-based swap on the same underlying obligor appropriate? If not, explain why not. For example, is the proposed provision that the reduced deduction would apply only if the CDS security-based swap allowed the nonbank SBSD to deliver the bond to satisfy the firm's obligation on the swap appropriate? If not, explain why not. Additionally, is reducing the deduction applicable to the bond by 50% an appropriate reduction level? Should the reduction be less than 50% (*e.g.,* 25%) or greater than 50% (*e.g.,* 75%)?

16. Is the proposed reduced deduction for a position where a nonbank SBDS is short a bond and short a CDS security-based swap on the same underlying bond appropriate? If not, explain why not.

17. Should the Commission propose separate grids for CDS security-based swaps that reference a single obligor or obligation and CDS security-based swaps that reference a narrow based index? If so, how should the two grids differ?

18. Are the proposed standardized haircuts for non-CDS security-based swaps appropriate? If not, explain why not. For example, would the risk characteristics of non-CDS security-based swaps (*e.g.,* price volatility) be similar to the instruments they reference? If not, explain why not.

19. Are there practical issues with treating equity security-based swaps under the Appendix A methodology? If so, describe them. Are there modifications that could be made to the Appendix A methodology to address any practical issues identified? If so, describe the modifications.

20. Are there provisions in Appendix A to Rule 15c3–1 not included in Appendix A to Rule 18a–1 that should be incorporated into the latter rule? If so, identify the provisions and explain why they should be incorporated into Appendix A to Rule 18a–1. For example, should the strategy-based methodology in Appendix A to Rule 15c3–1 be applied to equity security-based swaps? If so, explain why.

21. Are there practical issues with treating debt security-based swaps under the debt maturity grids in Rule 15c3–1? If so, describe them. Are there modifications that could be made to address any practical issues identified? If so, describe the modifications.

iii. VaR Models

The proposed capital requirements for nonbank SBSDs would permit the use of internal VaR models to compute deductions for proprietary securities positions, including security-based swap positions, in lieu of the standardized haircuts. VaR models are used by financial institutions for internal risk management purposes.[215] In addition, VaR models are used to compute market risk charges in international bank capital standards[216] and are permitted by the Commission's rules for ANC broker-dealers and OTC derivatives dealers.[217] Furthermore, the prudential regulators and the CFTC have proposed permitting the use of VaR models in their capital requirements for bank SBSDs, bank swap dealers, and swap dealers.[218] The use of VaR models to calculate market risk charges for security-based swap positions would be subject to the conditions described below.

Broker-dealer SBSDs that are not already ANC broker-dealers would need to obtain approval to operate as ANC broker-dealers to use internal VaR models to compute net capital. Stand-alone SBSDs also would need to obtain Commission approval to use VaR models for this purpose. The requirements for a broker-dealer to apply for approval to operate as an ANC broker-dealer are contained in Appendix E to Rule 15c3–1.[219] Pursuant to these requirements, the applicant must provide the Commission with various types of information about the applicant.[220] A stand-alone SBSD applying for approval to use internal models to compute net capital would be required to provide similar information (though a stand-alone SBSD would not be required to provide certain information relating to its holding company or affiliates that is required of ANC broker-dealer applicants).[221]

[215] *See Alternative Net Capital Requirements Adopting Release,* 69 FR 34428 (The option to use VaR models is ''intended to reduce regulatory costs for broker-dealers by allowing very highly capitalized firms that have developed robust internal risk management practices to use those risk management practices, such as mathematical risk measurement models, for regulatory purposes''); *Net Capital Rule,* Exchange Act Release No. 39456 (Dec. 17, 1997), 62 FR 68011 (Dec. 30, 1997) (''Given the increased use and acceptance of VAR as a risk management tool, the Commission believes that it warrants consideration as a method of computing net capital requirements for broker-dealers.'').

[216] *See, e.g., Amendment to the capital accord to incorporate market risks,* Basel Committee on Banking Supervision (Jan. 1996); 12 CFR part 3; 12 CFR parts 208 and 225; 12 CFR part 325.

[217] *See* 17 CFR 240.15c3–1e; 17 CFR 240.15c3–1f. *See also Alternative Net Capital Requirements Adopting Release,* 69 FR 34428; *OTC Derivatives Dealers,* 63 FR 59362.

[218] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564; *CFTC Capital Proposing Release,* 76 FR 27802.

[219] *See* 17 CFR 240.15c3–1e. The application covers both the use of internal VaR models to compute deductions for proprietary positions and internal credit risk models to compute charges for unsecured receivables relating to OTC derivatives. *Id.* Specifically, the broker-dealer may apply to the Commission for authorization to compute deductions pursuant to Appendix E to Rule 15c3–1 in lieu of computing deductions pursuant to paragraph (c)(2)(vi) (the standardized haircuts) and paragraph (c)(2)(vii) (the 100% deduction for securities with no ready market) of Rule 15c3–1 and to compute deductions for credit risk pursuant to Appendix E for unsecured receivables arising from transactions in OTC derivatives in lieu of computing deductions pursuant to paragraph (c)(2)(iv) of Rule 15c3–1 (the deductions for unsecured receivables). *See* 17 CFR 240.15c3–1e(a). The use of internal credit risk models is discussed below in section II.A.2.b.iv. of this release.

[220] *See Alternative Net Capital Requirements Adopting Release,* 69 FR at 34433.

[221] *See* paragraph (d)(1) of proposed new Rule 18a–1. Appendix E to Rule 15c3–1 requires a broker-dealer applying to become an ANC broker-dealer to provide information about the broker-dealer's ultimate holding company and affiliates. *See* 17 CFR 240.15c3–1e(a)(1)(viii)–(ix) and (a)(2). Consistent with the requirements for OTC derivatives dealers, the proposed application requirements for stand-alone SBSDs seeking

Continued

A broker-dealer applying to become an ANC broker-dealer is required to provide the Commission with, among other things, the following information:

- An executive summary of the information provided to the Commission with its application and an identification of the ultimate holding company of the ANC broker-dealer;[222]
- A comprehensive description of the internal risk management control system of the broker-dealer and how that system satisfies the requirements set forth in Rule 15c3–4;[223]
- A list of the categories of positions that the ANC broker-dealer holds in its proprietary accounts and a brief description of the methods that the ANC broker-dealer will use to calculate deductions for market and credit risk on those categories of positions;[224]
- A description of the mathematical models to be used to price positions and to compute deductions for market risk, including those portions of the deductions attributable to specific risk, if applicable, and deductions for credit risk; a description of the creation, use, and maintenance of the mathematical models; a description of the ANC broker-dealer's internal risk management controls over those models, including a description of each category of persons who may input data into the models; if a mathematical model incorporates empirical correlations across risk categories, a description of the process for measuring correlations; a description of the backtesting procedures the ANC broker-dealer will use to backtest the mathematical model used to calculate maximum potential exposure; a description of how each mathematical model satisfies the applicable qualitative and quantitative requirements set forth in paragraph (d) of Appendix E to Rule 15c3–1; and a statement describing the extent to which each mathematical model used to compute deductions for market and credit risk will be used as part of the risk analyses and reports presented to senior management;[225]
- If the ANC broker-dealer is applying to the Commission for approval to use scenario analysis to calculate deductions for market risk for certain positions, a list of those types of positions, a description of how those deductions will be calculated using scenario analysis, and an explanation of why each scenario analysis is appropriate to calculate deductions for market risk on those types of positions;[226]
- A description of how the ANC broker-dealer will calculate current exposure;[227]
- A description of how the ANC broker-dealer will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable;[228]
- For each instance in which a mathematical model used by the ANC broker-dealer to calculate a deduction for market risk or to calculate maximum potential exposure for a particular product or counterparty differs from the mathematical model used by the ultimate holding company of the ANC broker-dealer to calculate an allowance for market risk or to calculate maximum potential exposure for that same product or counterparty, a description of the difference(s) between the mathematical models;[229] and
- Sample risk reports that are provided to the persons at the ultimate holding company who are responsible for managing group-wide risk and that will be provided to the Commission pursuant to Rule 15c3–1g.[230]

The Commission may request that a broker-dealer applying to operate as an ANC broker-dealer supplement its application (''ANC application'') with other information relating to the internal risk management control system, mathematical models, and financial position of the broker-dealer.[231] A broker-dealer's ANC application and all submissions in connection with the ANC application are accorded confidential treatment, to the extent permitted by law.[232] If any information in an ANC application is found to be or becomes inaccurate before the Commission approves the application, the broker-dealer must notify the Commission promptly and provide the Commission with a description of the circumstances in which the information was inaccurate along with updated, accurate information.[233] The

approval to use internal models would not require the submission of the information about the firm's ultimate holding company and affiliates required in paragraphs (a)(1)(viii)–(ix) and (a)(2)(i)–(xi) of Appendix E to Rule 15c3–1. *Compare* 17 CFR 240.15c3–1e(a)(1) and (a)(2), *with* paragraph (d)(1) of proposed new Rule 18a–1 and 17 CFR 240.15c3–1f(a). This additional information may be more appropriate for a broker-dealer applying to operate as an ANC broker-dealer because of its ability to engage in wider ranges of activities than a stand-alone nonbank SBSD, such as engaging in a general securities business. The information about the ultimate holding company and affiliates is designed to help ensure the Commission can monitor activities of the holding company and affiliates that could negatively impact the financial well-being of the broker-dealer. *See Alternative Net Capital Requirements Adopting Release,* 69 FR at 34430.

[222] *See* 17 CFR 240.15c3–1e(a)(1)(i). A stand-alone SBSD also would be required to provide this information in an application to use internal models. *See* paragraph (d)(1)(i)(A) of proposed new Rule 18a–1.

[223] *See* 17 CFR 240.15c3–1e(a)(1)(ii). A stand-alone SBSD also would be required to provide this information in an application to use internal models. *See* paragraph (d)(1)(i)(B) of proposed new Rule 18a–1. As discussed below in section II.A.2.c. of this release, ANC broker-dealers are required to comply with Rule 15c3–4, and to provide this information in an application to use internal models. *See* 17 CFR 240.15c3–1e(a)(1)(ii), 17 CFR 240.15c3–1(a)(7)(iii) and 17 CFR 240.15c3–4. A nonbank SBSD that does not use internal models also would be required to comply with Rule 15c3–4, but would not have to provide information to the Commission unless it determined to apply to the Commission to use internal models. *See* paragraph (g) of proposed new Rule 18a–1 and section II.A.2.c. of this release discussing this requirement.

[224] *See* 17 CFR 240.15c3–1e(a)(1)(iii). A stand-alone SBSD also would be required to provide this information in an application to use internal models. *See* paragraph (d)(1)(i)(C) of proposed new Rule 18a–1.

[225] *See* 17 CFR 240.15c3–1e(a)(1)(iv). A stand-alone SBSD also would be required to provide this information in an application to use internal models. *See* paragraph (d)(1)(i)(D) of proposed new Rule 18a–1.

[226] *See* 17 CFR 240.15c3–1e(a)(1)(v). A stand-alone SBSD also would be required to provide this information in an application to use internal models. *See* paragraph (d)(1)(i)(E) of proposed new Rule 18a–1. As discussed below, ANC broker-dealers can use scenario analysis in certain cases to determine deductions for some positions.

[227] *See* 17 CFR 240.15c3–1e(a)(1)(vi). A stand-alone SBSD also would be required to provide this information in an application to use internal models. *See* paragraph (d)(1)(i)(F) of proposed new Rule 18a–1.

[228] *See* 17 CFR 240.15c3–1e(a)(1)(vii). A stand-alone SBSD also would be required to provide this information in an application to use internal models. *See* paragraph (d)(1)(i)(G) of proposed new Rule 18a–1. As discussed below in section II.A.2.b.iv. of this release, internal credit ratings are used to compute the credit risk charge.

[229] *See* 17 CFR 240.15c3–1e(a)(2)(xi). A stand-alone SBSD also would be required to provide this information in an application to use internal models. *See* paragraph (d)(1)(i)(H) of proposed new Rule 18a–1.

[230] *See* 17 CFR 240.15c3–1e(a)(2)(xiii). A stand-alone SBSD would be required to provide similar information in an application to use internal models. *See* paragraph (d)(1)(i)(I) of proposed new Rule 18a–1. The proposed requirement for stand-alone SBSDs to provide this information refers to sample risk reports that are provided to ''management'' as opposed to the ''ultimate holding company.'' *Id.* As a practical matter, the two provisions would achieve the same result; namely, the submission of sample reports that are provided to senior levels of the firm. However, because the stand-alone SBSD application provisions do not require information about holding companies and affiliates, the proposed text of the rule refers to ''management.''

[231] *See* 17 CFR 240.15c3–1e(a)(4). A similar provision would apply to stand-alone SBSDs applying to use internal models. *See* paragraph (d)(2) of proposed new Rule 18a–1.

[232] *See* 17 CFR 240.15c3–1e(a)(5). *See also* 5 U.S.C. 552; *Alternative Net Capital Requirements Adopting Release,* 69 FR at 34433 (discussing confidential treatment of ANC applications). A similar provision would apply to information submitted by stand-alone SBSDs applying to use internal models. *See* paragraph (d)(3) of proposed new Rule 18a–1.

[233] *See* 17 CFR 240.15c3–1e(a)(6). A similar provision would apply to stand-alone SBSDs applying to use internal models. *See* paragraph (d)(4) of proposed new Rule 18a–1.

Commission may approve, in whole or in part, an ANC application or an amendment to the application, subject to any conditions or limitations the Commission may require if the Commission finds the approval to be necessary or appropriate in the public interest or for the protection of investors.[234]

As part of the ANC application approval process, the Commission staff reviews the operation of the broker-dealer's VaR model, including a review of associated risk management controls and the use of stress tests, scenario analyses, and back-testing.[235] As part of this process and on an ongoing basis, the broker-dealer applicant is required to demonstrate to the Commission that the VaR model reliably accounts for the risks that are specific to the types of positions the broker-dealer intends to include in the model computations. During the review, the Commission assesses the quality, rigor, and adequacy of the technical components of the VaR model and of related model governance processes. Stand-alone SBSDs applying for approval to use internal models to compute net capital would be subject to similar reviews of their VaR models as part of the application process.

After an ANC application is approved, an ANC broker-dealer is required to amend and submit to the Commission for approval its ANC application before materially changing its VaR model or its internal risk management control system.[236] Further, an ANC broker-dealer is required to notify the Commission 45 days before it ceases using a VaR model to compute net capital.[237] Finally, the Commission, by order, can revoke an ANC broker-dealer's ability to use a VaR model to compute net capital if the Commission finds that the ANC broker-dealer's use of the model is no longer necessary or appropriate in the public interest or for the protection of investors.[238] In this case, the broker-dealer would need to revert to using the standardized haircuts for all positions.

An ANC broker-dealer must comply with certain qualitative and quantitative requirements set forth in Appendix E to Rule 15c3–1.[239] A stand-alone SBSD approved to use a VaR model would be subject to the same qualitative and quantitative requirements.[240] In this regard, VaR models estimate the maximum potential loss a portfolio of securities and other instruments would be expected to incur over a fixed time period at a certain probability level. The model utilizes historical market data to generate potential values of a portfolio of positions taking into consideration the observed correlations between different types of assets.

The qualitative requirements in Appendix E to Rule 15c3–1 specify, among other things, that: (1) Each VaR model must be integrated into the ANC broker-dealer's daily internal risk management system;[241] (2) each VaR model must be reviewed periodically by the firm's internal audit staff, and annually by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*);[242] and (3) the VaR measure computed by the model must be multiplied by a factor of at least three but potentially a greater amount based on the number of exceptions to the measure resulting from quarterly back-testing exercises.[243]

The quantitative requirements specify that the VaR model of the ANC broker-dealer must, among other things: (1) Use a 99%, one-tailed confidence level with price changes equivalent to a ten-business-day movement in rates and prices;[244] (2) use an effective historical observation period of at least one year;[245] (3) use historical data sets that are updated at least monthly and are reassessed whenever market prices or volatilities change significantly;[246] and (4) take into account and incorporate all significant, identifiable market risk factors applicable to positions of the ANC broker-dealer, including risks arising from non-linear price characteristics, empirical correlations within and across risk factors, spread risk, and specific risk for individual positions.[247]

The deduction an ANC broker-dealer must take to tentative net capital in lieu of the standardized haircuts is an amount equal to the sum of four charges.[248] The first is a portfolio market risk charge for all positions that are included in the ANC broker-dealer's VaR models (*i.e.,* the amount measured by each VaR model multiplied by a factor of at least three).[249] The second charge is a *specific risk* charge for positions where specific risk was not captured in the VaR model.[250] The third

[234] *See* 17 CFR 240.15c3–1e(a)(7). A similar provision would apply to applications of stand-alone SBSDs applying to use internal models. *See* paragraph (d)(5) of proposed new Rule 18a–1.

[235] The Commission also reviews the broker-dealer's credit risk model.

[236] *See* 17 CFR 240.15c3–1e(a)(8). This requirement also applies to material changes to the ANC broker-dealer's internal credit risk model. *Id.* A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(6) of proposed new Rule 18a–1.

[237] *See* 17 CFR 240.15c3–1(a)(10). This requirement also applies to the ANC broker-dealer's internal credit risk model. *Id.* A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(7) of proposed new Rule 18a–1.

[238] *See* 17 CFR 240.15c3–1e(a)(11). This requirement also applies to the ANC broker-dealer's internal credit risk model. *Id.* A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(8) of proposed new Rule 18a–1.

[239] *See* 17 CFR 15c3–1e(d).

[240] *Compare* 17 CFR 15c3–1e(d), *with* paragraph (d)(9) of proposed new Rule 18a–1.

[241] *See* 17 CFR 240.15c3–1e(d)(1)(i). A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(9)(i)(A) of proposed new Rule 18a–1.

[242] *See* 17 CFR 240.15c3–1e(d)(1)(ii). The annual review must be conducted in accordance with procedures agreed upon by the broker-dealer and the registered public accounting firm conducting the review. A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(9)(i)(B) of proposed new Rule 18a–1.

[243] *See* 17 CFR 240.15c3–1e(d)(1)(iii). A back-testing exception occurs when the ANC broker-dealer's actual one-day loss exceeds the amount estimated by its VaR model. *See, e.g., Supervisory framework for the use of ''backtesting'' in conjunction with the internal models approach to market risk capital requirements,* Basel Committee on Banking Supervision (Jan. 1996) (''The essence of all backtesting efforts is the comparison of actual trading results with model-generated risk measures. If this comparison is close enough, the backtest raises no issues regarding the quality of the risk measurement model. In some cases, however, the comparison uncovers sufficient differences that problems almost certainly must exist, either with the model or with the assumptions of the backtest. In between these two cases is a grey area where the test results are, on their own, inconclusive.''). Depending on the number of back-testing exceptions, the ANC broker-dealer may need to increase the market risk multiplier to 3.40, 3.50, 3.65, 3.75, 3.85, or 4.00. *Id.* Increasing the multiplier increases the deduction amount, which in turn is designed to account for a model that is producing less accurate measures. The same multiplier provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(9)(i)(C) of proposed new Rule 18a–1.

[244] *See* 17 CFR 240.15c3–1e(d)(2)(i). This means the potential loss measure produced by the model is a loss that the portfolio could experience if it were held for ten trading days and that this potential loss amount would be exceeded only once every 100 trading days. A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(9)(ii)(A) of proposed new Rule 18a–1.

[245] *See* 17 CFR 240.15c3–1e(d)(2)(iii). A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(9)(ii)(C) of proposed new Rule 18a–1.

[246] *See* 17 CFR 240.15c3–1e(d)(2)(iii). A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(9)(ii)(C) of proposed new Rule 18a–1.

[247] *See* 17 CFR 240.15c3–1e(d)(2)(iv). A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (d)(9)(ii)(D) of proposed new Rule 18a–1.

[248] *See* 17 CFR 240.15c3–1e(b). A similar provision would apply to stand-alone SBSDs approved to use internal models. *See* paragraph (e)(1) of proposed new Rule 18a–1.

[249] *See* 17 CFR 240.15c3–1e(b)(1). A similar charge would apply to stand-alone SBSDs in determining their deduction amount. *See* paragraph (e)(1)(i) of proposed new Rule 18a–1.

[250] *See* 17 CFR 240.15c3–1e(b)(2). *Specific risk* is the risk that a security price will change for reasons

Continued

charge is for positions not included in the VaR model where the ANC broker-dealer is approved to determine a charge using scenario analysis.[251] The fourth charge is determined by applying the standardized haircuts for all other positions.[252]

Finally, ANC broker-dealers are subject to on-going supervision with respect to their internal risk management, including their use of VaR models.[253] In this regard, the Commission staff meets regularly with senior risk managers at each ANC broker-dealer to review the risk analytics prepared for the firm's senior management. These reviews focus on the performance of the risk measurement infrastructure, including statistical models, risk governance issues such as modifications to and breaches of risk limits, and the management of outsized risk exposures. In addition, Commission staff and personnel from an ANC broker-dealer hold regular meetings focused on financial results, the management of the firm's balance sheet, and, in particular, the liquidity of the balance sheet. The Commission staff also monitors the performance of the ANC broker-dealer's internal models through regular reports generated by the firms for their internal risk management purposes (backtesting, stress test, and other monthly risk reports) and discussions with firm personnel (scheduled and *ad hoc*).[254] Material changes to the internal models are also subject to review and approval.[255] Stand-alone SBSDs approved to use internal models to compute net capital would be subject to similar monitoring and reviews.

Request for Comment

The Commission generally requests comment on the proposed requirements for using VaR models to compute net capital. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Would VaR models appropriately account for the risks of security-based swaps? If not, explain why not. For example, do the characteristics of security-based swaps make it more difficult to measure their market risk using VaR models than it is to measure the market risk of other types of securities using VaR models? If so, explain why.

2. Are the application requirements in Appendix E to Rule 15c3–1 an appropriate model for the application requirements in proposed new Rule 18a–1? If not, explain why not.

3. Are there provisions in the application requirements in Appendix E to Rule 15c3–1 not incorporated into proposed new Rule 18a–1 that should be included in the proposed rule, such as information regarding the ultimate holding company of the nonbank SBSD? If so, identify the provisions and explain why they should be incorporated into the proposed rule.

4. Is the review process for ANC applications an appropriate model for the review process for stand-alone SBSDs seeking approval to use internal models to compute net capital? If not, explain why not.

5. Are there ways to facilitate the timely review of applications from nonbank SBSDs to use internal models if a large number of applications are filed at the same time? For example, could a more limited review process be used if a banking affiliate of a nonbank SBSD has been approved by a prudential regulator to use the same model the nonbank SBSD intends to use? If so, what conditions should attach to such approval? Are there other indicia of the reliability of such models that could be relied on?

6. Are the qualitative requirements in Appendix E to Rule 15c3–1 an appropriate model for the qualitative requirements in proposed new Rule 18a–1?

7. More generally, are the qualitative requirements in Appendix E to Rule 15c3–1 appropriate for VaR models that will include security-based swaps? If not, explain why not. For example, are there additional or alternative qualitative requirements that should be required to address the unique risk characteristics of security-based swaps? If so, describe them and explain why they would be appropriate qualitative requirements.

8. Are the quantitative requirements in Appendix E to Rule 15c3–1 an appropriate model for the quantitative requirements in proposed new Rule 18a–1? If not, explain why not.

9. More generally, are the quantitative requirements in Appendix E to Rule 15c3–1 appropriate for VaR models that will include security-based swaps? If not, explain why not. For example, are there additional or alternative quantitative requirements that should be required to address the unique risk characteristics of security-based swaps? If so, describe them and explain why they would be preferable.

10. Are the components of the deduction an ANC broker-dealer must take from tentative net capital under Appendix E to Rule 15c3–1 an appropriate model for the components of the deduction a stand-alone SBSD approved to use internal models would be required to take from tentative net capital under proposed new Rule 18a–1? If not, explain why not.

11. Should the Commission employ the same type of on-going monitoring process used for ANC broker-dealers to monitor stand-alone SBSDs using internal models? If not, explain why not.

iv. Credit Risk Charges

Obtaining collateral is one of the ways dealers in OTC derivatives manage their credit risk exposure to OTC derivatives counterparties.[256] Collateral may be provided to cover the amount of the

unrelated to broader market moves. The market risk charge is designed to address the risk that the value of a portfolio of trading book assets will decline as a result of a broad move in market prices or interest rates. For example, the potential that the S&P 500 index will increase or decrease on the next trading day creates market risk for a portfolio of equity securities positions (longs, shorts, options, and OTC derivatives) and the potential that interest rates will increase or decrease on the next trading day creates market risk for a portfolio of fixed-income positions (longs, shorts, options, and OTC derivatives). The specific risk charge is designed to address the risk that the value of an individual position would decline for reasons unrelated to a broad movement of market prices or interest rates. For example, specific risk includes the risk that the value of an equity security will decrease because the issuer announces poor earnings for the previous quarter or the value of a debt security will decrease because the issuer's credit rating is lowered. The Commission is proposing a similar charge that would apply to stand-alone SBSDs in determining their deduction amount. *See* paragraph (e)(1)(ii) of proposed new Rule 18a–1.

[251] *See* 17 CFR 240.15c3–1e(b)(3). A similar charge would apply to stand-alone SBSDs in determining their deduction amount. *See* paragraph (e)(1)(iii) of proposed new Rule 18a–1.

[252] *See* 17 CFR 240.15c3–1e(b)(4). A similar charge would apply to stand-alone SBSDs in determining their deduction amount. *See* paragraph (e)(1)(iv) of proposed new Rule 18a–1.

[253] More detailed descriptions of the Commission's ANC broker-dealer program are available on the Commission's Web site at *http://www.sec.gov/divisions/marketreg/bdriskoffice.htm* and *http://www.sec.gov/divisions/marketreg/bdaltnetcap.htm*. The ultimate holding companies of the ANC broker-dealers also are subject to monitoring by Commission staff.

[254] In addition to regularly scheduled meetings, communications with ANC broker-dealers may increase in frequency, dependent on existing market conditions, and at times, may involve daily, weekly or other *ad hoc* calls or meetings.

[255] *See* 17 CFR 240.15c3–1e(a)(8).

[256] *See, e.g.,* International Swaps and Derivatives Association, Inc. (''ISDA''), *Market Review of OTC Derivative Bilateral Collateralization Practices,* Release 2.0 (Mar. 1, 2010), available at *http://www.isda.org/c_and_a/pdf/Collateral-Market-Review.pdf* (''*Market Review of OTC Derivative Bilateral Collateralization Practices*''); Committee on Payment and Settlement Systems and the Euro-currency Standing Committee of the Central Banks of the Group of Ten countries, *OTC Derivatives: Settlement Procedures And Counterparty Risk Management,* (Sept. 1998), available at *http://www.bis.org/publ/ecsc08.pdf* (''*OTC Derivatives: Settlement Procedures And Counterparty Risk Management*'').

current exposure of the dealer to the counterparty.[257] In this case, the collateral is designed to protect the dealer from losing the positive market value of the OTC contract if the counterparty defaults.[258] Collateral also may be provided to cover an amount in excess of the current exposure (sometimes referred to as ''residual exposure'') of the dealer to the counterparty.[259] In this case, the collateral is designed to protect the dealer from potential future credit risk exposure to the counterparty (''potential future exposure'').[260] This risk, among other things, is that the current exposure may increase in the future and the counterparty will default on the obligation to provide additional collateral to cover the increase or an increase in the amount of current exposure will occur after the counterparty defaults and is no longer providing collateral.[261]

As discussed below in section II.B. of this release, the margin rule for non-cleared security-based swaps—proposed new Rule 18a–3—would require a nonbank SBSD to collect collateral from a counterparty to cover current and potential future exposure to the counterparty.[262] However, under the rule, a nonbank SBSD would not be required to collect collateral from a *commercial end user* to cover current and potential future exposure to the *commercial end user.*[263] This proposed exception to collecting collateral from *commercial end users* is intended to address concerns that have been expressed by these entities and others that the imposition of margin requirements on commercial companies that use derivatives to mitigate business risks could disrupt their ability to enter into hedging transactions by making it prohibitively expensive.[264] At the same time, because collecting collateral is an important means of mitigating risk, nonbank SBSDs would be required to take a 100% deduction from net worth if collateral is not collected from a *commercial end user* to cover the amount of the nonbank SBSD's uncollateralized current exposure.[265] In addition, as discussed below in section II.A.2.b.v. of this release, nonbank SBSDs would be required to take a capital charge equal to the amount that the potential future exposure to the *commercial end user*—as measured under proposed new Rule 18a–3—is uncollateralized.[266] As an alternative to taking these 100% capital charges for uncollateralized current and potential future exposure to a *commercial end user,* an ANC broker-dealer and a stand-alone SBSD using internal models could take a credit risk charge using a methodology in Appendix E to Rule 15c3–1.[267] This charge would be designed to balance the concern of *commercial end users* that delivering collateral to nonbank SBSDs could disrupt their ability to enter into hedging transactions with the need for nonbank SBSDs to account for their credit risk to *commercial end users.*

ANC broker-dealers currently are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (*i.e.,* they can add back the amount of the uncollateralized current exposure).[268] Instead of the 100% deduction that applies to most unsecured receivables under Rule 15c3–1, ANC broker-dealers are permitted to take a credit risk charge based on the uncollateralized credit exposure to the counterparty.[269] In most cases, the credit risk charge is significantly less than a 100% deduction, since it is a percentage of the amount of the receivable that otherwise would be deducted in full. ANC broker-dealers are permitted to use this approach because they are required to implement processes for analyzing credit risk to OTC derivative counterparties and to develop mathematical models for estimating credit exposures arising from OTC derivatives transactions and determining risk-based capital charges for those exposures.[270] Under the current requirements, this approach is used for uncollateralized OTC derivatives receivables from all types of counterparties.[271] For the reasons discussed below, this treatment would be narrowed under the proposed capital requirements for ANC broker-dealers and stand-alone SBSDs using internal models so that it would apply only to uncollateralized receivables from *commercial end users* arising from security-based swaps (*i.e.,* uncollateralized receivables from other types of counterparties would be subject to the 100% deduction from net worth).[272]

[257] *See, e.g.,* ISDA, *Independent Amounts,* Release 2.0 (Mar. 1, 2010) (''*Independent Amounts*''). The current exposure is the amount that the counterparty would be obligated to pay the nonbank SBSD if all the OTC derivatives contracts with the counterparty were terminated (*i.e.,* the net positive value of the OTC contracts to the nonbank SBSD and the net negative value of the OTC contracts to the counterparty). The amount payable on the OTC derivatives contracts (the positive value) is determined by marking-to-market the OTC derivatives contracts and netting contracts with a positive value against contracts with a negative value. The market value of an OTC derivatives contract also is referred to as the *replacement value* of the contract as that is the amount the nonbank SBSD would need to pay to enter into an identical contract with a different counterparty.

[258] *Id.* at 2 (''The commercial reason for basing the collateral requirement around the Exposure is that this represents an approximation of the amount of credit default loss that would occur between the parties if one were to default.'').

[259] *Id.* at 4.

[260] *Id.* at 6 (''The underlying commercial reason behind Independent Amounts is the desire to create a ''cushion'' of additional collateral to protect against certain risk * * *'').

[261] *Id.*

[262] *See* proposed new Rule 18a–3.

[263] *See* paragraph (c)(1)(iii)(A) of proposed new Rule 18a–3. As discussed in section II.B. of this release, proposed new Rule 18a–3 would contain three other exceptions to the requirements in the rule to collect and hold collateral. *See* paragraphs (c)(1)(iii)(B), (C), and (D) of proposed new Rule 18a–3. The proposed alternative credit risk charge discussed in this section of the release would not apply to these other exceptions.

[264] *See, e.g.,* letter from the Honorable Debbie Stabenow, Chairman, Committee on Agriculture, Nutrition and Forestry, U.S. Senate, the Honorable Frank D. Lucas, Chairman, Committee on Agriculture, U.S. House of Representatives, the Honorable Tim Johnson, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and the Honorable Spencer Bachus, Chairman, Committee on Financial Services, U.S. House of Representatives to Secretary Timothy Geithner, Department of Treasury, Chairman Gary Gensler, CFTC, Chairman Ben Bernanke, Federal Reserve Board, and Chairman Mary Schapiro, Commission (Apr. 6, 2011); letter from the Honorable Christopher Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and the Honorable Blanche Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, to the Honorable Barney Frank, Chairman, Financial Services Committee, U.S. House of Representatives, and the Honorable Collin Peterson, Chairman, Committee on Agriculture, U.S. House of Representatives (June 30, 2010); 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Lincoln). *See also* letter from Coalition for Derivatives End-Users to David A. Stawick, Secretary, CFTC (July 11, 2011); letter from Paul Cicio, President, Industrial Energy Users of America, to David A. Stawick, Secretary, CFTC (July 11, 2011); letter from Coalition for Derivatives End-Users to Elizabeth Murphy, Secretary, Commission and David A. Stawick, Secretary, CFTC (Sept. 10, 2010).

[265] *See* 17 CFR 240.15c3–1(c)(2)(iv)(B) (which requires a broker-dealer—and would require a broker-dealer SBSD—to deduct unsecured and partly secured receivables); paragraph (c)(1)(iii)(B) of proposed new Rule 18a–1 (which would contain an analogous provision for stand-alone SBSDs).

[266] *See* proposed new paragraph (c)(2)(xiv) of Rule 15c3–1; paragraph (c)(1)(viii)(B)(*1*) of proposed Rule 18a–1.

[267] *See* proposed amendments to paragraph (a)(7) of Rule 15c3–1; paragraph (a)(2) of proposed new Rule 18a–1.

[268] *See* 17 CFR 240.15c3–1e(c). OTC derivatives dealers are permitted to treat such uncollateralized receivables in a similar manner. *See* 17 CFR 240.15c3–1f.

[269] *See* 17 CFR 240.15c3–1e(c); 17 CFR 240.15c3–1(a)(7).

[270] *Id.*

[271] *Id.* While the requirements permit this treatment for unsecured receivables from all types of counterparties, the amount of the credit risk charge—as discussed below—depends on the creditworthiness of the counterparty. *Id.*

[272] *See* proposed amendments to paragraphs (a) and (c) of Rule 15c3–1e.

The current requirements for determining risk-based capital charges for credit exposures are prescribed in Appendix E to Rule 15c3–1. These requirements are based on a method of computing capital charges for credit risk exposures in the international capital standards for banking institutions. In general terms, credit risk is the risk of loss arising from a borrower or counterparty's failure to meet its obligations in accordance with agreed terms, including, for example, by failing to make a payment of cash or delivery of securities. The considerations that inform an entity's assessment of a counterparty's credit risk therefore are broadly similar across the various relationships that may arise between the dealer and the counterparty. Accordingly, the methodology in Appendix E to Rule 15c3–1 should be a reasonable model for determining risk-based capital charges for credit exposures whether the entity in question is an ANC broker-dealer or a stand-alone SBSD using models. Similarly, because credit risk arises regardless of the number or size of transactions, the methodology should apply in a consistent manner whether an entity deals exclusively in OTC derivatives, maintains a significant book of such derivatives, or only engages in one from time to time.

As discussed above in section II.A.2.b.i. of this release, the capital standard in Rule 15c3–1 is a net liquid assets test. The rule imposes this test by requiring a broker-dealer to deduct all illiquid assets, including most unsecured receivables.[273] The goal is to require the broker-dealer to hold more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities. The rule requires a 100% deduction for most types of unsecured receivables because these assets cannot be readily converted into cash to provide immediate liquidity to the broker-dealer.[274] FOCUS Report data and Commission staff experience with supervising the ANC broker-dealers indicates that ANC broker-dealers have not engaged in a large volume of OTC derivatives transactions since these rules were adopted in 2004. Therefore, they have not had significant amounts of unsecured receivables that could be subject to the credit risk charge provisions in Appendix E to Rule 15c3–1. However, when the Dodd-Frank Act's OTC derivatives reforms are implemented and become effective, ANC broker-dealers could significantly increase the amount of the receivables these firms have relating to OTC derivatives. This development could adversely impact the liquidity of the ANC broker-dealers to the extent exposures to OTC derivatives are not collateralized.

For these reasons, ANC broker-dealers (including broker-dealer SBSDs that are approved to use internal models) would be required to treat uncollateralized receivables from counterparties arising from security-based swaps like most other types of unsecured receivables (*i.e.,* subjecting them to a 100% deduction from net worth) *except* when the counterparty is a *commercial end user.* In the case of a *commercial end user,* the ANC broker-dealer would be permitted to continue to take a credit risk charge in lieu of the 100% deduction.[275] Stand-alone SBSDs that are approved to use internal models also would be permitted to take a credit risk charge for uncollateralized receivables arising from security-based swaps with (and only with) *commercial end users* in lieu of the 100% deduction.[276]

Under the proposed capital requirements for nonbank SBSDs, this credit risk charge for a *commercial end user* could serve as an alternative to the proposed capital charge in lieu of collecting collateral to cover potential future exposure.[277] The proposed capital charge in lieu of margin is designed to address situations where a nonbank SBSD does not collect sufficient (or any) collateral to cover potential future exposure relating to cleared and non-cleared security-based swaps.[278] This situation may arise with respect to counterparties to non-cleared security-based swaps that are *commercial end users* because proposed new Rule 18a–3 would not require nonbank SBSDs to collect collateral from them to cover either current or potential future exposure.[279]

The proposed method for calculating the credit risk charge for *commercial end users* would be the same method ANC broker-dealers currently are permitted to use for all OTC derivatives counterparties.[280] A stand-alone SBSD approved to use internal models would use the same method.[281] Under this method, the credit risk charge is the sum of three calculated amounts: (1) A counterparty exposure charge; (2) a concentration charge if the current exposure to a single counterparty exceeds certain thresholds; and (3) a portfolio concentration charge if aggregate current exposure to all counterparties exceeds certain thresholds.[282]

The first component of the credit risk charge is the counterparty exposure charge.[283] An ANC broker-dealer must determine an exposure charge for each OTC derivatives counterparty. The first component of the credit risk charge is the aggregate of the exposure charges across all counterparties. The exposure charge for a counterparty that is insolvent, in a bankruptcy proceeding, or in default of an obligation on its senior debt, is the net replacement value of the OTC derivatives contracts with the counterparty (*i.e.,* the net amount of the uncollateralized current exposure to the counterparty).[284] The counterparty exposure charge for all other counterparties is the *credit equivalent amount* of the ANC broker-dealer's exposure to the counterparty multiplied by an applicable credit risk weight factor and then multiplied by 8%.[285] The *credit equivalent amount* is the sum of the ANC broker-dealer's: (1) Maximum potential exposure (''MPE'') to the counterparty multiplied by a back-testing determined factor; and (2) current exposure to the counterparty.[286]

[273] *See* 17 CFR 240.15c3–1(c)(2)(iv).

[274] *See Interpretation Guide to Net Capital Computation for Brokers and Dealers,* 32 FR at 858.

[275] *See* proposed amendments to paragraphs (a) and (c) of Rule 15c3–1e.

[276] *See* paragraph (e)(2) of proposed new Rule 18a–1.

[277] *See* proposed new paragraph (c)(2)(xiv) of Rule 15c3–1; paragraph (c)(1)(viii)(B)(*1*) of proposed Rule 18a–1.

[278] *Id.*

[279] *See* paragraph (c)(1)(iii)(A) of proposed new Rule 18a–3.

[280] *See* 17 CFR 240.15c3–1e(c); paragraph (e)(2) of proposed new Rule 18a–1.

[281] *See* paragraph (e)(2) of proposed new Rule 18a–1. While this discussion focuses on the application of the method in the context of ANC broker-dealers, the same method would be used by stand-alone SBSDs for the reasons described above, in particular the fact that credit risk exposure should not vary materially depending on whether an entity is a broker-dealer SBSD or a stand-alone SBSD.

[282] 17 CFR 240.15c3–1e(c).

[283] 17 CFR 240.15c3–1e(c)(1). A stand-alone SBSD approved to use internal models would be required to take an identical credit risk charge for this type of counterparty. *See* paragraph (e)(2)(i) of proposed new Rule 18a–1.

[284] *See* 17 CFR 240.15c3–1e(c)(1)(i). In other words, the uncollateralized receivable is deducted in full. A stand-alone SBSD approved to use internal models would take an identical credit risk charge for this type of counterparty. *See* paragraph (e)(2)(i)(A) of proposed new Rule 18a–1.

[285] *See* 17 CFR 240.15c3–1e(c)(1)(ii). A stand-alone SBSD approved to use internal models would take an identical credit risk charge for this type of counterparty. *See* paragraph (e)(2)(i)(B) of proposed new Rule 18a–1. The 8% multiplier is consistent with the calculation of credit risk in the OTC derivatives dealers rules and with the Basel Standard, and is designed to dampen leverage to help ensure that the firm maintains a safe level of capital. *See Alternative Net Capital Requirements Adopting Release,* 69 FR at 34436, note 42.

[286] *See* 17 CFR 240.15c3–1e(c)(4)(i). The amount of the factor is based on backtesting exceptions. A stand-alone SBSD approved to use internal models

The MPE amount is a charge to address potential future exposure and is calculated using the ANC broker-dealer's VaR model as applied to the counterparty's positions after giving effect to a netting agreement with the counterparty, taking into account collateral received from the counterparty, and taking into account the current replacement value of the counterparty's positions.[287] The current exposure amount is the current replacement value of the counterparty's positions after giving effect to a netting agreement with the counterparty and taking into account collateral received from the counterparty.[288]

A collateral agreement gives the dealer the right of recourse to an asset or assets that can be sold or the value of which can be applied in the event the counterparty defaults on an obligation arising from an OTC derivatives contract between the dealer and the counterparty.[289] Collateral ''ideally'' is ''an asset of stable and predictable value, an asset that is not linked to the value of the transaction in any way and an asset that can be sold quickly and easily if the need arises.''[290] Appendix E to Rule 15c3–1 sets forth requirements for taking account of collateral in determining the MPE and *current exposure* amounts.[291] These requirements are designed to require collateral that meets the characteristics noted above. The requirements, among other things, include that the collateral is: (1) Marked-to-market each day; (2) subject to a daily margin maintenance requirement;[292] (3) in the ANC broker-dealer's possession and control; (4) liquid and transferable; (5) capable of being liquidated promptly without intervention of any other party; (6) subject to a legally enforceable collateral agreement; (7) not comprised of securities issued by the counterparty or a party related to the ANC broker-dealer or the counterparty; (8) comprised of instruments that can be included in the ANC broker-dealer's VaR model; and (9) not used in determining the credit rating of the counterparty.[293]

Appendix E to Rule 15c3–1 sets forth certain minimum requirements for giving effect to netting agreements[294] when determining the MPE and current exposure amounts.[295] Specifically, an ANC broker-dealer may include the effect of a netting agreement that allows the netting of gross receivables from and gross payables to a counterparty upon default of the counterparty if:

- The netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings;
- The gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and
- For internal risk management purposes, the ANC broker-dealer monitors and controls its exposure to the counterparty on a net basis.[296]

These requirements are designed to ensure that the netting agreement between the ANC broker-dealer and the counterparty permits the ANC broker-dealer to reduce the receivables and payables between the two entities to a single net payment obligation.

The counterparty exposure charge is the sum of the MPE and current exposure amounts multiplied by an applicable credit risk weight factor and then multiplied by 8%.[297] Appendix E to Rule 15c3–1 prescribes three standardized credit risk weight factors (20%, 50%, and 150%) and, as an alternative, permits an ANC broker-dealer with Commission approval to use internal methodologies to determine appropriate credit risk weights to apply to counterparties.[298] A higher percentage credit risk weight factor results in a larger counterparty exposure charge amount. Moreover, because the counterparty exposure charge is designed to require the ANC broker-dealer to hold capital to address the firm's credit risk exposure to the counterparty, the selection of the appropriate risk weight factor to use for a given counterparty is based on an assessment of the creditworthiness of the counterparty. ANC broker-dealers are permitted to use internally derived credit ratings to select the appropriate risk weight factor.[299]

would determine the credit equivalent amount in the same manner. *See* paragraph (e)(2)(iv)(A) of proposed new Rule 18a–1.

[287] *See* 17 CFR 240.15c3–1e(c)(4)(ii). A stand-alone SBSD approved to use internal models would compute MPE in the same manner. *See* paragraph (e)(2)(iv)(B) of proposed new Rule 18a–1.

[288] *See* 17 CFR 240.15c3–1e(c)(4)(iii). A stand-alone SBSD approved to use internal models would compute *current exposure* in the same manner. *See* paragraph (e)(2)(iv)(C) of proposed new Rule 18a–1.

[289] *See Market Review of OTC Derivative Bilateral Collateralization Practices* at 5.

[290] *Id.*

[291] *See* 17 CFR 240.15c3–1e(c)(4)(v). A stand-alone SBSD approved to use internal models would be subject to the same requirements in order to be permitted to take into account collateral when determining the MPE and *current exposure* amounts. *See* paragraph (e)(2)(iv)(E) of proposed new Rule 18a–1.

[292] This refers to an internal maintenance margin requirement (*i.e.,* not one imposed by regulation).

[293] *See* 17 CFR 240.15c3–1e(c)(4)(v)(A)–(H). A stand-alone SBSD approved to use internal models would be subject to the same requirements. *See* paragraph (e)(2)(iv)(E)(*1*)–(*8*) of proposed new Rule 18a–1.

[294] Netting agreements are bilateral contracts between two counterparties that enter into OTC derivatives contracts with each other. In netting agreements, the two parties agree that if one counterparty defaults, the pending OTC derivatives contracts between the parties will be closed out and a single net payment obligation will be determined (as opposed to payment obligations for each separate OTC derivatives contract between the parties). The amount of the single net payment obligation is determined by offsetting OTC derivatives contracts that have a positive value to a counterparty with OTC derivatives contracts that have a negative value to the counterparty. After the offsets, one counterparty has an amount of positive value, which to the other counterparty is a negative value. This is the amount of the single net payment obligation. If the non-defaulting counterparty is owed the single net payment amount, it can liquidate collateral held to secure the obligations of the defaulting counterparty. However, if the non-defaulting party does not hold collateral, it becomes a general creditor of the defaulting counterparty with respect to the amount of the single net payment obligation.

[295] *See* 17 CFR 240.15c3–1e(c)(4)(iv). A stand-alone SBSD approved to use internal models would be subject to the same requirements in order to be permitted to take into account netting agreements when determining MPE and *current exposure* amounts. *See* paragraph (e)(2)(iv)(D) of proposed new Rule 18a–1.

[296] *See* 17 CFR 240.15c3–1e(c)(4)(iv)(A)–(C). A stand-alone SBSD approved to use internal models would be subject to the same requirements. *See* paragraphs (e)(2)(iv)(D)(*1*)–(*3*) of proposed new Rule 18a–1.

[297] *See* 17 CFR 240.15c3–1e(c)(1)(ii). As noted above, an 8% multiplier is consistent with the international bank capital standards and is designed to dampen leverage to help ensure that the ANC broker-dealer maintains a safe level of capital. *See Alternative Net Capital Requirements Adopting Release,* 69 FR at 34436.

[298] *See* 17 CFR 240.15c3–1e(c)(4)(vi). A stand-alone SBSD approved to use internal models would be subject to the same requirements. *See* paragraph (e)(2)(iv)(F) of proposed new Rule 18a–1. The credit risk weights in Appendix E to Rule 15c3–1 were based on the international bank capital standards. *See Alternative Net Capital Requirements Adopting Release,* 69 FR at 34436 (''These proposed credit risk weights were based on the formulas provided in the Foundation Internal Ratings-Based approach to credit risk proposed by the Basel Committee and were derived using a loss given default (the percent of the amount owed by the counterparty the firm expects to lose if the counterparty defaults) of 75%.'') (citations omitted).

[299] *See* 17 CFR 240.15c3–1e(c)(4)(vi)(D). There is a basic method for ANC broker-dealers to determine the applicable risk weight factor using external credit ratings of NRSROs. *See* 17 CFR 240.15c3–1e(c)(4)(vi)(A)–(C). Currently, all six ANC broker-dealers are approved to use internally derived credit ratings. *See Reference Removal Release,* 76 FR at 26555. Pursuant to section 939A of the Dodd-Frank Act, the Commission has proposed eliminating the basic method of using NRSRO credit ratings and, consequently, if the proposals are adopted, an ANC broker-dealer would be required to use internally derived credit ratings. *See* Public Law 111–203 § 939A and *Reference Removal Release,* 76 FR at 26555–26556. Consistent with section 939A of the Dodd-Frank Act, there would not be a basic method for stand-alone SBSDs approved to use internal models. *See* paragraph (e)(2)(iv)(F) of proposed new Rule 18a–1. Consequently, these nonbank SBSDs would be required to use internally derived credit ratings to determine the appropriate risk weight factor to apply to a counterparty. This does not mean that an ANC broker-dealer or stand-alone SBSD could

Continued

The second component of an ANC broker-dealer's credit risk charge is a counterparty concentration charge.[300] This charge accounts for the additional risk resulting from a relatively large exposure to a single counterparty.[301] This charge is triggered if the current exposure of the ANC broker-dealer to a counterparty exceeds 5% of the tentative net capital of the ANC broker-dealer.[302] In this case, the ANC broker-dealer must take a counterparty concentration charge equal to: (1) 5% of the amount by which the current exposure exceeds 5% of tentative net capital for a counterparty with a risk weight factor of 20% or less; (2) 20% of the amount by which the current exposure exceeds 5% of tentative net capital for a counterparty with a risk weight factor of greater than 20% and less than 50%; and (3) 50% of the amount by which the current exposure exceeds 5% of tentative net capital for a counterparty with a risk weight factor of 50% or more.[303]

The third—and final—component of the credit risk charge is a portfolio concentration charge.[304] The portfolio concentration charge is designed to address the risk of having a relatively large amount of unsecured receivables relative to the size of the firm. This charge is triggered when the aggregate current exposure of the ANC broker-dealer to all counterparties exceeds 50% of the firm's tentative net capital.[305] In this case, the portfolio concentration charge is equal to 100% of the amount by which the aggregate current exposure exceeds 50% of the ANC broker-dealer's tentative net capital.[306]

Request for Comment

The Commission generally requests comment on the proposed credit risk charges. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Should ANC broker-dealers and stand-alone SBSDs using internal models be required to deduct in full unsecured receivables from *commercial end users,* rather than being permitted to use the proposed credit risk charge? If so, explain why. If not, explain why not. For example, would ANC broker-dealers and stand-alone SBSDs using internal models have substantial amounts of receivables from *commercial end users* that, if not collateralized, could adversely impact the liquidity of these firms? If so, what measures in addition to the proposed credit risk charge could be implemented to address the risk of uncollateralized credit risk exposure to *commercial end users* in the absence of a required 100% deduction? Commenters should provide data to support their responses to these questions.

2. Should ANC broker-dealers and stand-alone SBSDs using internal models be required to take a capital charge in lieu of margin for non-cleared security-based swaps with *commercial end users*? If so, explain why. If not, explain why not. For example, would ANC broker-dealers and stand-alone SBSDs using internal models enter into substantial amounts of non-cleared security-based swaps with *commercial end users* that could adversely impact the risk profiles of these firms, if collateral was not collected to cover potential future exposure? If so, what measures in addition to the proposed credit risk charge could be implemented to address this risk in the absence of a required 100% deduction? Commenters should provide data to support their responses to these questions.

3. Is the credit risk charge an appropriate measure to address the risk to nonbank SBSDs of having uncollateralized current and potential future exposure to *commercial end users*? If so, explain why. If not, explain why not. Are there other measures that could be implemented as an alternative or in addition to the credit risk charge to address the risk of this uncollateralized exposure? If so, identify the measures and explain why they would be appropriate alternatives or supplements to the credit risk charge.

4. What will be the economic impact of the credit risk charge? For example, will the additional capital that a nonbank SBSD would be required to maintain because of the credit risk charge result in costs that will be passed through to end users? Please explain.

5. Should the application of the credit risk charge be expanded to unsecured receivables from other types of counterparties? If so, explain why. If not, explain why not. How would such an expansion impact the liquidity of nonbank SBSDs?

6. Should the application of the credit risk charge be expanded to the other exceptions to the margin collateral requirements in proposed new Rule 18a–3? If so, explain why. If not, explain why not. How would such an expansion impact the risk profile of nonbank SBSDs?

7. The ability to take a credit risk charge in lieu of a 100% deduction for an unsecured receivable would apply only to unsecured receivables from *commercial end users* arising from security-based swap transactions. Consequently, an ANC broker-dealer and a nonbank SBSD would need to take a 100% deduction for unsecured receivables from *commercial end users* arising from swap transactions. Should the application of the credit risk charge be expanded to include unsecured receivables from *commercial end users* arising from swap transactions? If so, explain why. If not, explain why not. How would such an expansion impact the liquidity of nonbank SBSDs?

8. Is the overall method of computing the credit risk charge appropriate for nonbank SBSDs? If not, explain why not. For example, are there differences between ANC broker-dealers and nonbank SBSDs that would make the method of computing the credit risk charge appropriate for the former but not appropriate for the latter? If so, identify the differences and explain why they would make the credit risk charge not appropriate for nonbank SBSDs. What modifications should be made to the method of computing the credit risk charge for nonbank SBSDs?

9. Are the steps required to compute the credit risk charge understandable? If not, identify the steps that require further explanation.

10. Is the method of computing the first component of the credit risk charge—the counterparty exposure charge—appropriate for nonbank SBSDs? If not, explain why not. For example, is the calculation of the *credit equivalent amount* for a counterparty

not include external credit ratings as part of its internal credit rating methodology. *See Reference Removal Release,* 76 FR at 26552–26553 (identifying external credit ratings as one of several factors a broker-dealer could consider when assessing credit risk under the Commission's proposals to substitute NRSRO credit ratings in the broker-dealer rules with a different standard of creditworthiness).

[300] *See* 17 CFR 240.15c3–1e(c)(2). A stand-alone SBSD approved to use internal models would be subject to the same counterparty concentration charge. *See* paragraph (e)(2)(ii) of proposed new Rule 18a–1.

[301] Concentration charges are intended to provide a liquidity cushion if a lack of diversification of positions exposes the firm to additional risk.

[302] *See* 17 CFR 240.15c3–1e(c)(2)(i)–(iii). A stand-alone SBSD approved to use internal models would be subject to the same threshold in determining the counterparty concentration charge. *See* paragraphs (e)(2)(ii)(A)–(C) of proposed new Rule 18a–1.

[303] *See* 17 CFR 240.15c3–1e(c)(1)(i)–(iii). A stand-alone SBSD approved to use internal models would be subject to the same charges. *See* paragraphs (e)(2)(ii)(A)–(C) of proposed new Rule 18a–1.

[304] *See* 17 CFR 240.15c3–1e(c)(3). A stand-alone SBSD approved to use internal models would be subject to the same portfolio concentration charge. *See* paragraph (e)(2)(iii) of proposed new Rule 18a–1.

[305] 17 CFR 240.15c3–1e(c)(3).

[306] *See* 17 CFR 240.15c3–1e(c)(3). A stand-alone SBSD approved to use internal models would be subject to the same charge. *See* paragraph (e)(2)(iii) of proposed new Rule 18a–1.

(*i.e.,* the sum of the MPE and the current exposure to the counterparty) a workable requirement for nonbank SBSDs? If not, explain why not.

11. Are the conditions for taking collateral into account when calculating the *credit equivalent amount* appropriate for nonbank SBSDs? If not, explain why not.

12. Are the conditions for taking netting agreements into account when calculating the *credit equivalent amount* appropriate for nonbank SBSDs? If not, explain why not.

13. Are the standardized risk weight factors (20%, 50%, and 150%) proposed for calculating the *credit equivalent amount* appropriate for nonbank SBSDs? If not, explain why not.

14. Is the method of computing the second component of the credit risk charge—the counterparty concentration charge—appropriate for nonbank SBSDs? If not, explain why not.

15. Is the method of computing the third component of the credit risk charge—portfolio concentration charge—appropriate for nonbank SBSDs? If not, explain why not.

v. Capital Charge In Lieu of Margin Collateral

As discussed above in section II.B. of this release, collateral is one of the ways dealers in OTC derivatives manage their credit risk exposure to OTC derivatives counterparties.[307] Collateral may be provided to cover the amount of the current exposure of the dealer to the counterparty.[308] Collateral also may be provided to cover the potential future exposure of the dealer to the counterparty, *i.e.,* margin collateral.[309] Clearing agencies will impose margin collateral requirements on their clearing members, including nonbank SBSDs, for cleared security-based swaps.[310] In addition, as discussed below in section II.B. of this release, proposed new Rule 18a–3 would establish margin collateral requirements for nonbank SBSDs with respect to non-cleared security-based swaps.[311] Furthermore, FINRA also prescribes margin requirements for security-based swaps.[312]

Rule 15c3–1 currently requires a broker-dealer to take a deduction from net worth for under-margined accounts.[313] Specifically, the broker-dealer is required to deduct from net worth the amount of cash required in each customer's and noncustomer's account to meet a maintenance margin requirement of the firm's designated examining authority after application of calls for margin, marks to the market, or other required deposits which are outstanding five business days or less.[314] These deductions serve the same purpose as the deductions a broker-dealer is required to take on proprietary securities positions in that they account for risk of the positions in the customer's account, which the broker-dealer may need to liquidate if the customer defaults on obligations to the broker-dealer.

In order to prescribe a similar requirement for security-based swap positions, Rule 15c3–1 would be amended to require broker-dealer SBSDs to take a deduction from net worth for the amount of cash required in the account of each security-based swap customer to meet the margin requirements of a clearing agency, self-regulatory organization (''SRO''), or the Commission, after application of calls for margin, marks to the market, or other required deposits which are outstanding one business day or less.[315] An analogous provision would be included in new Rule 18a–1, though it would not refer to margin requirements of SROs because stand-alone SBSDs will not be members of SROs.[316] These provisions would require broker-dealer SBSDs to take capital charges when their security-based swap customers do not meet margin collateral requirements of clearing agencies, SROs, or the Commission after one business day from the date the margin collateral requirement arises. The capital charge would be designed to address the risk to nonbank SBSDs that arises from not collecting the margin collateral.[317]

As discussed below in section II.B. of this release, proposed new Rule 18a–3 would require nonbank SBSDs to collect collateral to meet account *equity* requirements by noon of the next business day from the day the account *equity* requirement arises.[318] Consequently, to be consistent with the proposed requirement to collect collateral within one day, the under-margined capital charge for security-based swap accounts would be triggered within one day of the margin requirement arising, as opposed to the five-day trigger in Rule 15c3–1.

In addition to the deductions for under-margined security-based swap accounts, the proposed rules would impose capital charges designed to address situations where the account of a security-based swap customer is meeting all applicable margin requirements but the margin collateral requirement results in the collection of an amount of collateral that is insufficient to address the risk because, for example, the requirement for cleared security-based swaps established by a clearing agency does not result in sufficient margin collateral to cover the nonbank SBSD's exposure or because an exception to collecting margin collateral for non-cleared security-based swaps exists.[319] These proposed capital charges would not apply in the circumstance, discussed in the preceding section, involving unsecured receivables from *commercial end users,* which would be separately addressed by proposed new Rule 18a–1 and proposed amendments to Rule 15c3–1.[320] The proposed capital charges relating to margin collateral would be required deductions from the nonbank SBSD's net worth when computing net capital.[321] The proposals are intended to require a nonbank SBSD to set aside net capital to address the risks of potential future exposure that are mitigated through the collection of margin collateral. The set aside net capital would serve as an alternative to obtaining margin collateral for this purpose.

With respect to cleared security-based swaps, for which margin requirements will not be established by the Commission, the rules would impose a capital charge that would apply if a nonbank SBSD collects margin collateral from a counterparty in an amount that is less than the deduction that would apply to the security-based swap if it was a proprietary position of

[307] *See Market Review of OTC Derivative Bilateral Collateralization Practices.*

[308] *See Independent Amounts.*

[309] *Id.* at 4.

[310] *See* discussion below in section II.B. of this release.

[311] *See* proposed new Rule 18a–3.

[312] *See* FINRA Rule 4240.

[313] *See* 17 CFR 240.15c3–1(c)(2)(xii).

[314] *Id.*

[315] *See* proposed new paragraph (c)(2)(xii)(B) of Rule 15c3–1.

[316] *See* paragraph (c)(1)(ix) of proposed new Rule 18a–1.

[317] *See* section II.B.1. of this release for a discussion of the purpose of margin collateral.

[318] *See* paragraph (c)(1)(ii) of proposed new Rule 18a–3.

[319] *See* proposed new paragraph (c)(2)(xiv) of Rule 15c3–1; paragraph (c)(1)(viii) of proposed new Rule 18a–1. The exceptions to the proposed margin rule are discussed below.

[320] As discussed above in section II.A.2.b.v. of this release, nonbank SBSDs would be required to take a 100% deduction to net worth when calculating net capital equal to their uncollateralized current exposure to a counterparty arising from a security-based swap except that an ANC broker-dealer and a stand-alone SBSD approved to use internal models could take a credit risk charge as an alternative to the 100% deduction if the counterparty was a *commercial end user. See* 17 CFR 240.15c3–1(c)(2)(iv)(B) (which requires a broker-dealer—and would require a broker-dealer SBSD—to deduct unsecured and partly secured receivables); paragraph (c)(1)(iii)(B) of proposed new Rule 18a–1 (which would contain an analogous provision for stand-alone SBSDs).

[321] *Id.*

the nonbank SBSD (*i.e.,* less than an amount determined by using the standardized haircuts in Commission Rule 15c3–1, as proposed to be amended, and in proposed new Rule 18a–1 or a VaR model, as applicable).[322] This aspect of the proposal is intended to adequately account for the risk of the counterparty defaulting by requiring the nonbank SBSD to maintain capital in the place of margin collateral in an amount that is no less than would be required for a proprietary position.[323] This requirement also is intended to ensure that there is a standard minimum coverage for exposure to cleared security-based swap counterparties apart from the individual clearing agency margin requirements, which could vary among clearing agencies and over time. If the counterparty defaults, the nonbank SBSD would need to liquidate the counterparty's cleared security-based swaps and other positions in the account to cover the counterparty's obligation to the nonbank SBSD. Thus, the nonbank SBSD will become subject to the market risk of these positions in the event of the counterparty's default. If the positions decrease in value, the nonbank SBSD may not be able to cover the defaulted counterparty's obligations to the nonbank SBSD through the liquidation of the positions because the cash proceeds from the liquidation may yield less than the obligation.

Margin collateral is designed to mitigate this risk by serving as a buffer to account for a decrease in the market value of the counterparty's positions between the time of the default and the liquidation. If the amount of the margin collateral is insufficient to make up the difference, the nonbank SBSD will incur losses. This proposed capital charge is designed to require the nonbank SBSD to hold sufficient net capital, as an alternative to margin, to enable it to withstand such losses.

With respect to non-cleared security-based swaps, the rules would impose capital charges to address three exceptions in proposed new Rule 18a–3 (the nonbank SBSD margin rule).[324] Under these three exceptions, a nonbank SBSD would not be required to collect (or, in one case, hold) margin collateral. As discussed below in section II.B.2.b. of this release, proposed Rule 18a–3 would require a nonbank SBSD to perform a daily calculation of a *margin* amount for the account of each counterparty to a non-cleared security-based swap transaction.[325] Proposed new Rule 18a–3 also would require a nonbank SBSD to collect and hold margin collateral (in the form of cash, securities, and/or money market instruments) from each counterparty in an amount at least equal to the calculated margin amount to the extent that amount is greater than the amount of *positive equity* in the account.[326] The rule would, however, provide exceptions in certain cases.[327] Consequently, the three proposed capital charges discussed below are designed to serve as an alternative to margin collateral by requiring the nonbank SBSD to hold sufficient net capital to enable it to withstand losses if the counterparty defaults.

The first proposed capital charge would apply when a nonbank SBSD not approved to use internal models does not collect sufficient margin collateral from a counterparty to a non-cleared security-based swap because the counterparty is a *commercial end user.*[328] As discussed below in section II.B.2.c.i. of this release, a nonbank SBSD would not be required to collect margin collateral from *commercial end users* for non-cleared security-based swaps.[329] The nonbank SBSD would be required to take a capital charge equal to the margin amount less any *positive equity* in the account of the *commercial end user* if the nonbank SBSD did not collect margin collateral from the *commercial end user* pursuant to this exception.[330] As discussed above in section II.A.2.b.iv. of this release, as an alternative to this deduction, an ANC broker-dealer and a stand-alone SBSD approved to use internal models could incur a credit risk charge.

The second proposed capital charge would apply when the nonbank SBSD does not hold the margin collateral because the counterparty to the non-cleared security-based swap is requiring the margin collateral to be segregated pursuant to section 3E(f) of the Exchange Act.[331] Section 3E(f) of the Exchange Act, among other things, provides that the segregated account authorized by that provision must be carried by an independent third-party custodian and be designated as a segregated account for and on behalf of the counterparty.[332] Collateral held in this manner would not be in the

[322] *See* proposed paragraph (c)(2)(xiv)(A) of Rule 15c3–1; paragraph (c)(1)(viii)(A) of proposed Rule 18a–1.

[323] As discussed in section II.B.2. of this release, the margin requirements for non-cleared security-based swaps would be the same as the deductions to net capital that a nonbank SBSD would take on the positions under Rule 15c3–1, as proposed to be amended, and proposed new Rule 18a–1.

[324] *See* paragraphs (c)(1)(iii)(A), (C), and (D) of proposed new Rule 18a–3. There is a fourth exception in proposed new Rule 18a–3 under which a nonbank SBSD would not be required to collect margin collateral to cover potential future exposure to another SBSD. *See* paragraph (c)(1)(iii)(B)—Alternative A of proposed new Rule 18a–3. There would not be a capital charge in lieu of collecting margin collateral from another SBSD because capital charges could impact the firm's liquidity, and each SBSD would be subject to regulatory capital requirements. A second alternative (Alternative B) being proposed in new Rule 18a–3 would require a nonbank SBSD to have margin collateral posted to an account at a third-party custodian in an amount sufficient to cover the nonbank SBSD's potential future exposure to the other SBSD. *See* paragraph (c)(1)(iii)(B)—Alternative B—of proposed new Rule 18a–3. These two alternatives are discussed in more detail in section II.B.2. of this release.

[325] *See* paragraph (c)(1)(i)(B) of proposed new Rule 18a–3. The term *margin* in proposed new Rule 18a–3 would be defined to mean the amount of *positive equity* in an account of a counterparty. *See* paragraph (b)(5) of proposed new Rule 18a–3.

[326] *See* paragraph (c)(1)(ii) of proposed new Rule 18a–3. *See also* paragraph (c)(4) of proposed new Rule 18a–3 (requiring among other things that collateral be in the physical possession or control of the nonbank SBSD and that the collateral must be capable of being liquidated promptly by the nonbank SBSD). As discussed in section II.B.2. of this release, the term *equity* in proposed new Rule 18a–3 would be defined to mean the total current fair market value of securities positions in an account of a counterparty (excluding the time value of an over-the-counter option), plus any credit balance and less any debit balance in the account after applying a qualifying netting agreement with respect to gross derivatives payables and receivables. *See* paragraph (b)(4) of proposed new Rule 18a–3. The term *negative equity* in proposed new Rule 18a–3 would be defined to mean *equity* of less than $0. *See* paragraph (b)(6) of proposed new Rule 18a–3. The term *positive equity* in proposed new Rule 18a–3 would be defined to mean *equity* of greater than $0. *See* paragraph (b)(7) of proposed new Rule 18a–3.

[327] *See* paragraphs (c)(1)(iii)(A), (C), and (D) of proposed new Rule 18a–3. As noted above and discussed in more detail in section II.B.2. of this release, one alternative being considered is to establish a fourth exception in proposed new Rule 18a–3 under which a nonbank SBSD would not be required to collect margin collateral to cover potential future exposure to another SBSD. *See* paragraph (c)(1)(iii)(B) of proposed new Rule 18a–3. Under this alternative, there would not be a capital charge in lieu of collecting margin collateral from the other SBSD because capital charges could impact the firm's liquidity, and each SBSD would be subject to regulatory capital requirements. The other alternative would require nonbank SBSDs to have margin collateral posted to an account at a third-party custodian in an amount sufficient to cover the nonbank SBSD's potential future exposure to the other SBSD.

[328] *See* proposed paragraph (c)(2)(xiv)(B)(*1*) of Rule 15c3–1; paragraph (c)(1)(viii)(B)(*1*) of proposed new Rule 18a–1.

[329] *See* paragraph (c)(1)(iii)(A) of proposed new Rule 18a–3.

[330] *See* proposed new paragraph (c)(2)(xiv)(B)(*1*) of Rule 15c3–1; paragraph (c)(1)(viii)(B)(*1*) of proposed new Rule 18a–1. If collateral is not collected from a *commercial end user,* the nonbank SBSD would be required to take a 100% deduction for the amount of the uncollateralized current exposure. As discussed above in section II.A.2.b.iv. of this release, as alternative to this deduction, an ANC broker-dealer and a stand-alone SBSD approved to use internal models could take a credit risk charge.

[331] *See* proposed new paragraph (c)(2)(xiv)(B)(*2*) of Rule 15c3–1; paragraph (c)(1)(viii)(B)(*2*) of proposed new Rule 18a–1.

[332] *See* 15 U.S.C. 78c–5(f)(3).

physical possession or control of the nonbank SBSD, nor would it would be capable of being liquidated promptly by the nonbank SBSD without the intervention of another party. Consequently, it would not meet collateral requirements in proposed new Rule 18a–3.[333] Because collateral segregated under section 3E(f) of the Exchange Act would not be under the control of the nonbank SBSD, consistent with the existing capital requirements that apply to broker-dealers, the Commission is proposing to require the nonbank SBSD to take a capital charge equal to the margin amount less any *positive equity* in the account of the counterparty.[334]

The third proposed capital charge would apply when a nonbank SBSD does not collect sufficient margin collateral from a counterparty to a non-cleared security-based swap because the transaction was entered into prior to the effective date of proposed new Rule 18a–3 (a ''legacy non-cleared security-based swap'').[335] The nonbank SBSD would not be required to collect margin collateral for accounts holding legacy non-cleared security-based swaps.[336] This proposal is designed to avoid the difficulties of requiring a nonbank SBSD to renegotiate security-based swap contracts in order to come into compliance with new margin collateral requirements, which would be a complex task.[337] In lieu of collecting the margin collateral, the nonbank SBSD would be required to take a capital charge equal to the margin amount less any *positive equity* in the account.[338]

Request for Comment

The Commission generally requests comment on the proposed capital in lieu of margin requirements. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Would the proposed deductions for under-margined accounts be appropriate for cleared security-based swap margin requirements, which would be established by clearing agencies and SROs? If not, explain why not. For example, is the requirement to take the deduction after one business day workable in the context of cleared security-based swaps? If not, explain why not. In addition, should the margin requirements of clearing agencies be included in the deduction for under-margined accounts?

2. Would the proposed deductions for under-margined accounts be appropriate for non-cleared security-based swap margin requirements, which would be established by proposed new Rule 18a–3 and, potentially, by SROs? If not, explain why not. For example, is the requirement to take the deduction after one business day workable in the context of non-cleared security-based swaps? If not, explain why not.

3. Should there be a deduction for under-margined swap accounts? If so, explain why. If not, explain why not.

4. Would the proposed capital charges in lieu of collecting margin collateral appropriately address the potential future exposure risk of nonbank SBSDs arising from security-based swaps? If not, explain why not. Are there alternative means of addressing this risk? If so, identify and explain them.

5. Is the proposed capital charge in lieu of margin for cleared security-based swaps appropriate? If not, explain why not. In particular, if the amount of margin collateral required to be collected for cleared security-based swaps is less than the capital deduction that would apply to the positions, would the margin collateral nonetheless be sufficient? If so, explain why. In addition, should SBSDs approved to use internal models be permitted to use their VaR models (as opposed to the standardized haircuts) for purposes of determining whether this capital charge applies? If so, explain why.

6. Is the proposed capital charge in lieu of margin for non-cleared security-based swaps with counterparties that are *commercial end users* appropriate? If not, explain why not.

7. Should there be an exception for broker-dealer SBSDs and stand-alone SBSDs not using internal models from the requirement to take a capital charge in lieu of collecting margin collateral from *commercial end users*? If so, explain why such an exception would not negatively impact the risk profiles of these nonbank SBSDs and suggest alternative measures that could be implemented to address the risk of uncollateralized potential future exposure to *commercial end users.*

8. Should there be a capital charge in lieu of margin for non-cleared swaps with counterparties that are *commercial end users*? If so, explain why. If not, explain why not.

9. Is it appropriate to apply the proposed capital charge in lieu of margin for non-cleared security-based swaps with counterparties that require segregation pursuant to section 3E(f) of the Exchange Act? If not, explain why not.

10. Should there be an exception for counterparties that require segregation pursuant to section 3E(f) of the Exchange Act from the requirement to take a capital charge in lieu of margin collateral? If so, explain why such an exception would not negatively impact the risk profiles of nonbank SBSDs and suggest alternative measures that could be implemented to address the risk of not holding collateral to cover the potential future exposure.

11. Should there be a capital charge in lieu of margin for non-cleared swaps with counterparties that require margin

[333] *See* paragraphs (c)(4)(i) and (iii) of proposed new Rule 18a–3.

[334] *See* proposed new paragraph (c)(2)(xiv)(B)(*2*) of Rule 15c3–1; paragraph (c)(1)(viii)(B)(*2*) of proposed new Rule 18a–1.

[335] *See* proposed new paragraph (c)(2)(xiv)(B)(*3*) of Rule 15c3–1; paragraph (c)(1)(viii)(B)(*3*) of proposed new Rule 18a–1.

[336] *See* paragraph (c)(1)(iii)(D) of proposed new Rule 18a–3. A nonbank SBSD would need to take a 100% deduction for the amount of the uncollateralized current exposure arising from a legacy non-cleared security-based swap because (as discussed above) this amount would be an unsecured receivable from the counterparty and subject to a 100% deduction in the computation of net capital under Rule 15c3–1 and proposed new Rule 18a–1.

[337] The CFTC has proposed a similar exception for legacy swap transactions. *See CFTC Margin Proposing Release,* 76 FR at 23734 (''The Commission believes that the pricing of existing swaps reflects the credit arrangements under which they were executed and that it would be unfair to the parties and disruptive to the markets to require that the new margin rules apply to those positions.''). The prudential regulators proposed to permit a covered swap entity to exclude pre-effective swaps from initial margin calculations, while requiring these entities to collect variation margin, consistent with industry practice. *Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27569.

[338] The prudential regulators and CFTC have not proposed new capital charges for legacy swaps and legacy security-based swaps; nor have they proposed specific margin collateral requirements for such positions. *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564; *CFTC Capital Proposing Release,* 76 FR 27802; *CFTC Margin Proposing Release,* 76 FR 23732. With respect to banks, the credit risk of holding legacy security-based swap positions is already taken into account by existing capital requirements for banks. The proposed capital charge in lieu of margin for nonbank SBSDs is based on a concern that, after SBSD registration requirements take effect, financial institutions may transfer large volumes of legacy non-cleared security-based swaps from unregulated affiliates to newly registered nonbank SBSDs, including broker-dealer SBSDs. As noted above, the Commission understands that registered broker-dealers currently do not engage in a high volume of security-based swap transactions. An influx of legacy non-cleared security-based swaps into a newly registered nonbank SBSD could create substantial risks to the entity. Under the proposed rule, nonbank SBSDs would be required to hold sufficient collateral to cover the current exposure and potential future exposure that arise from these transactions or, alternatively, to take appropriate capital charges to address these risks. Entities holding legacy non-cleared security-based swaps could either obtain additional capital in order to register as nonbank SBSDs or legacy non-cleared security-based swaps could be held and ''wound down'' in one entity while a separate entity is used to conduct new business.

collateral with respect to the swaps to be segregated and held by an independent third party custodian? If so, explain why. If not, explain why not.

12. Is the proposed capital charge in lieu of margin for non-cleared security-based swaps in accounts that hold legacy security-based swaps appropriate, or should there be an exception from the capital charge for legacy security-based swaps? Is there an alternate measure that could be implemented to address the risk of uncollateralized potential future exposure resulting from legacy security-based swaps? If the proposed capital charge applies to legacy security-based swaps, explain how the proposed capital charge in lieu of margin collateral would change the economics of the transactions previously entered into. How would any such change(s) be reflected in the cost of maintaining those, or initiating, new positions? Would there be any other impacts of the change in treatment of the legacy positions?

13. If there is an exception from the capital charge for legacy security-based swaps, how would such an exception impact the risk profiles of nonbank SBSDs?

14. After the SBSD registration requirements take effect, would substantial amounts of legacy security-based swaps with uncollateralized potential future exposure be transferred to broker-dealer SBSDs? Would entities with substantial amounts of legacy security-based swaps with uncollateralized potential future exposure register as stand-alone SBSDs?

15. Would it be practical for financial institutions to wind down legacy security-based swaps in existing entities rather than transferring them to nonbank SBSDs? What legal and operational issues would this approach raise?

16. Should there be a capital charge in lieu of margin for non-cleared swap accounts that hold legacy swaps? If so, explain why. If not, explain why not.

17. What should be deemed a legacy security-based swap? For example, if a nonbank SBSD dealer holds an existing legacy security-based swap that is subsequently modified for risk mitigation purposes, should this be deemed a new security-based swap transaction or should it continue to be treated as a legacy security-based swap?

vi. Treatment of Swaps

CFTC Rule 1.17 prescribes minimum capital requirements for FCMs.[339] The rule imposes a net liquid assets test capital standard.[340] Broker-dealers that are registered as FCMs are subject to Rule 15c3–1 and CFTC Rule 1.17.[341] CFTC Rule 1.17 provides that an FCM registered as a broker-dealer must maintain a minimum amount of adjusted net capital equal to the greater of, among other amounts, the minimum amount of net capital required by Rule 15c3–1.[342] CFTC Rule 1.17 also prescribes standardized haircuts for securities positions by incorporating by reference the standardized haircuts in Rule 15c3–1.[343] Similarly, Rule 15c3–1, through Appendix B, prescribes capital deductions for commodities positions of a broker-dealer by incorporating by reference deductions in CFTC Rule 1.17 to the extent Rule 15c3–1 does not otherwise prescribe a deduction for the type of commodity position.[344]

Broker-dealer SBSDs (as broker-dealers) would be subject to Appendix B to Rule 15c3–1.[345] Appendix B to proposed new Rule 18a–1 would prescribe capital deductions for commodities positions of stand-alone SBSDs and would be modeled on Appendix B to Rule 15c3–1.[346] Consequently, under the provisions of Rule 15c3–1 and proposed new Rule 18a–1, nonbank SBSDs would be required to take deductions for commodity positions when computing net capital.[347]

In addition, nonbank SBSDs and broker-dealers may have proprietary positions in swaps. Consequently, Appendix B to Rule 15c3–1 would be amended to establish standardized haircuts for proprietary swap positions and analogous provisions would be included in Appendix B to proposed new Rule 18a–1.[348] This would make the standardized swap haircuts applicable to nonbank SBSDs and broker-dealers.[349] An ANC broker-dealer and a stand-alone SBSD could apply to include different types of swaps in their VaR models. If approved, the firm would not need to apply the standardized haircuts for the type of swaps covered by the approved models.

The proposed standardized haircuts for swaps are similar to the proposed standardized haircuts for security-based swaps. Specifically, swaps that are credit default swaps referencing a broad based securities index (''Index CDS swaps'') would be subject to a maturity grid similar to the proposed maturity grid for CDS security-based swaps.[350] All other swaps would be subject to a standardized haircut determined by multiplying the notional amount of the swap by the percentage deduction that would apply to the type of asset or event referenced by the swap.

Index CDS Swaps

The standardized haircuts proposed for Index CDS swaps would use the maturity grid approach proposed for CDS security-based swaps discussed above in section II.A.2.b.ii. of this release. This would provide for a consistent standardized haircut approach for Index CDS swaps and CDS security-based swaps though, as discussed below, the haircuts would be lower for the Index CDS security-based swaps. As with CDS security-based swaps, the proposed maturity grid for Index CDS swaps prescribes the applicable deduction based on two variables: the length of time to maturity of the swap and the amount of the current offered spread on the swap.[351] The vertical axis of the proposed grid would contain nine maturity categories ranging from 12 months or less (the smallest deduction) to 121 months and longer (the largest deduction).[352] The horizontal axis would contain six spread categories ranging from 100 basis points or less (the smallest deduction) to

[339] *See* 17 CFR 1.17.

[340] *Id.*

[341] *See* 17 CFR 240.15c3–1; 17 CFR 1.17.

[342] *See* 17 CFR 1.17(a)(1)(i)(D).

[343] *See* 17 CFR 1.17(c)(5)(v)–(vii).

[344] *See* 17 CFR 240.15c3–1b(a)(1).

[345] 17 CFR 240.15c3.–1b.

[346] *Compare* 17 CFR 240.15c3–1b, *with* Appendix B to proposed new Rule 18a–1. As discussed above in section II.A.2.b.ii. of this release, a broker-dealer's minimum net capital requirement is the greater of a fixed-dollar amount specified in Rule 15c3–1 and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of customer debit items ratio. The minimum net capital requirement for a stand-alone SBSD under proposed Rule 18a–1, however, would not use either of these financial ratios; rather, its minimum net capital requirement would be determined by calculating the 8% margin factor. Appendix B to Rule 15c3–1 contains provisions that factor into a broker-dealer's calculation of the aggregate indebtedness financial ratio. *See* 17 CFR 240.15c3–1b(a)(1) and (a)(2). Those provisions are not included in Appendix B to proposed new Rule 18a–1 because stand-alone SBSDs would not use the aggregate indebtedness financial ratio to determine their minimum net capital requirement.

[347] *See* 17 CFR 240.15c3–1b; Appendix B to proposed new Rule 18a–1.

[348] *See* proposed new paragraph (b) of Rule 15c3–1b; paragraph (b) of proposed new Rule 18a–1b.

[349] A nonbank SBSD that is registered as a swap dealer with the CFTC also would be required to comply with the CFTC's capital requirements applicable to swap dealers as would a broker-dealer that is registered as a swap dealer (just as a broker-dealer registered as an FCM must comply with Rule 15c3–1 and CFTC Rule 1.17).

[350] *See* proposed new paragraph (b)(1)(i) of Rule 15c3–1b; paragraph (b)(1)(i) of proposed new Rule 18a–1b.

[351] *See* proposed new paragraph (b)(1)(i)(A) of Rule 15c3–1b; paragraph (b)(1)(i)(A) of proposed new Rule 18a–1b.

[352] *Id.*

700 basis points and above (the largest deduction).[353]

The haircut percentages in the proposed maturity grid for Index CDS swaps would be one-third less than the haircut percentages in the maturity grid for CDS security-based swaps to account for the diversification benefits of an index.[354] For example, the proposed haircut for an Index CDS swap with a maturity of 12 months or less and a spread of 100 basis points or less would be 0.67% as opposed to a 1% haircut for a CDS security-based swap in the same maturity and spread categories. This one-third reduction in the haircut percentages is consistent with how broad-based equity security-indices are treated in the Appendix A methodology as compared with single name equity securities and narrow-based equity index securities. Specifically, as discussed above in section II.A.2.b.ii. of this release, the Appendix A methodology requires portfolios of single name equity securities and narrow-based equity index securities to be stressed at 10 equidistant valuation points within a range consisting of a (+/−) 15% market move. Portfolios of broad-based equity index securities are stressed at 10 equidistant valuation points within a range consisting of a (+/−) 10% market move, which is two-thirds of the market move range applicable to single name equity securities and narrow-based equity index securities.

Consistent with the maturity grid approach for CDS security-based swaps, the proposed deduction for an un-hedged long position in an Index CDS swap would be 50% of the applicable haircut in the grid.[355] The proposed deduction requirements for Index CDS swaps would permit a nonbank SBSD to net long and short positions where the credit default swaps reference the same index, are in the same spread categories, are in the same maturity categories or in adjacent maturity categories, and have maturities within three months of each other.[356] In this case, the nonbank SBSD would need to take the specified haircut only on the notional amount of the excess long or short position.[357]

Reduced deductions also would apply for strategies where the firm is long a basket of securities consisting of the components of an index and long (buyer of protection on) an Index CDS swap on the index.[358] The reduced deduction for this strategy would apply only if the credit default swap allowed the nonbank SBSD to deliver a security in the basket to satisfy the firm's obligation on the swap.[359] In this case, the nonbank SBSD would be required to take 50% of the deduction required on the securities in the basket (*i.e.,* no deduction would be required with respect to the Index CDS swap and a lesser deduction would apply to the securities).[360] If the nonbank SBSD is short (seller of protection) a basket of securities consisting of the components of an index and short a credit default swap that references the index, the nonbank SBSD would be required only to take the deduction required on the securities in the basket (*i.e.,* no deduction would be required with respect to the Index CDS swap).[361]

Interest Rate Swaps

For interest rate swaps, Appendix B to both Rule 15c3–1 and proposed new Rule 18a–1 would prescribe a standardized haircut equal to a percentage of the notional amount of the swap that is generally based on the standardized haircuts in Rule 15c3–1 for U.S. government securities.[362] An interest rate swap typically involves the exchange of specified or determinable cash flows at specified times based upon a notional amount.[363] The notional amount is not exchanged but is used to calculate the fixed or floating rate interest payments under the swap.

Under the proposed rule, each side of the interest rate swap would be converted into a synthetic bond position based on the notional amount of the swap and the interest rates against which payments are calculated. These synthetic bonds would then be placed into the standardized haircut grid in Rule 15c3–1 for U.S. government securities. Any obligation to receive payments under the swap would be categorized as a long position; any obligation to make payments under the swap would be categorized as a short position. A position receiving or paying based on a floating interest rate generally would be treated as having a maturity equal to the period until the next interest reset date; a position receiving or paying based on a fixed rate would be treated as having a maturity equal to the residual maturity of the swap. Synthetic bond equivalents derived from interest rate swaps, when offset against one another, would be subject to a one percent charge based on the swap's notional amount. Any synthetic bond equivalent that would be subject to a standardized haircut of less than one percent under the approach described above would be subject to a minimum deduction equal to a one percent charge against the notional value of the swap.[364] This minimum haircut of one percent is designed to account for potential differences between the movement of interest rates on U.S. government securities and interest rates upon which swap payments are based.

All Other Swaps

In the case of a swap that is not an Index CDS swap or an interest rate swap, the applicable haircut would be the amount calculated by multiplying the notional value of the swap and the percentage specified in either Rule 15c3–1 or CFTC Rule 1.17 for the asset, obligation, or event referenced by the swap.[365] For example, a swap referencing a commodity that is not covered by an open futures contract or commodity option would be subject to a capital deduction applicable to the commodity as if it were a long or short inventory position with a market value equal to the notional value of the swap. This would typically result in a deduction equal to 20% of the notional value of the swap.[366] The deduction for un-hedged currency swaps referencing certain major foreign currencies, including the euro, British pounds, Canadian dollars, Japanese yen, or Swiss francs, would be 6%.[367] This

[353] *Id.*

[354] *Id.*

[355] *See* proposed new paragraph (b)(1)(i)(B) of Rule 15c3–1b; paragraph (b)(1)(i)(B) of proposed new Rule 18a–1b.

[356] *See* proposed new paragraph (b)(1)(i)(C)(*1*) of Rule 15c3–1b; paragraph (b)(1)(i)(C)(*1*) of proposed new Rule 18a–1b.

[357] *Id.*

[358] *See* proposed new paragraph (b)(1)(i)(C)(*2*) of Rule 15c3–1b; paragraph (b)(1)(i)(C)(*2*) of proposed new Rule 18a–1b.

[359] *Id.*

[360] *Id.*

[361] *See* proposed new paragraph (b)(1)(i)(C)(*3*) of Rule 15c3–1b; paragraph (b)(1)(i)(C)(*3*) of proposed new Rule 18a–1b.

[362] *See* 17 CFR 240.15c3–1(c)(2)(vi)(A).

[363] *See Net Capital Rule,* Exchange Act Release No. 39455 (Dec. 17, 1997), 62 FR 67996 (Dec. 30, 1997).

[364] Under Rule 15c3–1, U.S. government securities with a maturity of less than nine months are subject to net capital deductions ranging from three-quarters of 1% to 0%. *See* 17 CFR 240.15c3–1(c)(2)(vi)(A)(*1*)(*i*)–(*iii*).

[365] *See* proposed new paragraph (b)(2) of Rule 15c3–1b; paragraph (b)(2) of proposed new Rule 18a–1b.

[366] *See* 17 CFR 240.15c3–1b(a)(3)(ix)(C); paragraph (a)(2)(ix)(C) of proposed new Rule 18a–1b.

[367] *See* CFTC Rule 1.17(c)(5)(ii)(E) (imposing a 6% haircut). 17 CFR 1.17(c)(5)(ii)(E). Currency swaps may involve exchanges of fixed amounts of currencies. If a nonbank SBSD has a currency swap in which it receives one foreign currency and pays out another foreign currency, the broker-dealer would treat the currency swap as a long position in a forward of the one foreign currency and an unrelated short position in the other foreign currency for capital purposes. *See, e.g., Net Capital Rule,* Exchange Act Release No. 32256 (May 4, 1993), 58 FR 27486, 27490 (May 10, 1993).

deduction could be reduced by an amount equal to any reduction recognized for a comparable long or short position in the referenced instrument, obligation, or event under Appendix B to Rule 15c3–1, as proposed to be amended, and proposed new Rule 18a–1, or CFTC Rule 1.17. For example, a commodity swap referencing an agricultural product that is covered by an open futures contract or commodity option in that product would be subject to a 5% deduction from the notional value of the swap, rather than the 20% deduction specified above.[368] Finally, swaps referencing an equity index could be treated under Appendix A to Rule 15c3–1 and proposed new Rule 18a–1.

Request for Comment

The Commission generally requests comment on the proposed standardized haircuts swaps. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Which types of swap activities would nonbank SBSDs engage in? How would nonbank SBSDs use swaps?
2. Which types of swap activities would broker-dealers engage in? How would broker-dealers use swaps?
3. Do the proposed standardized haircuts for swaps provide a reasonable and workable solution for determining capital charges? Explain why or why not. Are there preferable alternatives? If so, describe those alternatives.
4. Are there additional categories of swaps, other than commodity swaps, currency swaps, and interest rate swaps, that the Commission should address in Rule 15c3–1 and/or proposed Rule 18a–1? If so, describe them.
5. Are the proposed standardized haircuts for swaps too high or too low? If so, please explain why and provide data to support the explanation.
6. Are there capital charges that should be applied to swaps? If so, describe them.
7. Do the proposed standardized haircuts for swaps adequately recognize offsets in establishing capital deductions? If not, what offsets should be recognized, for what type of swap, and why? Provide data, if applicable, and identify why that offset would be appropriate.
8. Do the proposed standardized haircuts for swaps provide any incentives or disincentives to effect swap transactions in a particular type of legal entity (*e.g.,* in a stand-alone SBSD versus a broker-dealer SBSD)? Describe the incentives and/or disincentives.
9. Do the proposed standardized haircuts for swaps provide any competitive advantages or disadvantages for a particular type of legal entity? Describe the advantages and/or disadvantages.
10. How closely do the movements of interest rates on U.S. government securities track the movements of interest rates upon which interest rate swap payments are based? Is the proposed 1% minimum percentage deduction for interest rate swaps appropriate given that U.S. government securities with a maturity of less than nine months have a haircut ranging from three-quarters of 1% to 0%?

c. Risk Management

Prudent financial institutions establish and maintain integrated risk management systems that seek to have in place management policies and procedures designed to help ensure an awareness of, and accountability for, the risks taken throughout the firm and to develop tools to address those risks.[369] A key objective of a risk management system is to ensure that the firm does not ignore any material source of risk.[370] Elements of an integrated risk management system include a dedicated risk management function, which seeks to promote integrated and systematic approaches to risk management and to develop and encourage the use of a common set of metrics for risk throughout the firm.[371] This function generally includes establishing common firm-wide definitions of risk and requiring that different business segments of the firm apply such definitions consistently for risk reporting purposes.[372] The risk management function in a financial institution also typically prepares background material and data analysis (risk reports) for senior managers to review and use to discuss firm-wide risks.[373]

Nonbank SBSDs would be required to comply with Rule 15c3–4, which requires the establishment of a risk management control system.[374] Rule 15c3–4 was adopted in 1998 as part of the OTC derivatives dealer oversight program.[375] The rule requires an OTC derivatives dealer to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.[376] It also requires OTC derivatives dealers to establish, document, and maintain procedures designed to prevent the firm from engaging in securities activities that are not permitted of OTC derivatives dealers pursuant to Rule 15a–1.[377] Rule 15c3–4 identifies a number of elements that must be part of an OTC derivatives dealer's internal risk management control system.[378] These include, for example, that the system have:

- A risk control unit that reports directly to senior management and is independent from business trading units;[379]
- Separation of duties between personnel responsible for entering into a transaction and those responsible for recording the transaction in the books and records of the OTC derivatives dealer;[380]
- Periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent certified public accountants) of the OTC derivatives dealer's risk management systems;[381] and
- Definitions of risk, risk monitoring, and risk management.[382]

Rule 15c3–4 further provides that the elements of the internal risk management control system must include written guidelines, approved by the OTC derivatives dealer's governing body, that cover various topics, including, for example:

- Quantitative guidelines for managing the OTC derivatives dealer's overall risk exposure;[383]
- The type, scope, and frequency of reporting by management on risk exposures;[384]
- The procedures for and the timing of the governing body's periodic review of the risk monitoring and risk

[368] *See* 17 CFR 240.15c3–1b(a)(3)(ix)(B); paragraph (a)(2)(ix)(B) of proposed new Rule 18a–1b.

[369] *See Trends in Risk Integration and Aggregation,* Joint Forum, Bank of International Settlements (Aug. 2003), available at *http://www.bis.org/publ/joint07.pdf.*

[370] *Id.*

[371] *Id.*

[372] *Id.*

[373] *Id.*

[374] *See* proposed new paragraph (a)(10)(ii) of Rule 15c3–1 (17 CFR 240.15c3–1); paragraph (g) of proposed new Rule 18a–1. *See also* 17 CFR 240.15c3–4.

[375] *See* 17 CFR 240.15c3–4; *OTC Derivatives Dealers,* 63 FR 59362.

[376] *See* 17 CFR 240.15c3–4.

[377] *See* 17 CFR 240.15c3–4; 17 CFR 240.15a-1.

[378] *See* 17 CFR 240.15c3–4(c).

[379] *See* 17 CFR 240.15c3–4(c)(1).

[380] *See* 17 CFR 240.15c3–4(c)(2).

[381] *See* 17 CFR 240.15c3–4(c)(3). The annual review must be conducted in accordance with procedures agreed to by the firm and the independent certified public accountant conducting the review.

[382] *See* 17 CFR 240.15c3–4(c)(4).

[383] *See* 17 CFR 240.15c3–4(c)(5)(iii).

[384] *See* 17 CFR 240.15c3–4(c)(5)(iv).

management written guidelines, systems, and processes;[385]

- The process for monitoring risk independent of the business or trading units whose activities create the risks being monitored;[386]
- The performance of the risk management function by persons independent from or senior to the business or trading units whose activities create the risks;[387]
- The authority and resources of the groups or persons performing the risk monitoring and risk management functions;[388]
- The appropriate response by management when internal risk management guidelines have been exceeded;[389]
- The procedures to monitor and address the risk that an OTC derivatives transaction contract will be unenforceable;[390]
- The procedures requiring the documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions;[391] and
- The procedures authorizing specified employees to commit the OTC derivatives dealer to particular types of transactions.[392]

Rule 15c3–4 also requires management to periodically review, in accordance with the written procedures, the business activities of the OTC derivatives dealer for consistency with risk management guidelines.[393]

In 2004, when adopting the ANC broker-dealer oversight program, the Commission included a requirement that an ANC broker-dealer must comply with Rule 15c3–4.[394] The Commission explained this requirement:

> Participants in the securities markets are exposed to various risks, including market, credit, funding, legal, and operational risk. These risks result, in part, from the diverse range of financial instruments that broker-dealers now trade. Risk management controls within a broker-dealer promote the stability of the firm and, consequently, the stability of the marketplace. A firm that adopts and follows appropriate risk management controls reduces its risk of significant loss, which also reduces the risk of spreading the losses to other market participants or throughout the financial markets as a whole.[395]

The Commission is proposing to require that nonbank SBSDs comply with Rule 15c3–4 because their activities will involve risk management concerns similar to those faced by other firms subject to the rule.[396] In particular, dealing in OTC derivatives, including security-based swaps, creates various types of risk that need to be carefully managed.[397] These risks are due, in part, to the characteristics of OTC derivative products and the way OTC derivative markets have evolved in comparison to the markets for exchange-traded securities.[398] For example, individually negotiated OTC derivative products, including security-based swaps, generally are less liquid than exchange-traded instruments and involve a high degree of leverage. Furthermore, market participants face risks associated with the financial and legal ability of counterparties to perform under the terms of specific transactions. Consequently, a firm that is active in dealing in these types of instruments should have an internal risk management control system that helps the firm identify and mitigate the risks it is facing. Rule 15c3–4 is designed to require an OTC derivatives dealer and ANC broker-dealer to take prudent measures to protect the firm from losses that can result from failing to account for and control risk. Requiring nonbank SBSDs to comply with Rule 15c3–4 is designed to promote the establishment of effective risk management control systems by these firms.[399] Moreover, based on Commission staff experience, it is expected that many nonbank SBSDs will be affiliates of firms already subject to these requirements.

Request for Comment

The Commission generally requests comment on the proposed risk management requirements. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are the types of management controls required by Rule 15c3–4 appropriate for addressing the risks associated with engaging in a security-based swap business? If not, explain why not.
2. Are there types of risk management controls not identified in Rule 15c3–4 that would be appropriate to prescribe for nonbank SBSDs? If so, identify the controls and explain why they would be appropriate for nonbank SBSDs.
3. Are the factors listed in paragraph (b) of Rule 15c3–4 appropriate for nonbank SBSDs? If not, explain why not.
4. Are there any additional factors that a nonbank SBSD should consider when adopting its internal control system guidelines, policies, and procedures, in addition to the factors listed in paragraph (b) of Rule 15c3–4? If so, identify the factors and explain why they should be included.
5. Are the elements prescribed in paragraph (c) of Rule 15c3–4 appropriate for nonbank SBSDs? If not, explain why not.
6. Are there any additional elements that a nonbank SBSD should include in its internal risk management system in addition to the applicable elements prescribed in paragraph (c) of Rule 15c3–4? If so, identify the elements and explain why they should be included.
7. Are there any elements in paragraph (c) of Rule 15c3–4 that should not be applicable to nonbank SBSDs other than elements in paragraphs (c)(xiii) and (xiv)? If so, identify the elements and explain why they should not be applicable.
8. Are the factors management would need to consider in its periodic review of the nonbank SBSD's business activities for consistency with the risk management guidelines appropriate for nonbank SBSDs? If not, explain why not.
9. Should management consider any additional factors in its periodic review of the nonbank SBSD's business activities for consistency with the risk management guidelines other than those listed in paragraph (d) of Rule 15c3–4? If so, identify the factors and explain why they should be included.
10. Are there any factors in paragraph (d) of Rule 15c3–4 that management should not consider other than the factors in paragraphs (d)(8) and (9)? If so, identify the factors and explain why they should not be considered.

[385] *See* 17 CFR 240.15c3–4(c)(5)(v).

[386] *See* 17 CFR 240.15c3–4(c)(5)(vi).

[387] *See* 17 CFR 240.15c3–4(c)(5)(vii).

[388] *See* 17 CFR 240.15c3–4(c)(5)(viii).

[389] *See* 17 CFR 240.15c3–4(c)(5)(ix).

[390] *See* 17 CFR 240.15c3–4(c)(5)(x).

[391] *See* 17 CFR 240.15c3–4(c)(5)(xi).

[392] *See* 17 CFR 240.15c3–4(c)(5)(xii).

[393] *See* 17 CFR 240.15c3–4(d).

[394] *See* 17 CFR 240.15c3–1(a)(7)(iii); *Alternative Net Capital Requirements Adopting Release,* 69 FR 34428. ANC broker-dealers—because they are not subject to Rule 15a–1—do not need to comply with the provisions of Rule 15c3–4 relating to Rule 15a–1. *See* 17 CFR 240.15c3–1(a)(7)(iii); 17 CFR 240.15c3–4; 17 CFR 240.15a–1.

[395] *Alternative Net Capital Requirements Adopting Release,* 69 FR at 34449.

[396] Like ANC broker-dealers, nonbank SBSDs would not need to comply paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of Rule 15c3–4. These are the provisions that specifically reference Rule 15a–1. *See* 17 CFR 240.15c3–4.

[397] *See OTC Derivatives: Settlement Procedures And Counterparty Risk Management* at 11–15.

[398] *See OTC Derivatives Dealers,* Exchange Act Release No. 39454 (Dec. 17, 1997), 62 FR 67940 (Dec. 30, 1997).

[399] *See* paragraph (g) of proposed new Rule 18a–1 (which would apply Rule 15c3–4 to stand-alone SBSDs); proposed new paragraph (a)(10)(ii) of Rule 15c3–1 (which would apply Rule 15c3–4 to broker-dealer SBSDs); 17 CFR 240.15c3–1(a)(7)(iii) (which applies Rule 15c3–4 to ANC broker-dealers); 17 CFR 240.15c3–4.

d. Funding Liquidity Stress Test Requirement

The Commission is proposing that ANC broker-dealers and nonbank SBSDs approved to use internal models be subject to liquidity risk management requirements. Funding liquidity risk has been defined as the risk that a firm will not be able to efficiently meet both expected and unexpected current and future cash flow and collateral needs without adversely impacting either the daily operations or the financial condition of the firm.[400] The consequences of liquidity funding strains for financial institutions active in a securities business include the inability to continue to issue unsecured long-term debt to finance illiquid assets and requirements to deliver additional collateral to continue to finance liquid assets on a secured basis.[401] The causes of funding liquidity strain for a financial institution include firm-specific events such as credit rating downgrades and other negative news leading to a loss of market confidence in the firm.[402] Funding liquidity also can come under stress such as occurred during the financial crisis.[403] Traditionally, financial institutions have used liquidity funding stress tests as a means to measure liquidity risk.[404] For institutions active in securities trading, liquidity funding stress tests generally estimate cash and collateral needs over a period of time and assume that sources to meet those needs (*e.g.,* issuance of long and short unsecured term debt, secured funding lines, and lines of credit) will become impaired or be unavailable.[405] To manage funding liquidity risk, these firms maintain pools of liquid unencumbered assets that can be used to raise funds during a liquidity stress event to meet cash needs.[406] The size of the liquidity pool is based on the firm's estimation of how much funding will be lost from external sources during a stress event and the duration of the event.[407]

The financial crisis demonstrated that the funding liquidity risk management practices of certain individual financial institutions were not sufficient to handle a liquidity stress event of that magnitude.[408] In particular, it has been observed that the stress tests utilized by financial institutions had weaknesses [409] and the amount of contingent liquidity they maintained to replace external sources of funding was insufficient to cover the institutions' liquidity needs.[410]

As discussed above in section II.A.2.c. of this release, nonbank SBSDs approved to use internal models would be subject to Rule 15c3–4, which currently applies to ANC broker-dealers and OTC derivatives dealers.[411] Rule 15c3–4 requires each firm subject to the rule to ''establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.'' [412] The Commission's supervision of ANC broker-dealers consists of regular meetings with firm personnel to review each firm's financial results, the management of the firm's balance sheet, and, in particular, the liquidity of the firm's balance sheet.[413] Emphasis is placed on funding and liquidity risk management plans and liquidity stress scenarios.[414] The Commission staff also meets regularly with the firm's financial controllers to review and discuss price verification results and other financial controls, particularly concerning illiquid or hard-to-value assets or large asset concentrations.[415]

Given the large size of ANC broker-dealers and the potentially substantial role that stand-alone SBSDs approved to use internal models may play in the security-based swap markets, these firms would be required to take steps to manage funding liquidity risk.[416] Specifically, these firms would be required to perform a liquidity stress test at least monthly and, based on the results of that test, maintain liquidity reserves to address potential funding needs during a stress event.[417]

Under the proposal, an ANC broker-dealer and stand-alone SBSD using internal models would need to perform a liquidity stress test at least monthly that takes into account certain assumed conditions lasting for 30 consecutive days.[418] The results of the liquidity stress test would need to be provided within ten business days of the month end to senior management that has responsibility to oversee risk management at the firm. In addition, the assumptions underlying the liquidity stress test would need to be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the firm and at least annually by senior management of the firm. These provisions are designed to

[400] *See* Joint Forum, Bank of International Settlements, *The management of liquidity risk in financial groups,* (May 2006), at 1, note 1 (''*The management of liquidity risk in financial groups*''). *See also* Basel Committee on Banking Supervision, *Principles for Sound Liquidity Risk Management and Supervision* (Sept. 2008), at 1, note 2 (''Funding liquidity risk is the risk that the firm will not be able to meet efficiently both expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the firm. Market liquidity risk is the risk that a firm cannot easily offset or eliminate a position at the market price because of inadequate market depth or market disruption.''); *Amendments to Financial Responsibility Rules for Broker-Dealers,* Exchange Act Release No. 55432 (Mar. 9, 2007), 72 FR 12862, 12870, note 72 (Mar. 19, 2007) (''Liquidity risk includes the risk that a firm will not be able to unwind or hedge a position or meet cash demands as they become due.''); *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* Federal Reserve, 77 FR 594 (Jan. 5, 2012) (proposing a rule to require certain large financial institutions to conduct liquidity stress testing at least monthly).

[401] *See The management of liquidity risk in financial groups* at 10.

[402] *See id.* at 6–8.

[403] *See Risk Management Lessons from the Global Bank Crisis of 2008,* Senior Supervisors Group (SSG) (Oct. 21, 2009) (''*Risk Management Lessons from the Global Bank Crisis of 2008*'').

[404] *The management of liquidity risk in financial groups* at 8–12.

[405] *Id.* at 10–11.

[406] *Id.*

[407] *Id.*

[408] *See Risk Management Lessons from the Global Bank Crisis of 2008.*

[409] *Id.* at 14 (''Market conditions and the deteriorating financial state of firms exposed weaknesses in firms' approaches to liquidity stress testing, particularly with respect to secured borrowing and contingent funding needs. These deteriorating conditions underscored the need for greater consideration of the overlap between systemic and firm-specific events and longer time horizons, and the connection between stress tests and business-as-usual liquidity management.'').

[410] *Id.* at 15 (''Interviewed firms typically calculated and maintained a measurable funding cushion, such as 'months of coverage,' which is conceptually similar to rating agencies' twelve-month liquidity alternatives analyses. Some institutions were required to maintain a liquidity cushion that could withstand the loss of *unsecured* funding for one year. Many institutions found that this metric did not capture important elements of stress that the organizations faced, such as the loss of secured funding and demands for collateral to support clearing and settlement activity and to mitigate the risks of accepting novations.'') (emphasis in the original).

[411] *See* 17 CFR 240.15c3–4.

[412] 17 CFR 240.15c3–4.

[413] A more detailed description of the Commission's ANC broker-dealer program is available on the Commission's Web site at *http://www.sec.gov/divisions/marketreg/bdaltnetcap.htm.*

[414] *Id.*

[415] *Id.*

[416] *See* proposed new paragraph (f) to Rule 15c3–1; paragraph (f) of proposed new Rule 18a–1.

[417] *Id.* The requirement to conduct the liquidity stress test on at least a monthly basis is designed to ensure that the test is conducted at sufficiently regular intervals to account for material changes that could impact the firm's liquidity profile. In this regard, the ANC broker-dealers are required to prepare and file monthly financial reports, which are designed to allow securities regulators to monitor their financial condition. *See* 17 CFR 240.17a–5; *compare Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* 77 FR 594 (Jan. 5, 2012) (Federal Reserve's proposed rule to require a ''covered company'' to conduct liquidity stress testing at least monthly).

[418] Based on the Commission staff's experience, ANC broker-dealers currently perform regular liquidity stress tests.

promote the engagement of senior level risk managers and managers of the firm in the implementation of the liquidity stress test and senior level risk managers in monitoring the results of the liquidity stress test.

These required assumed conditions are designed to be consistent with the liquidity stress tests performed by the ANC broker-dealers (based on Commission staff experience supervising the firms) and to address the types of liquidity outflows experienced by ANC broker-dealers and other broker-dealers in times of stress. The required assumed conditions would be:

- A stress event that includes a decline in creditworthiness of the firm severe enough to trigger contractual credit-related commitment provisions of counterparty agreements;
- The loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding, including intercompany advances and unfunded committed lines of credit;
- The potential for a material net loss of secured funding;
- The loss of the ability to procure repurchase agreement financing for less liquid assets;
- The illiquidity of collateral required by and on deposit at clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets;
- A material increase in collateral required to be maintained at registered clearing agencies of which the firm is a member; and
- The potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the firm, including those related to customer businesses of the firm.[419]

These proposed minimum elements are designed to ensure that ANC broker-dealers and stand-alone SBSDs using internal models employ a stress test that is severe enough to produce an estimate of a potential funding loss of a magnitude that might be expected in a severely stressed market. As discussed below, the results of the stress test would be used by the firm to determine the amount of contingent liquidity to be maintained. The proposals would require that the ANC broker-dealer and stand-alone SBSD itself must maintain at all times liquidity reserves based on the results of the liquidity stress test.[420] The liquidity reserves would need to be comprised of unencumbered cash or U.S. government securities.[421] This limitation with respect to the assets that can be used for the liquidity reserves requirement is designed to ensure that only the most liquid instruments are held in the reserves, given that the market for less liquid instruments is generally disproportionately volatile during a time of market stress.

The results of stress tests play a key role in shaping an entity's liquidity risk contingency planning.[422] Thus, stress testing and contingency planning are closely intertwined.[423] Under the proposals, the ANC broker-dealer and a stand-alone SBSD using internal models would be required to establish a written contingency funding plan.[424] The plan would need to clearly set out the strategies for addressing liquidity shortfalls in emergency situations,[425] and would need to address the policies, roles, and responsibilities for meeting the liquidity needs of the firm and communicating with the public and other market participants during a liquidity stress event.[426]

Request for Comment

The Commission generally requests comment on the proposed liquidity stress test requirement. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are the proposed funding liquidity requirements appropriate for ANC broker-dealers and nonbank SBSDs that use internal models? If not, explain why not. Are there modifications that would improve the funding liquidity provisions? If so, explain them.
2. Should the proposed funding liquidity requirements apply to a broader group of broker-dealers (*e.g.,* all broker-dealers that hold customer securities and cash or all broker-dealer with total assets in excess of minimum threshold)? Explain why or why not.
3. Should the proposed funding liquidity requirements apply to all nonbank SBSDs? If so, explain why. If not, explain why not.
4. Is monthly an appropriate frequency for the liquidity stress test? For example, would it be preferable to require the liquidity stress test on a more frequent basis such as weekly, or, alternatively, on a less frequent basis such as quarterly? If so, explain why.
5. Is the requirement to provide the results of the liquidity stress test within ten business days to senior management that has responsibility to oversee risk management at the firm appropriate? If not, explain why not. Should results be provided in a shorter or longer timeframe than ten business days? For example, is ten business days sufficient time to run the stress tests, generate the results, and provide them to senior management? If the time-frame should be longer or shorter, identify the different timeframe and explain why it would be more appropriate than ten business days.
6. Is the requirement that the assumptions underlying the liquidity stress test be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the firm and at least annually by senior management of firm appropriate? If not, explain why not. Should the reviews be more or less frequent? If so, identify the frequency and explain why it would be more appropriate than quarterly and annually.
7. Are the required assumptions of the funding liquidity stress test appropriate? If not, explain why not.

[419] *See* proposed new paragraph (f)(1) to Rule 15c3–1; paragraph (f)(1) of proposed new Rule 18a–1.

[420] *See* proposed new paragraph (f)(3) of Rule 15c3–1; paragraph (f)(3) of proposed new Rule 18a–1.

[421] *See* proposed new paragraph (f)(3) of Rule 15c3–1; paragraph (f)(3) of proposed new Rule 18a–1.

[422] *See, e.g.,* Federal Reserve, FDIC, OCC, OTS, and NCUA, *Interagency Policy Statement on Funding and Liquidity Risk Management* 7, SR 10–6 (Mar. 17, 2010).

[423] *Id.*

[424] Based on staff experience supervising the ANC broker-dealers, all of the ANC broker-dealers that are part of a holding company generally have a written contingency funding plan, generally at the holding company level. This proposed rule would require that each ANC broker-dealer and stand-alone SBSD using internal models maintain a written contingency funding plan at the entity level (in addition to any holding company plan). *See also Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* 77 FR at 604. The Federal Reserve stated that the objectives of the contingency funding plan are to provide a plan for responding to a liquidity crisis, to identify alternate liquidity sources that a covered company can access during liquidity stress events, and to describe steps that should be taken to ensure that the covered company's sources of liquidity are sufficient to fund its operating costs and meet its commitments while minimizing additional costs and disruptions. *Id.* at 610.

[425] *See* proposed new paragraph (f)(4) of Rule 15c3–1; paragraph (f)(4) of proposed new Rule 18a–1.

[426] *See* proposed new paragraph (f)(4) of Rule 15c3–1; paragraph (f)(4) of proposed new Rule 18a–1. To promote the flow of necessary information during a liquidity stress, the Federal Reserve's proposed rule would require the event management process to include a mechanism that ensures effective reporting and communication within the covered company and with outside parties, including the Federal Reserve and other relevant supervisors, counterparties, and other stakeholders. *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* 77 FR at 611.

8. Are there additional or alternative assumptions that should be required in the funding liquidity stress test? If so, identify the additional or alternative assumptions and explain why they should be included.

9. Are the required assumptions of the funding liquidity stress test understandable? If not, identify the elements that require further explanation.

10. Should other types of securities in addition to U.S. government securities be permitted for the liquidity pool? If so, identify the types of securities and explain why they should be permitted.

11. Are the requirements for the written contingency funding plan appropriate? If not, explain why not.

12. Should additional or alternative requirements for the written contingency funding plan be required? If so, identify the additional or alternative requirements and explain why they should be required.

e. Other Rule 15c3–1 Provisions Incorporated into Rule 18a–1

Rule 15c3–1 has four other sets of provisions that are proposed to be included in new Rule 18a–1: (1) Debt-equity ratio requirements;[427] (2) capital withdrawal notice requirements;[428] (3) subsidiary consolidation requirements (Appendix C);[429] and (4) subordinated loan agreement requirements (Appendix D).[430]

i. Debt-Equity Ratio Requirements

Rule 15c3–1 sets limits on the amount of a broker-dealer's outstanding subordinated loans.[431] The limits are prescribed in terms of debt-to-equity amounts.[432] The debt-to-equity limits are designed to ensure that a broker-dealer has a base of permanent capital in addition to any subordinated loans, which—as discussed above—are permitted to be added back to net worth when computing net capital.[433] Proposed new Rule 18a–1 would contain the same debt-to-equity limits.[434] The objective of this parallel provision in Rule 18a–1 is to require nonbank SBSDs to maintain a base of permanent capital.

Request for Comment

The Commission generally requests comment on the proposal to incorporate the debt-equity ratio provisions of Rule 15c3–1 into proposed new Rule 18a–1. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following question:

1. Are the debt-equity ratio requirements in Rule 15c3–1 appropriate standards for stand-alone SBSDs? If not, explain why not and suggest an alternative standard.

ii. Capital Withdrawal Requirements

Rule 15c3–1 requires that a broker-dealer provide notice when it seeks to withdraw capital in an amount that exceeds certain thresholds.[435] For example, a broker-dealer must give the Commission a two-day notice before a withdrawal that would exceed 30% of the firm's excess net capital and a notice within two days after a withdrawal that exceeded 20% of that measure.[436] The notice provisions are designed to alert the Commission and the firm's designated examining authority that capital is being withdrawn to assist in the monitoring of the financial condition of the broker-dealer. Rule 15c3–1 also restricts capital withdrawals that could have certain financial impacts on the firm, including withdrawals that reduce net capital below certain numerical levels.[437] These restrictions are designed to ensure that the broker-dealer maintains a buffer of net capital above its minimum required amount. Finally, under the rule, the Commission may issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain circumstances.[438] This provision and several of the notice and restriction provisions were put in place after the failure of the investment bank Drexel Burnham Lambert, Inc. (''Drexel'').[439] Drexel, prior to its bankruptcy, transferred significant funds from its broker-dealer subsidiary to the holding company without notice to the Commission or Drexel's designated examining authority.[440]

Stand-alone SBSDs would be subject to the same provisions, with one difference.[441] In 2007, the Commission proposed amendments to Rule 15c3–1 to eliminate certain of the conditions required in an order restricting the withdrawals or the making of loans or advances to stockholders, insiders, and affiliates.[442] More specifically, under Rule 15c3–1, the Commission can, by order, restrict a broker-dealer for a period up to 20 business days from making capital withdrawals, loans, and advances only to the extent the withdrawal, loan, or advance would exceed 30% of the broker-dealer's excess net capital when aggregated with other such transactions over a 30-day period.[443] The current requirement raises a concern, based on Commission staff experience, that to the extent the books and records of a broker-dealer that is in financial distress are incomplete or inaccurate it can be difficult for regulators to determine the firm's actual net capital and excess net capital amounts.[444] An order that limits withdrawals to a percentage of excess net capital may be difficult to enforce as it may not always be clear when that threshold had been reached.[445] Given these concerns and consistent with the proposed amendment to Rule 15c3–1, the Commission is proposing that its ability to restrict withdrawals of capital, loans or advances by stand-alone SBSDs not be limited based on the amount of the withdrawal, loan or advance in relation to the amount of the firms' excess net capital.[446]

[427] *See* 17 CFR 240.15c3–1(d).

[428] *See* 17 CFR 240.15c3–1(e).

[429] *See* 17 CFR 240.15c3–1c.

[430] *See* 17 CFR 240.15c3–1d.

[431] *See* 17 CFR 240.15c3–1(d).

[432] *Id.*

[433] *See Net Capital Rule,* Exchange Act Release No. 9891 (Dec. 5, 1972), 38 FR 56, 59 (Jan. 3, 1973) (''The Commission has discovered a large number of instances in which broker-dealers were able to comply with the net capital although the firms [*sic*] net worth been entirely depleted. Compliance with the rule was possible only because subordinated debt is a permissible form of capital. Such conditions rendered the firm technically insolvent since its liabilities exceeded its assets.'').

[434] *See* paragraph (h) of proposed new Rule 18a–1.

[435] *See* 17 CFR 240.15c3–1(e)(1).

[436] See 17 CFR 240.15c3–1(e)(1).

[437] *See* 17 CFR 240.15c3–1(e)(2).

[438] *See* 17 CFR 240.15c3–1(e)(3).

[439] *See Net Capital Rule,* Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991).

[440] *Id.* at 9125.

[441] *See* paragraph (i) of proposed new Rule 18a–1.

[442] *Amendments to Financial Responsibility Rules for Broker-Dealers,* 72 FR 12862.

[443] *See* 17 CFR 240.15c3–1(e)(3)(i). To issue an order, the Commission must, based on the facts and information available, conclude that the withdrawal, advance or loan may be detrimental to the financial integrity of the broker-dealer, or may unduly jeopardize the broker-dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker-dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970 (''SIPA''). *See* 17 CFR 240.15c3–1(e)(3)(i)(B). Furthermore, the rule provides that an order temporarily prohibiting the withdrawal of capital shall be rescinded if the Commission determines that the restriction on capital withdrawal should not remain in effect and that the hearing will be held within two business days from the date of the request in writing by the broker-dealer. *See* 17 CFR 240.15c3–1(e)(3)(ii).

[444] *See Amendments to Financial Responsibility Rules for Broker-Dealers,* 72 FR at 12873.

[445] *Id.*

[446] *See* paragraph (i) of proposed new Rule 18a–1; *Amendments to Financial Responsibility Rules for Broker-Dealers,* 72 FR at 12873.

Request for Comment

The Commission generally requests comment on the proposal to incorporate the capital withdrawal provisions of Rule 15c3–1 into proposed new Rule 18a–1. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are the capital withdrawal requirements in Rule 15c3–1 appropriate standards for stand-alone SBSDs? If not, explain why and suggest an alternative standard.

2. Under Rule 15c3–1, a broker-dealer must give the Commission notice two days before a withdrawal that would exceed 30% of the firm's excess net capital and two days after a withdrawal that exceeded 20% of that measure. Are these thresholds appropriate for stand-alone SBSDs? If not, explain why not and suggest alternative thresholds.

3. Rule 15c3–1 also restricts capital withdrawals that would have certain financial impacts on a broker-dealer such as lowering net capital below certain levels. Are these same requirements appropriate standards for stand-alone SBSDs?

4. Under the proposed amendments, the 30% of excess net capital limitation currently contained in Rule 15c3–1 with respect to Commission orders restricting withdrawals would be eliminated. However, under the proposed amendments, the Commission in issuing an order restricting withdrawals could impose such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors. Please identify terms and conditions that the Commission should consider to be included in such orders. For example, under certain circumstances, would it be appropriate for the current limitation in Rule 15c3–1 to be included in the order? Alternatively, should the 30% of excess net capital limitation currently contained in Rule 15c3–1 be retained in proposed new Rule 18a–1? If so, please explain why.

iii. Appendix C

Appendix C to Rule 15c3–1 requires a broker-dealer in computing its net capital and aggregate indebtedness to consolidate in a single computation assets and liabilities of any subsidiary or affiliate for which it guarantees, endorses or assumes directly or indirectly obligations or liabilities.[447] The assets and liabilities of a subsidiary or affiliate whose liabilities and obligations have not been guaranteed, endorsed, or assumed directly or indirectly by the broker-dealer may also be consolidated.[448] By including the assets and liabilities of a subsidiary in its net capital computation, a firm may receive flow-through net capital benefits because the consolidation may serve to increase the firm's net capital and thereby assist it in meeting the minimum requirements of Rule 15c3–1. Appendix C sets forth the requirements that must be met to consolidate in a single net capital computation the assets and liabilities of subsidiaries and affiliates in order to obtain flow-through capital benefits for a parent broker-dealer.[449] Specifically, the broker-dealer must possess majority ownership and control over the consolidated subsidiary or affiliate and obtain an opinion of counsel essentially stating that at least the portion of the subsidiary's or affiliate's net asset value related to the broker-dealer's ownership interest therein may be distributed to the broker-dealer (or a trustee in a SIPA liquidation) within thirty days, at the request of the distributee.[450] In addition, subordinated obligations of the subsidiary or affiliate may not serve to increase the net worth of the broker-dealer unless the obligations also are subordinated to the claims of present and future creditors of the broker-dealer.[451] Appendix C also requires that liabilities and obligations of a subsidiary or affiliate of the broker-dealer that are guaranteed, endorsed, or assumed either directly or indirectly by the broker-dealer must be reflected in the firm's net capital computation.[452]

Based on Commission staff experience and information from an SRO, very few broker-dealers consolidate subsidiaries or affiliates to obtain the flow-through capital benefits under Appendix C to Rule 15c3–1. The review and information from the SRO indicate that the limited use results from the difficulty in obtaining the required opinion of counsel. Consequently, Appendix C to proposed new Rule 18a–1 would contain only the requirement that a stand-alone SBSD include in its net capital computation all liabilities or obligations of a subsidiary or affiliate of the stand-alone SBSD that the SBSD guarantees, endorses, or assumes either directly or indirectly. Thus, stand-alone SBSDs would not be able to claim flow-through capital benefits for consolidated subsidiaries or affiliates. The Commission does not expect that this difference in approach between Rule 15c3–1 and proposed new Rule 18a–1 would create any competitive disadvantage for stand-alone SBSDs vis-à-vis broker-dealer SBSDs, given the limited use of the flow-through benefits provision under the current rule.

Request for Comment

The Commission generally requests comment on Appendix C of both Rule 15c3–1 and proposed Rule 18a–1. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Should the flow-through capital benefit provisions of Appendix C to Rule 15c3–1 be eliminated? If so, explain why. Alternatively, should the flow-through capital benefit provisions in Appendix C to Rule 15c3–1 be incorporated into proposed Rule 18a–1? If so, explain why.

2. Would stand-alone SBSDs be subject to a competitive disadvantage vis-à-vis broker-dealer SBSDs as a result of the differences between proposed Appendix C of Rule 18a–1 and Appendix C of Rule 15c3–1? Would these differences provide an incentive for an entity to register a nonbank SBSD as a broker-dealer SBSD? Please explain.

iv. Appendix D

Appendix D to Rule 15c3–1 sets forth the minimum and non-exclusive requirements for satisfactory subordination agreements.[453] A subordination agreement is a contract between a broker-dealer and a third party pursuant to which the third party lends money or provides a collateralized note to the broker-dealer. Generally, broker-dealers use subordination agreements to borrow from third parties (typically affiliates) to increase the broker-dealer's net capital.[454] Nonbank SBSDs also are expected to use subordinated debt to obtain financing for their activities and the proposals discussed below would prescribe when

[447] *See* 17 CFR 240.15c3–1c.

[448] *Id.*

[449] *See* 17 CFR 240.15c3–1c.

[450] *See* 17 CFR 240.15c3–1c(b). FINRA Rule 4150(a) requires that prior written notice be given to FINRA whenever a FINRA member guarantees, endorses or assumes, directly or indirectly, the obligations or liabilities of another person. Paragraph (b) of the rule requires that prior written approval must be obtained from FINRA whenever any member seeks to receive flow-through capital benefits in accordance with Appendix C to Rule 15c3–1. This makes compliance with the rule more stringent because FINRA must pre-approve the subordinated debt for FINRA member firms who wish to take advantage of the capital benefits available under Appendix C of Rule 15c3–1. As of June 1, 2012, of the 4,711 broker-dealers registered with the Commission, 4,437 were FINRA member firms.

[451] *See* 17 CFR 240.15c3–1c(c)(2).

[452] *See* 17 CFR 240.15c3–1c(d).

[453] 17 CFR 240.15c3–1d.

[454] *See* 17 CFR 240.15c3–1(c)(2)(ii).

such loans would receive favorable capital treatment.

In order to receive beneficial regulatory capital treatment under Rule 15c3–1, the obligation to the third party must be subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as defined under Appendix D.[455] Among other things, a satisfactory subordination agreement must prohibit, except under strictly defined limitations, prepayments or any payment of an obligation before the expiration of at least one year from the effective date of the subordination agreement.[456] This provision was designed to ensure the adequacy as well as the permanence of capital in the industry.[457]

There are two types of subordination agreements under Appendix D to Rule 15c3–1: (1) a subordinated loan agreement, which is used when a third party lends cash to a broker-dealer;[458] and (2) a secured demand note agreement, which is a promissory note in which a third party agrees to give cash to a broker-dealer on demand during the term of the note and provides cash or securities to the broker-dealer as collateral.[459]

A broker-dealer SBSD would be subject to the provisions of Appendix D to Rule 15c3–1 through parallel provisions in Appendix D to proposed new Rule 18a–1.[460] However, only the subordinated loan agreement provisions would be included in Appendix D to proposed new Rule 18a–1. Thus, stand-alone SBSDs would not be able to use secured demand note agreements to obtain beneficial regulatory capital treatment under proposed Appendix D to Rule 18a–1. Based on Commission staff experience, broker-dealers infrequently utilize secured demand notes as a source of capital, and the amounts of these notes are relatively small in size. Therefore, this form of regulatory capital is not being proposed for stand-alone SBSDs. Accordingly, Appendix D to proposed new Rule 18a–1 would refer solely to ''subordinated loan agreements'' in the provisions where Appendix D to Rule 15c3–1 refers more broadly to ''subordination agreements.''[461]

Subordination agreements under Appendix D to Rule 15c3–1 are approved by a broker-dealer's designated examining authority.[462] A broker-dealer also is required to notify its designated examining authority upon the occurrence of certain events under Appendix D to Rule 15c3–1.[463] Because the term ''designated examining authority'' applies only to registered broker-dealers (*i.e.,* stand-alone SBSDs would not have a designated examining authority), the provisions of Appendix D to Rule 18a–1 refer to the ''Commission'' instead of the ''designated examining authority.'' Specifically, under paragraph (c)(5) of Appendix D to proposed Rule 18a–1, a stand-alone SBSD would be required to file two copies of any proposed subordinated loan agreement (including nonconforming subordinated loan agreements) at least 30 days prior to the proposed execution date of the agreement with the Commission.[464] The rule would also require an SBSD to file with the Commission a statement setting forth the name and address of the lender, the business relationship of the lender to the SBSD, and whether the SBSD carried an account for the lender effecting transactions in security-based swaps at or about the time the proposed agreement was filed.[465]

Request for Comment

The Commission generally requests comment on Appendix D to both Rule 15c3–1 and proposed new Rule 18a–1. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Should the secured demand note provisions of Appendix D to Rule 15c3–1 be eliminated? Alternatively, should the secured demand note provisions be incorporated into Appendix D to proposed new Rule 18a–1? If so, explain why.

2. Would stand-alone SBSDs be disadvantaged vis-à-vis broker-dealer SBSDs as a result of the differences between proposed Appendix D to proposed new Rule 18a–1 and Appendix D to Rule 15c3–1? Would these differences provide an incentive for an entity to register a nonbank SBSD as a broker-dealer SBSD? Please explain.

3. Proposed Capital Rules for Nonbank MSBSPs

Proposed new Rule 18a–2 would establish capital requirements for nonbank MSBSPs. In particular, a nonbank MSBSP would be required at all times to have and maintain positive tangible net worth.[466] A tangible net worth standard is being proposed for nonbank MSBSPs, rather than the net liquid assets test in Rule 15c3–1, because the entities that may need to register as nonbank MSBSPs may engage in a diverse range of business activities different from, and broader than, the securities activities conducted by broker-dealers or SBSDs (otherwise they would be required to register as an SBSD and/or broker-dealer). For example, these entities may engage in commercial activities that require them to have substantial fixed assets to support manufacturing and/or result in them having significant assets comprised of unsecured receivables. Requiring them to adhere to a net liquid assets test could result in their having to obtain significant additional capital or engage in costly restructurings.

The term *tangible net worth* would be defined to mean the nonbank MSBSP's net worth as determined in accordance with generally accepted accounting principles in the United States, excluding goodwill and other intangible assets.[467] In determining net worth, all long and short positions in security-based swaps, swaps, and related positions would need to be marked to

[455] *Id.*

[456] *See* 17 CFR 240.15c3–1d(b)(1).

[457] *See Net Capital Requirements for Broker-Dealers; Amended Rules,* Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512, 3516 (Jan. 25, 1982).

[458] *See* 17 CFR 240.15c3–1d(a)(2)(ii).

[459] *See* 17 CFR 240.15c3–1d(a)(2)(v)(A). Under a secured demand note agreement, the third party cannot sell or otherwise use the collateral unless the third party substitutes securities of equal value for the deposited securities. *See* 17 CFR 240.15c3–1d(a)(2)(v)(D).

[460] Appendix D to Rule 15c3–1d has provisions that apply if an action (*e.g.,* repayment of the subordinated loan) would cause the broker-dealer's net capital to fall below certain thresholds (*e.g.,* 120% of the broker-dealer's minimum net capital requirement) and a provision that applies if the broker-dealer's net capital has fallen below its minimum net capital requirement. *See* paragraphs (b)(7), (b)(8)(i), (b)(10)(ii)(B), (c)(2), and (c)(5)(i)(B) of 17 CFR 240.15c3–1d. Proposed new Rule 18a–1 would contain analogous provisions that would be based on the proposed minimum net capital and tentative net capital requirements for stand-alone SBSDs. *See* paragraphs (b)(6), (b)(7), (b)(9)(ii)(A), (c)(2), and (c)(4)(i) of proposed new Rule 18a–1d. In addition, in order to reflect the minimum net capital requirements that would apply to broker-dealer SBSDs, conforming amendments are being proposed for Rule 15c3–1d. *See* proposed amendments to paragraphs (b)(7), (b)(8)(i), (b)(10)(ii)(B), (c)(2), and (c)(5)(i)(B) of 17 CFR 240.15c3–1d.

[461] The term ''subordination agreements'' as used in Appendix D to Rule 15c3–1 references both subordinated loan agreements and secured demand note agreements.

[462] *See* 17 CFR 240.15c3–1d(c)(6)(i). *See also* FINRA Rule 4110(e)(1), which provides that subordinated loans and secured demand notes must be approved by FINRA in order to receive beneficial regulatory capital treatment.

[463] *See, e.g.,* 17 CFR 240.15c3–1d(b)(6).

[464] *See* paragraph (c)(5) of proposed new Rule 18a–1d.

[465] *Id.*

[466] *See* paragraph (a) of proposed new Rule 18a–2. If a broker-dealer is required to register as a nonbank MSBSP, it would need to continue to comply with Rule 15c3–1 in addition to proposed new Rule 18a–2.

[467] *See* paragraph (b) of proposed new Rule 18a–2.

their market value.[468] Further, a nonbank MSBSP would be required to include in its computation of tangible net worth all liabilities or obligations of a subsidiary or affiliate that the participant guarantees, endorses, or assumes, either directly or indirectly.[469] The proposed definition of *tangible net worth* would allow nonbank MSBSPs to include as regulatory capital assets that would be deducted from net worth under Rule 15c3–1, such as property, plant, equipment, and unsecured receivables. At the same time, it would require the deduction of goodwill and other intangible assets.[470]

Because nonbank MSBSPs, by definition, will be entities that engage in a substantial security-based swap business, they would be required to comply with Rule 15c3–4 with respect to their security-based swap and swap activities.[471] As discussed above in section II.A.2.c. of this release, Rule 15c3–4 requires OTC derivatives dealers and ANC broker-dealers to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with their business activities, including market, credit, leverage, liquidity, legal, and operational risks.[472] The proposal that nonbank MSBSPs be subject to Rule 15c3–4 is designed to promote sound risk management practices with respect to the risks associated with OTC derivatives.

Finally, the risk that the failure of a nonbank MSBSP could have a destabilizing market impact is being addressed in part by the account *equity* requirements in proposed new Rule 18a–3—as discussed below in section II.B.2.c.ii. of this release—that would require a nonbank MSBSP to deliver collateral to counterparties to cover the counterparty's current exposure to the nonbank MSBSP. The proposed requirement that nonbank MSBSPs deliver collateral to counterparties is designed to address a risk that arose during the 2008 credit crisis (*i.e.,* the existence of large uncollateralized exposures of market participants to a single entity). The proposed requirements in proposed new Rule 18a–2 that a nonbank MSBSP maintain positive tangible net worth and establish risk management controls are designed to serve as an extra measure of protection but be flexible enough to account for the potential range of business activities of these entities.

Request for Comment

The Commission generally requests comment on the proposed capital requirements for nonbank MSBSPs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is a tangible net worth test an appropriate standard for a nonbank MSBSP? Would a net liquid assets test capital standard be more appropriate? If so, describe the rationale for such an approach.

2. Should nonbank MSBSPs be permitted to calculate their tangible net worth using generally accepted accounting principles in jurisdictions other than U.S., such as where the nonbank MSBSP is incorporated, organized, or has its principal office? If so, explain why.

3. Can the risks to market stability presented by nonbank MSBSPs be largely addressed through margin requirements?

4. Should proposed new Rule 18a–2 require that a nonbank MSBSP maintain a minimum fixed-dollar amount of tangible net equity, for example, equal to $20,000,000 or some greater or lesser amount? If so, explain the merits of imposing a fixed-dollar amount and identify the recommended fixed-dollar amount.

5. Should proposed new Rule 18a–2 require that a nonbank MSBSP compute capital charges for market risk and credit risk? For example, should such a requirement be modeled on the CFTC's proposed market and credit risk charges for nonbank swap dealers and nonbank major swap participants that are not using internal models and are not FCMs?[473] If nonbank SBSDs should be required to take market and credit risk charges, explain why. If not, explain why not.

6. Should nonbank MSBSPs be subject to a leverage test and if so, how should it be designed? Explain the rationale for such a test.

7. Should a nonbank MSBSP be subject to a minimum tangible net worth requirement that is proportional to the amount of risk incurred by the MSBSP through its outstanding security-based swap transactions? More specifically, should an MSBSP calculate an ''adjusted tangible net worth'' by subtracting market risk deductions for their security-based swaps (either based on the standardized haircuts or on approved models) from their tangible net worth and be required to maintain sufficient capital such that this adjusted tangible net worth figure is positive?

B. Margin

1. Introduction

As discussed above in section II.A.2.b.iv. of this release, dealers in OTC derivatives manage credit risk to their OTC derivatives counterparties through collateral and netting agreements.[474] The two types of credit exposure arising from OTC derivatives are current exposure and potential future exposure. The current exposure is the amount that the counterparty would be obligated to pay the dealer if all the OTC derivatives contracts with the counterparty were terminated (*i.e.,* it is the amount of the current receivable from the counterparty). This form of credit risk arises from the potential that the counterparty may default on the obligation to pay the current receivable. The potential future exposure is the amount that the current exposure may increase in favor of the dealer in the future. This form of credit risk arises from the potential that the counterparty may default before providing the dealer with additional collateral to cover the incremental increase in the current exposure or that the current exposure will increase after a default when the counterparty has ceased to provide additional collateral to cover such increases and before the dealer can liquidate the position.

Dealers may require counterparties to provide collateral to cover their current and potential future exposures to the counterparty.[475] On the other hand, they may not require collateral for these purposes because, for example, the counterparty is deemed to be of low

[468] *Id.* This provision is modeled on paragraph (c)(2)(vi)(B)(*1*) of Rule 15c3–1. *See* 17 CFR 240.15c3–1(c)(2)(vi)(B)(*1*). *See also* paragraph (c)(1)(i)(B)(*1*) of proposed new Rule 18a–1.

[469] *See* paragraph (b) of proposed new Rule 18a–2.

[470] The proposed definition of *tangible net worth* is consistent with the CFTC's proposed definition of *tangible net equity. See CFTC Capital Proposing Release,* 76 FR at 27828 (defining *tangible net equity* as ''equity as determined under U.S. generally accepted accounting principles, and excludes goodwill and other intangible assets.'').

[471] *See* paragraph (c) of proposed new Rule 18a–2.

[472] *See* 17 CFR 240.15c3–4.

[473] *See CFTC Capital Proposing Release,* 76 FR at 27809–27812.

[474] *See Market Review of OTC Derivative Bilateral Collateralization Practices; OTC Derivatives: Settlement Procedures and Counterparty Risk Management.*

[475] In the Dodd-Frank Act, collateral collected to cover current exposure is referred to as *variation margin* and collateral collected to cover potential future exposure is referred to as *initial margin. See, e.g.,* section 15F(e)(2)(B)(i)–(ii) of the Exchange Act (15 U.S.C. 78o–10(e)(2)(B)(i)–(ii)) and section 4s(e)(1)(A)–(B) of the CEA (7 U.S.C. 6s(e)(1)(A)–(B)), added by the Dodd-Frank Act. In this release, collateral collected to cover potential future exposure is referred to as *margin collateral.*

credit risk.[476] Alternatively, agreements between a dealer and its counterparties could require the counterparties to begin delivering collateral during the pendency of the transaction if certain ''trigger events,'' *e.g.,* a downgrade of the counterparty's credit rating, occur. Prior to the financial crisis, the ability to enter into OTC derivatives transactions without having to deliver collateral allowed counterparties to enter into OTC derivatives transactions without the necessity of using capital to support the transactions.[477] So, when ''trigger events'' occurred during the financial crisis, counterparties faced significant liquidity strains in seeking to meet the requirements to deliver collateral.[478] As a result, some dealers experienced large uncollateralized exposures to counterparties experiencing financial difficulty, which, in turn, risked exacerbating the already severe market dislocation.[479]

The Dodd-Frank Act seeks to address the risk of uncollateralized credit risk exposure arising from OTC derivatives by, among other things, mandating margin requirements for non-cleared security-based swaps and swaps. In particular, section 764 of the Dodd-Frank Act added new section 15F to the Exchange Act.[480] Section 15F(e)(2)(B) of the Exchange Act provides that the Commission shall adopt rules for nonbank SBSDs and nonbank MSBSPs imposing ''both initial and variation margin requirements on all security-based swaps that are not cleared by a registered clearing agency.'' [481] Section 15F(e)(2)(A) of the Exchange Act provides that the prudential regulators shall prescribe initial and variation margin requirements for non-cleared security-based swap transactions applicable to bank SBSDs and bank MSBSPs.[482] Section 15F(e)(3)(A) also provides that ''[t]o offset the greater risk to the security-based swap dealer or major security-based swap participant and the financial system arising from the use of security-based swaps that are not cleared,'' the margin requirements proposed by the Commission and prudential regulators shall ''help ensure the safety and soundness'' of the SBSDs and the MSBSPs, and ''be appropriate for the risk associated with non-cleared security-based swaps held'' by an SBSD or MSBSP.[483]

Similarly, sections 4s(e)(1)(A) and (B) of the CEA provide that the prudential regulators and the CFTC shall prescribe margin requirements for, respectively, bank swap dealers and bank major swap participants, and nonbank swap dealers and nonbank major swap participants.[484] Further, section 4s(e)(3)(A) of the CEA provides, among other things, that ''[t]o offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared,'' the margin requirements adopted by the prudential regulators and the CFTC shall ''help ensure the safety and soundness'' of swap dealers and major swap participants, and ''be appropriate for the risk associated with non-cleared swaps held'' by these entities.[485]

The margin requirements that must be established with respect to non-cleared security-based swaps and non-cleared swaps will operate in tandem with provisions in the Dodd-Frank Act requiring that security-based swaps and swaps must be cleared through a registered clearing agency or registered DCO, respectively, unless an exception to mandatory clearing exists.[486] More specifically, section 3C of the Exchange Act,[487] as added by section 763(a) of the Dodd-Frank Act, creates, among other things, a clearing requirement with respect to certain security-based swaps. Specifically, this section provides that ''[i]t shall be unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to a clearing agency that is registered under this Act or a clearing agency that is exempt from registration under this Act if the security-based swap is required to be cleared.'' [488]

Clearing agencies and DCOs that operate as central counterparties (''CCPs'') manage credit and other risks through a range of controls and methods, including prescribed margin rules for their members.[489] Thus, the

[476] *See, e.g.,* Orice M. Williams, Director, Financial Markets and Community Investment, General Accountability Office (''GAO''), *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps,* GAO–09–397T (Mar. 2009), available at *http://www.gao.gov/new.items/d09397t.pdf* (testimony before the U.S. House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises).

[477] *Id.* at 13.

[478] *Id. See also* GAO, *Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc.,* GAO–11–616 (Sept. 2011), available at *http://www.gao.gov/assets/590/585560.pdf* (''*Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc.''*).

[479] *See Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc.* at 5–6.

[480] *See* Public Law 111–203 § 764.

[481] 15 U.S.C. 78o–10(e)(2)(B).

[482] *See* 15 U.S.C. 78o–10(e)(2)(A). The prudential regulators have proposed margin rules with respect to non-cleared swaps and security-based swaps that would apply to bank swap dealers, bank major swap participants, bank SBSDs, and bank MSBSPs. *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564. The prudential regulators refer to collateral to cover current exposure as *variation margin* and collateral to cover potential future exposure as *initial margin. Id.*

[483] 15 U.S.C. 78o–10(e)(3)(A).

[484] *See* 7 U.S.C. 6s(e)(1)(A) and (B). The CFTC has proposed margin requirements with respect to non-cleared swaps that would apply to nonbank swap dealers and nonbank major swap participants. *See CFTC Margin Proposing Release,* 76 FR 23732. The CFTC refers to collateral to cover current exposure as *variation margin* and collateral to cover potential future exposure as *initial margin. Id.*

[485] 7 U.S.C. 6s(e)(3)(A).

[486] *See* Public Law 111–203 § 763 (adding section 3C(a)(1) of the Exchange Act (15 U.S.C. 78c–3(a)(1) (mandatory clearing of security-based swaps)) and Public Law 111–203 § 723 (adding section 2(h) of the CEA (7 U.S.C. 2(h) (mandatory clearing of swaps)). The mandatory clearing provisions in the Exchange Act and CEA contain exceptions from the mandatory clearing requirement for certain types of entities, security-based swaps, and swaps. *See Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b–4 and Form 19b–4 Applicable to All Self-Regulatory Organizations,* Exchange Act Release No. 67286 (June 28, 2012), 77 FR 41602 (July 13, 2012) (explaining exceptions to mandatory clearing for security-based swaps) (''*Process for Submissions of Security-Based Swaps''*); *Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade,* 76 FR 77728 (Dec. 30, 2010) (explaining exceptions to mandatory clearing for swaps). Security-based swaps and swaps that are not required to be cleared would be non-cleared security-based swaps and swaps.

[487] 15 U.S.C. 78c–3 *et seq.*

[488] 15 U.S.C. 78c–3(a)(1) (as added by section 763(a) of the Dodd-Frank Act). The requirement that a security-based swap must be cleared will stem from the determination to be made by the Commission. Such determination may be made in connection with the review of a clearing agency's submission regarding a security-based swap, or any group, category, type or class of security-based swap, the clearing agency plans to accept for clearing. *See* 15 U.S.C. 78c–3(b)(2)(C)(ii) (as added by section 763(a) of the Dodd-Frank Act) (''[t]he Commission shall * * * review each submission made under subparagraphs (A) and (B), and determine whether the security-based swap, or group, category, type, or class of security-based swaps, described in the submission is required to be cleared''.). In addition, section 3C(b)(1) of the Exchange Act provides that ''[t]he Commission on an ongoing basis shall review each security-based swap, or any group, category, type, or class of security-based swaps to make a determination that such security-based swap, or group, category, type, or class of security-based swaps should be required to be cleared.''

[489] *See Clearing Agency Standards for Operation and Governance,* Exchange Act Release No. 64017 (Mar. 3, 2011), 76 FR 14472 (Mar. 16, 2011) (''*Clearing Agency Standards for Operation and Governance''*). A CCP interposes itself between two counterparties to a transaction. *See Process for Submissions of Security-Based Swaps,* 77 FR at 41603. For example, when an OTC derivatives contract between two counterparties that are members of a CCP is executed and submitted for clearing, it is typically replaced by two new contracts—separate contracts between the CCP and each of the two original counterparties. At that point, the original counterparties are no longer counterparties to each other. Instead, each acquires the CCP as its counterparty, and the CCP assumes the counterparty credit risk of each of the original counterparties that are members of the CCP. To address the credit risk of acting as a CCP, clearing

mandatory clearing requirements established by the Dodd-Frank Act for security-based swaps and swaps, in effect, will establish margin requirements for cleared security-based swaps and cleared swaps and, thereby, complement the margin requirements for non-cleared security-based swaps and non-cleared swaps established by the Commission, the prudential regulators, and the CFTC.[490]

Pursuant to section 15F(e) of the Exchange Act, the Commission is proposing new Rule 18a–3 to establish margin requirements for nonbank SBSDs and nonbank MSBSPs with respect to non-cleared security-based swaps. The provisions of proposed Rule 18a–3 are based on the margin rules applicable to broker-dealers (the ''broker-dealer margin rules'').[491] The goal of modeling proposed new Rule 18a–3 on the broker-dealer margin rules is to promote consistency with existing rules and to facilitate the portfolio margining of security-based swaps with other types of securities. In the securities markets, margin rules have been set by relevant regulatory authorities (the Federal Reserve and the SROs) since the 1930s.[492] The requirement that an SRO file proposed margin rules with the Commission has promoted the establishment of consistent margin levels across the SROs, which mitigates the risk that SROs (as well as their member firms) will compete by implementing lower margin levels and also helps ensure that margin levels are set at sufficiently prudent levels to reduce systemic risk.[493] Basing proposed Rule 18a–3 on the broker-dealer margin rules is intended to achieve these same objectives in the market for security-based swaps.

Under the broker-dealer margin rules, an accountholder is required to maintain a specified level of *equity* in a securities account at a broker-dealer (*i.e.,* the market value of the assets in the account must exceed the amount of the accountholder's obligations to the broker-dealer by a prescribed amount).[494] This equity serves as a buffer in the event the accountholder fails to meet an obligation to the broker-dealer and the broker-dealer must liquidate the assets in the account to satisfy the obligation.[495] The equity also provides liquidity to the broker-dealer with which to fund the credit extended to the accountholder. The amount of the equity required to be maintained in the account depends on the securities transactions being facilitated through the resources of the broker-dealer because the equity requirement increases as the risk of the securities purchased with borrowed funds or sold short with borrowed securities increases.

Proposed new Rule 18a–3 is based on these same principles and is intended to form part of an integrated program of financial responsibility requirements, along with the proposed capital and segregation standards. For example, proposed new Rule 18a–1 would impose a capital charge in certain cases for uncollateralized exposures arising from security-based swaps. The segregation requirements are intended to ensure that initial margin collected by SBSDs is protected from their proprietary business risks.[496]

Request for Comment

The Commission generally requests comment on the proposal to model the nonbank SBSD margin rule for non-cleared security-based swaps on the broker-dealer margin rules. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are there other margin standards that would more appropriately address the risks of non-cleared security-based swaps and/or be more practical margining programs for non-cleared security-based swaps? If so, identify them and explain how they would be more appropriate and/or practical.

2. What are the current margining practices of dealers in OTC derivatives with respect to contracts that likely would be security-based swaps subject to proposed new Rule 18a–3? How do those margining practices differ from the proposed requirements in proposed new Rule 18a–3?

3. As a practical matter, would the structure of proposed new Rule 18a–3 accommodate portfolio margining of security-based swaps and swaps? If so, explain why. If not, explain why not.

2. Proposed Margin Requirements for Nonbank SBSDs and Nonbank MSBSPs

a. Scope of Rule 18a–3

Proposed new Rule 18a–3 would apply to nonbank SBSDs and nonbank MSBSPs.[497] As discussed in more detail below, the proposed rule would require nonbank SBSDs to collect collateral from their counterparties to non-cleared security-based swaps to cover both current exposure and potential future exposure to the counterparty (*i.e.,* the rule would require the account to have prescribed minimum levels of *equity*); however, there would be exceptions to

agencies and DCOs require their clearing members to post collateral for proprietary and customer positions of the member cleared by the clearing agency or DCO. They also may require their clearing members to collect collateral from their customers. In addition, as discussed below, the Federal Reserve and the broker-dealer SROs prescribe margin rules requiring broker-dealers to collect margin collateral from their customers for financed securities transactions and facilitated short sales of securities. *Id.*

[490] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27567 (''In the derivatives clearing process, central counterparties (CCPs) manage the credit risk through a range of controls and methods, including a margining regime that imposes both initial margin and variation margin requirements on parties to cleared transactions. Thus, the mandatory clearing requirement established by the Dodd-Frank Act for swaps and security-based swaps will effectively require any party to any transaction subject to the clearing mandate to post initial and variation margin to the CCP in connection with that transaction.'') (footnote omitted). *See also Clearing Agency Standards for Operation and Governance,* 76 FR at 14482 (proposing a requirement that clearing agencies acting as CCPs must establish, implement, maintain, and enforce written policies and procedures reasonably designed to use margin requirements to limit credit exposures to members in normal market conditions, use risk-based models and parameters to set margin requirements, and review the models and parameters at least monthly).

[491] Broker-dealers are subject to margin requirements in rules promulgated by the Federal Reserve (12 CFR 220.1, *et seq.*), SROs (*see, e.g.,* FINRA Rules 4210–4240), and, with respect to security futures, jointly by the Commission and the CFTC (17 CFR 242.400–406).

[492] The Federal Reserve originally adopted Regulation T pursuant to section 7 of the Exchange Act shortly after the enactment of the Exchange Act. *See* 1934 Fed. Res. Bull. 675. The purposes of the Federal Reserve's margin rules include: (1) Regulation of the amount of credit directed into securities speculation and away from other uses; (2) protection of the securities markets from price fluctuations and disruptions caused by excessive margin credit; (3) protection of investors against losses arising from undue leverage in securities transactions; and (4) protection of broker-dealers from the financial exposure involved in excessive margin lending to customers. *See* Charles F. Rechlin, *Securities Credit Regulation* § 1:3 (2d ed. 2008).

[493] Pursuant to section 19(b)(1) of the Exchange Act, each SRO must file with the Commission any proposed change in, addition to, or deletion from the rules of the exchange electronically on a Form 19b–4 through the Electronic Form 19b–4 Filing System, which is a secure Web site operated by the Commission. 15 U.S.C. 78s(b)(1); 17 CFR 240.19b–4.

[494] *See, e.g.,* 12 CFR 220.2; FINRA Rule 4210(a)(5); 17 CFR 242.401(a)(8). Accountholder obligations to the broker-dealer generally arise from the accountholder borrowing funds from the broker-dealer to finance securities purchases and the accountholder relying on the broker-dealer to borrow securities or use its own securities to make delivery on short sales of securities by the accountholder.

[495] The account *equity* requirement, in effect, mandates that the account contain sufficient collateral to cover the broker-dealer's current exposure to the accountholder plus a buffer to address potential future exposure.

[496] *See* proposed new Rules 18a–1, 18a–3, and 18a–4.

[497] *See* paragraph (a) of proposed new Rule 18a–3.

these requirements for certain types of counterparties and for certain types of transactions. The collateral collected to address the potential future exposure (the margin collateral) would need to be sufficient to meet the level of account *equity* required by the proposed rule. The required level of account *equity* would be based on the risk of the positions in the account.

Proposed new Rule 18a–3 would require a nonbank MSBSP to collect collateral from counterparties to which the nonbank MSBSP has current exposure and deliver collateral to counterparties that have current exposure to the nonbank MSBSP; however, there would be exceptions to these requirements for certain types of counterparties. These requirements would apply only to current exposure (*i.e.,* nonbank MSBSPs and their counterparties would not be required to exchange collateral to cover potential future exposure to each other).

The proposed rule would not identify the types of instruments that must be delivered as collateral (*e.g.,* U.S. government securities). However, it would place limitations on the collateral that could be collected by nonbank SBSDs. First, the rule would require the nonbank SBSD to take haircuts on the collateral equal to the amounts of the deductions required under Rule 15c3–1, as proposed to be amended, and proposed new Rule 18a–1, as applicable to the nonbank SBSD. Second, the rule would prescribe conditions with respect to the collateral modeled on the conditions in Appendix E to Rule 15c3–1, discussed above in section II.A.2.b.iv. of this release, that determine when collateral can be taken into account for purposes of determining a potential credit risk charge for exposure to certain counterparties.[498]

Finally, the provisions in proposed new Rule 18a–3 are intended to establish *minimum* margin requirements for non-cleared security-based swaps. A nonbank SBSD and a nonbank MSBSP could establish ''house'' margin requirements that are more conservative than those specified in the proposed new rule.[499] For example, a nonbank SBSD could require that a minimum level of *equity* must be maintained in the accounts of counterparties that exceed the level of *equity* required to be maintained pursuant to the proposed new rule. In addition, a nonbank SBSD and a nonbank MSBSP could specifically identify and thereby limit the types of instruments they will accept as collateral.

b. Daily Calculations

i. Nonbank SBSDs

Proposed new Rule 18a–3 would require nonbank SBSDs to collect collateral from their counterparties to non-cleared security-based swaps to cover both current exposure and potential future exposure, subject to certain exceptions discussed below.[500] Consequently, proposed new Rule 18a–3 would require a nonbank SBSD to perform two calculations as of the close of each business day with respect to each account carried by the firm for a counterparty to a non-cleared security-based swap transaction.[501] A nonbank SBSD would be required to increase the frequency of the calculations (*i.e.,* perform intra-day calculations) during periods of extreme volatility and for accounts with concentrated positions.[502] These more frequent calculations would be designed to monitor the nonbank SBSD's counterparty risk exposure in situations where a default by a counterparty or multiple counterparties would have a more significant adverse impact on the financial condition of the nonbank SBSD than under more normal circumstances.[503] One consequence of the more frequent calculations could be that the nonbank SBSD requests that a counterparty deliver collateral during the day pursuant to a ''house'' margin requirement to account for changes in the value of the securities and money market instruments held in the account.

As discussed below in section II.B.2.c.i. of this release, the daily calculations would form the basis for the nonbank SBSD to determine the amount of collateral the counterparty would need to deliver to cover any current exposure and potential future exposure the nonbank SBSD has to the counterparty. The proposed rule would except certain counterparties from this requirement. Even if the counterparty is not required to deliver collateral, the calculations—by measuring the current and potential future exposure to the counterparty—would assist the nonbank SBSD in managing its credit risk and understanding the extent of its uncollateralized credit exposure to the counterparty and across all counterparties. In addition, as discussed above in section II.A.2.a. of this release, the calculations would be used for determining the *risk margin amount* for purposes of calculating the 8% margin factor to determine the nonbank SBSD's minimum net capital requirement.[504]

The first calculation would be to determine the amount of *equity* in the account.[505] For purposes of the rule, the term *equity* would mean the total current fair market value of securities positions in an account of a counterparty (excluding the time value of an over-the-counter option), plus any credit balance and less any debit balance in the account after applying a qualifying netting agreement with respect to gross derivatives payables and receivables.[506] Consequently, the first step in calculating the *equity* would be to mark-to-market all of the securities positions in the account, including non-cleared security-based swap positions. The second step would be to add to that amount any credit balance in the account or subtract from that amount any debit balance in the account. Credit balances would include payables the nonbank SBSD owed to the counterparty. Payables could relate to cash deposited into the account, the proceeds of the sales of securities held in the account, and/or interest and dividends earned from securities held in the account. In addition, payables could relate to derivatives in the account, including non-cleared security-based swaps with a net replacement value in the favor of the counterparty. Debit balances would be receivables to the nonbank SBSD owed by the

[498] *See* 17 CFR 240.15c3–1e(c)(4)(v)(A)–(H).

[499] Under broker-dealer margin rules, broker-dealers also can establish ''house'' margin requirements as long as they are at least as restrictive as the Federal Reserve and SRO margin rules. *See, e.g.,* FINRA Rule 4210(d).

[500] *See* paragraphs (c)(1)(ii) and (iii) of proposed new Rule 18a–3.

[501] *See* paragraphs (c)(1)(i)(A) and (B) of proposed new Rule 18a–3. For purposes of proposed new Rule 18a–3, the term *account* would mean an account carried by a nonbank SBSD or nonbank MSBSP for a counterparty that holds non-cleared security-based swaps. *See* paragraph (b)(1) of proposed new Rule 18a–3. In addition, the term *counterparty* would mean a person with whom the nonbank SBSD or nonbank MSBSP has entered into a non-cleared security-based swap transaction. *See* paragraph (b)(3) of proposed new Rule 18a–3.

[502] *See* paragraph (c)(7) of proposed new Rule 18a–3.

[503] *Compare* FINRA Rule 4210(d) which states that procedures shall be established by members to: ''(1) review limits and types of credit extended to all customers; (2) formulate their own margin requirements; and (3) review the need for instituting higher margin requirements, mark-to-markets and collateral deposits than are required by this [margin rule] for individual securities or customer accounts.''

[504] *See* proposed new paragraph (c)(16) of Rule 15c3–1; paragraph (c)(6) of proposed new Rule 18a–1.

[505] *See* paragraph (c)(1)(i)(A) of proposed new Rule 18a–3.

[506] *See* paragraph (b)(4) of proposed new Rule 18a–3. The time value of an OTC option is the amount that the current market value of the option exceeds the in-the-money amount of the option. *See also, generally,* FINRA Rule 4210(a)(5) (defining *equity* to mean the customer's ownership interest in the account, computed by adding the current market value of all securities ''long'' and the amount of any credit balance and subtracting the current market value of all securities ''short'' and the amount of any debit balance).

counterparty, including any net replacement values in favor of the nonbank SBSD arising from derivatives positions and any other amounts owed to the nonbank SBSD by the counterparty.

As indicated by the proposed definition of *equity,* the nonbank SBSD could offset payables and receivables relating to derivatives in the account by applying a qualifying netting agreement with the counterparty. To qualify for this treatment, a netting agreement would need to meet the minimum requirements prescribed in Appendix E to Rule 15c3–1 to qualify for purposes of the credit risk charge discussed above in section II.A.2.b.iv. of this release.[507] These requirements are designed to ensure that the netting agreement between the nonbank SBSD and the counterparty permits the nonbank SBSD to reduce the receivables and payables relating to derivatives between the two entities to a single net payment obligation.

The *equity* is the amount that results after marking-to-market the securities positions and adding the credit balance or subtracting the debit balance (including giving effect to qualifying netting agreements). If the value of the securities positions in the account exceeds the amount of any debit balance, the account would have a *positive equity.*[508] On the other hand, if the amount of the debit balance is greater, the account would have a *negative equity.*[509] The *negative equity* in an account would be equal to the nonbank SBSD's current exposure to the counterparty.

The second calculation would be to determine a *margin* amount for the account to address potential future exposure.[510] The proposed rule would prescribe a standardized method and a model-based method for calculating the *margin* amount.[511] The method for determining the *margin* amount would be similar to the approach a nonbank SBSD would need to use to determine haircuts on proprietary security-based swap positions when computing net capital.[512] This approach would maintain consistency between the proposed margin and capital rules. Specifically, paragraph (d) of proposed new Rule 18a–3 would divide security-based swaps into two classes: CDS security-based swaps and all other security-based swaps. Paragraph (d) would define the standardized methodology for determining the *margin* amount for each class of security-based swap by reference to the standardized haircuts that would apply to the class in proposed new Rule 18a–1 (if a stand-alone SBSD) or Rule 15c3–1, as proposed to be amended (if a broker-dealer SBSD).[513] Paragraph (d) would provide further that, if the nonbank SBSD was approved to use internal models to compute net capital, the firm could use its internal VaR model to determine the margin amount for security-based swaps for which the firm had been approved to use the model, except that the margin amount for equity security-based swaps would need to be determined exclusively using the standardized haircuts.[514] Consequently, for debt security-based swaps, a nonbank SBSD approved to use internal models could calculate the margin amount using the firm's VaR model to the extent the firm is approved to include these types of positions in the model for the purposes of computing net capital. For all other positions, a nonbank SBSD would need to use the standardized haircut approach. Nonbank SBSDs that are not approved to use internal models to compute net capital would need to use the standardized haircuts for all positions to calculate the margin amount.

As noted above, a nonbank SBSD (regardless of whether it is approved to use internal models to compute net capital) would be required to calculate the *margin* amount for equity security-based swaps using the standardized haircuts, which includes the ability to use the methodology in Appendix A to Rule 15c3–1. This proposal is designed to establish a margin requirement for equity security-based swaps that is consistent with SRO portfolio margin rules for equity securities, which are based on the Appendix A methodology.[515] This provision would

[507] *See* paragraph (c)(5) of proposed new Rule 18a–3; 17 CFR 240.15c3–1e(c)(4)(iv).

[508] The proposed rule would define the term *positive equity* to mean *equity* of greater than $0. *See* paragraph (b)(7) of proposed new Rule 18a–3.

[509] The proposed rule would define the term *negative equity* to mean *equity* of less than $0. *See* paragraph (b)(6) of proposed new Rule 18a–3.

[510] *See* paragraph (c)(1)(i)(B) of proposed new Rule 18a–3.

[511] *See* paragraph (d) of proposed new Rule 18a–3. Similarly, the prudential regulators have proposed that bank SBSDs and bank swap dealers have the option of using internal models to calculate initial margin requirements for non-cleared security-based swaps. *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27567–27568 (''With respect to initial margin, the proposed rule permits a covered swap entity to select from two alternatives to calculate its initial margin requirements. A covered swap entity may calculate its initial margin requirements using a standardized 'lookup' table that specifies the minimum initial margin that must be collected, expressed as a percentage of the notional amount of the swap or security-based swap. These percentages depend on the broad asset class of the swap or security-based swap. Alternatively, a covered swap entity may calculate its minimum initial margin requirements using an internal margin model that meets certain criteria and that has been approved by the relevant prudential regulator.'') (footnotes omitted). On the other hand, the CFTC, because of concerns about the resources necessary to approve the use of internal models for margining purposes and the fact that nonbank swap dealers may not have internal models, proposed that nonbank swap dealers must use either external models or a standardized approach to determine initial margin (though the CFTC did propose a provision under which the CFTC could approve the use of an internal model should the CFTC obtain sufficient resources). *See CFTC Margin Proposing Release,* 76 FR at 23737. The external models proposed by the CFTC are: (1) a model currently in use for margining cleared swaps at a DCO; (2) a model currently in use for modeling non-cleared swaps by an entity subject to regular assessment by a prudential regulator; or (3) a model available for licensing to any market participant by a vendor. *Id.* The use of external models is not being proposed for nonbank SBSDs because the basis for permitting firms to use VaR models to compute net capital is to align their internally developed (*i.e.,* not vender-developed) risk management processes with the process for computing net capital. *See Alternative Net Capital Requirements Adopting Release,* 69 FR at 34428 (the option to use VaR models is ''intended to reduce regulatory costs for broker-dealers by allowing very highly capitalized firms that have developed robust internal risk management practices to use those risk management practices, such as mathematical risk measurement models, for regulatory purposes'').

[512] *See* paragraph (d) of proposed new Rule 18a–3; proposed new paragraph (c)(2)(vi)(O) of Rule 15c3–1; paragraph (c)(1)(vi) of proposed new Rule 18a–1.

[513] *See* paragraphs (d)(1)(i) and (ii) of proposed new Rule 18a–3. As discussed in section II.A.2.b.ii. of this release, proposed new Rule 18a–1 and Rule 15c3–1, as proposed to be amended, would prescribe standardized haircuts for security-based swaps. *See* proposed new paragraph (c)(2)(vi)(O) of Rule 15c3–1; paragraph (c)(1)(vi) of proposed new Rule 18a–1. Consequently, for CDS security-based swaps, the nonbank SBSD would use the proposed maturity/spread grid in proposed new paragraph (c)(2)(vi)(O)(*1*) of Rule 15c3–1 and paragraph (c)(1)(vi)(A) of proposed new Rule 18a–1 to determine the margin amount. *See* paragraph (d)(1)(i) of proposed new Rule 18a–3. While the required standardized haircuts would be the same in Rule 15c3–1, as proposed to be amended, and proposed new Rule 18a–1, the nonbank SBSD would refer to Rule 15c3–1 if it is a broker-dealer SBSD and proposed new Rule 18a–1 if it is a stand-alone SBSD. For all equity security-based swaps and debt security-based swaps (other than CDS security-based swaps), the nonbank SBSD would use the method of multiplying the notional amount of the position by the standardized haircut that would apply to the underlying security as specified in proposed new paragraph (c)(2)(vi)(O)(*2*) of Rule 15c3–1 and paragraph (c)(1)(vi)(B) of proposed new Rule 18a–1. *See* paragraph (d)(ii) of proposed new Rule 18a–3. For equity security-based swaps, this would include being able to use the methodology in Appendix A to Rule 15c3–1, as proposed to be amended, and in Appendix A to proposed new Rule 18a–1, as applicable to the nonbank SBSD. For debt security-based swaps, this would include being able to use the offsets that are permitted in the debt maturity grids in paragraph (c)(2)(vi) of Rule 15c3–1. *See* 17 CFR 240.15c3–1(c)(2)(vi).

[514] *See* paragraph (d)(2) of proposed new Rule 18a–3.

[515] *See* FINRA Rule 4210(g); CBOE Rule 12.4. *See also* FINRA, Portfolio Margin Frequently Asked Questions, available at *www.finra.org.* As discussed in section II.A.2.b.ii. of this release, Appendix A to Rule 15c3–1 permits a broker-dealer to group

Continued

allow broker-dealer SBSDs to include equity security-based swaps in the portfolios of equity securities positions for which they calculate margin requirements using the SRO portfolio margin rules.[516] The proposal also would ensure a consistent portfolio margin approach for equity security products across nonbank SBSDs and broker-dealers that are not SBSDs, and thereby reduce opportunity for regulatory arbitrage.

Request for Comment

The Commission generally requests comment on the proposed daily calculation requirements for nonbank SBSDs in proposed new Rule 18a–3. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is the proposed definition of *equity* appropriate? For example, would the proposed definition be practical in terms of determining the net *equity* in an account holding non-cleared security-based swaps? If the proposed definition is not appropriate, explain why and provide suggested alternative definitions.

2. Should the definition of *equity* include the time value of an over-the-counter option? If so, explain why.

3. Should the terms *current market value, credit balance,* and *debit balance* be defined for the purpose of proposed new Rule 18a–3? For example, would defining these terms provide greater clarity to the definition of *equity* in the proposed rule? If these terms should be defined, explain why and provide suggested definitions.

4. Are the proposed requirements for netting agreements to qualify for purposes of determining the amount of *equity* in an account appropriate? If not, explain why not. Are there additional or alternative provisions that should be contained in the netting agreement requirements? If so, identify and explain them.

5. Is the proposed method for calculating the *margin* amount appropriate? If not, explain why not. For example, is it appropriate to use the techniques in Rule 15c3–1, as proposed to be amended, and proposed new Rule 18a–1 to determine the *margin* amount? If not, explain why not. Are there alternative methods for calculating the *margin* amount that would be preferable? If so, identify them and explain why they would be preferable.

6. Should proposed new Rule 18a-3 allow an alternative method of calculating the *margin* amount that would permit a nonbank SBSD to determine the *margin* amount for a non-cleared security-based swap based on the margin required by a registered clearing agency for a cleared security-based swap whose terms and conditions closely resemble the terms and conditions of the non-cleared security-based swap (similar to the CFTC's proposal)? Would there be sufficient similarity between certain cleared and non-cleared security-based swaps to make this approach workable? In addition, if this alternative approach was permitted, how could the potential differences in margin requirements across clearing agencies be addressed?

7. In addition to internal models, should external models be permitted such as: (1) a model currently in use for margining cleared security-based swaps at a clearing agency; (2) a model currently in use for modeling non-cleared swaps by an entity subject to regular assessment by a prudential regulator; or (3) a model available for licensing to any market participant by a vendor? What would be the advantages and disadvantages of permitting external models?

8. How would the proposed standardized approaches to determining the *margin* amount differ from the standardized approaches the prudential regulators proposed for determining the initial margin amount?

9. The provisions for using VaR models to compute net capital require that the model use a 99%, one-tailed confidence level with price changes equivalent to a ten-business-day movement in rates and prices. This means the VaR model used for the purpose of determining a counterparty's *margin* amount also would need to use a 99%, one-tailed confidence level with price changes equivalent to a ten-business-day movement in rates and prices. The ten-business-day requirement is designed to account for market movements that occur over a period of time as opposed to a single day. This is designed to ensure that the VaR model uses potential market moves that are large enough to capture multi-day moves in rates and prices. Given this purpose, should the VaR model be required to use a longer period of time (*e.g.,* 15, 20, 25, or 30 business days) to establish a potentially greater margin collateral requirement for customers given that they may not be subject to capital and other prudential requirements? Would the 3-times multiplication factor proposed to be required for VaR models used by nonbank SBSDs (which, under the proposal, would need to be increased in response to back-testing exceptions) be necessary if the time period were longer than 10 business days? If not, explain why not.

ii. Nonbank MSBSPs

Proposed new Rule 18a–3 would require nonbank MSBSPs to collect collateral from counterparties to which the nonbank MSBSP has current exposure and provide collateral to counterparties that have current exposure to the nonbank MSBSP.[517] Consequently, a nonbank MSBSP would be required to calculate as of the close of business each day the amount of *equity* in each account of a counterparty.[518] Consistent with the proposal for nonbank SBSDs, a nonbank MSBSP would be required to increase the frequency of its calculations (*i.e.,* perform intra-day calculations) during periods of extreme volatility and for accounts with concentrated positions.[519]

options, futures, long securities positions, and short securities positions involving the same underlying security and stress the current market price for each position at ten equidistant points along a range of positive and negative potential future market movements, using an approved theoretical options pricing model that satisfies certain conditions specified in the rule. *See* 17 CFR 240.15c3–1a. The gains and losses of each position in the portfolio offset each other to yield a net gain or loss at each stress point. The stress point that yields the largest potential net loss for the portfolio would be used to calculate the aggregate haircut for all the positions in the portfolio. *Id.*

[516] *See, e.g.,* FINRA Rule 4210(g)(2)(G) (defining the term ''unlisted derivative'' for purposes of inclusion in the Appendix A methodology as used in the rule to calculate a portfolio margin requirement to mean ''any equity-based or equity index-based unlisted option, forward contract, or *security-based swap* that can be valued by a theoretical pricing model approved by the [Commission].'') (emphasis added).

[517] *See* paragraph (c)(2)(ii) of proposed new Rule 18a-3.

[518] *See* paragraph (c)(2)(i) of proposed new Rule 18a–3. A nonbank MSBSP would apply the definitions in paragraph (b) of proposed new Rule 18a–3 for the purposes of complying with the requirements in the rule. *See* paragraph (b) of proposed new Rule 18a–3. The term *equity* would be defined to mean the total current fair market value of securities positions in an account of a counterparty (excluding the time value of an over-the-counter option), plus any credit balance and less any debit balance in the account after applying a qualifying netting agreement with respect to gross derivatives payables and receivables. *See* paragraph (b)(4) of proposed new Rule 18a–3. The time value of an OTC option is the amount that the current market value of the option exceeds the in-the-money amount of the option. In addition, the term *account* is proposed to be defined to mean an account carried by a nonbank SBSD or nonbank MSBSP for a counterparty that holds non-cleared security-based swaps. *See* paragraph (b)(1) of proposed new Rule 18a-3. Furthermore, the term *counterparty* is proposed to mean a person with whom the nonbank SBSD or nonbank MSBSP has entered into a non-cleared security-based swap transaction. *See* paragraph (b)(3) of proposed new Rule 18a–3.

[519] *See* paragraph (c)(7) of proposed new Rule 18a–3. These more frequent calculations would be designed to monitor the nonbank MSBSP's

As would be the case for a nonbank SBSD, the first step for a nonbank MSBSP in calculating the *equity* in an account would be to mark-to-market all of the securities positions in the account, including non-cleared security-based swap positions. The second step would be to add to that amount any credit balance in the account or subtract from that amount any debit balance.[520] The nonbank MSBSP could offset payables and receivables relating to derivatives in the account by applying a qualifying netting agreement with the counterparty. To qualify for this treatment, a netting agreement would need to meet the minimum requirements prescribed in Appendix E to Rule 15c3–1 to qualify for purposes of the credit risk charge discussed above in section II.A.2.b.iv. of this release.[521] These requirements, set forth in paragraph (c)(5) of Rule 18a–3, are designed to ensure that the netting agreement between the nonbank MSBSP and the counterparty permits the nonbank MSBSP to reduce the receivables and payables between the two entities to a single net payment obligation.[522]

If the value of the securities positions plus the amount of any cash in the account exceeds the amount of the debit balance, the account would have *positive equity*.[523] This would mean the counterparty has current exposure to the nonbank MSBSP. On the other hand, if the amount of the debit balance is greater, the account would have *negative equity*.[524] This would mean the nonbank MSBSP has current exposure to the counterparty.

Nonbank MSBSPs would not be required to deliver or collect margin collateral to collateralize potential future exposure.[525] For that reason, Rule 18a–3 would not require nonbank MSBSPs to calculate a *margin* amount, and the rule would not require counterparties to provide margin collateral to nonbank MSBSPs to maintain *equity* levels above the nonbank MSBSP's current exposure. When a counterparty provides margin collateral to collateralize potential future exposure, the counterparty is exposed to credit risk in the amount that the collateral provided to the dealer exceeds the dealer's current exposure to the counterparty. With respect to nonbank SBSDs, collateralizing potential future exposure is intended to promote the financial responsibility of the nonbank SBSD, as the margin collateral received from the counterparty protects the nonbank SBSD from the risks arising from fluctuations in the value of the underlying positions before the collateral can be sold. The counterparty, in turn, would be protected by the net liquid assets test standard applicable to the nonbank SBSD,[526] which is significantly more conservative than the tangible net worth capital standard proposed for nonbank MSBSPs.[527] The counterparties also would be protected by the proposed segregation requirements with respect to the margin collateral delivered by counterparties.[528]

The proposed margin requirements for nonbank MSBSPs are designed to ''neutralize'' the credit risk between a nonbank MSBSP and a counterparty. The collection of collateral from counterparties would strengthen the liquidity of the nonbank MSBSP by collateralizing its current exposure to counterparties. Nonbank MSBSPs, in contrast to nonbank SBSDs, would be required to deliver collateral to counterparties to collateralize their current exposure to the nonbank MSBSP, which would lessen the impact on the counterparties if the nonbank MSBSP failed, and is intended to account for the fact that nonbank MSBSPs would be subject to less stringent capital requirements than nonbank SBSDs.

In addition, as discussed in section II.A.3. of the release, the entities that may need to register as nonbank MSBSPs could include companies that engage in commercial activities that are not necessarily financial in nature (*e.g.,* manufacturing, agriculture, and energy) and for which a net liquid assets test could be impractical. Finally, because of these differences in business models, nonbank MSBSPs may not have the systems and personnel necessary to operate daily margin collateral programs to address potential future exposure.

Request for Comment

The Commission generally requests comment on the proposed daily calculation requirements for nonbank MSBSPs. Commenters are referred to the questions about the daily calculation requirements for nonbank SBSDs above in section II.B.2.b.i. of this release to the extent those questions address provisions in proposed new Rule 18a–3 that also apply to nonbank MSBSPs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Which types of counterparties would be expected to transact with nonbank MSBSPs? Which types of security-based swap transactions would these counterparties enter into with nonbank MSBSPs?

2. Should nonbank MSBSPs be required to calculate a daily *margin* amount for each counterparty? For example, even if they were not required to collect collateral to cover potential future exposure, would the calculation of the *margin* amount better enable them to measure and understand their counterparty risk?

3. If nonbank MSBSPs should calculate a daily *margin* amount, how should such amount be calculated? Should a nonbank MSBSP be required to calculate a *margin* amount using the methods prescribed in paragraph (d) of proposed new Rule 18a–3 or some other method? For example, should nonbank MSBSPs be permitted to use external models to determine a *margin* amount?

4. Would nonbank MSBSPs have the systems and personnel necessary to operate daily margin collateral programs to calculate a daily margin amount?

c. Account Equity Requirements

i. Nonbank SBSDs

A nonbank SBSD would be required to calculate as of the close of each business day: (1) the amount of *equity*

counterparty risk exposure in situations where a default by a counterparty or multiple counterparties would have a more significant adverse impact on the financial condition of the nonbank MSBSP than under more normal circumstances. One consequence of the more frequent calculations could be that the nonbank MSBSP requests that a counterparty deliver collateral during the day pursuant to a ''house'' margin requirement to account for changes in the value of the securities and money market instruments held in the account.

[520] Credit balances would include payables the nonbank MSBSP owed to the counterparty. Payables could relate to cash deposited into the account, the proceeds of the sales of securities held in the account, and interest and dividends earned from securities held in the account. In addition, payables could relate to derivatives in the account such as non-cleared security-based swaps with a net replacement value in the favor of the counterparty. Debit balances would be receivables to the nonbank MSBSP owed by the counterparty. Receivables could relate to derivatives in the account such as non-cleared security-based swaps with a net replacement value in the favor of the nonbank MSBSP.

[521] *See* paragraph (c)(5) of proposed new Rule 18a–3; 17 CFR 240.15c3–1e(c)(4)(iv).

[522] *See* paragraph (c)(5) of proposed new Rule 18a–3.

[523] The proposed rule would define the term *positive equity* to mean *equity* of greater than $0. *See* paragraph (b)(7) of proposed new Rule 18a–3.

[524] The proposed rule would define the term *negative equity* to mean *equity* of less than $0. *See* paragraph (b)(6) of proposed new Rule 18a–3.

[525] *See* paragraph (c)(2)(i) of proposed new Rule 18a-3 (only requiring calculation of the *equity* in the account of each counterparty).

[526] *See* 17 CFR 240.15c3–1; proposed new Rule 18a–1.

[527] *See* proposed new Rule 18a–2.

[528] *See* proposed new Rule 18a–4.

in the account of each counterparty; and (2) a *margin* amount for the account of each counterparty.[529] On the next business day following the calculations, the nonbank SBSD would be required to collect cash, securities, and/or money market instruments from the counterparty in an amount at least equal to the *negative equity* (current exposure) in the account plus the *margin* amount (potential future exposure).[530] The collateral collected would be designed to ensure that the counterparty maintains a minimum level of positive net equity in the account. The proposed rule would require the nonbank SBSD to collect collateral for this purpose from each counterparty, except as discussed below.

A nonbank SBSD would need to collect cash, securities, and/or money market instruments to meet the account *equity* requirements in proposed new Rule 18a–3. Other types of assets would not be eligible as collateral. In addition, under proposed new Rule 18a–3, the fair market value of securities and money market instruments held in the account of a counterparty would need to be reduced by the amount of the deductions the nonbank SBSD would apply to the positions pursuant to Rule 15c3–1, as proposed to be amended, or proposed new Rule 18a–1, as applicable, for the purpose of determining whether the level of *equity* in the account meets the minimum requirement.[531] Accordingly, securities and money market instruments with no ''ready market'' or which cannot be publicly offered or sold because of statutory, regulatory, or contractual arrangements or other restrictions would be subject to a 100% deduction and, therefore, these types of securities and money market instruments would have no value in terms of meeting the account *equity* requirement.[532] All other securities and money market instruments in the account would be reduced in value by the amount of the deductions required in Rule 15c3–1, as proposed to be amended, and proposed new Rule 18a–1, as applicable to the nonbank SBSD.[533] The amount of the deductions would increase for securities and money market instruments with greater market risk and, thereby, account for the risk that the nonbank SBSD may not be able to liquidate the securities and money market instruments at current market values to satisfy the obligation of a defaulted counterparty.[534] These deductions would limit the types of securities and money market instruments a counterparty could provide as collateral and require a counterparty to increase the amount of collateral delivered to account for the deductions taken on securities collateral in the account.[535]

The prudential regulators and the CFTC are proposing to specifically identify the asset classes that would be eligible collateral for purposes of their margin rules.[536] Proposed new Rule 18a-3 would not limit collateral in this way. However, comment is sought below in section II.B.3. of this release on the question of whether to define the term *eligible collateral* in a manner that is similar to the proposals of the prudential regulators and the CFTC.

The reason for not proposing a definition of *eligible collateral* is that counterparties are expected to engage in a wide range of trading strategies that include security-based swaps. Consequently, the account of a counterparty may hold, for example, the security underlying a security-based swap, as well as a short position, option, and single stock future on the underlying security.[537] Because of the relationship between security-based swaps and these other security positions, permitting various types of securities to count as collateral may be more practical for margin arrangements involving security-based swaps than for other types of derivatives. A more limited definition of eligible collateral could require a counterparty that has *positive equity* in an account equal to or in excess of the *margin* amount to deliver additional collateral to the extent the positions in the account did not meet the definition. The counterparty's credit exposure to the nonbank SBSD therefore would be increased in a way that may not be necessary to account for the nonbank SBSD's potential future exposure to the counterparty.[538]

The Commission is proposing certain additional requirements for eligible collateral, which are modeled on the existing collateral requirements in Appendix E to Rule 15c3–1.[539] As discussed above in section II.A.2.b.iv. of this release, collateral ''ideally'' is ''an asset of stable and predictable value, an asset that is not linked to the value of the transaction in any way, and an asset that can be sold quickly and easily if the need arises.'' [540] The requirements in Appendix E to Rule 15c3–1 are designed to achieve these objectives.[541] The proposed additional requirements include:

- The collateral must be subject to the physical possession or control of the nonbank SBSD;

[529] *See* paragraph (c)(1)(i) of proposed new Rule 18a–3. *See also* paragraph (b)(4) of proposed new Rule 18a–3 (defining the term *equity*).

[530] *See* paragraph (c)(1)(ii) of proposed new Rule 18a-3.

[531] *See* paragraph (c)(3) of proposed new Rule 18a-3.

[532] *See* 17 CFR 240.15c3–1(c)(2)(vii); paragraph (c)(1)(iv) of proposed new Rule 18a–1.

[533] *See* 17 CFR 240.15c3–1(c)(2)(vi); paragraphs (c)(1)(vi)–(vii) of proposed new Rule 18a–1.

[534] *See* 17 CFR 240.15c3–1(c)(2)(vi); paragraphs (c)(1)(vi)–(vii) of proposed new Rule 18a–1.

[535] For example, assume an account holds securities and money market instruments valued at $50, a credit balance of $10, and a debit balance of $58. The *equity* in the account would be $2 ($50 of securities and money market instruments' value + $10 in credits − $58 in debits = $2). Assume that the margin amount calculated for the account is $10. This would mean that the account needs to have *positive equity* of at least $10 (it currently has *positive equity* of only $2). Assume that the deduction under Rule 15c3–1 for the $50 of securities and money market positions held in the account is $7. This would mean that the counterparty would need to deliver $15 in cash (*i.e.,* not $8) to meet the minimum $10 account *equity* requirement ($50 of securities and money market instruments' value − $7 deduction + $10 in credits − $58 in debits + $15 cash collateral deposit = $10). Moreover, if the counterparty delivered securities and/or money market instruments to meet the account *equity* requirement, the fair market value of the securities and money market instruments would need to be greater than $15 because their value would be reduced by the amount of the deduction in Rule 15c3–1 or proposed new Rule 18a–1, as applicable.

[536] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564; *CFTC Margin Proposing Release,* 76 FR 23732. The proposal of the prudential regulators would limit eligible collateral to cash, foreign currency to the extent the payment obligation under the security-based swap or swap is denominated in the currency, obligations guaranteed by the United States as to principal and interest, and, with respect to initial margin only, a senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks, and the Federal Agricultural Mortgage Corporation, or any obligation that is an ''insured obligation,'' as the term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank. *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27589. The proposal of the CFTC would limit eligible collateral for initial margin to cash, foreign currency to the extent the payment obligation under the security-based swap or swap is denominated in the currency, obligations guaranteed by the United States as to principal and interest, and a senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks, and the Federal Agricultural Mortgage Corporation, or any obligation that is an ''insured obligation,'' as the term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank. *CFTC Margin Proposing Release,* 76 FR at 23747. The CFTC's proposal would limit eligible collateral for variation margin to cash and obligations guaranteed by the United States as to principal and interest. *Id.*

[537] *See, e.g.,* FINRA Rule 4210(g) (permitting customer portfolio margining); 17 CFR 240.15c3–1a; Appendix A to proposed new Rule 18a–1.

[538] A counterparty will have credit exposure to a nonbank SBSD to the extent that collateral held in the account of the counterparty has a mark-to-market value in excess of the nonbank SBSD's current exposure to the counterparty.

[539] *See* paragraph (c)(4) of proposed new Rule 18a-3.

[540] *Market Review of OTC Derivative Bilateral Collateralization Practices* at 5.

[541] *See* 17 CFR 240.15c3–1e(c)(4)(v).

• The collateral must be liquid and transferable;

• The collateral must be capable of being liquidated promptly by the nonbank SBSD without intervention by any other party;

• The collateral agreement between the nonbank SBSD and the counterparty must be legally enforceable by the nonbank SBSD against the counterparty and any other parties to the agreement;

• The collateral must not consist of securities issued by the counterparty or a party related to the nonbank SBSD, or to the counterparty; and

• If the Commission has approved the nonbank SBSD's use of a VaR model to compute net capital, the approval allows the nonbank SBSD to calculate deductions for market risk for the type of collateral.[542]

These proposed collateral requirements are designed to ensure that the treatment of collateral requirements remains consistent between the proposed capital and margin requirements. As discussed above in section II.A.2.b.v. of this release, a nonbank SBSD would be required to take a capital charge if a counterparty does not deliver cash, securities, and/or money market instruments to the nonbank SBSD to meet an account *equity* requirement within one business day of the requirement being triggered. In addition, proposed new Rule 18a–3 would require the nonbank SBSD to take prompt steps to liquidate securities and money market instruments in the account to the extent necessary to eliminate the account *equity* deficiency.[543] Under this provision, which is modeled on a similar requirement in the broker-dealer margin rules,[544] a nonbank SBSD could need to liquidate positions in the account to reduce debits arising from those transactions. The rule would not require that the liquidations must be completed within a specific timeframe.[545] Instead, the rule is designed to give the nonbank SBSD the flexibility to conduct an orderly liquidation, taking into account market conditions and the risk profile of the account.

There would be four exceptions to the account *equity* requirements.[546] The first would apply to counterparties that are *commercial end users.*[547] The second would apply to counterparties that are SBSDs.[548] The third would apply to counterparties that are not *commercial end users* and that require their margin collateral to be segregated pursuant to section 3E(f) of the Exchange Act.[549] The fourth would apply to accounts of counterparties that are not *commercial end users* and that hold legacy non-cleared security-based swaps.[550] Under these exceptions, applicable accounts would not need to meet certain account *equity* requirements in proposed new Rule 18a–3 and, therefore, the nonbank SBSD would be exempted from the requirements to take prompt steps to liquidate securities in the account to the extent necessary to eliminate the account *equity* deficiency. However, as discussed above in section II.A.2.b.v. of this release, in these cases the nonbank SBSD would need to take capital charges in lieu of meeting the account *equity* requirements in certain circumstances.[551]

Exception for Commercial End Users

Under the first exception to the account *equity* requirements, a nonbank SBSD would not be required to collect cash, securities, and/or money market instruments to cover the *negative equity* (current exposure) or margin amount (potential future exposure) in the account of a counterparty that is a *commercial end user.*[552] As discussed above in section II.A.2.b.v. of this release, this proposed exception to the requirement to collect collateral is intended to address concerns that have been expressed by *commercial end users* and others that the imposition of margin requirements on commercial companies that use derivatives to mitigate the risk of business activities that are not financial in nature could unduly disrupt their ability to enter into hedging transactions. The proposed exception is intended to permit nonbank SBSDs and *commercial end users* to negotiate individual agreements that would reflect the credit risk of the *commercial end user* and the nature and extent of the non-cleared security-based swap transactions with the end user, without creating an undue impediment to the ability of the *commercial end user* to hedge its commercial risks.[553]

The proposed exception for *commercial end users* also is intended to account for the different risk profiles of *commercial end users* as compared with financial end users.[554] When credit markets are under strain, as in 2008, financial end users, such as hedge funds, can face liquidity stress, which increases their risk of default. Further,

[542] *See* paragraphs (c)(4)(i)–(c)(4)(vi) of proposed new Rule 18a–3.

[543] *See* paragraph (c)(8) of proposed new Rule 18a–3.

[544] *See* 12 CFR 220.4(d) (providing that if a margin call is not met within the required time, the broker-dealer must liquidate securities sufficient to meet the margin call or to eliminate any margin deficiency existing on the day such liquidation is required, whichever is less).

[545] *See* paragraph (c)(8) of proposed new Rule 18a–3.

[546] *See* paragraphs (c)(1)(iii)(A)–(D) of proposed new Rule 18a–3.

[547] *See* paragraph (c)(1)(iii)(A) of proposed new Rule 18a–3.

[548] *See* paragraph (c)(1)(iii)(B)—Alternative A of proposed new Rule 18a–3. An alternative approach is being proposed that would not be an exception to the account *equity* requirement under which a nonbank SBSD would need to collect collateral from another SBSD to cover the *negative equity* in the account and the margin amount for the account. In addition, the collateral collected to cover the margin amount would need to be held by an independent third-party custodian. *See* paragraph (c)(1)(iii)(B)—Alternative B of proposed new Rule 18a–3.

[549] *See* paragraph (c)(1)(iii)(C) of proposed new Rule 18a–3.

[550] *See* paragraph (c)(1)(iii)(D) of proposed new Rule 18a–3.

[551] *See* proposed new paragraph (c)(2)(xiv) of Rule 15c3–1; paragraph (c)(1)(viii) of proposed Rule 18a–1.

[552] *See* paragraph (c)(1)(iii)(A) of proposed Rule 18a–3. The exception would apply to *negative equity* in the account and the margin amount calculated for the account. However, a nonbank SBSD would be required to take a 100% deduction from net worth for the amount of the uncollateralized *negative equity* and take the proposed capital charge in lieu of margin collateral discussed above in section II.A.2.b.v. of this release. *See* 17 CFR 240.15c3–1(c)(2)(iv)(B) (deductions for unsecured receivables); paragraph (c)(1)(iii)(B) of proposed new Rule 18a–1 (deductions for unsecured receivables); proposed new paragraph (c)(2)(xiv) of Rule 15c3–1 (proposed capital charge in lieu of margin); paragraph (c)(1)(viii) of proposed Rule 18a–1 (proposed capital charge in lieu of margin). As an alternative to these capital charges, ANC broker-dealers and stand-alone SBSDs using internal models could take the credit risk charge discussed in section II.A.2.b.iv. of this release. *See* amendments to paragraph (a)(7) of Rule 15c3–1; paragraph (a)(2) of proposed new Rule 18a–1.

[553] The margin rule proposed by the prudential regulators would require the entities subject to the rule to establish credit exposure limits for each nonfinancial end user ''under appropriate credit processes and standards,'' and to collect collateral to the extent that individual exposures exceed those limits. *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27587. The margin rule proposed by the CFTC would permit entities subject to the rule and nonfinancial end users ''to set initial margin and variation margin requirements in their discretion'' but each entity subject to the proposed rule would be required to calculate daily exposure amounts for nonfinancial end users for risk management purposes. *See CFTC Margin Proposing Release,* 76 FR at 27736.

[554] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27571 (''Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity.''). *See also CFTC Margin Proposing Release,* 76 FR at 27735 (''The Commission believes that financial entities, which are generally not using swaps to hedge or mitigate commercial risk, potentially pose greater risk to CSEs than non-financial entities.'').

financial end users as a group, due to the nature of their business, may engage in security-based swap transactions in greater volume than *commercial end users,* increasing the risk of substantial concentration of counterparty exposure to nonbank SBSDs, and potentially creating greater systemic risk from the failure of a single entity.[555]

For purposes of the rule, the term *commercial end user* means any person (other than a natural person) that: (1) Engages primarily in commercial activities that are not financial in nature and that is not a *financial entity* as that term is defined in section 3C(g)(3) of the Exchange Act; [556] and (2) is using non-cleared security-based swaps to hedge or mitigate risk relating to the commercial activities.[557] The proposed definition of *commercial end user* is modeled on the exception to the mandatory clearing provisions for security-based swaps in section 3C of the Exchange Act.[558] Among other things, to qualify for the mandatory clearing exception, one of the counterparties to the security-based swap transaction must not be a *financial entity* and must be using security-based swaps to hedge or mitigate commercial risk.[559]

Under the proposed definition, an individual could not qualify as a *commercial end user.* In addition, because the proposed definition provides that a *commercial end user* must engage primarily in commercial activities that are not financial in nature and must not be a financial entity as defined in section 3C(g)(3) of the Exchange Act, entities such as banks, broker-dealers, FCMs, SBSDs, swap dealers, MSBSPs, swap participants, mutual funds, private funds, commodity pools, and employee benefit plans would not qualify as a *commercial end user.*[560] Furthermore, the proposed definition provides that the *commercial end user* must be using non-cleared security-based swaps to hedge or mitigate commercial risk.

The rationale for exempting *commercial end users* from the requirement to deliver collateral to meet the account *equity* requirements is that these end users often do not deliver collateral by current practice, and requiring them to do so could adversely impact their ability to mitigate the risk of their commercial activities by entering into hedging transactions. If an end user is using non-cleared security-based swaps for purposes other than hedging (*e.g.,* to take directional investment positions), the rationale for exempting the end user from the account *equity* requirements would not apply. An end user that is using non-cleared security-based swaps for investment purposes is not acting like a *commercial end user,* and, as such, no exemption would be available under the rule.

As discussed below in section II.B.2.e. of this release, a nonbank SBSD would be required to establish, maintain, and document procedures and guidelines for monitoring the risk of accounts holding non-cleared security-based swaps.[561] Among other things, a nonbank SBSD would be required to have procedures and guidelines for determining, approving, and periodically reviewing credit limits for each counterparty to a non-cleared security-based swap.[562] Consequently, if a nonbank SBSD does not collect collateral from a *commercial end user,* it would need to establish a credit limit for the end user and periodically review the credit limit in accordance with its risk monitoring guidelines.[563] The rule would not prohibit a nonbank SBSD from requiring margin collateral from a *commercial end user.*

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[555] The margin rules proposed by the prudential regulators and the CFTC would differentiate collateral requirements based on whether a financial end user is ''high risk'' or ''low risk.'' *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27571–27572; *CFTC Margin Proposing Release,* 76 FR at 23736–23737. A ''low risk'' financial end user is defined in their proposals as an entity that: (1) is subject to capital requirements established by a prudential regulator or a state insurance regulator; (2) predominantly uses OTC derivatives for hedging purposes; and (3) does not have significant OTC derivatives exposure. *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27572; *CFTC Margin Proposing Release,* 76 FR at 23735–23736. A low risk financial end user would not be required to deliver initial or variation margin if the amounts required are less than certain prescribed thresholds. *See id.* While not all financial end users present the same degree of counterparty risk, an exception from the account *equity* requirements based on the risk profile of the financial end user is not being proposed. This is because margin collateral is an important means of managing credit risk and the concerns expressed with respect to *commercial end users* being required to deliver margin collateral generally do not apply to financial end users as they customarily deliver margin collateral. As discussed in sections II.A.1. and II.A.2.b.i. of this release, the proposed capital standard for nonbank SBSDs is based on the net liquid assets test embodied in Rule 15c3–1. Under this test, most unsecured receivables are deducted in full when computing net capital because of their illiquidity. Proposed new Rule 18a–3 is designed to complement this treatment of unsecured receivables by limiting the exceptions to the requirement to collect collateral from counterparties to circumstances that provide a compelling reason for the trade-off between the risk-mitigating benefits of collateral and practical impediments to delivering collateral. With respect to nonbank SBSDs, there does not appear to be a compelling reason to establish a two-tiered approach for financial end users. First, financial end users generally pose more risk than *commercial end users.* Second, the different credit risk profiles of financial end users may not always be clear, which may make it difficult to differentiate between high and low risk financial end users. Third, market participants have told the Commission staff that financial end users entering into security-based swap transactions generally already deliver collateral to dealers to cover current and potential future exposure.

[556] *See* 15 U.S.C. 78o–3(g)(3). Section 3C(g) of the Exchange Act defines the term *financial entity* to mean: (1) a swap dealer; (2) an SBSD; (3) a major swap participant; (4) an MSBSP; (5) a commodity pool as defined in section 1a(10) of the CEA; (6) a private fund as defined in section 202(a) of the Investment Advisors Act of 1940; (7) an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002); or (8) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956.

[557] *See* paragraph (b)(2) of proposed new Rule 18a–3.

[558] *Compare* 15 U.S.C. 78c–3(g)(1), *with* paragraph (b)(2) of proposed new Rule 18a–3.

[559] *See* 15 U.S.C. 78c–3(g)(1).

[560] *See, e.g.,* 15 U.S.C. 78c–3(g)(3). The prudential regulators and the CFTC have proposed definitions of *financial end user* and *financial entity,* respectively, in their non-cleared security-based swap margin rules in addition to their proposed definitions of *nonfinancial end user. See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27571 (defining *financial end user*), and *CFTC Capital Proposing Release,* 76 FR at 23736 (defining *financial entity*). As discussed above, the CFTC and prudential regulators are proposing margin requirements that would differentiate collateral requirements based on whether a financial end user or financial entity is ''high risk'' or ''low risk.'' *Id.* In other words, their proposals would provide for potentially different treatment for three classes of entities: (1) Nonfinancial end users; (2) financial end users (low risk and high risk); and (3) entities that are neither a nonfinancial end user nor a financial end user. Therefore, they need to define the terms *financial end user* and *financial entity,* respectively. Because proposed new Rule 18a–3 would treat financial end users no differently than entities that are neither a *commercial end user* nor a financial end user, the Commission's proposed margin rule does not contain a definition of financial end user. However, as discussed below, the proposed rule would provide different treatment for counterparties that are SBSDs.

[561] *See* paragraph (e) of proposed new Rule 18a–3.

[562] *See* paragraph (e)(2) of proposed new Rule 18a–3. This is also consistent with the broker-dealer margin rules. *See* FINRA Rule 4210(d), which requires that FINRA member firms establish procedures to: (1) Review limits and types of credit extended to all customers; (2) formulate their own margin requirements; and (3) review the need for instituting higher margin requirements, mark-to-markets and collateral deposits than are required by the Rule for individual securities or customer accounts. See also FINRA Interpretation 4210(d)/01, available at *http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/industry/p122203.pdf* (noting that FINRA Rule 4210(d) ''requires that members determine the total dollar amount of credit to be extended to any one customer or on any one security to limit the potential loss or exposure to the member. It is important that specific limits be established to prevent any one customer or group of customers from endangering the member's capital.'').

[563] *See id.*

Exception for Counterparties That Are SBSDs

The second exception to the account *equity* requirements in proposed new Rule 18a–3 would apply to counterparties that are SBSDs.[564] Two alternatives with respect to SBSD counterparties are being proposed. Under the first alternative, a nonbank SBSD would not need to collect cash, securities, and/or money instruments to collateralize the margin amount (potential future exposure) in the account of a counterparty that is another SBSD (''Alternative A''). This approach is consistent with the broker-dealer margin rules, which generally do not require a broker-dealer to collect margin collateral from another broker-dealer. Under the second alternative, a nonbank SBSD would be required to collect cash, securities and/or money market instruments to collateralize both the *negative equity* (current exposure) and the margin amount (potential future exposure) in the account of a counterparty that is another SBSD (''Alternative B'').[565] Moreover, the cash, securities, and/or money market instruments would be required to be segregated in an account at an independent third-party custodian pursuant to the requirements of section 3E(f) of the Exchange Act.[566] Alternative B is consistent with the proposals of the prudential regulators and the CFTC.[567]

The two alternatives are being proposed in order to elicit detailed comment on each approach in terms of comparing how they would meet the goals of the Dodd-Frank Act,[568] address systemic issues relating to non-cleared security-based swaps, raise practical issues, alter current market practices and conventions, result in benefits and costs, and impact the security-based swap markets and the participants in those markets.

Under Alternative A, a nonbank SBSD would be required to collect cash, securities, and/or money market instruments from another SBSD only to cover the amount of *negative equity* (the current exposure) in the account of the counterparty.[569] Accordingly, under this approach, the nonbank SBSD would not be required to collect cash, securities, and/or money market instruments from another SBSD to collateralize the *margin* amount (the potential future exposure).[570] In other words, a counterparty that is another SBSD would not be required to maintain a minimum level of *positive equity* in the counterparty's account.

Requiring a nonbank SBSD to deliver collateral to cover potential future exposure could impact its liquidity. As discussed above in sections II.A.1. and II.A.2.b.i. of this release, the proposed capital requirements for nonbank SBSDs are based on a net liquid assets test. The objective of the test is to require the firm to maintain in excess of a dollar of highly liquid assets for each dollar of liabilities in order to facilitate the liquidation of the firm if necessary and without the need for a formal proceeding. When assets are delivered to another party as margin collateral, they become unsecured receivables from the party holding the margin collateral. Consequently, they no longer are readily available to be liquidated by the delivering party. In times of market stress, a nonbank SBSD may need to liquidate assets to raise funds and reduce its leverage. However, if assets are in the control of another nonbank SBSD, they would not be available for this purpose. For this reason, the assets would need to be deducted from net worth when the nonbank SBSD computes net capital under the proposed capital requirements.[571] As a result, the nonbank SBSD would need to maintain the required minimum amount of net capital after taking into account these deductions.

Promoting the liquidity of nonbank SBSDs is the policy consideration underlying Alternative A. In addition, the prudential regulators and the CFTC have received comments on this issue in response to their proposals raising concerns about requiring bank SBSDs and swap dealers to exchange collateral to cover potential future exposure and to have the collateral held by an independent third-party custodian. For example, some commenters assert that imposing segregated initial margin requirements on trades between swap entities would result in a tremendous cost to the financial system in the form of a massive liquidity drain, and that swap dealers will lose the ability to reinvest this collateral to finance other lending or derivatives transactions, thereby reducing capital formation and increasing costs.[572] One commenter stated that, in general, with respect to non-cleared swaps, charging more initial margin (as compared to cleared swaps) could have unintended consequences, including the inefficient use of capital by sophisticated market participants in highly regulated industries, which could create a drag on the financial system, slow economic

[564] *See* paragraph (c)(1)(iii)(B) of proposed new Rule 18a–3.

[565] Alternative B is not an exception to the account *equity* requirements in proposed new Rule 18a–3 because it would require collateral to cover the *negative equity* and margin amount in an account of another SBSD. However, its requirement for how the collateral must be held—at an independent third-party custodian on behalf of the counterparty—is different from how the proposed rule requires that collateral from other types of counterparties be held (other than counterparties that elect segregation under section 3E(f) of the Exchange Act (15 U.S.C. 78c–5(f)).

[566] *See* 15 U.S.C. 78c–5(f).

[567] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564; *CFTC Margin Proposing Release,* 76 FR 23732.

[568] *See* 15 U.S.C. 78o–10(e)(3)(A) (''[t]o offset the greater risk to the security-based swap dealer or major security-based swap participant and the financial system arising from the use of security-based swaps that are not cleared,'' the margin requirements proposed by the Commission and prudential regulators shall ''help ensure the safety and soundness'' of the SBSD and the MSBSP and ''be appropriate for the risk associated with non-cleared security-based swaps held'' by an SBSD and MSBSP).

[569] *See* paragraph (c)(1)(iii)(B) of proposed new Rule 18a–3–Alternative A. To the extent the margin amount was not collateralized, the nonbank SBSD would be required to take the proposed capital charge in lieu of margin collateral discussed above in section II.A.2.b.v. of this release.

[570] *Id.* Like all counterparties to non-cleared security-based swaps, counterparties that are SBSDs would be subject to the risk monitoring requirements in paragraph (e) of proposed new Rule 18a–3.

[571] *See* 17 CFR 240.15c3–1(c)(2)(iv)(B); paragraph (c)(1)(iii)(B) of proposed Rule 18a–1. Collateral provided to another party as margin would be subject to this 100% deduction.

[572] *See, e.g.,* letter from Robert Pickel, Executive Vice Chairman, ISDA, and Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, Securities Industry and Financial Markets Association (''SIFMA''), to David Stawick, Secretary, CFTC (July 11, 2011), available at *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47802&SearchText=SIFMA* (''*SIFMA/ISDA Comment Letter to the CFTC''*); letter from Robert Pickel, Executive Vice Chairman, ISDA, and Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, to Jennifer J. Johnson, Secretary, Federal Reserve, *et al.* (July 6, 2011), available at *http://www.fdic.gov/regulations/laws/federal/2011/11c22ad79.PDF* (''*SIFMA/ISDA Comment Letter to the Prudential Regulators''*); letter from the Honorable Darrell Issa, Chairman, Committee on Oversight and Government Reform, U.S. House of Representatives, to Ben Bernanke, Chairman, Federal Reserve *et al.* (July 22, 2011), available at *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47943&SearchText=issa*, and letter from Mark Scanlan, Vice President, Agriculture and Rural Policy, Independent Community Bankers of America, to the CFTC *et al.* (July 11, 2011), available at *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47762&SearchText=scanlan*. One commenter noted that there is no statutory requirement for covered swap entities to hold initial margin of other covered swap entities at an independent third party custodian. *See* letter from Christine Cochran, President, Commodity Markets Council, to the OCC *et al.* (July 11, 2011), available at *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47777&SearchText=cochran*. Here and below, this release refers to public comments on the margin proposals by the CFTC and the prudential regulators to more fully reflect the available views without endorsing those comments or expressing a view as to the validity of the comments.

growth, and diminish customer choice.[573]

Another commenter stated that a combination of daily variation margin, robust operational procedures, legally enforceable netting and collateral agreements, and regulatory capital requirements provide comprehensive risk mitigation for collateralized derivatives, and that any additional initial margin requirements for swaps between swap entities would be unnecessary and unwarranted.[574] A commenter argued that the proposed initial margin requirements are inconsistent with proven market practice, ignore significant differences in credit quality among swap dealers and financial entities which justify different margining treatment, and will lead to excessive amounts of collateral being required in comparison to the actual risks of the underlying swap transactions and portfolios.[575] Finally, a commenter argued that initial margin requirements should differentiate based on credit quality, and that the prudential regulators' margin rulemaking identifies no risk-based justification for layering zero threshold, bilateral initial margin requirements for all swap dealers above and beyond their existing variation margin requirements.[576]

On the other hand, a number of comments submitted in response to the proposals of the prudential regulators and the CFTC supported bilateral margining and argued that it should be extended to require SBSDs and swap dealers to exchange margin collateral with all counterparties.[577] For example, one commenter stated that the financial crisis demonstrated that the premise of one-way margin is flawed.[578] This commenter stated that two-way margin requirements would aid safety and soundness by helping a swap dealer and its counterparty offset their exposures and prevent them from building up exposures they cannot fulfill.[579]

The prudential regulators explained the reasoning behind their proposal as follows:

> Non-cleared swaps transactions with counterparties that are themselves swap entities pose risk to the financial system because swap entities are large players in swap and security-based swap markets and therefore have the potential to generate systemic risk through their swap activities. Because of their interconnectedness and large presence in the market, the failure of a single swap entity could cause severe stress throughout the financial system. Accordingly, it is the preliminary view of the Agencies that all non-cleared swap transactions with swap entities should require margin.[580]

Alternative B is being proposed in light of the policy considerations underlying the proposals of the prudential regulators and the CFTC.[581] Under Alternative B, a nonbank SBSD would be required to obtain cash, securities, and/or money market instruments from another SBSD to cover the *negative equity* (current exposure) and margin amount (potential future exposure) in the other SBSD's account.[582] In addition, the cash, securities, and/or money market instruments delivered to cover the margin amount would need to be carried by an independent third party custodian pursuant to the requirements of section 3E(f) of the Exchange Act.[583] Therefore, not only would there be no exception to the account *equity* requirement for counterparties that are SBSDs, but the treatment of the collateral would be different than for other types of counterparties in that it would be required to be held by an independent third-party custodian.[584]

Exception for Counterparties That Elect Segregation Under Section 3E(f)

Under the third exception to the account *equity* requirements in proposed new Rule 18a–3, a nonbank SBSD would not be required to hold the cash, securities, and/or money market instruments delivered by a counterparty that is not a *commercial end user* to cover the margin amount (potential future exposure), if the counterparty elects to have the cash, securities, and/or money market instruments segregated pursuant to section 3E(f) of the Exchange Act.[585] Section 3E(f) sets forth provisions under which a counterparty to a non-cleared security-based swap with an SBSD can require that collateral to cover potential future exposure must be segregated.[586] Among other things, section 3E(f) provides that the collateral must be segregated in an account carried by an independent third-party custodian and designated as a segregated account for and on behalf of the counterparty.[587]

As discussed below in section II.C. of this release, proposed new Rule 18a–3 would establish certain conditions that

[573] *See* letter from Mark R. Thresher, Executive Vice President, Chief Financial Officer, Nationwide, to the OCC (June 24, 2011), available at *http://www.federalreserve.gov/SECRS/2011/June/20110628/R–1415/R–1415_062311_81363_349039663039_1.pdf.*

[574] *See SIFMA/ISDA Comment Letter to the CFTC; SIFMA/ISDA Comment Letter to the Prudential Regulators.* This commenter also stated that precedent exists in the broker-dealer margin rules for not imposing any initial margin requirements on trades between swap entities. *Id.*

[575] *See* letter from Don Thompson, Managing Director and Associate General Counsel, J.P. Morgan Chase & Co., to the OCC *et al.* (June 24, 2011), available at *http://www.federalreserve.gov/SECRS/2011/June/20110627/R–1415/R–1415_062311_81366_349039350535_1.pdf* (''*J.P. Morgan Letter*''). Another commenter pointed out that life insurers also typically do not post initial margin and recommended that initial margin requirements be appropriately sized to reflect the potential exposure during the close out of a defaulting party. *See* letter from Carl B. Wilkerson, Vice President and Chief Counsel, Securities and Litigation, American Council of Life Insurers, to the OCC *et al.* (July 11, 2011), available at *http://www.federalreserve.gov/SECRS/2011/July/20110728/R–1415/R–1415_071111_81817_507164831320_1.pdf.*

[576] *See J.P. Morgan Letter.* This commenter stated that initial margin is appropriate in some circumstances, but it must take into account the credit quality of counterparties.

[577] *See, e.g.,* letter from Scott C. Goebel, Senior Vice President, General Counsel, FMR Co., to John Walsh, Acting Comptroller of the Currency, OCC (July 11, 2011); letter from Kevin M. Budd, Associate General Counsel, and Todd F. Lurie, Assistant General Counsel, MetLife, to OCC *et al.* (July 11, 2011); letter from John R. Gidman, on behalf of the Association of Institutional Investors, to Ms. Jennifer Johnson, Secretary, Federal Reserve, *et al.* (July 11, 2011); letter from R. Glenn Hubbard, Co-Chair, John L. Thornton, Co-Chair, and Hal S. Scott, Director, Committee on Capital Markets Regulation, to John Walsh, Acting Comptroller, OCC (July 11, 2011), available at *http://www.federalreserve.gov/SECRS/2011/July/20110719/R–1415/R–1415_071111_81821_322996697020_1.pdf*; letter from Dennis M. Kelleher, President and Chief Executive Officer, and Wallace C. Turbeville, Derivatives Specialist, Better Markets, Inc., to Jennifer J. Johnson, Secretary, Federal Reserve (July 11, 2011), available at *http://www.federalreserve.gov/SECRS/2011/July/20110728/R–1415/R–1415_071111_81861_504963784471_1.pdf*; letter from Americans for Financial Reform, to John Walsh, Acting Comptroller, OCC (July 11, 2011), available at *http://www.federalreserve.gov/SECRS/2011/July/20110728/R–1415/R–1415_071111_81864_448738394756_1.pdf.*

[578] Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David Stawick, Secretary, CFTC (July 11, 2011), available at is *http://www.ici.org/pdf/25344.pdf* (''ICI Letter'').

[579] *See* the ICI Letter.

[580] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27570–27571 (footnote omitted). *See also CFTC Margin Proposing Release,* 76 FR at 23735 (''It is the nature of the dealer business that dealers are at the center of the markets in which they participate. Similarly, a major swap participant, by its terms, is a significant trader. Collectively, [swap dealers and major swap participants] pose greater risk to the markets and the financial system than other swap market participants. Accordingly, under the mandate of Section 4s(e), the Commission believes that they should be required to collect margin from one another.'').

[581] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564; *CFTC Margin Proposing Release,* 76 FR 23744.

[582] *See* paragraph (c)(1)(iii)(B) of proposed Rule 18a–3—Alternative B.

[583] *Id.*

[584] *Id.*

[585] *See* paragraph (c)(1)(iii)(C) of proposed new Rule 18a–3. This exception would not apply to *negative equity* in the counterparty's account, which would need to be collateralized by cash, securities, and/or money market instruments held by the nonbank SBSD. *See* 15 U.S.C. 78c–5(f)(2)(B)(i) (providing that the segregation provisions in section 3E(f) of the Exchange Act do not apply to variation margin payments).

[586] *See* 15 U.S.C. 78c–5(f)(1)–(3).

[587] *See* 15 U.S.C. 78c–5(f)(3).

collateral would need to meet before its value could be included in the determination of the amount of *equity* in an account.[588] Among other conditions, the collateral would need to be subject to the physical possession or control of the nonbank SBSD and capable of being liquidated promptly by the nonbank SBSD without intervention by any other party.[589] Margin collateral segregated pursuant to section 3E(f) of the Exchange Act would not meet either of these conditions. First, the collateral would be in the physical possession or control of an independent third-party custodian rather than the nonbank SBSD. Second, the collateral could not be liquidated by the nonbank SBSD without the intervention of the independent third-party custodian. For these reasons, the value of the margin collateral held by the independent third-party custodian could not be included when determining the amount of *equity* in the account of the counterparty at the nonbank SBSD.

Exception for Accounts Holding Legacy Security-Based Swaps

Under the fourth exception to the account *equity* requirements in proposed new Rule 18a–3, a nonbank SBSD would not be required to collect cash, securities, and/or money market instruments to cover the *negative equity* (current exposure) or margin amount (potential future exposure) in a *security-based swap legacy account.*[590] Proposed new Rule 18a–3 would define *security-based swap legacy account* to mean an account that holds no security-based swaps entered into after the effective date of the rule and that is used to hold only security-based swaps entered into prior to the effective date of the rule, as well as collateral for those security-based swaps.[591] As discussed above in section II.A.2.b.v. of this release, this exception would be designed to address the impracticality of renegotiating contracts governing security-based swap transactions that predate the effectiveness of proposed new Rule 18a–3 in order to come into compliance with the account *equity* requirements in the rule.[592]

Request for Comment

The Commission generally requests comment on the proposed account *equity* requirements for counterparties of nonbank SBSDs in proposed new Rule 18a–3.[593] In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Would it be appropriate to limit the assets that could be used to collateralize the *negative equity* and *margin* amounts in an account to cash, securities, and money market instruments? Are there other types of assets that should be permitted to meet the account *equity* requirements in proposed new Rule 18a–3? If so, identify the other asset types and compare their liquidity to cash, securities, and money market instruments.

2. Is the proposed requirement to take deductions on securities and money market instruments in calculating the amount of *equity* in an account appropriate? If not, explain why not. Are there other measures that a nonbank SBSD could be required to take to address the risk that securities and money market instruments may not be able to be liquidated at current market values to cover the obligations of a defaulted counterparty? If so, explain how the other measures would be an adequate substitute to deductions.

3. Are the proposed conditions (modeled on the Appendix E conditions) for taking into account collateral in determining the amount of *equity* in an account appropriate for proposed new Rule 18a–3? If not, explain why not. Should any individual condition be eliminated? If so, explain why. Are there additional conditions that should be added? If so, identify them and explain how they would promote the goal of ensuring that collateral can be promptly liquidated to cover the obligation of a defaulted counterparty.

4. Is the proposed requirement that a nonbank SBSD take prompt steps to liquidate securities in an account to the extent necessary to eliminate an account *equity* deficiency appropriate? For example, should there be a specific time-frame (*e.g.,* 1, 2, 3, 4, 5, or some other number of business days) in which the nonbank SBSD is required to liquidate securities in the account? If so, explain why a specific time-frame would be preferable to requiring the nonbank SBSD to act promptly.

5. Is the proposed exception to the account *equity* requirements for *commercial end users* appropriate? If not, explain why not. Should *commercial end users* be required to collateralize *negative equity* and the margin amount in their accounts? Explain why or why not. Should the exception apply only to the margin amount (*i.e.,* should *commercial end users* be required to collateralize the *negative equity* in their accounts)? Explain why or why not.

6. Is the proposed definition of *commercial end user* appropriate? If not, explain why not. For example, would the proposed definition of *commercial end user* be too broad, or too narrow, in terms of capturing types of counterparties for which the exception would not be appropriate? If so, explain why and suggest how the definition could be modified to address this issue.

7. Should the rule contain a proposed definition of *financial end user*? If so, explain why. For example, would a definition of *financial end user* similar to the definitions of the prudential regulators and CFTC provide needed clarity to the definition of *commercial end user* (*i.e.,* by specifying certain entities that are not *commercial end users*)?

8. Do *commercial end users* use security-based swaps to hedge commercial risk? If so, identify the type of commercial risk they hedge with security-based swaps and explain how security-based swaps are used to hedge this risk.

9. Should proposed new Rule 18a–3 define the term *commercial risk* for the purpose of providing greater clarity as to the meaning of the term *commercial end user*? If so, how should the term *commercial risk* be defined?

10. Should there be a two-tiered approach with respect to the account *equity* requirements for financial end users based on whether they are low risk or high risk, similar to the proposed approach of the prudential regulators and the CFTC? If so, explain why.

[588] *See* paragraph (c)(4) of proposed new Rule 18a–3.

[589] *See* paragraphs (c)(4)(i)–(iii) of proposed new Rule 18a–3.

[590] *See* paragraph (c)(1)(iii)(D) of proposed new Rule 18a–3. While this exception would apply to *negative equity* in the account and the margin amount calculated for the account, a nonbank SBSD would be required to take a 100% deduction from net worth for the amount of the uncollateralized current exposure and take the proposed capital charge in lieu of margin collateral discussed above in section II.A.2.b.v. of this release. *See* proposed new paragraph (c)(2)(xiv) of Rule 15c3–1; paragraph (c)(1)(viii) of proposed new Rule 18a–1. In addition, like all counterparties to non-cleared security-based swaps, these counterparties would be subject to the risk monitoring requirements in paragraph (e) of proposed new Rule 18a–3.

[591] *See* paragraph (b)(9) of proposed new Rule 18a–3.

[592] As noted above in section II.A.2.b.v. of this release, the CFTC has proposed a similar exception for legacy swaps. *See CFTC Margin Proposing Release,* 76 FR at 23734. The prudential regulators proposed to permit a covered swap entity to exclude pre-effective swaps from initial margin calculations, while requiring these entities to collect variation margin, consistent with industry practice. *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27569.

[593] As discussed earlier, the Commission is soliciting comment below in section II.B.3. of this release on whether to define the term eligible collateral in a manner similar to the prudential regulators and the CFTC.

11. How do non-*commercial end users* presently use security-based swaps? For example, do they use them to hedge commercial risk? If so, identify the type of commercial risk they hedge with security-based swaps.

12. With respect to counterparties that are SBSDs, how would Alternatives A and B compare in terms of promoting the goals of the Dodd-Frank Act, including limiting the risks posed by non-cleared security-based swaps? How would each address or fail to address systemic issues relating to non-cleared security-based swaps?

13. What would be the impact of Alternatives A and B on the efficient use of capital?

14. What would be the practical effects of Alternatives A and B on the capital and liquidity positions, or the financial health generally, of nonbank SBSDs? How would each alter current market practices and conventions with respect to collateralizing credit exposures arising from non-cleared security-based swaps? Are there practical issues with respect to Alternatives A and B? If so, identify and explain them.

15. How would the benefits of Alternatives A and B compare? How would the costs compare?

16. How would Alternatives A and B impact the market for security-based swaps? How would they impact participants in those markets?

17. How would Alternatives A and B promote the clearing of security-based swaps? For example, would Alternative B—because of the requirement to fund margin collateral requirements—incentivize nonbank SBSDs to transact in cleared security-based swaps? If so, explain why.

18. What would be the potential impact if the Commission adopted Alternative A and the prudential regulators and the CFTC adopted rules similar to Alternative B? Consider and explain the impact competitively and practically.

19. Would the proposed exception to the account *equity* requirements for counterparties that elect segregation under section 3E(f) of the Exchange Act be appropriate? If not, explain why not.

20. Would the proposed exception to the account *equity* requirements for accounts that elect to hold legacy security-based swaps be appropriate? If not, explain why not.

21. Would it be appropriate to permit legacy security-based swaps to be held in an entity that is not an SBSD? If so, why, and what conditions should be imposed on such an entity?

22. Should counterparties be required to post variation margin with respect to legacy swaps? Is this consistent with current market practice?

23. Should there be an exception from the account *equity* requirements for small banks, savings associations, farm credit system institutions, and credit unions from the account *equity* requirements (*e.g.,* for entities with assets of $10 billion or less)? [594] Explain why or why not.

24. Should there be an exception from the account *equity* requirements for affiliates of the nonbank SBSD? For example, do affiliates present less credit risk than non-affiliates? If there should be an exception for affiliates, should it be limited to certain affiliates? For example, should the exception only apply to affiliates that are subject to capital and other regulatory requirements? Please explain.

25. Should there be an exception for foreign governmental entities? Explain why or why not. Should types of foreign governmental entities be distinguished for purposes of an exception? For example, are there objective benchmarks based on creditworthiness that could be used to distinguish between foreign governmental entities for which the exception to the account *equity* requirements would and would not be appropriate? If so, identify the benchmarks and explain how they could be incorporated into the rule.

26. Do dealers in OTC derivatives currently collect collateral from foreign governmental entities for their OTC derivatives transactions? If so, from which types of foreign governmental entities?

27. Do national foreign governments typically guarantee the obligations of political subdivisions and agencies? If so, identify the types of political subdivisions and agencies that are guaranteed and are not guaranteed.

ii. Nonbank MSBSPs

A nonbank MSBSP would be required to calculate as of the close of each business day the amount of *equity* in the account of each counterparty to a non-cleared security-based swap.[595] On the next business day following the calculation, the nonbank MSBSP would be required to either collect or deliver cash, securities, and/or money market instruments to the counterparty depending on whether there was negative or *positive equity* in the account of the counterparty.[596] Specifically, if the account has *negative equity* as calculated on the previous business day, the nonbank MSBSP would be required to collect cash, securities, and/or money market instruments in an amount equal to the *negative equity.*[597] Conversely, if the account has *positive equity* as calculated on the previous business day, the nonbank MSBSP would be required to deliver cash, securities, and/or money market instruments to the counterparty in an amount equal to the *positive equity.*[598]

Nonbank MSBSPs may not maintain two-sided markets or otherwise engage in activities that would require them to register as an SBSD.[599] They will, however, by definition, maintain substantial positions in particular categories of security-based swaps.[600] These positions could create significant risk to counterparties to the extent the counterparties have uncollateralized current exposure to the nonbank MSBSP. In addition, they could pose significant risk to the nonbank MSBSP to the extent it has uncollateralized current exposure to its counterparties. The proposed account *equity* requirements for nonbank MSBSPs are designed to address these risks by imposing a requirement that nonbank MSBSPs on a daily basis must ''neutralize'' the credit risk between the nonbank MSBSP and the counterparty either by collecting or delivering cash, securities, and/or money market instruments in an amount equal to the positive or *negative equity* in the account.

Unlike nonbank SBSDs, nonbank MSBSPs would not be required to reduce the fair market value of securities and money market instruments held in the account of a counterparty (or delivered to a counterparty) for purposes of determining whether the level of *equity* in the account meets the minimum

[594] *See, e.g.,* 15 U.S.C. 78c–3(g)(3)(B) (requiring the Commission to consider whether to exempt small banks, savings associations, farm credit system institutions and credit unions from the definition of ''financial entity'' contained in Exchange Act section 3C(g)(3)(A) for the purposes of mandatory clearing of security-based swaps). *See also End-User Exception to Mandatory Clearing of Security-Based Swaps,* Exchange Act Release No. 63556 (Dec. 15, 2010), 75 FR 79992, 80000–80002 (Dec. 21, 2010).

[595] *See* paragraph (c)(2)(i) of proposed new Rule 18a–3.

[596] *See* paragraph (c)(2)(ii) of proposed new Rule 18a–3. As indicated, the nonbank MSBSP would need to deliver cash, securities, and/or money market instruments and, consequently, other types of assets would not be eligible as collateral.

[597] *See* paragraph (c)(2)(ii)(A) of proposed new Rule 18a–3. In this case, the nonbank MSBSP would have current exposure to the counterparty in an amount equal to the *negative equity.*

[598] *See* paragraph (c)(2)(ii)(B) of proposed new Rule 18a–3.

[599] *See Entity Definitions Adopting Release,* 77 FR 30596.

[600] *See* 15 U.S.C. 78c(a)(67); *Entity Definitions Adopting Release,* 77 FR 30596.

requirement. As discussed above in section II.B.2.c.i. of this release, the reductions taken by a nonbank SBSD would be based on the deductions that would apply to the positions pursuant to Rule 15c3–1, as proposed to be amended, and proposed new Rule 18a–1, as applicable.[601] Nonbank MSBSPs would not be subject to these rules and, consequently, would not be required to comply with them for purposes of proposed new Rule 18a–3.

Like nonbank SBSDs, nonbank MSBSPs would be subject to the requirements in paragraph (c)(4) of proposed new Rule 18a–3, which are modeled on the existing collateral requirements in Appendix E to Rule 15c3–1.[602] As discussed above in section II.A.2.b.iv of this release, these requirements are designed to ensure that the collateral is an asset of stable and predictable value, an asset that is not linked to the value of the transaction in any way, and an asset that can be sold quickly and easily if the need arises.

Nonbank MSBSPs would be required to take prompt steps to liquidate securities and money market instruments in the account to the extent necessary to eliminate an account *equity* deficiency.[603] These steps could include liquidating non-cleared security-based swap positions in the account to reduce debits arising from those transactions. The rule would not require that the liquidations must be completed within a specific timeframe in order to provide the nonbank MSBSP flexibility to conduct an orderly liquidation, taking into account market conditions and the risk profile of the account.

There would be three exceptions to the account *equity* requirements for nonbank MSBSPs.[604] The first exception would apply to counterparties that are *commercial end users*.[605] Under this exception, the nonbank MSBSP would not be required to collect collateral from a *commercial end user* when the account of the end user has *negative equity*.[606] This exception would be consistent with the proposed exception from the account *equity* requirements for accounts of *commercial end users* at nonbank SBSDs. However, nonbank MSBSPs would not be required to take a credit risk charge or capital charge relating to the amount of the uncollected margin.[607] The reason for this proposed exception is the concern that requiring *commercial end users* to deliver collateral could impair their ability to manage commercial risks through hedging transactions. A nonbank MSBSP would be required to deliver cash, securities, and/or money market instruments to a *commercial end user* as necessary to collateralize the end user's current exposure to the nonbank MSBSP.

Under the second exception, a nonbank MSBSP would not be required to collect cash, securities, and/or money market instruments from an SBSD to collateralize the amount of the *negative equity* in the account of the SBSD. Under the account *equity* requirements in proposed new Rule 18a–3, a nonbank SBSD would be required to collect collateral from a nonbank MSBSP to cover the *negative equity* and margin amount in the account of the nonbank MSBSP carried by the nonbank SBSD.[608] Once a nonbank SBSD collected these amounts, a nonbank MSBSP would have current exposure to the nonbank SBSD, at a minimum, equal to the amount of the *positive equity* required to be maintained in the nonbank MSBSP's account at the nonbank SBSD. A regulatory requirement that the nonbank MSBSP must collect collateral from the nonbank SBSD to collateralize the amount of the *positive equity* in the account at the nonbank SBSD could defeat the purpose of proposed new Rule 18a–3; namely, that nonbank SBSDs collect cash, securities, and/or money market instruments to collateralize their potential future exposure to the counterparties, including nonbank MSBSPs.[609] In essence, the proposed requirements reflect a general preference in favor of requiring counterparties to nonbank SBSDs to fully collateralize their obligations to the nonbank SBSDs.

The third exception would apply to a *security-based swap legacy account*.[610] Under this exception, consistent with the proposed corresponding exception applying to accounts with nonbank SBSDs, a nonbank MSBSP would not be required to collect cash, securities, and/or money market instruments to collateralize the *negative equity* in a security-based swap legacy account. In addition, the MSBSP would not be required to deliver collateral to cover the *positive equity* in the account. This exception would be designed to address the impracticality of renegotiating contracts governing security-based swap transactions that predate the effectiveness of proposed new Rule 18a–3 in order to come into compliance with the account *equity* requirements in the rule.

Request for Comment

The Commission generally requests comment on the proposed account *equity* requirements for counterparties of nonbank MSBSPs in proposed Rule 18a–3. Commenters are referred to the questions about the account *equity* requirements for nonbank SBSDs above in section II.B.2.c.i. of this release to the extent those questions address provisions in proposed new Rule 18a–3 that also apply to nonbank MSBSPs. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are the proposed account *equity* requirements for nonbank MSBSPs appropriate? If not, explain why not.

2. Should nonbank MSBSPs be required to reduce the fair market value of securities and money market instruments for purposes of determining whether the level of *equity* in the account meets the minimum requirement? What would be the impact of not requiring nonbank MSBSPs to reduce the fair market value of

[601] *See* paragraph (c)(3) of proposed new Rule 18a–3.

[602] *See* paragraph (c)(4) of proposed new Rule 18a–3; 17 CFR 240.15c3–1e(c)(4)(v).

[603] *See* paragraph (c)(8) of proposed new Rule 18a–3.

[604] *See* paragraph (c)(2)(iii) of proposed new Rule 18a–3. MSBSPs could choose to collect collateral in these cases.

[605] *See* paragraph (c)(2)(iii)(A) of proposed new Rule 18a–3.

[606] *Id.*

[607] *Compare* paragraph (c)(1)(iii)(A) of proposed new Rule 18a–3, *with* paragraph (c)(2)(iii)(A) of proposed Rule new 18a–3.

[608] *See* paragraph (c)(1)(ii) of proposed Rule 18a–3. As discussed above, MSBSPs would not be included in the definition of *commercial end user.* Consequently, an MSBSP would be required to deliver cash, securities, and/or money market instruments to collateralize the *negative equity* and the margin amount in its security-based swap account at a nonbank SBSD.

[609] For example, assume a nonbank SBSD calculates that the account of a nonbank MSBSP has a *negative equity* of $20 (current exposure) and a margin amount of $50 (potential future exposure) pursuant to paragraph (c)(1)(i) of proposed new Rule 18a–3. On the next business day, the nonbank SBSD would need to collect cash, securities, and/or money market instruments to collateralize these amounts pursuant to paragraph (c)(1)(ii) of proposed new Rule 18a–3. Assume the nonbank MSBSP delivers cash as collateral. It would need to deliver $70 in cash, of which $50 (as collateral for the margin amount) would be a receivable from the nonbank SBSD to the nonbank MSBSP. In other words, the $50 (as a receivable from the nonbank SBSD) would be the nonbank MSBSP's current exposure to the nonbank SBSD. If the nonbank MSBSP was required to collect collateral from the nonbank SBSD to cover this amount, the account of the nonbank MSBSP at the nonbank SBSD would not meet the minimum *equity* requirement of $50.

[610] *See* paragraph (c)(2)(iii)(C) of proposed new Rule 18a–3. The term *security-based swap legacy account* would be defined to mean an account that holds no security-based swaps entered into after the effective date of the rule and that is used only to hold security-based swaps entered into prior to the effective date of the rule and collateral for those security-based swaps. *See* paragraph (b)(9) of proposed new Rule 18a–3.

securities and money market instruments for purposes of determining whether the level of *equity* in the account meets the minimum requirement?

3. Should nonbank MSBSPs be required to collect or deliver cash, securities, and/or money market instruments to collateralize a margin amount (potential future exposure) in addition to the *negative equity* amount (current exposure)? Should they be required to deliver cash, securities, and/or money market instruments to a *commercial end user* to collateralize a margin amount? Please explain.

4. Is the proposed exception to the account *equity* requirements for credit exposures to *commercial end users* appropriate? If not, explain why not. For example, because nonbank MSBSPs would not be required to take a credit risk charge or capital charge relating to the amount of uncollected margin collateral, would nonbank MSBSPs be subject to additional risks not applicable to nonbank SBSDs? If so, explain why. If not, explain why not.

5. Is the proposed exception to the account *equity* requirements for credit exposures to SBSDs appropriate? If not, explain why not.

6. Is the proposed exception to the account *equity* requirements for credit exposures in security-based swap legacy accounts appropriate? If not, explain why not.

d. $100,000 Minimum Transfer Amount

Proposed new Rule 18a–3 would establish a minimum transfer amount of $100,000 with respect to a particular counterparty.[611] Under this provision, a nonbank SBSD and a nonbank MSBSP would not be required to collect or deliver collateral to meet an account *equity* requirement if the amount required to be collected or delivered is equal to or less than $100,000. If the minimum transfer amount is exceeded, the entire account *equity* requirement would need to be collateralized, not just the amount of the requirement that exceeds $100,000.

The proposed minimum transfer provision is designed to establish a threshold so that the degree of risk reduction achieved by requiring account *equity* requirements to be collateralized is sufficiently small that the costs of delivering collateral may not be justified. The proposed $100,000 threshold is based on the proposals of the prudential regulators and the CFTC.[612]

Request for Comment

The Commission generally requests comment on the minimum transfer amount in proposed new Rule 18a–3. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is it appropriate to have a minimum transfer amount? If not, explain why not. For example, should an account *equity* requirement be collateralized regardless of the amount of cash, securities, and/or money market instruments that would need to be transferred to meet the requirement?

2. Is $100,000 an appropriate minimum transfer amount? Should the amount be greater than $100,000 (*e.g.,* $150,000, $200,000, $500,000, or some other amount)? If so, identify the amount and explain why it would be a better threshold. Should the amount be less than $100,000 (*e.g.,* $75,000, $50,000, $25,000, or some other amount)? If so, identify the amount and explain why it would be a better threshold.

e. Risk Monitoring and Procedures

A nonbank SBSD would be required to monitor the risk of each account of a counterparty to a non-cleared security-based swap and establish, maintain, and document procedures and guidelines for monitoring the risk of such accounts.[613] The nonbank SBSD also would be required to review, in accordance with written procedures, and at reasonable periodic intervals, its non-cleared security-based swap activities for consistency with the risk monitoring procedures and guidelines.[614] The risk monitoring procedures and guidelines would need to include, at a minimum, procedures and guidelines for:

- Obtaining and reviewing the account documentation and financial information necessary for assessing the amount of current and potential future exposure to a given counterparty permitted by the nonbank SBSD;
- Determining, approving, and periodically reviewing credit limits for each counterparty, and across all counterparties;
- Monitoring credit risk exposure to the security-based swap dealer from non-cleared security-based swaps, including the type, scope, and frequency of reporting to senior management;
- Using stress tests to monitor potential future exposure to a single counterparty and across all counterparties over a specified range of possible market movements over a specified time period;
- Managing the impact of credit exposure related to non-cleared security-based swaps on the nonbank SBSD's overall risk exposure;
- Determining the need to collect collateral from a particular counterparty, including whether that determination was based upon the creditworthiness of the counterparty and/or the risk of the specific non-cleared security-based swap contracts with the counterparty;
- Monitoring the credit exposure resulting from concentrated positions with a single counterparty and across all counterparties, and during periods of extreme volatility; and
- Maintaining sufficient equity in the account of each counterparty to protect against the largest individual potential future exposure of a non-cleared security-based swap carried in the account of the counterparty as measured by computing the largest maximum possible loss that could result from the exposure.

[611] *See* paragraph (c)(6) of proposed Rule 18a–3.

[612] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27575; *CFTC Margin Proposing Release,* 76 FR at 23735 (''In order to reduce transaction costs, proposed § 23.150 would establish a 'minimum transfer amount' of $100,000. Initial and variation margin payments would not be required to be made if below that amount. This amount was selected in consultation with the prudential regulators. It represents an amount sufficiently small that the level of risk reduction might not be worth the transaction costs of moving the money. It only affects the timing of collection; it does not change the amount of margin that must be collected once the $100,000 level is exceeded.''). Some commenters to the CFTC and Prudential Regulators proposed margin rules, while generally supporting the use of minimum transfer amounts, stated that they should have the flexibility to set higher minimum transfer amounts and that minimum transfer amounts up to $250,000 were more consistent with prevailing industry practice. *See* letter from the Coalition for Derivatives End-Users, to David A. Stawick, Secretary, CFTC (July 11, 2011), available at *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47804*; letter from Carl B. Wilkerson, Vice President & Chief Counsel, Securities & Litigation, American Council of Life Insurers, to the Prudential Regulators and David A. Stawick, Secretary, CFTC (July 11, 2011), available at *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47742*; letter from Lisa M. Ledbetter, Vice President and Deputy General Counsel, Legislative and Regulatory Affairs, Freddie Mac, to David A. Stawick, Secretary, CFTC (July 11, 2011), available at *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47771.*

[613] *See* paragraph (e) of proposed new Rule 18a–3. Paragraph (e) of proposed new Rule 18a–3 would not apply to nonbank MSBSPs. As discussed below, the proposed risk monitoring procedures are designed to address the risk that results from dealing in non-cleared security-based swaps (*i.e.,* the type of activity that would require a nonbank MSBSP to register as an SBSD). *See* 15 U.S.C. 78o–10(a)(1); *Entity Definitions Proposing Release,* 75 FR at 80174. As discussed above in section II.A.3 of this release, a nonbank MSBSP would be required to comply with Rule 15c3–4, which requires an entity subject to its provisions to establish a risk management control system.

[614] *See* paragraph (e) of proposed new Rule 18a–3.

These proposed requirements are modeled on similar requirements in FINRA Rule 4240, which establishes an interim pilot program imposing margin requirements for transactions in credit default swaps executed by a FINRA member.[615] As discussed above in section II.A.2.c. of this release, nonbank SBSDs would be required to comply with Rule 15c3–4.[616] Rule 15c3–4 requires an OTC derivatives dealer to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.[617] Risk management systems are designed to help ensure an awareness of, and accountability for, the risks taken throughout a firm and to develop tools to address those risks.[618] A key objective of a risk management system is to ensure that a firm does not ignore any material source of risk.[619]

The procedures and guidelines that a nonbank SBSD would establish pursuant to proposed new Rule 18a–3 would be a part of the broader system of risk management controls the nonbank SBSD would establish pursuant to Rule 15c3–4.[620] The requirement in proposed new Rule 18a–3 is designed to require specific risk management procedures and guidelines with respect to the risks of acting as a dealer in non-cleared security-based swaps, which could result in a nonbank SBSD carrying accounts for significant numbers of counterparties and effecting numerous transactions for counterparties on a daily basis. For example, the nonbank SBSD would be required to have procedures and guidelines for determining, approving, and periodically reviewing credit limits for each counterparty, and across all counterparties.[621] In addition, the nonbank SBSD would be required to have procedures and guidelines for determining the need to collect collateral from a particular counterparty, including whether that determination was based upon the creditworthiness of the counterparty and/or the risk of the specific non-cleared security-based swap contracts with the counterparty.[622] As discussed above in section II.B.2.c.i. of this release, nonbank SBSDs would not be required to collect collateral from a *commercial end user* to meet the account *equity* requirements in proposed new Rule 18a–3.[623] However, the firm would be required to determine credit limits for the end user and analyze the need for collecting collateral from the end user. These risk monitoring procedures and guidelines are designed to prevent the nonbank SBSD from allowing its credit exposure to the end user to reach a level that creates a substantial risk that the default of the end user could have a material adverse impact on the nonbank SBSD.

Request for Comment

The Commission generally requests comment on the requirements in proposed new Rule 18a–3 to monitor risk and to have risk monitoring procedures and guidelines. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are the required elements of the risk monitoring procedures and guidelines appropriate? If not, explain why not. Should there be additional or alternative required elements to the risk monitoring procedures and guidelines? If so, identify them and explain why they should be included.

2. Are the descriptions of the required elements of the risk monitoring procedures and guidelines in paragraphs (e)(1) through (8) of proposed new Rule 18a–3 sufficiently clear in terms of what is proposed to be required of nonbank SBSDs? If not, explain why not and suggest changes to make the elements more clear.

3. Is it appropriate to require that the risk monitoring procedures and guidelines be a part of the system of risk management control prescribed in Rule 15c3–4? If not, explain why not.

4. What are the current practices of dealers in OTC derivatives in terms of monitoring the risk of counterparties? Are the requirements in proposed new Rule 18a–3 consistent with current practices? Are they more limited or are they broader than current practices?

5. Should nonbank MSBSPs be subject to the requirements of paragraph (e) of proposed new Rule 18a–3? If so, explain why. If not, explain why not.

3. Specific Request for Comment To Limit the Use of Collateral

Proposed new Rule 18a–3 does not specifically identify classes of assets that could be used to meet the account *equity* requirements in the rule. The Commission, however, is considering whether it would be appropriate to adopt limits on eligible collateral similar to those the prudential regulators and the CFTC proposed.[624] Specifically, comment is sought on whether proposed new Rule 18a–3 should define the term *eligible collateral* in order to narrowly prescribe the classes of assets that would qualify as collateral to meet the account *equity* requirements. For example, one approach would be to limit *eligible collateral* to cash and U.S. government securities.

Limiting eligible collateral to cash and U.S. government securities could be a way to ensure that a nonbank SBSD will be able to liquidate the collateral promptly and at current market prices if necessary to cover the obligations of a defaulting counterparty. During a period of market stress, the value of collateral other than cash pledged as margin also may come under stress through rapid market declines and systemic liquidations and deleveraging by financial institutions. Generally, U.S. government securities are substantially less susceptible to this risk than other types of securities and, in fact, may become the investment of choice during a period of market stress as investors seek the relative safety of these securities.[625]

Another approach would be to adopt the definition of *eligible collateral* proposed by the prudential regulators or to adopt the ''forms of margin'' proposed by the CFTC.[626] Both of these proposed approaches would extend eligible collateral beyond cash and U.S. government securities but would not permit the use of certain securities (*e.g.,* listed equities that would be permitted by proposed Rule 18a–3).

The Commission also seeks comment in response to the following questions, including empirical data in support of comments:

1. Should the types of assets that could be used to meet the nonbank

[615] *See* FINRA Rule 4240. The risk monitoring requirements in FINRA Rule 4240 were, in turn, modeled on risk monitoring requirement in SRO portfolio margining rules. *See* FINRA Rule 4210(g); Rules 12.4 and 15.8A of the CBOE.

[616] 17 CFR 240.15c3–4.

[617] *Id.*

[618] *See* Joint Forum, Bank of International Settlements, *Trends in Risk Integration and Aggregation,* (Aug. 2003), available at *http://www.bis.org/publ/joint07.pdf.*

[619] *Id.*

[620] 17 CFR 240.15c3–4.

[621] *See* paragraph (e)(2) of proposed new Rule 18a–3.

[622] *See* paragraph (e)(6) of proposed new Rule 18a–3.

[623] *See* paragraph (c)(1)(iii)(A) of proposed new Rule 18a–3.

[624] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27578; *CFTC Margin Proposing Release,* 76 FR at 23738–23739.

[625] *See* IMF, *Global Financial Stability Report, The Quest for Lasting Stability* (Apr. 2012), available at *http://www.imf.org/external/pubs/ft/gfsr/2012/01/pdf/text.pdf.*

[626] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27578; *CFTC Margin Proposing Release,* 76 FR at 23738–23739 (proposing that only certain types of financial instruments be eligible collateral).

SBSD account *equity* requirements in proposed new Rule 18a–3 be more limited? Explain why or why not. For example, are the proposed provisions that would require a nonbank SBSD to mark-to-market the value of the collateral, apply haircuts to the collateral, and adhere to the collateral requirements incorporated from Appendix E to Rule 15c3–1 sufficient to ensure that collateral is able to serve the purpose of protecting the nonbank SBSD from the credit exposure of a counterparty to a non-cleared security-based swap? If so, explain why. If not, explain why not.

2. Explain the risk to nonbank SBSDs if they are permitted to accept a broader range of securities and money market instruments (as proposed in new Rule 18a–3) to meet the account *equity* requirements.

3. Should the types of assets that could be used to meet the nonbank MSBSP account *equity* requirements in proposed new Rule 18a–3 be more limited? Explain why or why not. Since nonbank MSBSPs would not be required to apply haircuts to the collateral or adhere to the collateral requirements incorporated from Appendix E to Rule 15c3–1, should the types of collateral they are allowed to accept be more limited? Explain why or why not.

4. Explain the risk to nonbank MSBSPs if they are permitted to accept a broader range of securities and money market instruments (as proposed in new Rule 18a–3) to meet the account *equity* requirements.

5. If the term *eligible collateral* is defined for purposes of proposed new Rule 18a–3, should the definition include securities of government-sponsored entities? If so, identify the government-sponsored entities and explain why the securities of the identified entity would be appropriate collateral. Alternatively, explain why securities of government-sponsored entities generally or individually should not be included in a potential definition of eligible collateral.

6. If the term *eligible collateral* is defined for purposes of proposed new Rule 18a–3, should the definition include immediately-available cash funds denominated in a foreign currency when the currency is the same currency in which payment obligations under the security-based swap are required to be settled? If so, should eligible collateral be limited to specific foreign currencies? If so, identify the currencies and explain why the identified currencies would be appropriate collateral. Alternatively, explain why foreign currencies generally or individually should not be included in a potential definition of *eligible collateral.*

7. If the term *eligible collateral* is defined for purposes of proposed new Rule 18a–3, should the definition include immediately-available cash funds denominated in foreign currency even in cases where the currency is not the same currency in which payment obligations under the security-based swap are required to be settled? If so, should eligible collateral be limited to specific foreign currencies? If so, identify the currencies and explain why the identified currencies would be appropriate collateral in this circumstance. Alternatively, explain why foreign currencies in this circumstance should not be included in a potential definition of *eligible collateral.*

8. If the term *eligible collateral* is defined for purposes of proposed new Rule 18a–3, should the definition include securities of foreign sovereign governments? If so, identify the foreign sovereign governments and explain why the securities of the identified foreign sovereign governments would be appropriate collateral. Alternatively, explain why securities of foreign sovereign governments should not be included in the definition of *eligible collateral.*

9. If the term *eligible collateral* is defined for purposes of proposed new Rule 18a–3, should the definition include a fully paid *margin equity security,* as that term is defined in 12 CFR 220.2,[627] in the case where a non-cleared equity security-based swap references the margin equity security? If so, explain why margin equity securities would be appropriate collateral in this circumstance. Alternatively, explain why margin equity securities in this circumstance should not be included in the definition of *eligible collateral.*

10. Should there be separate *eligible collateral* requirements for collateralizing *negative equity* and the margin amount? For example, should the assets permitted to collateralize *negative equity* be limited to cash and U.S. government securities, while the assets permitted to collateralize the margin amount encompass a broader range of securities?

C. Segregation

1. Background

The U.S. Bankruptcy Code provides special protections for *customers* of stockbrokers (the ''stockbroker liquidation provisions'').[628] Among other protections, *customers* share ratably with other customers ahead of all other creditors in the *customer property* held by the failed stockbroker.[629] Segregation requirements are designed to identify customer property as distinct from the proprietary assets of the firm and to protect customer property by, for example, preventing the firm from using it to make proprietary investments. The goal of segregation is to facilitate the prompt return of customer property to customers either before or during a liquidation proceeding if the firm fails.[630]

The Dodd-Frank Act contains provisions designed to ensure that cash and securities held by an SBSD relating to security-based swaps will be deemed customer property under the stockbroker liquidation provisions.[631] In particular, section 3E(g) of the Exchange Act provides, among other things, that a security-based swap shall be considered to be a *security* as such term is ''used in section 101(53A)(B) and subchapter III of title 11, United States Code'' [632] and in the stockbroker liquidation provisions.[633] Section 3E(g) also provides that an account that holds a security-based swap shall be considered to be a *securities account* as that term is ''defined'' in the stockbroker liquidation provisions.[634] In addition, section 3E(g) provides that the terms *purchase* and *sale* as defined in sections 3(a)(13) and (14) of the Exchange Act, respectively, shall be applied to the terms *purchase* and *sale* as used in the

[627] Regulation T defines *margin equity security* as a margin security that is an equity security (as defined in section 3(a)(11) of the Exchange Act). *See* 12 CFR 220.2.

[628] *See* 11 U.S.C. 741–753. SIPA provides similar protections for ''customers'' of registered broker-dealers. *See* 15 U.S.C. 78aaa *et seq.* However, SIPA also provides additional protections such as the right for each customer to receive an advance of up to $500,000 to facilitate the prompt satisfaction of a claim for securities and cash ($250,000 of the $500,000 may be used to satisfy the cash portion of a claim).

[629] *See* 11 U.S.C. 752.

[630] *See* Michael P. Jamroz, *The Customer Protection Rule,* 57 Bus. Law. 1069 (May 2002).

[631] *See* Public Law 111–203 § 763(d) adding section 3E(g) to the Exchange Act (15 U.S.C. 78c–5(g)).

[632] *See* 15 U.S.C. 78c–5(g); 11 U.S.C. 101(53A)(B). Section 101(53A)(B) defines a *stockbroker* to mean a person—(1) with respect to which there is a customer, as defined in section 741, subchapter III, title 11, United States Code (the definition section of the stockbroker liquidation provisions); and (2) that is engaged in the business of effecting transactions in *securities*—(i) for the account of others; or (ii) with members of the general public, from or for such person's own account. 11 U.S.C. 101(53A)(B).

[633] *See* 15 U.S.C. 78c–5(g); 11 U.S.C. 741–753.

[634] *See* 15 U.S.C. 78c–5(g); 11 U.S.C. 741. There is no definition of *securities account* in 11 U.S.C. 741. The term *securities account* is used in 11 U.S.C. 741(2) and (4) in defining the terms *customer* and *customer property.*

stockbroker liquidation provisions.[635] Finally, section 3E(g) provides that the term *customer* as defined in the stockbroker liquidation provisions excludes any person to the extent the person has a claim based on a non-cleared security-based swap transaction except to the extent of any margin delivered to or by the customer with respect to which there is a customer protection requirement under section 15(c)(3) of the Exchange Act or a segregation requirement.[636]

The provisions of section 3E(g) of the Exchange Act apply the customer protection elements of the stockbroker liquidation provisions to cleared security-based swaps, including related collateral, and, if subject to segregation requirements, to collateral delivered as margin for non-cleared security-based swaps.[637] The Dodd-Frank Act established segregation requirements for cleared and non-cleared security-based swaps and provided the Commission with the authority to adopt rules with respect to segregation. In particular, section 763 of the Dodd-Frank Act amended the Exchange Act to add new section 3E.[638] Section 3E sets forth requirements applicable to SBSDs and MSBSPs with respect to the segregation of cleared and non-cleared security-based swap collateral and provides the Commission with rulemaking authority in this area.[639] The Commission also has concurrent authority under section 15(c)(3) of the Exchange Act to prescribe segregation requirements for broker-dealers.[640]

Section 3E(b)(1) of the Exchange Act provides that a broker, dealer, or SBSD shall treat and deal with all money, securities, and property of any security-based swap customer received to margin, guarantee, or secure a cleared security-based swap transaction as belonging to the customer.[641] Section 3E(b)(2) provides that the money, securities, and property shall be separately accounted for and shall not be commingled with the funds of the broker, dealer, or SBSD or used to margin, secure, or guarantee any trades or contracts of any security-based swap customer or person other than the person for whom the money, securities, or property are held.[642]

Section 3E(c)(1) of the Exchange Act provides that, notwithstanding section 3E(b), money, securities, and property of cleared security-based swap customers of a broker, dealer, or SBSD may, for convenience, be commingled and deposited in the same one or more accounts with any bank, trust company, or clearing agency.[643] Section 3E(c)(2) further provides that the Commission may by rule, regulation, or order prescribe terms and conditions under which money, securities, and property of a customer with respect to cleared security-based swaps may be commingled and deposited with any other money, securities, and property received by the broker, dealer, or SBSD and required by the Commission to be separately accounted for and treated and dealt with as belonging to the security-based swap customer of the broker, dealer, or SBSD.[644]

With respect to non-cleared security-based swaps, section 3E(f)(1)(A) of the Exchange Act provides that an SBSD and an MSBSP shall be required to notify a counterparty of the SBSD or MSBSP at the beginning of a non-cleared security-based swap transaction that the counterparty has the right to require the segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty.[645] Section 3E(f)(1)(B) provides that, if requested by the counterparty, the SBSD or MSBSP shall segregate the funds or other property for the benefit of the counterparty and, in accordance with such rules and regulations as the Commission may promulgate, maintain the funds or other property in a segregated account separate from the assets and other interests of the SBSD or MSBSP.[646] Section 3E(f)(3) provides that the segregated account shall be carried by an independent third-party custodian and be designated as a segregated account for and on behalf of the counterparty (''individual segregation'').[647] In the case of non-cleared security-based swaps, therefore, each counterparty has the right to require its collateral to be isolated in an account at an independent custodian that identifies the counterparty by name, rather than commingled with collateral of other counterparties.

The objective of individual segregation is for the funds and other property of the counterparty to be carried in a manner that will keep these assets separate from the bankruptcy estate of the SBSD or MSBSP if it fails financially and becomes subject to a liquidation proceeding. Having these assets carried in a bankruptcy-remote manner protects the counterparty from the costs of retrieving assets through a bankruptcy proceeding caused, for example, because another counterparty of the SBSD or MSBSP defaults on its obligations to the SBSD or MSBSP.

Section 3E(f)(2)(B)(i) of the Exchange Act provides that the segregation requirements for non-cleared security-based swaps do not apply to variation margin payments, so that the right of a counterparty to require individual account segregation applies only to initial and not variation margin.[648] It also provides that the segregation requirements shall not preclude any commercial arrangement regarding the investment of segregated funds or other property that may only be invested in such investments as the Commission may permit by rule or regulation, and the related allocation of gains and losses

[635] *See* 15 U.S.C. 78c–5(g); 11 U.S.C. 741–753. Section 3(a)(13) of the Exchange Act, as amended by the Dodd-Frank Act (Pub. L. 111–203 § 761(a)), defines the term *purchase* to mean, in the case of security-based swaps, the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require. 15 U.S.C. 78c(a)(13). Section 3(a)(14) of the Exchange Act, as amended by the Dodd-Frank Act (Pub. L. 111–203 § 761(a)), defines the term *sale* to mean, in the case of security-based swaps, the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require. *See* 15 U.S.C. 78c(a)(14).

[636] *See* 15 U.S.C. 78c–5(g); 11 U.S.C. 741(2).

[637] *See* 15 U.S.C. 78c–5(g); 11 U.S.C. 741–753.

[638] *See* Public Law 111–203 § 763; 15 U.S.C. 78c–5.

[639] *See* 15 U.S.C. 78c–5. Unlike the grants of capital and margin rulemaking authority in the Dodd-Frank Act, section 3E does not divide rulemaking authority for segregation requirements for SBSDs and MSBSPs between the Commission and the prudential regulators. *Compare* 15 U.S.C. 78o–10(e)(1), *with* 15 U.S.C. 78c–5. Consequently, the Commission's rulemaking authority in this area extends to bank SBSDs and bank MSBSPs. 15 U.S.C. 78c–5.

[640] *See* 15 U.S.C. 78o(c)(3). *See also* Public Law 111–203 § 771 (codified at 15 U.S.C. 78o–10(e)(3)(B)). Section 771 of the Dodd-Frank Act states that unless otherwise provided by its terms, its provisions relating to the regulation of the security-based swap markets do not divest any appropriate Federal banking agency, the Commission, the CFTC, or any other Federal or State agency, of any authority derived from any other provision of applicable law. *See* Public Law 111–203 § 771. In addition, section 15F(e)(3)(B) of the Exchange Act provides that nothing in section 15F ''shall limit, or be construed to limit, the authority'' of the Commission ''to set financial responsibility rules for a broker or dealer * * * in accordance with Section 15(c)(3).'' 15 U.S.C. 78o–8(e)(3)(B).

[641] *See* section 3E(b)(1) of the Exchange Act (15 U.S.C. 78c–5(b)(1)). As indicated, the provisions of section 3E(b) do not apply to MSBSPs.

[642] *See* section 3E(b)(2) of the Exchange Act (15 U.S.C. 78c–5(b)(2)).

[643] *See* section 3E(c)(1) of the Exchange Act (15 U.S.C. 78c–5(c)(1)).

[644] *See* section 3E(c)(2) of the Exchange Act (15 U.S.C. 78c–5(c)(2)).

[645] *See* 15 U.S.C. 78c–5(f)(1)(A). *See also* section 3E(f)(2)(A) of the Exchange Act, which provides that the provisions of section 3E(f)(1) apply only to a security-based swap between a counterparty and SBSD or MSBSP that is not submitted for clearing to a clearing agency. *See* 15 U.S.C. 78c–5(f)(2)(A).

[646] *See* 15 U.S.C. 78c–5(f)(1)(B).

[647] *See* 15 U.S.C. 78c–5(f)(3).

[648] *See* 15 U.S.C. 78c–5(f)(2)(B)(i).

resulting from any investment of the segregated funds or other property.[649] Finally, section 3E(f)(4) provides that if the counterparty does not choose to require segregation of funds or other property, the SBSD or MSBSP shall send a quarterly report to the counterparty that the firm's back office procedures relating to margin and collateral requirements are in compliance with the agreement of the counterparties.[650]

Pursuant, in part, to the grants of rulemaking authority in sections 3E and 15(c)(3) of the Exchange Act, the Commission is proposing new Rule 18a–4 to establish segregation requirements for SBSDs with respect to cleared and non-cleared security-based swaps that would supplement the requirements in section 3E.[651] Proposed new Rule 18a–4 would apply to all types of SBSDs (*i.e.,* it would apply to bank SBSDs, stand-alone SBSDs, and broker-dealer SBSDs).[652] As discussed in more detail below, proposed new Rule 18a–4 would prescribe detailed requirements for how cash, securities, and money market instruments of a customer with cleared security-based swaps must be segregated when an SBSD commingles those assets with the cash and securities of other customers (''omnibus segregation'') pursuant to section 3E(c)(1) of the Exchange Act.[653] In addition, the proposed rule would require that cash, securities, and money market instruments of a customer with respect to non-cleared security-based swaps must be treated in the same manner as cash, securities, and money market instruments of a customer with respect to cleared security-based swaps in cases where the counterparty does not elect individual segregation[654] *and* does not affirmatively waive segregation altogether.[655] In other words, proposed new Rule 18a–4 would establish an alternative omnibus, or ''commingled'', segregation approach for non-cleared security-based swaps. This approach would be the default requirement under which an SBSD would be required to segregate securities and funds relating to non-cleared security-based swaps and, therefore, apply in the absence of a counterparty electing individual segregation or affirmatively waiving segregation.[656]

The omnibus segregation requirements in Rule 18a–4 would not apply to MSBSPs.[657] Consequently, if an MSBSP holds collateral from a counterparty with respect to non-cleared security-based swaps, it would be subject only to the segregation requirements in section 3E of the Exchange Act with respect to the collateral, and would not be required to segregate the collateral unless the counterparty required individual segregation under section 3E.[658] The omnibus segregation requirements in Rule 18a–4 may not be practical for MSBSPs for the same reasons discussed in sections II.A.3. and II.B.2. of this release with respect to the proposed capital and margin requirements for MSBSPs (*i.e.,* the potentially wide range of business models under which nonbank MSBSPs may operate under the proposed rule, and the uncertain impact that requirements designed for broker-dealers could have on these entities). MSBSPs will instead be subject to the provisions in section 3E(f) of the Exchange Act, which provide certain baseline segregation requirements for non-cleared security-based swaps.[659] In addition, counterparties would be able to negotiate customized segregation agreements with MSBSPs, subject to these provisions.[660]

As discussed in more detail below, the omnibus segregation requirements of Rule 18a–4 are modeled on the provisions of the broker-dealer segregation rule—Rule 15c3–3.[661] Rule 15c3–3 is designed ''to give more specific protection to customer funds and securities, in effect forbidding brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers; *e.g.,* a firm is virtually precluded from using customer funds to buy securities for its own account.'' [662] To meet this objective, Rule 15c3–3 requires a broker-dealer that maintains custody of customer securities and cash (a ''carrying broker-dealer'') to take two primary steps to safeguard these assets. The steps are designed to protect customers by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under SIPA, the securities and cash should be isolated and readily identifiable as ''customer property'' and, consequently, available to be distributed to customers ahead of other creditors.[663]

The first step required by Rule 15c3–3 is that a carrying broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities.[664] Physical possession or control means the broker-dealer must hold these securities in one of several locations specified in Rule 15c3–3 and free of liens or any other

[649] *See* 15 U.S.C. 78c–5(f)(2)(B)(ii). No requirements are being proposed at this time pursuant to the authority in section 3E(f)(1)(B)(ii) of the Exchange Act.

[650] *See* section 3E(f)(4) of the Exchange Act (15 U.S.C. 78c–5(f)(4)).

[651] *See* 15 U.S.C. 78c–5; 15 U.S.C. 78o(c)(3).

[652] Unlike section 15F of the Exchange Act that divides responsibility for capital and margin rules between the Commission and the prudential regulators, section 3E of the Exchange Act provides authority solely to the Commission. *Compare* 15 U.S.C. 78o–10, *with* 15 U.S.C. 78c–5.

[653] *See* 15 U.S.C. 78c–5(c)(1).

[654] *See* 15 U.S.C. 78c–5(f)(1)–(3).

[655] *See* 15 U.S.C. 78c–5(f)(4).

[656] As discussed below in section II.C.2.c. of this release, an SBSD would be required to obtain a subordination agreement from a counterparty that waives segregation. By entering into the subordination agreement, the counterparty would affirmatively waive segregation. The absence of a subordination agreement would mean that the counterparty is presumed not to have waived segregation and the SBSD would need to treat the counterparty's cash, securities, and/or money market instruments pursuant to the omnibus segregation requirements of proposed new Rule 18a–4.

[657] As discussed in more detail below, MSBSPs would be subject to a notification requirement. *See* paragraph (d)(1) of proposed new Rule 18a–4.

[658] The provisions of section 3E of the Exchange Act governing cleared security-based swaps do not apply to nonbank MSBSPs. *See* 15 U.S.C. 78c–5(b) (referring specifically to a ''broker, dealer, or security-based swap dealer'' and not to an MSBSP.).

[659] *See* 15 U.S.C. 78c–5(f).

[660] *Id.*

[661] *See* 17 CFR 240.15c3–3.

[662] *See Net Capital Requirements for Brokers and Dealers,* Exchange Act Release No. 21651 (Jan. 11, 1985), 50 FR 2690, 2690 (Jan. 18, 1985). *See also Broker-Dealers; Maintenance of Certain Basic Reserves,* Exchange Act Release No. 9856 (Nov. 10, 1972), 37 FR 25224, 25224 (Nov. 29, 1972).

[663] *See* 15 U.S.C. 78aaa *et seq.*

[664] *See* 17 CFR 240.15c3–3(d). The term *fully paid securities* includes all securities carried for the account of a customer in a special cash account as defined in Regulation T promulgated by the Board of Governors of the Federal Reserve System, as well as margin equity securities within the meaning of Regulation T which are carried for the account of a customer in a general account or any special account under Regulation T during any period when section 8 of Regulation T (12 CFR 220.8) specifies that margin equity securities shall have no loan value in a general account or special convertible debt security account, and all such margin equity securities in such account if they are fully paid: provided, however, that the term ''fully paid securities'' shall not apply to any securities which are purchased in transactions for which the customer has not made full payment. 17 CFR 240.15c3–3(a)(3). The term *margin securities* means those securities carried for the account of a customer in a general account as defined in Regulation T, as well as securities carried in any special account other than the securities referred to in paragraph (a)(3) of Rule 15c3–3. 17 CFR 240.15c3–3(a)(4). The term *excess margin securities* means those securities referred to in paragraph (a)(4) of Rule 15c3–3 carried for the account of a customer having a market value in excess of 140 percent of the total of the debit balances in the customer's account or accounts encompassed by paragraph (a)(4) of Rule 15c3–3 which the broker-dealer identifies as not constituting margin securities. 17 CFR 240.15c3–3(a)(5).

interest that could be exercised by a third-party to secure an obligation of the broker-dealer.[665] Permissible locations include a bank, as defined in section 3(a)(6) of the Exchange Act, and a clearing agency.[666]

The second step is that a carrying broker-dealer must maintain a reserve of funds or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers.[667] The account must be titled ''Special Account for the Exclusive Benefit of Customers of the Broker-Dealer'' (''customer reserve account'').[668] The amount of net cash owed to customers is computed pursuant to a formula set forth in Exhibit A to Rule 15c3–3 (''Exhibit A formula'').[669] Under the Exhibit A formula, the broker-dealer adds up customer credit items (*e.g.,* cash in customer securities accounts) and then subtracts from that amount customer debit items (*e.g.,* margin loans).[670] If credit items exceed debit items, the net amount must be on deposit in the customer reserve account in the form of cash and/or qualified securities.[671] A broker-dealer cannot make a withdrawal from the customer reserve account until the next computation and even then only if the computation shows that the reserve requirement has decreased.[672] The broker-dealer must make a deposit into the customer reserve account if the computation shows an increase in the reserve requirement.

In addition, the Exhibit A formula permits the broker-dealer to offset *customer* credit items only with *customer* debit items.[673] This means the broker-dealer can use customer cash to facilitate customer transactions such as financing customer margin loans and borrowing securities to make deliveries of securities customers have sold short.[674] As discussed above in section II.B. of this release, the broker-dealer margin rules require securities customers to maintain a minimum level of *equity* in their securities accounts. In addition to protecting the broker-dealer from the consequences of a customer default, this *equity* serves to over-collateralize the customers' obligations to the broker-dealer. This buffer protects the customers whose cash was used to facilitate the broker-dealer's financing of securities purchases and short-sales by customers. For example, if the broker-dealer fails, the customer debits, because they generally are over-collateralized, should be attractive assets for another broker-dealer to purchase or, if not purchased by another broker-dealer, they should be able to be liquidated to a net positive equity.[675] The proceeds of the debits sale or liquidation can be used to repay the customer cash used to finance the customer obligations. This cash plus the funds and/or U.S. government securities held in the customer reserve account should equal or exceed the total amount of customer credit items (*i.e.,* the total amount owed by the broker-dealer to its customers).[676]

Proposed new Rule 18a–4 would contain certain provisions that are modeled on corresponding provisions of Rule 15c3–3.[677] Paragraph (a) of the proposed rule would define key terms used in the rule.[678] Paragraph (b) would require an SBSD to promptly obtain and thereafter maintain physical possession or control of all *excess securities collateral* (a term defined in paragraph (a)) and specify certain locations where *excess securities collateral* could be held and would be deemed to be in the SBSD's control.[679] Paragraph (c) would require an SBSD to maintain a special account for the exclusive benefit of security-based swap customers and have on deposit in that account at all times an amount of cash and/or *qualified securities* (a term defined in paragraph (a)) determined through a computation using the formula in Exhibit A to proposed new Rule 18a–4.[680] A broker-dealer SBSD would need to treat security-based swap accounts separately from other securities accounts and, consequently, would need to perform separate possession and control and reserve account computations for security-based swap accounts and other securities accounts. The former would be subject to the possession and control and reserve account requirements in proposed new Rule 18a–4 and the latter would continue to be subject to the analogous requirements in Rule 15c3–3. This would keep separate the segregated customer property related to security-based swaps from customer property related to other securities, including property of retail securities customers.

Paragraph (d) of Rule 18a–4 would contain certain additional provisions that do not have analogues in Rule 15c3–3. First, it would require an SBSD and an MSBSP to provide the notice required by section 3E(f)(1)(A) of the Exchange Act prior to the execution of the first non-cleared security-based swap transaction with the counterparty.[681] Second, it would require the SBSD to obtain subordination agreements from counterparties that opt out of the segregation requirements in proposed

[665] *See* 17 CFR 240.15c3–3(c). Customer securities held by the carrying broker-dealer are not assets of the firm. Rather, the carrying broker-dealer holds them in a custodial capacity and the possession and control requirement is designed to ensure that the carrying broker-dealer treats them in a manner that allows for their prompt return.

[666] *Id.*

[667] 17 CFR 240.15c3–3(e). The term ''qualified security'' is defined in Rule 15c3–3 to mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States (''U.S. government security''). *See* 17 CFR 240.15c3–3(a)(6).

[668] *See* 17 CFR 240.15c3–3(e)(1). The purpose of giving the account this title is to alert the bank and creditors of the broker-dealer that this reserve fund is to be used to meet the broker-dealer's obligations to customers (and not the claims of general creditors) in the event the broker-dealer must be liquidated in a formal proceeding.

[669] 17 CFR 240.15c3–3a.

[670] *See id.*

[671] 17 CFR 240.15c3–3(e). Customer cash is a balance sheet item of the carrying broker-dealer (*i.e.,* the amount of cash received from a customer increases the amount of the carrying broker-dealer's assets and creates a corresponding liability to the customer). The reserve formula is designed to isolate these broker-dealer assets so that an amount equal to the net liabilities to customers is held as a reserve in the form of cash or U.S. government securities. The requirement to establish this reserve is designed to effectively prevent the carrying broker-dealer from using customer funds for proprietary business activities such as investing in securities. The goal is to put the carrying broker-dealer in a position to be able to readily meet its cash obligations to customers by requiring the firm to make deposits of cash and/or U.S. government securities into the customer reserve account in the amount of the net cash owed to customers.

[672] *See* 17 CFR 240.15c3–3(e).

[673] *See* 17 CFR 240.15c3–3a.

[674] For example, if a broker-dealer holds $100 for customer A, the broker-dealer can use that $100 to finance a security purchase of customer B. The $100 the broker-dealer owes customer A is a credit in the formula and the $100 customer B owes the broker-dealer is a debit in the formula. Therefore, under the Exhibit A formula there would be no requirement to maintain cash and/or U.S. government securities in the customer reserve account. However, if the broker-dealer did not use the $100 held in customer A's account for this purpose, there would be no offsetting debit and, consequently, the broker-dealer would need to have on deposit in the customer reserve account cash and/or U.S. government securities in an amount at least equal to $100.

[675] The attractiveness of the over-collateralized debits facilitates the bulk transfer of customer accounts from a failing or failed broker-dealer to another broker-dealer.

[676] *See Net Capital Requirements for Broker-Dealers; Amended Rules,* Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512, 3513 (Jan. 25, 1982) (''The alternative approach is founded on the concept that, if the debit items in the Reserve Formula can be liquidated at or near their contract value, these assets along with any cash required to be on deposit under the [customer protection] rule, will be sufficient to satisfy all liabilities to customers (which are represented as credit items in the Reserve Formula).'').

[677] *Compare* 17 CFR 240.15c3–3, *with* proposed new Rule 18a–4.

[678] *Compare* 17 CFR 240.15c3–3(a), *with* paragraph (a) of proposed new Rule 18a–4.

[679] *Compare* 17 CFR 240.15c3–3(b)–(d), *with* paragraph (b) of proposed new Rule 18a–4.

[680] *Compare* 17 CFR 240.15c3–3(e), *with* paragraph (c) of proposed new Rule 18a–4.

[681] *See* 15 U.S.C. 78c–5(f)(1)(A); paragraph (d)(1) of proposed new Rule 18a–4.

new Rule 18a–4 because they either elect individual segregation pursuant to the provisions of section 3E(f) of the Exchange Act [682] or agree that the SBSD need not segregate their assets at all.[683]

As discussed in more detail below, the omnibus segregation requirements in proposed new Rule 18a–4 are designed to accommodate the operational aspects of an SBSD collecting cash, securities, and/or money market instruments from security-based swap customers to margin cleared security-based swaps and delivering cash, securities, and/or money market instruments to registered clearing agencies to meet margin requirements of the clearing agencies with respect to the customers' transactions. Similarly, the omnibus segregation requirements are designed to accommodate the current practice of dealers in OTC derivatives to collect cash, securities, and/or money market instruments from a counterparty to cover current and potential future exposure arising from an OTC derivatives transaction with the counterparty and concurrently deliver cash, securities, and/or money market instruments to another dealer as collateral for an OTC derivatives transaction that hedges (takes the opposite side of) the OTC derivatives transaction with the counterparty. At the same time, the omnibus segregation requirements are designed to isolate, identify, and protect cash, securities, and/or money market instruments received by the SBSD as collateral for cleared and non-cleared security-based swaps, whether the collateral is held by the SBSD, a registered clearing agency, or another SBSD.

Finally, the Commission is proposing a conforming amendment to add new paragraph (p) to Rule 15c3–3 to state that a broker-dealer that is registered as an SBSD pursuant to section 15F of the Exchange Act must also comply with the provisions of Rule 18a–4.[684] This proposed amendment would clarify that a broker-dealer SBSD must comply with both Rule 15c3–3 and Rule 18a–4.

Request for Comment

The Commission generally requests comment on the approach of proposed new Rule 18a–4. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Should there be rules under section 3E(f)(1)(B)(i) of the Exchange Act with respect to how an SBSD and an MSBSP must segregate funds and other property relating to non-cleared security-based swaps to supplement the individual segregation provisions in section 3E(f)? If so, describe the types of requirements the rules should impose.

2. Should there be rules under section 3E(f)(2)(B)(ii)(I) of the Exchange Act with respect to how an SBSD and an MSBSP may invest funds or other property relating to non-cleared security-based swaps to supplement the individual segregation provisions in section 3E(f)? If so, describe the types of requirements the rules should impose. For example, should the rules require that the funds may be invested only in U.S. government securities or in *qualified securities* as that term is defined in paragraph (a)(5) of proposed new Rule 18a–4? Explain why or why not.

3. Is it appropriate to model the segregation provisions for security-based swap customers on the provisions of Rule 15c3–3? If not, explain why and identify another segregation model.

4. Should MSBSPs be required to comply with all the omnibus segregation requirements of proposed new Rule 18a–4? If so, explain why. If not, explain why not.

5. Should the omnibus segregation requirements accommodate the ability to hold swaps in security-based swap customer accounts to facilitate a portfolio margin treatment for related or offsetting positions in the account? What practical or legal impediments may exist to doing so? If swaps could be held in the account along with security-based swaps, how would the existence of differing bankruptcy regimes for securities and commodities instruments impact the ability to unwind positions or distribute assets to customers in the event of insolvency of the SBSD?

2. Proposed Rule 18a–4

a. Possession and Control of Excess Securities Collateral

Paragraph (b)(1) of Rule 18a–4 would require an SBSD to promptly obtain and thereafter maintain physical possession or control of all excess securities collateral carried for the accounts of security-based swap customers.[685] Physical possession or control as used in Rule 15c3–3 means a broker-dealer cannot lend or hypothecate securities subject to the requirement and must hold them itself or, as is more common, in a satisfactory control location.[686] As discussed below, physical possession or control is intended to have the same meaning in proposed new Rule 18a–4.

The term *security-based swap customer* would be defined to mean any person from whom or on whose behalf the SBSD has received or acquired or holds funds or other property for the account of the person with respect to a cleared or non-cleared security-based swap transaction.[687] The definition would exclude a person to the extent that person has a claim for funds or other property which by contract, agreement or understanding, or by operation of law, is part of the capital of the SBSD or is subordinated to all claims of security-based swap customers of the SBSD.[688] This proposed definition of *security-based swap customer* is modeled on the current definition of *customer* in Rule 15c3–3.[689] As discussed above, an SBSD would be required to obtain subordination agreements from counterparties that elect individual segregation pursuant to the self-executing provisions of section 3E(f) of the Exchange Act [690] or that waive segregation.[691] Because these counterparties would enter into subordination agreements, they would not meet the definition of *security-based swap customer* and, consequently, the omnibus segregation requirements of proposed new Rule 18a–4 would not apply to their funds and other property.[692]

[682] *See* 15 U.S.C. 78c–5(f)(1)–(3).

[683] *See* 15 U.S.C. 78c–5(f)(4).

[684] *See* proposed paragraph (p) of Rule 15c3–3.

[685] This paragraph is modeled on paragraph (b)(1) of Rule 15c3–1. *Compare* 17 CFR 240.15c3–1(b)(1), *with* paragraph (b)(1) of proposed new Rule 18a–4.

[686] *See Amendments to Financial Responsibility Rules for Broker-Dealers,* 72 FR 12862.

[687] *See* paragraph (a)(6) of proposed new Rule 18a–4. Paragraph (a)(1) of proposed Rule 18a–4 would define the term *cleared security-based swap* to mean a security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered with the Commission pursuant to section 17A of the Exchange Act (15 U.S.C. 78q–1). Any other security-based swap would be a non-cleared security-based swap.

[688] *See* paragraph (a)(6) of proposed new Rule 18a–4.

[689] *Compare* 17 CFR 240.15c3–3(a)(1), *with* paragraph (a)(6) of proposed new Rule 18a–4. The proposed definition also is based on the definitions of ''customer'' in 11 U.S.C. 741(2) and 15 U.S.C. 78*lll*(2), which, respectively, apply to liquidations of stockbrokers under the stockbroker liquidation provisions and broker-dealers under the SIPA. As discussed above in section II.C.1 of this release, under these liquidation provisions, customers receive special protections such as priority claims to customer property over general creditors. *See* 11 U.S.C. 101 *et seq.;* 15 U.S.C. 78aaa *et seq.*

[690] *See* 15 U.S.C. 78c–5(f)(1)–(3).

[691] *See* 15 U.S.C. 78c–5(f)(4).

[692] Counterparties that elect individual segregation would not need the protections of the omnibus segregation requirements because their funds and other property would be held by an independent third-party custodian and, therefore, the third-party custodian—rather than the SBSD—would owe the securities and funds to the counterparty. Counterparties that waive segregation,

Proposed new Rule 18a–4 would define the term *excess securities collateral* to mean securities and money market instruments carried for the account of a security-based swap customer that have a market value in excess of the current exposure of the SBSD to the customer, excluding: (1) Securities and money market instruments held in a *qualified clearing agency account* but only to the extent the securities and money market instruments are being used to meet a margin requirement of the clearing agency resulting from a security-based swap transaction of the customer; and (2) securities and money market instruments held in a *qualified registered security-based swap dealer account* but only to the extent the securities and money market instruments are being used to meet a margin requirement of the other SBSD resulting from the SBSD entering into a non-cleared security-based swap transaction with the other SBSD to offset the risk of a non-cleared security-based swap transaction between the SBSD and the customer. The proposed definition of *excess securities collateral* is based on the provisions of Rule 15c3–3 requiring a broker-dealer to maintain physical possession or control of *fully paid* and *excess margin securities* (*i.e.,* securities that are not being used to secure the obligations of the customer to the broker-dealer).[693] Under the proposed definition of *excess securities collateral,* securities and money market instruments of a security-based swap customer of the SBSD that are not being used to collateralize the SBSD's current exposure to the customer would need to be in the physical possession or control of the SBSD unless one of the two exceptions in the definition applies to the securities and money market instruments.

The first exception in the definition refers to securities and money market instruments held in a *qualified clearing agency account* but only to the extent the securities and money market instruments are being used to meet a margin requirement of the clearing agency resulting from a security-based swap transaction of the customer. This exception is designed to accommodate the margin requirements of clearing agencies, which will require SBSDs to deliver margin collateral to the clearing agency to cover exposures arising from cleared security-based swaps of the SBSD's security-based swap customers.[694] Customer securities and money market instruments provided to the clearing agency for this purpose would not meet the definition of *excess securities collateral* and, therefore, would not be subject to the physical possession or control requirement.[695] This exception would allow the clearing agency to hold the securities as collateral against obligations of the SBSD's customers arising from their cleared security-based swaps.

The term *qualified clearing agency account* would be defined to mean an account of an SBSD at a clearing agency established to hold funds and other property in order to purchase, margin, guarantee, secure, adjust, or settle cleared security-based swaps of the SBSD's security-based swap customers that meets the following conditions:

- The account is designated ''Special Clearing Account for the Exclusive Benefit of the Cleared Security-Based Swap Customers of [name of the SBSD]''; [696]
- The clearing agency has acknowledged in a written notice provided to and retained by the SBSD that the funds and other property in the account are being held by the clearing agency for the exclusive benefit of the security-based swap customers of the SBSD in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the SBSD with the clearing agency; [697] and
- The account is subject to a written contract between the SBSD and the clearing agency which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the clearing agency or any person claiming through the clearing agency, except a right, charge, security interest, lien, or claim resulting from a cleared security-based swap transaction effected in the account.[698]

These provisions are designed to ensure that securities and money market instruments of security-based swap customers related to cleared security-based swaps provided to a clearing agency are isolated from the proprietary assets of the SBSD and identified as property of the security-based swap customers.

The second exception in the definition of *excess securities collateral* is for securities and money market instruments held in a *qualified registered security-based swap dealer account* but only to the extent the securities and money market instruments are being used to meet a margin requirement of the other SBSD resulting from the SBSD entering into a non-cleared security-based swap transaction with the other SBSD to offset the risk of a non-cleared security-based swap transaction between the SBSD and the customer. This exception is designed to accommodate the practice of dealers in OTC derivatives transactions maintaining ''matched books'' of transactions in which an OTC derivatives transaction with a counterparty is hedged with an offsetting transaction with another dealer. SBSDs, as dealers in security-based swaps, are expected to actively manage the risk of their non-cleared security-based swap positions by entering into offsetting transactions with other SBSDs.[699] These other SBSDs may require margin collateral from the SBSD.[700] Customer securities and

in effect, have agreed that their funds and other property can be used by the SBSD for its proprietary business purposes. Therefore, they have agreed to forego the benefits of segregation.

[693] *See* 17 CFR 240.15c3–3(d); 17 CFR 240.15c3–3(a)(3) (defining the term *fully paid securities*); 17 CFR 240.15c3–3(a)(4) (defining the term *margin securities*); 17 CFR 240.15c3–3(a)(5) (defining the term *excess margin securities*).

[694] As discussed above, security-based swap clearing agencies will require SBSDs to deliver margin collateral for the security-based swap transactions of the SBSD's customers that are cleared by the clearing agency.

[695] While the Commission is proposing this exemption, these customer securities and money market instruments would still be required to be included in the SBSD's reserve formula calculation under proposed new Rule 18a–4a.

[696] *See* paragraph (a)(3)(i) of proposed new Rule 18a–4. This provision is modeled on paragraph (e)(1) of Rule 15c3–3, which requires a broker-dealer to maintain a ''Special Reserve Bank Account for the Exclusive Benefit of Customers.'' *Compare* 17 CFR 240.15c3–3(e), *with* paragraph (a)(3)(i) of proposed new Rule 18a–4.

[697] *See* paragraph (a)(3)(ii) of proposed new Rule 18a–4. This provision is modeled on paragraph (f) of Rule 15c3–3, which requires a broker-dealer to obtain a written notification from a bank where it maintains a customer reserve account. *Compare* 17 CFR 240.15c3–3(f), *with* paragraph (a)(3)(iii) of proposed new Rule 18a–4.

[698] *See* paragraph (a)(3)(iii) of proposed new Rule 18a–4. This provision is modeled on paragraph (f) of Rule 15c3–3, which requires a broker-dealer to obtain a contract from a bank where it maintains a ''Special Reserve Bank Account for the Exclusive Benefit of Customers.'' *Compare* 17 CFR 240.15c3–3(f), *with* paragraph (a)(3)(ii) of proposed new Rule 18a–4.

[699] For example, assume an SBSD and a counterparty enter into a CDS security-based swap on XYZ Company with a notional amount of $10 million and term of five years and in which the SBSD is the seller of protection and counterparty is the buyer of protection. The SBSD could enter into a matching transaction (a CDS security-based swap on XYZ Company with a notional amount of $10 million and term of five years) with another SBSD in which the SBSD is the buyer of protection and the other SBSD is the seller of protection. This would match the transaction with the counterparty with the transaction with the other SBSD and hedge the SBSD's risk resulting from the transaction with the customer.

[700] As discussed above in section II.B.2.c.i. of this release, an SBSD would not be required to collect collateral equal to the margin amount if the counterparty was another SBSD under the

Continued

money market instruments provided to another SBSD for this purpose would be excepted from the definition of *excess securities collateral* and, therefore, would not be subject to the physical possession or control requirement. Thus, this provision would allow an SBSD to finance customer transactions in non-cleared security-based swaps by using customer collateral to secure offsetting transactions with another SBSD, provided that the collateral is held in an account with the other SBSD that meets certain requirements.

The term *qualified registered security-based swap dealer account* (''qualified SBSD account'') would be defined to mean an account at another SBSD registered with the Commission pursuant to section 15F of the Exchange Act that is not an affiliate of the SBSD and that meets the following conditions:

- The account is designated ''Special Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of the SBSD]'';[701]
- The account is subject to a written acknowledgement by the other SBSD provided to and retained by the SBSD that the funds and other property held in the account are being held by the other SBSD for the exclusive benefit of the security-based swap customers of the SBSD in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the SBSD with the other SBSD;[702]
- The account is subject to a written contract between the SBSD and the other SBSD which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the other SBSD or any person claiming through the SBSD, except a right, charge, security interest, lien, or claim resulting from a non-cleared security-based swap transaction effected in the account;[703] and
- The account and the assets in the account are not subject to any type of subordination agreement.[704]

These conditions are largely identical to the conditions for a qualified clearing agency account and are similarly designed to ensure that securities and money market instruments of security-based swap customers relating to non-cleared security-based swaps provided to another SBSD are isolated from the proprietary assets of the SBSD and are identified as property of the security-based swap customers. Further, the account and the assets in the account could not be subject to any type of subordination agreement. This condition is designed to ensure that if the other SBSD holding the qualified SBSD account fails, the SBSD accountholder will be treated as a security-based swap customer in a liquidation proceeding and, therefore, could make a *pro rata* claim for customer property with other customers ahead of all other creditors.[705]

Paragraph (b)(2) of proposed new Rule 18a–4 would identify five satisfactory control locations for *excess securities collateral.*[706] Rule 15c3–3 identifies the same locations as satisfactory control locations.[707] Proposed new Rule 18a–4 would provide that an SBSD has *control* of *excess securities collateral* only if the securities and money market instruments:

- Are represented by one or more certificates in the custody or control of a clearing corporation or other subsidiary organization of either national securities exchanges, or of a custodian bank in accordance with a system for the central handling of securities complying with the provisions of Exchange Act Rule 8c–1(g) and Exchange Act Rule 15c2–1(g) the delivery of which certificates to the SBSD does not require the payment of money or value, and if the books or records of the SBSD identify the security-based swap customers entitled to receive specified quantities or units of the securities so held for such security-based swap customers collectively;[708]
- Are the subject of bona fide items of transfer; provided that securities and money market instruments shall be deemed not to be the subject of bona fide items of transfer if, within 40 calendar days after they have been transmitted for transfer by the SBSD to the issuer or its transfer agent, new certificates conforming to the instructions of the SBSD have not been received by the SBSD, the SBSD has not

Alternative A account *equity* requirement in proposed new Rule 18a–3. *See* paragraph (c)(1)(iii)(B)—Alternative A of proposed new Rule 18a–3. Consequently, an SBSD would not be required to maintain a minimum level of *positive equity* in its account at another SBSD with respect to non-cleared security-based swaps. This would mean that the SBSD may not need to provide collateral to the other SBSD other than an amount necessary to cover the current exposure of the other SBSD, which, in turn could reduce the need to use securities and money market instruments of security-based swap customers to collateralize hedging transactions. However, under the Alternative B account *equity* requirement, an SBSD would be required to provide collateral equal to the margin amount to the other SBSD. *See* paragraph (c)(1)(iii)(B)—Alternative B of proposed new Rule 18a–3. This could increase the need to use securities and money market instruments of security-based swap customers to collateralize hedging transactions.

[701] *See* paragraph (a)(4)(i) of proposed new Rule 18a–4. Similar to the proposed conditions for a qualified clearing agency account, this provision is modeled on paragraph (e)(1) of Rule 15c3–3, which requires a broker-dealer to maintain a ''Special Reserve Bank Account for the Exclusive Benefit of Customers.'' *Compare* 17 CFR 240.15c3–3(e), *with* paragraph (a)(4)(i) of proposed new Rule 18a–4.

[702] *See* paragraph (a)(4)(ii) of proposed new Rule 18a–4. Similar to the proposed conditions for a qualified clearing agency account, this provision is modeled on paragraph (f) of Rule 15c3–3, which requires a broker-dealer to obtain a written notification from a bank where it maintains a ''Special Reserve Bank Account for the Exclusive Benefit of Customers.'' *Compare* 17 CFR 240.15c3–3(f), *with* paragraph (a)(4)(ii) of proposed new Rule 18a–4.

[703] *See* paragraph (a)(4)(iii) of proposed new Rule 18a–4. Similar to the proposed conditions for a qualified clearing agency account, this provision is modeled on paragraph (f) of Rule 15c3–3, which requires a broker-dealer to obtain a contract from a bank where it maintains a ''Special Reserve Bank Account for the Exclusive Benefit of Customers.'' *Compare* 17 CFR 240.15c3–3(f), *with* paragraph (a)(4)(iii) of proposed new Rule 18a–4.

[704] *See* paragraph (a)(4)(iv) of proposed new Rule 18a–4.

[705] *See* paragraph (a)(6) of proposed new Rule 18a–4 (excluding persons who subordinate their claims against the SBSD to all other creditors from the definition of security-based swap customer).

[706] *See* paragraph (b)(2) of proposed new Rule 18a–4.

[707] *Compare* 17 CFR 240.15c3–3(c), *with* paragraph (b)(2) of proposed new Rule 18a–4. Rule 15c3–3 identifies two control locations that the Commission is not proposing be identified in proposed new Rule 18a–4. First, paragraph (c)(2) of Rule 15c3–3 identifies as a control location ''a special omnibus account in the name of such broker or dealer with another broker or dealer in compliance with the requirements of section 4(b) of Regulation T under the Act (12 CFR 220.4(b)), such securities being deemed to be under the control of such broker or dealer to the extent that he has instructed such carrying broker or dealer to maintain physical possession or control of them free of any charge, lien, or claim of any kind in favor of such carrying broker or dealer or any persons claiming through such carrying broker or dealer.'' *See* 17 CFR 240.15c3–3(c)(2). Stand-alone SBSDs are not expected to maintain such accounts. Second, Rule 15c3–3 identifies as a control location ''a foreign depository, foreign clearing agency or foreign custodian bank which the Commission upon application from a broker or dealer, a registered national securities exchange or a registered national securities association, or upon its own motion shall designate as a satisfactory control location for securities.'' *See* 17 CFR 240.15c3–3(c)(4). *See also Interpretative Release: Guidelines for Control Locations for Foreign Securities,* Exchange Act Release No. 10429 (Oct. 12, 1973), 38 FR 29217, 29217 (Oct. 23, 1973). As discussed below, the last control location identified in Rule 15c3–3 and proposed to be identified in new Rule 18a–4 is such other location ''as the Commission shall upon application from a broker or dealer find and designate to be adequate for the protection of customer securities.'' *See* 17 CFR 240.15c3–3(c)(7) and paragraph (b)(2)(v) of proposed new Rule 18a–4. Under the Commission's proposal, SBSDs seeking to have a foreign depository, foreign clearing agency, or foreign custodian bank identified as a satisfactory control location would need to apply to the Commission under paragraph (b)(2)(v) of proposed new Rule 18a–4.

[708] *See* paragraph (b)(2)(i) of proposed new Rule 18a–4. This provision is modeled on paragraph (c)(1) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(c)(1), *with* paragraph (b)(2)(i) of proposed new Rule 18a–4.

received a written statement by the issuer or its transfer agent acknowledging the transfer instructions and the possession of the securities and money market instruments, or the security-based swap dealer has not obtained a revalidation of a window ticket from a transfer agent with respect to the certificate delivered for transfer;[709]

• Are in the custody or control of a bank as defined in section 3(a)(6) of the Act, the delivery of which securities and money market instruments to the SBSD does not require the payment of money or value and the bank having acknowledged in writing that the securities and money market instruments in its custody or control are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank;[710]

• Are held in or are in transit between offices of the SBSD; or are held by a corporate subsidiary if the SBSD owns and exercises a majority of the voting rights of all of the voting securities of such subsidiary, assumes or guarantees all of the subsidiary's obligations and liabilities, operates the subsidiary as a branch office of the SBSD, and assumes full responsibility for compliance by the subsidiary and all of its associated persons with the provisions of the Federal securities laws as well as for all of the other acts of the subsidiary and such associated persons;[711] or

• Are held in such other locations as the Commission shall upon application from an SBSD find and designate to be adequate for the protection of customer securities.[712]

The identification of these locations as satisfactory control locations is designed to limit where the SBSD can hold *excess securities collateral.* The identified locations are places from which the securities and money market instruments can promptly be retrieved and returned to the security-based swap customers.

Paragraph (b)(3) of Rule 18a–4 would require that each business day the SBSD must determine from its books and records the quantity of *excess securities collateral* that the firm had in possession and control as of the close of the previous business day and the quantity of *excess securities collateral* the firm did not have in possession or control on that day.[713] The paragraph would provide further that the SBSD must take steps to retrieve *excess securities collateral* from certain specifically identified non-control locations if securities and money market instruments of the same issue and class are at these locations.[714] Specifically, paragraph (b)(3) would provide that if securities or money market instruments of the same issue and class are:

• Subject to a lien securing an obligation of the SBSD, then the SBSD, not later than the next business day on which the determination is made, must issue instructions for the release of the securities or money market instruments from the lien and must obtain physical possession or control of the securities and money market instruments within two business days following the date of the instructions;[715]

• Held in a qualified clearing agency account, then the SBSD, not later than the next business day on which the determination is made, must issue instructions for the release of the securities or money market instruments by the clearing agency and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;[716]

• Held in a qualified SBSD account maintained by another SBSD, then the SBSD, not later than the next business day on which the determination is made, must issue instructions for the release of the securities and money market instruments by the other SBSD and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;[717]

• Loaned by the SBSD, then the SBSD, not later than the next business day on which the determination is made, must issue instructions for the return of the loaned securities and money market instruments and must obtain physical possession or control of the securities or money market instruments within five business days following the date of the instructions;[718]

• Failed to receive more than 30 calendar days, then the SBSD, not later than the next business day on which the determination is made, must take prompt steps to obtain physical possession or control of the securities or money market instruments through a buy-in procedure or otherwise;[719]

• Receivable by the SBSD as a security dividend, stock split or similar distribution for more than 45 calendar days, then the SBSD, not later than the next business day on which the determination is made, must take

[709] *See* paragraph (b)(2)(ii) of proposed new Rule 18a–4. This provision is modeled on paragraph (c)(3) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(c)(3), *with* paragraph (b)(2)(ii) of proposed new Rule 18a–4.

[710] *See* paragraph (b)(2)(iii) of proposed new Rule 18a–4. This provision is modeled on paragraph (c)(5) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(c)(5), *with* paragraph (b)(2)(iii) of proposed new Rule 18a–4.

[711] *See* paragraph (b)(2)(iv) of proposed new Rule 18a–4. This provision is modeled on paragraph (c)(6) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(c)(6), *with* paragraph (b)(2)(iv) of proposed new Rule 18a–4.

[712] *See* paragraph (b)(2)(v) of proposed new Rule 18a–4. This provision is modeled on paragraph (c)(7) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(c)(7), *with* paragraph (b)(2)(v) of proposed new Rule 18a–4. *See Guidelines for Control Locations for Foreign Securities,* Exchange Act Release No. 10429 (Oct. 12, 1973, 38 FR 29217 (Oct. 23, 1973) (prescribing the process under Rule 15c3–3 for a broker-dealer to apply to the Commission to utilize a foreign control location). Among other things, certain conditions must be met for the foreign control location to be deemed satisfactory. A broker-dealer must represent in an application to the Commission that the conditions are satisfied. An application submitted shall be considered accepted unless the Commission rejects the application within 90 days of receipt by the Commission. *Id.*

[713] *See* paragraph (b)(3) of proposed new Rule 18a–4. The provisions in this paragraph are modeled on the provisions in paragraph (d) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(d), *with* paragraph (b)(3) of proposed new Rule 18a–4.

[714] *See* paragraph (b)(3) of proposed new Rule 18a–4.

[715] *See* paragraph (b)(3)(i) of proposed new Rule 18a–4. This provision is modeled on paragraph (d)(1) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(d)(1), *with* paragraph (b)(3)(i) of proposed new Rule 18a–4.

[716] *See* paragraph (b)(3)(ii) of proposed new Rule 18a–4. As discussed above, securities held in a qualified clearing agency account are not *excess securities collateral,* but only to the extent the securities are being used to meet a margin requirement of the clearing agency resulting from a security-based swap transaction of the customer. *See* paragraph (a)(2)(i) of proposed new Rule 18a–4. Consequently, if securities held in a qualified clearing agency account are not necessary to meet a margin requirement of the clearing agency, they would be *excess securities collateral* and the SBSD would need to move them to a satisfactory control location.

[717] *See* paragraph (b)(3)(iii) of proposed new Rule 18a–4. As discussed above, securities held in a qualified SBSD account are not *excess securities collateral* but only to the extent the securities are being used to meet a margin requirement of the other SBSD resulting from the SBSD entering into a non-cleared security-based swap transaction with the other SBSD to offset the risk of a non-cleared security-based swap transaction between the SBSD and the customer. *See* paragraph (a)(2)(ii) of proposed new Rule 18a–4. Consequently, if securities held in a qualified clearing agency account are not necessary to meet a margin requirement of the other SBSD and/or are not collateralizing a transaction that offsets the risk of n non-cleared security-based swap with the customer, they would be *excess securities collateral* and the SBSD would need to move them to a satisfactory control location.

[718] *See* paragraph (b)(3)(iv) of proposed new Rule 18a–4. This provision is modeled on paragraph (d)(1) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(d)(1), *with* paragraph (b)(3)(iv) of proposed new Rule 18a–4.

[719] *See* paragraph (b)(3)(v) of proposed new Rule 18a–4. This provision is modeled on paragraph (d)(2) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(d)(2), *with* paragraph (b)(3)(v) of proposed new Rule 18a–4.

prompt steps to obtain physical possession or control of the securities or money market instruments through a buy-in procedure or otherwise;[720] or

• Included on the books or records of the SBSD as a proprietary short position or as a short position for another person more than 10 business days (or more than 30 calendar days if the SBSD is a market maker in the securities), then the SBSD must, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities or money market instruments.[721]

Request for Comment

The Commission generally requests comment on the proposed physical possession and control requirements in proposed new Rule 18a–4. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are possession and control requirements modeled on Rule 15c3–3 appropriate for security-based swaps? If not, explain why not.

2. Is the proposed definition of *security-based swap customer* appropriate? If not, explain why not and suggest modifications to the definition.

3. Is the proposed definition of *excess securities collateral* appropriate? If not, explain why not and suggest modifications to the definition.

4. Is the proposed exception in the definition of *excess securities collateral* for securities and money market instruments held in a qualified clearing agency account appropriate? If not, explain why not. Would this proposed exception raise practical or legal issues? If so, explain why.

5. Is the proposed definition of *qualified clearing agency account* appropriate? If not, explain why not and suggest modifications to the definition.

6. Is the proposed exception in the definition of *excess securities collateral* for securities and money market instruments held in a *qualified registered security-based swap dealer account* appropriate? If not, explain why not. Would this proposed exception raise practical or legal issues? If so, explain why.

7. Is the proposed definition of *qualified registered security-based swap dealer account* appropriate? For example, is the condition that the qualified registered security-based swap dealer account not be held by an affiliate of the SBSD appropriate? If the definition is not appropriate, explain why not and suggest modifications to the definition.

8. How do dealers in OTC derivatives that will be security-based swaps use offsetting transactions to hedge the risk of these positions? Would the proposed possession and control requirements for non-cleared security-based swaps adversely affect the ability of SBSDs to enter into hedging transactions? If so, explain why and suggest modifications to the requirements that could address this issue.

9. Are the control locations identified in proposed new Rule 18a–4 appropriate for security-based swaps? If not, explain why not. Should the two additional control locations in paragraphs (c)(2) and (c)(4) of Rule 15c3–3 that are not being incorporated into proposed new Rule 18a–4 be included in the rule? If so, explain why.

10. Should the process for applying to the Commission to have a location designated to be adequate for the protection of customer securities and money market instruments under paragraph (b)(2)(v) of proposed new Rule 18a–4 be similar to the current process for a broker-dealer to utilize a foreign control location under Rule 15c3–3 (*i.e.,* a process in which the SBSD must submit an application representing that certain conditions are met and in which an application is deemed accepted if not specifically rejected by the Commission within 90 days)? Alternatively, should the Commission be required to formally act on each application through the issuance of an order?

11. Are the steps in paragraph (b)(3) of proposed new Rule 18a–4 that an SBSD would be required to take to move securities and money market instruments from non-control locations to control locations appropriate for security-based swaps? If not, explain why not.

12. Are there any possession and control provisions in Rule 15c3–3 that are not being incorporated in proposed new Rule 18a–4 that should be included in the rule? If so, identify them and explain why they should be incorporated into proposed new Rule 18a–4.

b. Security-Based Swap Customer Reserve Account

Paragraph (c)(1) of Rule 18a–4 would require an SBSD, among other things, to maintain a *special account for the exclusive benefit of security-based swap customers* separate from any other bank account of the SBSD.[722] The term *special account for the exclusive benefit of security-based swap customers* (''Rule 18a–4 Customer Reserve Account'') would be defined to mean an account at a bank that is not the SBSD or an affiliate of the SBSD and that meets the following conditions:

• The account is designated ''Special Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of the SBSD]'';[723]

• The account is subject to a written acknowledgement by the bank provided to and retained by the SBSD that the funds and other property held in the account are being held by the bank for the exclusive benefit of the security-based swap customers of the SBSD in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the SBSD with the bank;[724] and

• The account is subject to a written contract between the SBSD and the bank which provides that the funds and other property in the account shall at no time be used directly or indirectly as security for a loan or other extension of credit to the SBSD by the bank and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.[725]

[720] *See* paragraph (b)(3)(vi) of proposed new Rule 18a–4. This provision is modeled on paragraph (d)(3) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(d)(3), *with* paragraph (b)(3)(vi) of proposed new Rule 18a–4.

[721] *See* paragraph (b)(3)(vii) of proposed new Rule 18a–4. This provision is modeled on a proposed amendment to Rule 15c3–3 that is still pending. *See Amendments to Financial Responsibility Rules for Broker-Dealers,* 72 FR at 12895. The provisions of paragraph (b)(3)(vii) of proposed new Rule 18a–4 are intended to achieve the same objectives of the proposed amendments to Rule 15c3–3. *See id.* at 12865–66 (explaining the basis for the proposed amendment to Rule 15c3–3).

[722] *See* paragraph (c) of proposed new Rule 18a–4. The provisions of paragraph (c) of proposed new Rule 18a–4 are modeled on paragraph (e) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(e), *with* paragraph (c) of proposed new Rule 18a–4.

[723] *See* paragraph (a)(7)(i) of proposed new Rule 18a–4. Similar to the proposed conditions for a qualified clearing agency account and a qualified SBSD account, this provision is modeled on paragraph (e)(1) of Rule 15c3–3, which requires a broker-dealer to maintain a ''Special Reserve Bank Account for the Exclusive Benefit of Customers'' (the ''Rule 15c3–3 Customer Reserve Account''). *Compare* 17 CFR 240.15c3–3(e), *with* paragraph (a)(7)(i) of proposed new Rule 18a–4.

[724] *See* paragraph (a)(7)(ii) of proposed new Rule 18a–4. Similar to the proposed conditions for a qualified clearing agency account and a qualified SBSD account, this provision is modeled on paragraph (f) of Rule 15c3–3, which requires a broker-dealer to obtain a written notification from a bank where it maintains a Rule 15c3–3 Customer Reserve Account. *Compare* 17 CFR 240.15c3–3(f), *with* paragraph (a)(7)(ii) of proposed new Rule 18a–4.

[725] *See* paragraph (a)(7)(iii) of proposed new Rule 18a–4. Similar to the proposed conditions for a qualified clearing agency account and a qualified SBSD account, this provision is modeled on paragraph (f) of Rule 15c3–3, which requires a broker-dealer to obtain a written contract from a bank where it maintains a ''Special Reserve Bank

These conditions are largely identical to the conditions for a qualified clearing agency account and qualified SBSD account and are similarly designed to ensure that cash and qualified securities deposited into the special bank account (as discussed below) are isolated from the proprietary assets of the SBSD and identified as property of the security-based swap customers.

Paragraph (c)(1) of proposed new Rule 18a–4 would provide that the SBSD must at all times maintain in a Rule 18a–4 Customer Reserve Account, through deposits into the account, cash and/or qualified securities in amounts computed in accordance with the formula set forth in Exhibit A to Rule 18a–4.[726] The formula in Exhibit A to proposed new Rule 18a–4 is modeled on the formula in Exhibit A to Rule 15c3–1, which requires a broker-dealer to add up various credit items and debit items.[727] The credit items include credit balances in customer accounts and funds obtained through the use of customer securities.[728] The debit items include money owed by customers (*e.g.,* from margin lending), securities borrowed by the broker-dealer to effectuate customer short sales, and required margin posted to certain clearing agencies as a consequence of customer securities transactions.[729] If, under the formula, customer credit items exceed customer debit items, the broker-dealer must maintain cash and/or qualified securities in that net amount in a Rule 15c3–3 Customer Reserve Account.

The formula in Exhibit A for determining the amount to be maintained in a Rule 18a–4 Customer Reserve Account similarly would require an SBSD to add up credit items and debit items.[730] If, under the formula, the credit items exceed the debit items, the SBSD would be required to maintain cash and/or qualified securities in that net amount in a Rule 18a–4 Customer Reserve Account.[731] The credit and debit items identified in Exhibit A to proposed new Rule 18a–4 are the same as the credit and debit items in Exhibit A to Rule 15c3–1, though Exhibit A to proposed new Rule 18a–4 would identify two additional debit items.[732] As discussed above, SBSDs will be required to deliver collateral to meet margin requirements of clearing agencies arising from cleared security-based swap transactions of their customers. In addition, SBSDs may deliver collateral to other SBSDs to meet margin requirements under proposed new Rule 18a–3 and, possibly, to meet ''house'' margin requirements of the other SBSD with respect to non-cleared security-based swaps the SBSD is using to hedge the risk of customer non-cleared security-based swaps. Consequently, Exhibit A to proposed new Rule 18a–4 would identify the following debit items that are not identified in Exhibit A to Rule 15c3–3:

- Margin related to cleared security-based swap transactions in accounts carried for security-based swap customers required and on deposit at a clearing agency registered with the Commission pursuant to section 17A of the Exchange Act (15 U.S.C. 78q–1); and
- Margin related to non-cleared security-based swap transactions in accounts carried for security-based swap customers held in a qualified registered SBSD account at another SBSD.

These debit items would serve the same purpose as the debit items in Exhibit A to Rule 15c3–3 that identify margin required and on deposit at the Options Clearing Corporation, a registered clearing agency, and a DCO.[733]

If the total credits exceed the total debits, an SBSD would need to maintain that amount on deposit in a Rule 18a–4 Customer Reserve Account in the form of funds and/or qualified securities.[734] An SBSD would be permitted under the proposed rule to use qualified securities to meet this account deposit requirement to implement section 3E(d) of the Exchange Act.[735] Section 3E(d) provides that money of security-based swap customers received by an SBSD to margin, guarantee, or secure a cleared security-based swap may be invested in obligations of the United States, obligations fully guaranteed as to principal and interest by the United States, general obligations of a State or any subdivision of a State (''municipal securities''), and in any other investment that the Commission may by rule or regulation prescribe.[736] Section 3E(d) further provides that such investments shall be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe.[737]

The term *qualified security* as used in proposed new Rule 18a–4 would be defined to mean: (1) Obligations of the United States; (2) obligations fully guaranteed as to principal and interest by the United States; and (3) general obligations of any State or subdivision of a State that are not traded flat or are not in default, were part of an initial offering of $500 million or greater, and were issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year-end.[738] Rule 15c3–3 contains a similar definition of *qualified security,* except the definition does not include municipal securities.[739]

While section 3E(d) of the Exchange Act permits the use of municipal

Account for the Exclusive Benefit of Customers.'' *Compare* 17 CFR 240.15c3–3(f), *with* paragraph (a)(7)(iii) of proposed new Rule 18a–4.

[726] *See* paragraph (c)(1) of proposed new Rule 18a–4; Exhibit A to proposed new Rule 18a–4.

[727] *Compare* 17 CFR 240.15c3–3a, *with* Exhibit A to proposed new Rule 18a–4.

[728] *See* 17 CFR 240.15c3–3a, Items 1–9. Broker-dealers are permitted to use customer margin securities to, for example, obtain bank loans to finance the funds used to lend to customers to purchase the securities. The amount of the bank loan is a credit in the formula because this is the amount that the broker-dealer would need to pay the bank to retrieve the securities. Similarly, broker-dealers may use customer margin securities to make stock loans to other broker-dealers in which the lending broker-dealer typically receives cash in return. The amount payable to the other broker-dealer on the stock loan is a credit in the formula because this is the amount the broker-dealer would need to pay the other broker-dealer to retrieve the securities.

[729] *See* 17 CFR 240.15c3–3a, Items 10–14. Item 13 identifies as a debit item margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in accounts of securities customers. *See* 17 CFR 240.15c3–3a, Item 13. Similarly, Item 14 identifies as a debit item margin related to security futures products written, purchased, or sold in accounts carried for security-based swap customers required and on deposit with a clearing agency registered with the Commission under section 17A of the Exchange Act (15 U.S.C. 78q–1) or a DCO registered with the CFTC under section 5b of the CEA (7 U.S.C. 78q–1). These debits reflect the fact that customer options and security futures transactions that are cleared generate margin requirements in which the broker-dealer must deliver collateral to the Options Clearing Corporation in the case of options or a clearing agency or DCO in the case of security futures products. Identifying the collateral delivered to the Options Clearing Corporation, a clearing agency, or a DCO as a debit item permits the broker-dealer to use customer cash or securities to meet margin requirements generated by customer transactions.

[730] *See* proposed new Rule 18a–4a. Exhibit A to Rule 15c3–3 has a number of ''Notes'' that provide further explanation of the credit and debit items. *See* 17 CFR 240.15c3–3a, Notes A–G. Exhibit A to proposed new Rule 18a–4 would have substantially similar notes. *See* Notes A–G to Exhibit A to proposed new Rule 18a–4.

[731] As discussed above, the account would need to be at a bank that is not the SBSD or an affiliate of the SBSD and that meets certain additional conditions. *See* paragraph (a)(7) of proposed new Rule 18a–4.

[732] *Compare* 17 CFR 240.15c3–3a, *with* Exhibit A to proposed new Rule 18a–4.

[733] *See* 17 CFR 240.15c3–3a, Items 13–14.

[734] *See* paragraph (c)(1) of proposed new Rule 18a–4.

[735] 15 U.S.C. 78c–5(d).

[736] *Id.*

[737] *Id.*

[738] *See* paragraph (a)(5) of proposed new Rule 18a–4.

[739] *See* 17 CFR 240.15c3–3(a)(6) (defining the term *qualified security* to mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States).

securities, the rule imposes conditions on their use designed to ensure that only municipal securities with the most reliable valuations—and therefore greater safety and liquidity—are permitted to meet the Rule 18a–4 Customer Reserve Account funding requirement in paragraph (c)(1) of proposed new Rule 18a–4 (consistent with the objective of the current definition of ''qualified security'' in Rule 15c3–3).[740] Because of the diversity and breadth of the municipal market, the availability of issuer information and the related ability to value and trade a particular municipal security can vary considerably.[741] The objective of segregation requirements is to isolate customer assets from a firm's proprietary business and, therefore, enable the firm to quickly return the assets to the customers if the firm fails. Rule 15c3–3 limits the definition of qualified securities to U.S. government securities to ensure that securities deposited in a customer reserve account can be liquidated quickly at current market values even in stressed market conditions. The proposed conditions for depositing municipal securities into the SBSD's Rule 18a–4 Customer Reserve Account are designed to help ensure that only securities that are likely to have significant issuer information available and that can be valued and liquidated quickly at current market values are permitted to meet the minimum account deposit requirement.[742]

The first proposed condition for municipal securities is that they must be general obligation bonds. General obligation bonds are backed by the full faith and credit and/or taxing authority of the issuer.[743] They normally are issued to finance non-revenue producing public works projects (*e.g.,* schools and roads) and generally are paid off with funds from taxes or fees. Issuers typically have the ability to raise taxes in order to service the debt obligations of these municipal securities. In contrast, revenue bonds are issued to fund projects that will eventually generate revenue (*e.g.,* a toll road). The anticipated revenue is used to make payments of principal and interest owing on the bonds. Revenue bonds generally do not permit the bondholders to compel taxation or legislative appropriation of funds not pledged for the purpose of servicing the debt obligations of these municipal securities.[744] Consequently, the creditworthiness of revenue bonds depends on the success of the project being financed, whereas the creditworthiness of general obligation bonds ultimately depends on the taxing authority of the issuer. Therefore, general obligation bonds tend to have lower rates of default than other types of municipal securities.[745] In order to limit the use of municipal securities in the Rule 18a–4 Customer Reserve Account to the most creditworthy instruments,[746] the proposed definition of *qualified security* would limit the use of municipal securities to general obligation bonds.

The second proposed condition for the use of municipal securities is that they must be part of an initial offering of $500 million or greater. The size of the initial offering is an indication of the size of the market for a particular issuer's municipal securities. Additionally, the secondary market for a municipal security is generally smaller than for the initial offering.[747] The $500 million threshold is designed to be large enough to ensure that the market for a particular issuer's securities is large enough that the securities can be liquidated quickly and at their current market price in order to raise cash to return to an SBSD's customers.

The third proposed condition for the use of municipal securities is that they must be issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year-end.[748] Prices for municipal securities issued by issuers that have published relatively current information about their financial condition may tend to be more transparent than prices for municipal securities issued by issuers for which such financial information is not available, because investors and analysts have more current information to assess the creditworthiness of the issuer and to inform pricing decisions.[749]

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[740] *See* paragraphs (a)(5)(iii)(A)–(C) of proposed new Rule 18a–4.

[741] Despite its size and importance, the municipal securities market has not been subject to the same level of regulation as other sectors of the U.S. capital markets. *See* Commission, *Report on the Municipal Securities Market* (July 31, 2012) (''*Municipal Securities Report''*), available at *http://www.sec.gov/news/studies/2012/munireport073112.pdf.* The *Municipal Securities Report* notes concerns about access to issuer information; the presentation and comparability of information; and the existence/adequacy of disclosure controls and procedures. *Id.* at iv, 108–09. For example, the *Municipal Securities Report* notes that studies have shown that disclosure of audited annual financial statements by many municipal issuers is particularly slow. *Id.* at 76. By the time annual financial statements are filed or otherwise publicly available, many municipal market analysts and investors believe that the financial information has diminished usefulness or has lost relevance in assessing the current financial position of a municipal issuer. *Id.* Correspondingly, weaker or more distressed entities are more likely to have later audit completion times. *Id.* In addition, the *Municipal Securities Report* notes that although there have been improvements in the availability of pricing information about completed trades (*i.e.,* post-trade information), the secondary market for municipal securities remains opaque. Investors have very limited access to information regarding which market participants would be interested in buying or selling a municipal security, and at which prices (*i.e.,* pre-trade information). *Id.* at vi, 115.

[742] *See Municipal Securities Report* at 113–115 (recognizing the municipal securities market's ''relatively low liquidity'' and the ''relatively opaque'' pre-trade information about municipal securities' prices).

[743] *See Municipal Securities Report* at 7.

[744] *Id.*

[745] *See, e.g.,* Moody's Investor Services (''Moody's''), *Special Comment: U.S. Municipal Bonds Defaults and Recoveries, 1970–2011,* at 1 (Mar. 7, 2012), available at *http://www.moodys.com/research documentcontentpage.aspx?docid=PBC_140114. See also Municipal Securities Report,* at 7 (noting reports indicate that a majority of defaults in the municipal securities market are in conduit revenue bonds issued for nongovernmental purposes, such as multi-family housing, healthcare (hospitals and nursing homes), and industrial development bonds (for economic development and manufacturing purposes).

[746] *See* Fitch Ratings (''Fitch''), *Default Risk and Recovery Rates on U.S. Municipal Bonds,* note 116, at 1 (Jan. 9, 2007), available at *http://www.cdfa.net/cdfa/cdfaweb.nsf/ordredirect.html?open&id=fitchdefaultreport.html* Fitch is not aware of any state or local municipality of size that has experienced a permanent or extended default on its general obligation bonds since the Great Depression, so that in one of its studies, Fitch assumed a 100% recovery rate on general obligation bonds). *Id. See also* Moody's, *Special Comment: Moody's US Municipal Bond Rating Scale,* 11 (Nov. 2002), available at *http://www.moodys.com/sites/products/DefaultResearch/2001700000407258.pdf.* Similarly, Moody's acknowledged the ''anticipated near 100% recovery rate on any defaulted general obligation bond,'' because there have been no defaults among Moody's-rated issuers of general obligation bonds since at least 1970. *Id.*

[747] While almost all municipal bonds trade in the first month following the initial offering, only 15% trade in the second month, and even fewer trade in subsequent months. *Municipal Securities Report* at 113–14 (citing Richard C. Green, Burton Hollifield and Normal Schürhoff, *Financial Intermediation and the Costs of Trading in an Opaque Market,* 20 Rev. Fin. Stud. 275, 282 (2007)).

[748] *See, e.g., Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment Nos. 1 and 2 Thereto, Relating to Additional Voluntary Submissions by Issuers to the MSRB's Electronic Municipal Market Access System (''EMMA®''),* Exchange Act Release No. 62183 (May 26, 2010), 75 FR 30876 (June 2, 2010) (''MSRB Rule Filing''). The MSRB stated that, ''issuers that seek to make their financial information available under the voluntary annual filing undertaking also would be bringing the timing of their disclosures into closer conformity with the timeframes that investors in the registered securities market have come to rely upon.'' *Id.* at 30882.

[749] *See* MSRB Notice 2010–15 (June 2, 2010), available at *http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2010/2010–15.aspx?n=1* (requesting voluntary submissions of audited financial statements within 120 calendar days of the fiscal year-end, or as a transitional alternative available through December 31, 2013, within 150 calendar days of the fiscal year-end). Timely financial reporting ''is critical to the

As discussed above, an SBSD would be required to add up credit items and debit items pursuant to the formula in Exhibit A to proposed new Rule 18a–1. If, under the formula, the credit items exceed the debit items, the SBSD would be required to maintain cash and/or qualified securities in that net amount in the Rule 18a–4 Customer Reserve Account. Paragraph (c)(1) of proposed new Rule 18a–4 would require an SBSD to take certain deductions for purposes of this requirement.[750] The amount of cash and/or qualified securities in the Rule 18a–4 Customer Reserve Account would need to equal or exceed the amount required pursuant to the formula in Exhibit A to proposed new Rule 18a–1*after* applying the deductions.

First, the SBSD would need to deduct the percentage of the value of municipal securities specified in paragraph (c)(2)(vi) of Rule 15c3–1.[751] Paragraph (c)(2)(vi) of Rule 15c3–1 prescribes the standardized haircuts a broker-dealer must apply to municipal securities when computing net capital. For the purposes of proposed new Rule 18a–4, the SBSD would need to apply the standardized haircuts to municipal securities held in the Rule 18a–4 Customer Reserve Account even if the firm is approved to use VaR models for purposes of computing its net capital under Appendix E to Rule 15c3–1, as proposed to be amended, or proposed new Rule 18a–1. The purpose of these deductions would be to account for potential market losses that may be incurred when municipal securities held in a Rule 18a–4 Customer Reserve Account are liquidated to return funds to security-based swap customers.

Second, the SBSD would need to deduct the aggregate value of the municipal securities of a single issuer to the extent the value exceeds 2% of the amount required to be maintained in the Rule 18a–4 Customer Reserve Account. The Commission preliminarily believes that this deduction would serve as a reasonable benchmark designed to avoid the potential that the SBSD might use customer funds to establish a concentrated position in municipal securities of a single issuer. A concentrated position could be more difficult to liquidate at current market values.

Third, the SBSD would need to deduct the aggregate value of all municipal securities to the extent the amount of the securities exceeds 10% of the amount required to be maintained in the Rule 18a–4 Customer Reserve Account. The Commission preliminarily believes that this deduction would serve as a reasonable benchmark designed to limit the amount of customer funds an SBSD could invest in municipal securities.[752] As noted above, the segregation provisions are designed to prevent an SBSD from using customer property for proprietary business purposes such as paying expenses. The purpose of the deposits into the Rule 18a–4 Customer Reserve Account is to create a reserve to protect the funds of security-based swap customers. The deposits are not intended as a means for the SBSD to earn investment returns by, for example, establishing positions in higher yielding municipal securities. The 10% threshold is designed to limit the ability of the SBSD to use the Rule 18a–4 Customer Reserve Account deposit requirement to invest in municipal securities, for the purpose of obtaining higher yields than U.S. government securities.

Fourth, the SBSD would be required to deduct the amount of funds held in a Rule 18a–4 Customer Reserve Account at a single bank to the extent the amount exceeds 10% of the equity capital of the bank as reported by the bank in its most recent Consolidated Report of Condition and Income (''Call Report'').[753] This provision is consistent with a pending proposed amendment to Rule 15c3–3.[754] As the Commission stated when proposing the amendment to Rule 15c3–3:

> Broker-dealers must deposit cash or ''qualified securities'' into the customer reserve account maintained at a ''bank'' under Rule 15c3–3(e). Rule 15c3–3(f) further requires the broker-dealer to obtain a written contract from the bank in which the bank agrees not to re-lend or hypothecate securities deposited into the reserve account. Consequently, the securities should be readily available to the broker-dealer. Cash deposits, however, are fungible with other deposits carried by the bank and may be freely used in the course of the bank's commercial lending activities. Therefore, to the extent a broker-dealer deposits cash in a reserve bank account, there is a risk the cash could be lost or inaccessible for a period if the bank experiences financial difficulties. This could adversely impact the broker-dealer and its customers if the balance of the reserve deposit is concentrated at one bank in the form of cash.[755]

The deduction in proposed new Rule 18a–4 is designed to address the same risk to SBSDs that the Commission identified with respect to concentrating in a single bank cash deposits in a customer reserve account maintained under Rule 15c3–1.

Paragraph (c)(2) of proposed new Rule 18a–4 would provide that it is unlawful for an SBSD to accept or use credits identified in the items of the formula set forth in Exhibit A to proposed new Rule 18a–4 except to establish debits for the specified purposes in the items of the formula.[756] This provision would prohibit the SBSD from using customer cash and cash realized from the use of customer securities for purposes other than those identified in the debit items in Exhibit A to proposed new Rule 18a–4. Thus, the SBSD would be prohibited from using customer cash to, for example, pay expenses.

Paragraph (c)(3) of proposed new Rule 18a–4 would provide that the computations necessary to determine the amount required to be maintained in the Rule 18a–4 Customer Reserve Account must be made daily as of the close of the previous business day and any deposit required to be made into the account must be made on the next business day following the computation no later than one hour after the opening of the bank that maintains the account.[757] Paragraph (c)(3) also would provide that the SBSD may make a

functioning of an efficient trading market,'' especially since bond ratings are only updated when a significant change is about to occur, and credit reports represent a costly alternative. *Municipal Securities Report* at 74 (citing Jeff L. Payne and Kevin L. Jensen, *An Examination of Municipal Audit Delay,* J. Acc. & Pub. Pol'y, Vol. 21, Issue 1, 3 (2002)).

[750] *See* paragraph (c)(1) of proposed new Rule 18a–4.

[751] *See* 17 CFR 240.15c3–1(c)(2)(vi)(B).

[752] *Compare* to Rule 15c3–1(c)(2)(vi)(M)(*1*) (imposing undue concentration charges on certain securities in the proprietary account of a broker-dealer whose market value exceeds more than 10% of the ''net capital'' of a broker-dealer before application of haircuts).

[753] With the passage of the Dodd-Frank Act, the supervision of savings associations was transferred from the Office of Thrift Supervision to the OCC for federal savings associations and to the FDIC for state savings associations on the ''transfer date,'' which is defined as one year after enactment of the Dodd-Frank Act, subject to an additional six month extension. *See* section Public Law 111–203 §§ 300–378. *See also List of OTS Regulations to be Enforced by the OCC and the FDIC Pursuant to the Dodd-Frank Act,* OCC, FDIC, 76 FR 39246 (July 6, 2011). Supervision of savings and loan holding companies and their subsidiaries (other than depository institutions) was transferred from the OTS to the Federal Reserve. Therefore, in February 2011, the OTS, the OCC, and the FDIC proposed to require, ''savings associations currently filing the Thrift Financial Report to convert to filing the Consolidated Reports of Condition and Income or Call Reports beginning with the reporting period ending on March 31, 2012.'' *Proposed Agency Information Collection Activities; Comment Request,* 76 FR 7082, 7082 (Feb. 8, 2011).

[754] *Amendments to Financial Responsibility Rules for Broker-Dealers,* 72 FR at 12864.

[755] *Id.*

[756] *See* paragraph (c)(2) of proposed new Rule 18a–4. This provision is modeled on paragraph (e)(2) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(e)(2), *with* paragraph (c)(2) of proposed new Rule 18a–4.

[757] *See* paragraph (c)(3) of proposed new Rule 18a–4.

withdrawal from the Rule 18a–4 Customer Reserve Account only if the amount remaining in the account after the withdrawal is equal to or exceeds the amount required to be maintained in the account.[758]

Proposed new Rule 18a–4 would require a daily computation as opposed to the weekly computation that is required by Rule 15c3–3. The margin requirements of clearing agencies and other SBSDs for security-based swaps are expected generally to be determined on a daily basis, which will require SBSDs to deliver collateral to, and receive the return of collateral from, clearing agencies and other SBSDs on a daily basis.[759] If the Rule 18a–4 Customer Reserve Account computation were performed on a weekly basis, the SBSD might need to fund margin requirements relating to customer security-based swaps using its own funds for up to a week because the customer cash necessary to meet the requirement is ''locked up'' in the Rule 18a–4 Customer Reserve Account and cannot be withdrawn for a number of days, which could cause liquidity strains on the SBSD.

Finally, paragraph (c)(4) of proposed new Rule 18a–4 would require an SBSD to promptly deposit funds or qualified securities into a Rule 18a–4 Customer Reserve Account of the SBSD if the amount of funds and/or qualified securities held in one or more Rule 18a–4 Customer Reserve Accounts falls below the amount required to be maintained pursuant to the rule.[760] This proposal is designed to require an SBSD to use its own resources to fund the deposit requirement if there is a shortfall in the amount of cash or qualified securities maintained in its Rule 18a–4 Customer Reserve Account.

Request for Comment

The Commission generally requests comment on the requirements for the Rule 18a–4 Customer Reserve Account in proposed new Rule 18a–4. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Are Rule 18a–4 Customer Reserve Account requirements modeled on Rule 15c3–3 appropriate for security-based swaps? If not, explain why not.

2. Is the proposed definition of *special account for the exclusive benefit of security-based swap customers* appropriate? If not, explain why not and suggest modifications to the definition.

3. Are the proposed credit and debit items in Exhibit A to proposed new Rule 18a–4 appropriate? If not, explain why not. Are there alternative or additional credit and debit items that should be included in the formula? If so, describe them and explain why they should be included in the formula.

4. How would the formula computation for a broker-dealer SBSD differ from the formula computation for a stand-alone SBSD? For example, the debit items relating to financing securities transactions would not apply to stand-alone SBSDs as financing securities transactions would need to be conducted in a broker-dealer. Consequently, should there be a separate Exhibit A formula for stand-alone SBSDs?

5. Are the two additional debit items in Exhibit A to proposed new Rule 18a–4 relating to margin collateral required and on deposit at clearing agencies, DCOs, and other SBSDs appropriate? If not, explain why not.

6. Note G to Exhibit A to proposed new Rule 18a–4 is analogous to Note G to Exhibit A to Rule 15c3–3. Note G to Exhibit A to Rule 15c3–3 prescribes (and Note G to Exhibit A to proposed new Rule 18a–1 would prescribe) the conditions for when a clearing agency or DCO can qualify for purposes of including debits in the reserve formula under Item 14 (margin related to security futures products). Should these conditions apply to when a clearing agency would qualify for purposes of including debits in the Rule 18a–4 Customer Reserve Account formula under Item 15? If so, explain why. If not, explain why not. For example, could the Note G conditions, if applied to Item 15, be used instead of the proposed definition of *qualified clearing agency account* in proposed new Rule 18a–4? Would the Note G conditions be a workable alternative to the proposed definition? Would the Note G conditions achieve the same customer protection objectives as the proposed definition?

7. Is the proposed definition of *qualified security* appropriate? If not, explain why not and suggest modifications to the definition. For example, should additional types of securities be included in the definition? If so, identify the types of securities and explain why they should be included in the definition and how their inclusion would meet the objective of segregation that customer cash is not used to make proprietary investments.

8. Is the proposed condition to the definition of qualified security that municipal securities be general obligation bonds in the definition appropriate? If not, explain why not. Identify other types of municipal securities that should be included and explain how their inclusion would be consistent with the objective that only the most highly liquid securities (*i.e.,* securities capable of being liquidated at market value even during times of market stress) be permitted to meet the Rule 18a–4 Customer Reserve Account deposit requirement.

9. It is expected that the proposed condition that municipal securities be part of an initial offering of $500 million or greater in the definition of *qualified security* would limit qualifying securities to a very small percentage of general obligation municipal security issuances.[761] Would the $500 million threshold be appropriate? If not, explain why not. For example, should this threshold be a greater amount (*e.g.,* $750 million, $1 billion, or some other amount) or a lesser amount (*e.g.,* $250 million, $100 million, or some other amount)? If so, indicate the recommended threshold and explain why it would be preferable.

10. Is the proposed condition that municipal securities must be issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year-end in the definition of *qualified security* appropriate? If not, explain why not.

11. The MSRB Rule Filing contemplates those issuers who are engaged in the voluntary annual filing undertaking will be able to provide the information to the MSRB's Electronic Muni Market Access System within 150 calendar days after the end of the applicable fiscal year prior to January 1, 2014. The 150 calendar day time frame is an interim measure and would no longer be available after January 1, 2014. Should municipal securities that otherwise meet the definition of qualified securities be permitted if the issuer submits financial information within 150 calendar days after the end of the applicable fiscal year during this transitional period that would end on January 1, 2014?

12. Is the proposed deduction for municipal securities held in a Rule 18a–4 Customer Reserve Account equal to the percentage specified in paragraph

[758] *Id.*

[759] As discussed above in section II.B.2.b.i. of this release, proposed new Rule 18a–3 would require a nonbank SBSD to calculate the *equity* in the account of each counterparty on a daily basis and to collect collateral needed to collateralize an account *equity* requirement on the next business day. *See* paragraphs (c)(1)(i)–(ii) of proposed new Rule 18a–3.

[760] *See* paragraph (c)(4) of proposed new Rule 18a–4.

[761] Data source: Mergent's Municipal Bond Securities Database.

(c)(2)(vi) of Rule 15c3–1 appropriate? If not, explain why not.

13. Is the proposed deduction for municipal securities of a single issuer held in a Rule 18a–4 Customer Reserve Account in excess of 2% of the amount required to be maintained in the account appropriate? If not, explain why not. For example, should the threshold be greater (*e.g.,* 3%, 5%, 7%, 10%, or some other amount) or lesser (*e.g.,* 1.5%, 1%, 0.5%, or some other amount)? If so, identify the recommended threshold and explain why it would be preferable.

14. Is the proposed deduction for municipal securities held in a Rule 18a–4 Customer Reserve Account in excess of 10% of the amount required to be maintained in the account appropriate? If not, explain why not. For example, should the threshold be greater (*e.g.,* 15%, 20%, 25%, 30%, or some other amount) or lesser (*e.g.,* 7%, 5%, 3%, or some other amount)? If so, identify the recommended threshold and explain why it would be preferable.

15. Is the proposed deduction for the amount that funds held in a Rule 18a–4 Customer Reserve Account at a single bank exceed 10% of the equity capital of the bank as reported by the bank in its most recent Call Report appropriate? If not, explain why not. For example, should the threshold be greater (*e.g.,* 15%, 20%, 25%, 30%, or some other amount) or lesser (*e.g.,* 7%, 5%, 3%, or some other amount)? If so, identify the recommended threshold and explain why it would be preferable.

16. Is it appropriate to require that the computations to determine the amount required to be maintained in the Rule 18a–4 Customer Reserve Account must be made daily as of the close of the previous business day and any deposit required to be made into the account must be made on the next business day following the computation? If not, explain why not. For example, should the computations be required on a weekly basis consistent with Rule 15c3–3? If so, explain why.

17. Are there any customer reserve account provisions in Rule 15c3–1 that are not being incorporated in proposed new Rule 18a–4 that should be included in the rule? If so, identify them and explain why they should be incorporated into proposed new Rule 18a–4.

18. More generally, are there any provisions in Rule 15c3–1 that are not being incorporated in proposed new Rule 18a–4 that should be included in the rule? If so, identify them and explain why they should be incorporated into proposed new Rule 18a–4.

c. Special Provisions for Non-Cleared Security-Based Swap Counterparties

Paragraph (d) of proposed new Rule 18a–4 would require an SBSD and an MSBSP to provide the notice required by section 3E(f)(1)(A) of the Exchange Act prior to the execution of the first non-cleared security-based swap with the counterparty.[762] Paragraph (d) also would require an SBSD to obtain subordination agreements from counterparties that opt out of the omnibus segregation requirements in proposed new Rule 18a–4 because they either elect individual segregation pursuant to the self-executing provisions of section 3E(f) of the Exchange Act [763] or agree that the SBSD need not segregate their assets at all.[764]

Notice Requirement

The provisions in section 3E(f) of the Exchange Act allow a program by which a counterparty to non-cleared security-based swaps with an SBSD or an MSBSP can choose individual segregation.[765] These provisions provide a framework of baseline requirements that can be supplemented by commercial arrangements between counterparties and SBSDs and MSBSPs. Proposed new Rule 18a–4 would augment these provisions by prescribing when the notice specified in section 3E(f)(1)(A) must be provided to the counterparty by the SBSD or MSBSP. Section 3E(f)(1)(A) provides that an SBSD and an MSBSP shall be required to notify the counterparty at the ''beginning'' of a non-cleared security-based swap transaction about the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty.[766] To provide greater clarity as to the meaning of ''beginning'' as used in the statute, paragraph (d)(1) of proposed new Rule 18a–4 would require an SBSD or MSBSP to provide the notice in writing to a counterparty prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the effective date of the rule.[767] Consequently, the notice would need to be given in writing to the counterparty prior to the execution of a transaction and, therefore, before the counterparty is required to deliver margin collateral to the SBSD or MSBSP. The notice, therefore, would give the counterparty an opportunity to determine whether to elect individual segregation, waive segregation, or, by not electing individual segregation or waiving segregation, to have the collateral segregated pursuant to the omnibus segregation provisions of proposed new Rule 18a–4.

Subordination Agreements

Paragraph (d)(2) of proposed new Rule 18a–4 would require an SBSD to obtain agreements from counterparties that either elect individual segregation or waive segregation altogether that such counterparties subordinate all of their claims against the SBSD to the claims of security-based swap customers.[768] By entering into subordination agreements, these counterparties would not meet the definition of *security-based swap customer* in proposed new Rule 18a–4.[769] They also would not be entitled to share ratably with security-based swap customers in the fund of customer property held by the SBSD if it is liquidated. This provision would be consistent with text in Rule 15c3–3 concerning the exclusion of persons whose interests are subordinated from the definition of ''customer.'' [770]

As discussed in section II.C.1. of this release, segregation requirements are designed to identify customer property as distinct from the proprietary assets of the firm and to protect the customer property by, for example, preventing the firm from using it to make proprietary investments. The goal of segregation is to facilitate the prompt return of customer property to customers either before or during a liquidation proceeding if the firm fails. However, if a counterparty's property is held by a third-party custodian because the counterparty elects individual segregation or if the counterparty waives segregation, there is no need to isolate the counterparty's property since it is with the third-party custodian in the former case or the counterparty has agreed that the SBSD can use it for proprietary purposes in the latter case. The subordination provisions in proposed new Rule 18a–4 are designed to clarify the rights of counterparties

[762] *See* 15 U.S.C. 78c–5(f)(1)(A); paragraph (d)(1) of proposed new Rule 18a–4.

[763] *See* 15 U.S.C. 78c–5(f)(1)–(3).

[764] *See* 15 U.S.C. 78c–5(f)(4).

[765] *See* 15 U.S.C. 78c–5(f)(1)–(3).

[766] *See* 15 U.S.C. 78c–5(f)(4).

[767] *See* paragraph (c)(1) of proposed new Rule 18a–4.

[768] *See* paragraph (d)(2) of proposed new Rule 18a–4.

[769] *See* paragraph (a)(6) of proposed new Rule 18a–4.

[770] *See* paragraph (a)(1) of Rule 15c3–3 defining ''customer'' for purposes of Rule 15c3–3 to specifically exclude ''any other person to the extent that person has a claim for property or funds which by contract, agreement or understanding, or by operation of law, is part of the capital of the broker-dealer or is subordinated to the claims of creditors of the broker-dealer. 17 CFR 240.15c3–3(a)(1).

that have their property held by the SBSD and elect segregation and the rights of counterparties that either elect to have their property held by a third-party custodian or waive segregation.

An SBSD would need to obtain a conditional subordination agreement from a counterparty that elects individual segregation.[771] The agreement would be conditional because the subordination agreement required under the proposed rule would not be effective in a case where the counterparty's assets are included in the bankruptcy estate of the SBSD. Specifically, the proposed rule would provide that the counterparty would need to subordinate claims but only to the extent that funds or other property provided by the counterparty to the independent third-party custodian are not treated as *customer property* under the stockbroker liquidation provisions in a liquidation of the security-based swap dealer.[772] Counterparties that choose individual segregation are opting to have their funds and other property held in a manner that makes the counterparty's property bankruptcy remote from the SBSD. If the arrangement is effective, the counterparties should not have any *customer* claims to cash, securities, or money market instruments used to margin their non-cleared security-based swap transactions in a liquidation of the SBSD, as their property will be held by the independent third party custodian. However, because there is a possibility that an individual segregation arrangement would not be effective, the subordination agreement of a counterparty that chooses individual segregation would be conditioned on the funds and other property of the counterparty not being included in the bankruptcy estate of the SBSD. If a counterparty elects individual segregation but the election is not effective in keeping the counterparty's assets bankruptcy remote, then the counterparty should be treated as a *security-based swap customer* with a *pro rata* priority claim to customer property.

An SBSD also would need to obtain an unconditional subordination agreement from a counterparty that waives segregation altogether.[773] By opting out of segregation, the counterparty agrees that cash, securities, and money market instruments delivered to the SBSD can be used by the SBSD for proprietary purposes and need not be isolated from the proprietary assets of the SBSD. Therefore, these counterparties are foregoing the protections of segregation, which include the right to share ratably with other customers in customer property held by the SBSD. If these counterparties were deemed *security-based swap customers,* they could have a *pro rata* priority claim on customer property. This result could disadvantage the security-based swap customers that did not waive segregation by diminishing the amount of customer property available to be distributed to customers.

Request for Comment

The Commission generally requests comment on the special provisions for non-cleared security-based swaps in proposed new Rule 18a–4. In addition, the Commission requests comment, including empirical data in support of comments, in response to the following questions:

1. Is the requirement to have notice be given in writing prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the effective date of the rule appropriate? If not, explain why not. Should the notice be required on a periodic basis such as monthly or annually? If so, explain why. If not, explain why not. Should the notice be required before every transaction? If so, explain why. If not, explain why not.

2. Describe the current practices and arrangements for individual segregation. For example, are these arrangements based on tri-party agreements between the SBSD, counterparty, and independent third-party custodian? If so, describe the terms of the these third-party agreements. Under these agreements, how would the SBSD perfect its security interest in the funds and other property held by the third-party custodian? What terms would the counterparty require that are designed to ensure that funds or property held by the independent third-party custodian at the time of a liquidation proceeding of the SBSD are not included in the bankruptcy estate of the SBSD?

3. Is it appropriate to require counterparties electing individual segregation to subordinate their claims to security-based swap customers? If not, explain why not and describe other measures that could be taken to ensure that security-based swap customers whose cash, securities, and money market instruments are subject to the omnibus segregation requirements have a first priority claim to these assets over counterparties whose funds and other property are individually segregated at a third party custodian.

4. Is it appropriate to require counterparties who waive all right to segregation to subordinate their claims to security-based swap customers? If not, explain why not and describe other measures that could be taken to ensure that security-based swap customers whose cash, securities, and money market instruments are subject to the omnibus segregation requirements have a first priority claim to these assets over counterparties who waive all right to segregation.

III. General Request for Comment

In responding to the specific requests for comment above, interested persons are encouraged to provide supporting data and analysis and, when appropriate, suggest modifications to proposed rule text. Responses that are supported by data and analysis provide great assistance to the Commission in considering the practicality and effectiveness of proposed new requirements as well as weighing the benefits and costs of proposed requirements. In addition, commenters are encouraged to identify in their responses a specific request for comment by indicating the section number of the release.

The Commission also seeks comment on the proposals as a whole. In this regard, the Commission seeks comment, including empirical data in support of comments, on the following:

1. Are there financial responsibility programs other than the broker-dealer financial responsibility program that could serve as a better model for establishing financial responsibility requirements for SBSDs and MSBSPs? If so, identify the program and explain how it would be a better model for implementing the provisions of the Dodd-Frank Act mandating capital and margin requirements for nonbank SBSDs and nonbank MSBSPs.

2. Should any of the proposed quantitative requirements (*e.g.,* minimum capital thresholds, margin risk factor, standardized haircuts) be modified? If so, how? Are there new quantitative requirements that should be used? What would be the financial or other consequences for individual firms and the financial markets of such modified or new quantitative requirements and how would such consequences differ from the proposed requirements? Please provide detailed data regarding such consequences and describe in detail any econometric or other mathematical models, or economic analyses of data, that would

[771] *See* paragraph (d)(2)(i) of proposed new Rule 18a–4.

[772] *Id.*

[773] *See* paragraph (d)(2)(ii) of proposed new Rule 18a–4.

be relevant for evaluating or modifying any quantitative requirements.

3. How would the proposals integrate with provisions in other titles and subtitles of the Dodd-Frank Act and any regulations or proposed regulations under those other titles and subtitles?

4. How would the proposals integrate with other proposals applicable to SBSDs or MSBSPs in the Exchange Act and any applicable regulations adopted under authority in the Exchange Act?

5. As discussed throughout this release, many of the proposed amendments are based on dollar amounts that are prescribed in existing requirements. Should any of these proposed dollar amounts be adjusted to account for inflation?

6. What should the implementation timeframe be for the proposed amendments and new rules? For example, should the compliance date be 90, 120, 150, 180, or some other number of days after publication? Should the proposed requirements have different time frames before their compliance dates are triggered? For example, would it take longer to come into compliance with certain of these proposals than others? If so, rank the requirements in terms of the length of time it would take to come into compliance with them and propose a schedule of compliance dates.

IV. Paperwork Reduction Act

Certain provisions of the proposed rule amendments and proposed new rules would contain a new ''collection of information'' within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[774] The Commission is submitting the proposed rule amendments and proposed new rules to the Office of Management and Budget (''OMB'') for review in accordance with the PRA. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The titles for the collections of information are:

(1) Rule 18a–1 and related appendices, Net capital requirements for security-based swap dealers for which there is not a prudential regulator (a proposed new collection of information);

(2) Rule 18a–2, Capital requirements for major security-based swap participants for which there is not a prudential regulator (a proposed new collection of information);

(3) Rule 18a–3, Non-cleared security-based swap margin requirements for security-based swap dealers and major security-based swap participants for which there is not a prudential regulator (a proposed new collection of information);

(4) Rule 18a–4, Segregation requirements for security-based swap dealers and major security-based swap participants (a proposed new collection of information); and

(5) Rule 15c3–1 Net capital requirements for brokers or dealers (OMB Control Number 3235–0200).

The burden estimates contained in this section do not include any other possible costs or economic effects beyond the burdens required to be calculated for PRA purposes.

A. Summary of Collections of Information Under the Proposed Rules and Rule Amendments

1. Proposed Rule 18a–1 and Amendments to Rule 15c3–1

Section 764 of the Dodd-Frank Act added section 15F to the Exchange Act.[775] Section 15F(e)(1)(B) of the Exchange Act provides that the Commission shall prescribe capital and margin requirements for nonbank SBSDs and nonbank MSBSPs. Proposed new Rule 18a–1 [776] would establish minimum capital requirements for stand-alone SBSDs and the amendments to Rule 15c3–1 [777] would augment the current capital requirements for broker-dealers to address broker-dealers that register as SBSDs and to enhance the provisions applicable to ANC broker-dealers (all of which the Commission preliminarily estimates would register as SBSDs). The proposed new rule and amendments would establish a number of new collection of information requirements.

First, under proposed Rule 18a–1, a stand-alone SBSD would need to apply to the Commission to be authorized to use internal models to compute net capital.[778] As part of the application process, a stand-alone SBSD would be required to provide the Commission staff with, among other things: (1) A comprehensive description of the firm's internal risk management control system; (2) a description of the VaR models the firm will use to price positions and compute deductions for market risk; (3) a description of the firm's internal risk management controls over the VaR models, including a description of each category of person who may input data into the models; and (4) a description of the back-testing procedures that that firm will use to review the accuracy of the VaR models.[779] In addition, under proposed Rule 18a–1, a stand-alone SBSD authorized to use internal models would review and update the models it uses to compute market and credit risk, as well as backtest the models.

Second, under proposed Rule 18a–1 and amendments to Rule 15c3–1, nonbank SBSDs that are approved to use models to compute deductions for market and credit risk under Rule 18a–1 and ANC broker-dealers would be required to perform a liquidity stress test at least monthly and, based on the results of that test, maintain liquidity reserves to address funding needs.[780] The result of the test must be provided within 10 business days to senior management that has the responsibility to oversee risk management of the nonbank SBSD or ANC broker-dealer. The assumptions underlying the liquidity stress test must be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the nonbank SBSD and at least annually by senior management of the nonbank SBSD.[781] In addition, if such a nonbank SBSD or ANC broker-dealer is part of a consolidated entity using liquidity stress tests, the nonbank SBSD or ANC broker-dealer would need to justify and document any differences in the assumptions used in their liquidity stress tests from those used in the liquidity stress tests of the consolidated entity.[782] Furthermore, the nonbank SBSDs and ANC broker-dealers would be required to establish a written contingency funding plan.[783] The plan would need to address the policies and roles and responsibilities of relevant personnel for meeting the liquidity needs of the firm and communications with the public and other market participants during a liquidity stress event.[784]

Third, nonbank SBSDs, including broker-dealer SBSDs, would be required to comply with certain requirements of

[774] 44 U.S.C. 3501 *et seq.;* 5 CFR 1320.11.

[775] *See* Public Law 111–203 § 764; 15 U.S.C. 78o–10.

[776] *See* proposed new Rule 18a–1. *See also* section II.A. of this release.

[777] *See* proposed amendments to Rule 15c3–1. *See also* section II.A. of this release.

[778] *See* paragraphs (a)(2) and (d) of proposed new Rule 18a–1. This collection of information requirement already exists in Rule 15c3–1 and applies to broker-dealers seeking to become ANC broker-dealers.

[779] *See* paragraph (d) of proposed new Rule 18a–1.

[780] *See* proposed new paragraph (f) to Rule 15c3–1; paragraph (f) of proposed new Rule 18a–1.

[781] *See* proposed new paragraph (f)(1) to Rule 15c3–1; paragraph (f)(1) of proposed new Rule 18a–1.

[782] *See* proposed new paragraph (f)(2) of Rule 15c3–1; paragraph (f)(2) of proposed new Rule 18a–1.

[783] *See* proposed new paragraph (f)(4) of Rule 15c3–1; paragraph (f)(3) of proposed new Rule 18a–1.

[784] *Id.*

Rule 15c3–4.[785] Rule 15c3–4 requires OTC derivatives dealers and firms subject to its provisions, to establish, document, and maintain a system of internal risk management controls to assist the firm in managing the risks associated with business activities, including market, credit, leverage, liquidity, legal, and operational risks.[786]

Fourth, under paragraph (c)(2)(vi)(O)(*1*)(*iii*) of Rule 15c3–1 and paragraph (c)(1)(vi)(A)(*3*)(*i*) of proposed new Rule 18a–1, broker-dealers, broker-dealers registered as SBSDs, and stand-alone SBSDs not using models would be required to use an industry sector classification system that is documented and reasonable in terms of grouping types of companies with similar business activities and risk characteristics, used for credit default swap reference names for purposes of calculating ''haircuts'' on security-based swaps under the applicable net capital rules.[787] These firms could use a classification system of a third-party or develop their own classification system, subject to these limitations, and would need to be able to demonstrate the reasonableness of the system they use.[788]

Fifth, under paragraph (i) of proposed Rule 18a–1, stand-alone SBSDs would be required to provide the Commission with certain written notices with respect to equity withdrawals.[789]

Finally, under paragraph (c)(5) of Appendix D to proposed Rule 18a–1, a stand-alone SBSD would be required to file with the Commission two copies of any proposed subordinated loan agreement (including nonconforming subordinated loan agreements) at least 30 days prior to the proposed execution date of the agreement.[790] The rule would also require an SBSD to file with the Commission a statement setting forth the name and address of the lender, the business relationship of the lender to the SBSD, and whether the SBSD carried an account for the lender effecting transactions in security-based swaps at or about the time the proposed agreement was filed.[791]

2. Proposed Rule 18a–2

Proposed new Rule 18a–2 would establish capital requirements for nonbank MSBSPs.[792] In particular, a nonbank MSBSP would be required at all times to have and maintain positive tangible net worth.[793] The proposed definition of *tangible net worth* would allow nonbank MSBSPs to include as regulatory capital assets that would be deducted from net worth under Rule 15c3–1, such as property, plants, equipment, and unsecured receivables. At the same time, it would require the deduction of goodwill and other intangible assets.[794]

Because MSBSPs, by definition, will be entities that engage in a substantial security-based swap business, the Commission is proposing that they be required to comply with Rule 15c3–4,[795] which requires OTC derivatives dealers and other firms subject to its provisions to establish, document, and maintain a system of internal risk management controls to assist the firm in managing the risks associated with their business activities, including market, credit, leverage, liquidity, legal, and operational risks.[796]

3. Proposed Rule 18a–3

Proposed new Rule 18a–3 would establish minimum margin requirements for non-cleared security-based swap transactions entered into by nonbank SBSDs and nonbank MSBSPs.[797] Proposed Rule 18a–3 would prescribe the requirements for nonbank SBSDs or nonbank MSBSPs to collect or post collateral with regard to non-cleared security-based swap transactions. The provisions of proposed Rule 18a–3 contain a collection of information requirement for nonbank SBSDs. Specifically, paragraph (e) of proposed Rule 18a–3 would require a nonbank SBSD to monitor the risk of each account and establish, maintain, and document procedures and guidelines for monitoring the risk of accounts as part of the risk management control system required by Rule 15c3–4.[798] In addition, the rule would require a nonbank SBSD to review, in accordance with written procedures and at reasonable periodic intervals, its non-cleared security-based swap activities for consistency with the risk monitoring procedures and guidelines required by paragraph (e) of Rule 18a–3. The nonbank SBSD would also be required to determine whether information and data necessary to apply the risk monitoring procedures and guidelines required by paragraph (e) of Rule 18a–3 are accessible on a timely basis and whether information systems are available to adequately capture, monitor, analyze, and report relevant data and information. Finally, the rule would require that the risk monitoring procedures and guidelines must include, at a minimum, procedures and guidelines for:

- Obtaining and reviewing account documentation and financial information necessary for assessing the amount of current and potential future exposure to a given counterparty permitted by the SBSD;
- Determining, approving, and periodically reviewing credit limits for each counterparty, and across all counterparties;
- Monitoring credit risk exposure to the SBSD from non-cleared security-based swaps, including the type, scope, and frequency of reporting to senior management;
- Using stress tests to monitor potential future exposure to a single counterparty and across all counterparties over a specified range of possible market movements over a specified time period;
- Managing the impact of credit exposure related to non-cleared security-based swaps on the SBSD's overall risk exposure;
- Determining the need to collect collateral from a particular counterparty, including whether that determination was based upon the creditworthiness of the counterparty and/or the risk of the specific non-cleared security-based swap contracts with the counterparty;
- Monitoring the credit exposure resulting from concentrated positions with a single counterparty and across all counterparties, and during periods of extreme volatility; and
- Maintaining sufficient equity in the account of each counterparty to protect against the largest individual potential future exposure of a non-cleared security-based swap carried in the

[785] *See* 17 CFR 240.18a–1(g); 15c3–1(a)(10)(ii). *See also* 17 CFR 240.15c3–4.

[786] *Id.*

[787] *See* paragraph (c)(2)(vi)(O)(*1*)(*iii*) of Rule 15c3–1; paragraph (c)(1)(vi)(A)(*3*)(*i*) of proposed new Rule 18a–1.

[788] *See* proposed new paragraph (c)(2)(vi)(O)(*1*)(*iii*)(*A*) of Rule 15c3–1; paragraph (c)(1)(vii)(A)(*3*)(*i*) of proposed new Rule 18a–1.

[789] *See* paragraph (i) of proposed new Rule 18a–1.

[790] *See* paragraph (c)(5) of proposed new Rule 18a–1d.

[791] *Id.*

[792] *See* proposed new Rule 18a–2. *See also* section II.A.3 of this release.

[793] *See* paragraph (a) of proposed new Rule 18a–2.

[794] The proposed definition of *tangible net worth* under proposed new Rule 18a–2 is consistent with the CFTC's proposed definition of *tangible net equity. See CFTC Capital Proposing Release,* 76 FR at 27828 (Defining *tangible net equity* as ''equity as determined under U.S. generally accepted accounting principles, and excludes goodwill and other intangible assets.'').

[795] *See* paragraph (c) of proposed new Rule 18a–2.

[796] *See* 17 CFR 240.15c3–4.

[797] *See* proposed new Rule 18a–3. *See also* section II.B. of this release for a more detailed description of the proposed rule.

[798] *See* paragraph (e) to proposed new Rule 18a–3.

account of the counterparty as measured by computing the largest maximum possible loss that could result from the exposure.

4. Proposed Rule 18a–4

Proposed new Rule 18a–4 would establish segregation requirements for cleared and non-cleared security-based swap transactions, which would apply to all types of SBSDs (*i.e.,* they would apply to bank SBSDs, nonbank stand-alone SBSDs, and broker-dealer SBSDs), as well as notification requirements for SBSDs and MSBSPs.[799] The provisions of proposed Rule 18a–4 are modeled on Rule 15c3–3, the broker-dealer segregation rule.[800] Paragraph (a) of the proposed new rule would define key terms used in the rule.[801] Paragraph (b) would require an SBSD to promptly obtain and thereafter maintain physical possession or control of all *excess securities collateral* (a term defined in paragraph (a)) and specify certain locations where *excess securities collateral* could be held and deemed in the SBSD's control.[802] Paragraph (c) would require an SBSD to maintain a special account for the exclusive benefit of security-based swap customers and have on deposit in that account at all times an amount of cash and/or *qualified securities* (a term defined in paragraph (a)) determined through a computation using the formula in Exhibit A to proposed new Rule 18a–4.[803]

Paragraph (d) of proposed new Rule 18a–4 would contain provisions that are not modeled specifically on Rule 15c3–1. First, it would require an SBSD and an MSBSP to provide the notice required by section 3E(f)(1)(A) of the Exchange Act to a counterparty in writing prior to the execution of the first non-cleared security-based swap transaction with the counterparty.[804] Second, it would require the SBSD to obtain subordination agreements from counterparties that opt out of the segregation requirements in proposed new Rule 18a–4 because they either elect individual segregation pursuant to the self-executing provisions of section 3E(f) of the Exchange Act[805] or agree that the SBSD need not segregate their assets at all.[806]

Additionally, paragraph (a)(3) of proposed new Rule 18a–4 would define *qualified clearing agency account* to mean an account of an SBSD at a clearing agency established to hold funds and other property in order to purchase, margin, guarantee, secure, adjust, or settle cleared security-based swaps of the SBSD's security-based swap customers that meets the following conditions (which would contain collection of information requirements):

- The account is designated ''Special Clearing Account for the Exclusive Benefit of the Cleared Security-Based Swap Customers of [name of the SBSD]''; [807]
- The clearing agency has acknowledged in a written notice provided to and retained by the SBSD that the funds and other property in the account are being held by the clearing agency for the exclusive benefit of the cleared security-based swap customers of the SBSD in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the SBSD with the clearing agency; [808] and
- The account is subject to a written contract between the SBSD and the clearing agency which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the clearing agency or any person claiming through the clearing agency, except a right, charge, security interest, lien, or claim resulting from a cleared security-based swap transaction effected in the account.[809]

Under paragraph (a)(4) of proposed new Rule 18a–4, a qualified SBSD account would be defined to mean an account at another SBSD registered with the Commission pursuant to section 15F of the Exchange Act that is not an affiliate of the SBSD and that meets conditions that are largely identical to the conditions for a qualified clearing agency account. Finally, paragraph (c)(1) of proposed new Rule 18a–4 would require an SBSD, among other things, to maintain a *special account for the exclusive benefit of security-based swap customers* separate from any other bank account of the SBSD.[810] The term *special account for the exclusive benefit of security-based swap customers* would be defined under paragraph (a)(7) of proposed new Rule 18a–4 to mean an account at a bank that is not an affiliate of the SBSD and that meets conditions that are largely identical to the conditions for a qualified clearing agency account and qualified SBSD account.[811]

Paragraph (c)(1) of proposed new Rule 18a–4 would provide that the SBSD must at all times maintain in a Rule 18a–4 Customer Reserve Account, through deposits into the account, cash and/or qualified securities in amounts computed in accordance with the formula set forth in Exhibit A to Rule 18a–4.[812] The formula in Exhibit A to proposed new Rule 18a–4 is modeled on the formula in Exhibit A to Rule 15c3–3.[813] Paragraph (c)(3) of proposed new Rule 18a–4 would provide that the computations necessary to determine the amount required to be maintained in the special bank account must be made daily as of the close of the previous business day and any deposit required to be made into the account must be made on the next business day following the computation no later than 1 hour after the opening of the bank that maintains the account.[814]

B. Proposed Use of Information

As discussed more fully above, the Commission and SROs, as applicable, would use the information collected under new Rules 18a–1, 18a–2, 18a–3 and 18a–4, as well as the amendments to Rule 15c3–1 to determine whether an SBSD, MSBSP, or ANC broker-dealer, as applicable, is in compliance with each applicable rule and to help fulfill their oversight responsibilities. The

[799] *See* proposed new Rule 18a–4. *See also* section II.C. of this release for a more detailed description of the proposal.

[800] 17 CFR 240.15c3–3.

[801] *Compare* 17 CFR 240.15c3–3(a), *with* paragraph (a) of proposed new Rule 18a–4.

[802] *Compare* 17 CFR 240.15c3–3(b)–(d), *with* paragraph (b) of proposed new Rule 18a–4.

[803] *Compare* 17 CFR 240.15c3–3(e), *with* paragraph (c) of proposed new Rule 18a–4.

[804] *See* 15 U.S.C. 78c–5(f)(1)(A); proposed paragraph (d)(1) of proposed new Rule 18a–4.

[805] *See* 15 U.S.C. 78c–5(f)(1)–(3).

[806] *See* 15 U.S.C. 78c–5(f)(4).

[807] *See* paragraph (a)(3)(i) of proposed new Rule 18a–4. This provision is modeled on paragraph (e)(1) of Rule 15c3–3, which requires a broker-dealer to maintain a ''Special Reserve Bank Account for the Exclusive Benefit of Customers.'' *Compare* 17 CFR 240.15c3–3(e), *with* paragraph (a)(3)(i) of proposed new Rule 18a–4.

[808] *See* paragraph (a)(3)(ii) of proposed new Rule 18a–4. This provision is modeled on paragraph (f) of Rule 15c3–3, which requires a broker-dealer to obtain a written notification from a bank where it maintains a customer reserve account. *Compare* 17 CFR 240.15c3–3(f), *with* paragraph (a)(3)(ii) of proposed new Rule 18a–4.

[809] *See* paragraph (a)(3)(iii) of proposed new Rule 18a–4. This provision is modeled on paragraph (f) of Rule 15c3–3, which requires a broker-dealer to obtain a contract from a bank where it maintains a ''Special Reserve Bank Account for the Exclusive Benefit of Customers.'' *Compare* 17 CFR 240.15c3–3(f), *with* paragraph (a)(3)(ii) of proposed new Rule 18a–4.

[810] *See* paragraph (c) of proposed new Rule 18a–4. The provisions of paragraph (c) of proposed new Rule 18a–1 are modeled on paragraph (e) of Rule 15c3–3. *Compare* 17 CFR 240.15c3–3(e), *with* paragraph (c) of proposed new Rule 18a–4.

[811] *See* paragraph (a)(7) of proposed new Rule 18a–4. *See also* Section II.C.1. of this release for a more detailed description of the proposed requirements.

[812] *See* paragraph (c)(1) of proposed new Rule 18a–4; Exhibit A to proposed new Rule 18a–4.

[813] *See* 17 CFR 240.15c3–3a.

[814] *See* paragraph (c)(3) of proposed new rule 18a–4.

collections of information would also help to ensure that SBSD, MSBSPs and broker-dealers are meeting their obligations under the proposed rules and rule amendments and have the required policies and procedures in place.

Proposed new Rules 18a–1 and 18a–2, as well as the proposed amendments to Rule 15c3–1 would be integral parts of the Commission's financial responsibility program for SBSDs and MSBSPs, and ANC broker-dealers, respectively. Proposed Rule 18a–1 and Rule 15c3–1 are designed to ensure that nonbank SBSDs and broker-dealers (including broker-dealer SBSDs), respectively, have sufficient liquidity to meet all unsubordinated obligations to customers and counterparties and, consequently, if the SBSD or broker-dealer fails, sufficient resources to wind-down in an orderly manner without the need for a formal proceeding. The collections of information in proposed new Rule 18a–1, Rule 18a–2 and the amendments to Rule 15c3–1 would facilitate the monitoring of the financial condition of nonbank SBSDs, nonbank MSBSPs and broker-dealers by the Commission.

Proposed new Rule 18a–3 would prescribe, among other things, requirements for nonbank SBSDs to collect collateral with regard to non-cleared security-based swap transactions. Under proposed Rule 18a–3, a nonbank SBSD would be required to establish and implement risk monitoring procedures with respect to counterparty accounts.[815] The purpose of the proposed rule is to limit risks to individual firms and systemic risk arising from non-cleared security-based swaps. The collections of information in proposed Rule 18a–3 would assist examiners in determining whether SBSDs are in compliance with requirements in the rule.

Proposed new Rule 18a–4 would establish segregation requirements for cleared and non-cleared security-based swap transactions, which would apply to all types of SBSDs (*i.e.,* they would apply to bank SBSDs, nonbank stand-alone SBSDs, and broker-dealer SBSDs), as well as establish notice requirements for SBSDs and MSBSPs. Proposed new Rule 18a–4 would be an integral part of the Commission's financial responsibility program for SBSDs. Its purpose is to protect the rights of security-based swap customers and their ability to promptly obtain their property from an SBSD. The collection of information requirements in the proposed new rule would facilitate the process by which the Commission monitors how SBSDs are fulfilling their custodial responsibilities to SBSD customers. Proposed Rule 18a–4 also would require that an SBSD provide certain notices to counterparties.[816] These notices would alert counterparties to the alternatives available to them with respect to segregation of non-cleared security-based swaps. The Commission staff would use this new collection of information in its examination and oversight program.

C. Respondents

Consistent with the *Entity Definitions Adopting Release,* the Commission staff estimates that 50 or fewer entities ultimately may have to register with the Commission as SBSDs.[817] In addition, consistent with the *Entity Definitions Adopting Release,* based on available data regarding the single-name credit default swap market—which the Commission believes will comprise the majority of security-based swaps—the Commission staff estimates that the number of MSBSPs likely will be five or fewer and, in actuality, may be zero.[818] Therefore, to capture the likely number of MSBSPs that may be subject to the collections of information for purposes of this PRA, the Commission staff estimates for purposes of this PRA that 5 entities will register with the Commission as MSBSPs. Accordingly, for the purposes of calculating PRA reporting burdens, the Commission staff estimates there are 50 SBSDs and 5 MSBSPs respondents.

The Commission previously estimated that 16 broker-dealers would likely seek to register as SBSDs.[819] The Commission is retaining this estimate for purposes of this release.[820] Accordingly, for the purposes of calculating PRA reporting burdens, the Commission staff estimates there are 16 broker-dealer SBSDs.

Because proposed Rules 18a–1 and 18a–3 would apply only to nonbank SBSDs, including nonbank subsidiaries of bank holding companies the Federal Reserve regulates, the number of respondents subject to these proposed rules would be less than the 50 entities expected to register with the Commission as an SBSD, as many of the dealers that currently engage in OTC derivative activities are banks, and would therefore be ''bank SBSDs.''[821] Because the Commission staff estimates that 16 broker-dealers would likely register as SBSDs, there would be an estimated maximum of 34 bank SBSDs.[822] However, because of business planning purposes, risk management purposes, potential regulatory requirements, or other reasons, some of these entities would likely register with the Commission as nonbank stand-alone SBSDs. Therefore, as stated above, because many of the dealers that currently engage in OTC derivatives activities are banks, the Commission staff estimates that approximately 75% of the maximum estimated bank SBSDs will register as bank SBSDs, and the remainder (approximately 25%) will register as stand-alone nonbank SBSDs. As a result, for purposes of the reporting burdens, the Commission staff estimates that approximately 9 entities will register as stand-alone SBSDs.[823] Therefore, for purposes of the reporting burdens, the Commission staff estimates

[815] *See* paragraph (e) of proposed new Rule 18a–3.

[816] *See* paragraphs (a) and (c) of proposed new Rule 18a–4.

[817] *Entity Definitions Adopting Release,* 77 FR at 30725. This estimate—which potentially overstates the number of potential entities that ultimately have to register with the Commission as SBSDs—is consistent with the data regarding activities and positions of participants in the single-name credit default swap market summarized in a memorandum of the Commission staff. *See Memorandum* (Mar. 15, 2012), available at *http://www.sec.gov/comments/s7-39-10/s73910-154.pdf* (''*CDS Data Analysis''*). Depending on the final capital requirements as well as other requirements for SBSDs and how businesses choose to respond to such requirements, the actual number of SBSDs may be significantly fewer. *See Business Conduct Standards for Security-Based Swap Dealers and Major-Security Based Swap Participants,* Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396, 42442 (July 18, 2011) (''*Business Conduct Release''*). *See also SBSD Registration Proposing Release,* 76 FR at 65808.

[818] *Entity Definitions Adopting Release,* 77 FR at 30727, 30729. The number of MSBSPs likely will depend on the final capital requirements and other requirements for MSBSPs and how businesses choose to respond to such requirements. *See Business Conduct Release,* 76 FR at 42442. *See also SBSD Registration Proposing Release,* 76 FR at 65808.

[819] *See SBSD Registration Proposing Release,* 76 FR at 65808. No comments were received on this estimate.

[820] *Id.*

[821] *See, e.g., ISDA Margin Survey 2012* (May 2012), at Appendix 1, available at *http://www2.isda.org/functional-areas/research/surveys/margin-surveys/* (''*ISDA Margin Survey 2012''*). ISDA is a global trade association for OTC derivatives. The ISDA margin survey is conducted annually to examine the state of collateral use and management among derivatives dealers and end-users. *See id.; ISDA Margin Survey 2011,* available at *http://www2.isda.org/functional-areas/research/surveys/margin-surveys/* (''*ISDA Margin Survey 2011''*). Appendix 1 to the survey lists firms that responded to the survey including the largest dealer banks. *See ISDA Margin Survey 2012* at Appendix 1; *ISDA Margin Survey 2011* at Appendix 1. *See also* Economic Analysis in section V.A. of this release (discussing overview of OTC derivatives market).

[822] 50 SBSDs – 16 broker-dealer SBSDs = 34 maximum estimated bank SBSDs.

[823] 34 maximum estimated bank SBSDs × 25% = 8.5, rounded to 9 stand-alone nonbank SBSDs.

that approximately 25 nonbank SBSDs would be subject to Rules 18a–1 and 18a–3.[824]

Of the 9 stand-alone SBSDs, the Commission staff estimates that, based on its experience with ANC broker-dealers and OTC derivatives dealers, the majority of stand-alone SBSDs would apply to use internal models.[825] Consequently, the Commission is estimating that 6 of the 9 stand-alone SBSDs would apply to use internal models under Rule 18a–1. Because the Commission staff estimates that 6 stand-alone SBSDs would apply to the Commission to use internal models, the Commission staff estimates that three stand-alone SBSDs would not use models.[826] For purposes of estimating the number of respondents with respect to the proposed amendments to Rule 15c3–1, the Commission staff estimates that there would be 10 respondents currently subject to the collection of information as it relates to Appendix E to Rule 15c3–1.[827] Finally, because the Commission staff estimates that 10 of the broker-dealers registered as SBSDs would be ANC broker-dealers, the Commission staff estimates that 6 broker-dealers registered as SBSDs would not use internal models.[828]

Type of respondent	Number of respondents
SBSDs	50
Bank SBSDs	25
Nonbank SBSDs	25
Broker-Dealer SBSDs	16
Stand-Alone SBSD	9
ANC Broker-Dealer SBSDs	10
Broker-Dealer SBSDs (Not Using Models)	6
Stand-Alone SBSDs (Using Models)	6
Stand-Alone SBSDs (Not Using Models)	3
Nonbank MSBSPs	5

The Commission generally requests comment on all aspects of these estimates of the number of respondents. Commenters should provide specific data and analysis to support any comments they submit with respect to the number of respondents, including identifying any sources of industry information that could be used to estimate the number of respondents.

D. Total Initial and Annual Recordkeeping and Reporting Burden

1. Proposed Rule 18a–1 and Amendments to Rule 15c3–1

Proposed Rule 18a–1 and the proposed amendments to Rule 15c3–1 would have collection of information requirements that result in one-time and annual hour burdens for nonbank SBSDs and ANC broker-dealers. The estimates in this section are based in part on the Commission's experience with burden estimates for similar collections of information requirements, including the current collection of information requirements for Rule 15c3–1.[829]

First, under paragraph (a)(2) of proposed Rule 18a–1, the Commission is proposing that a stand-alone SBSD be required to file an application for authorization to compute net capital using internal models.[830] The requirements for the application would be set forth in paragraph (d) of proposed Rule 18a–1, which is modeled on the application requirements of Appendix E to Rule 15c3–1.[831] ANC broker-dealers—the number of which would include broker-dealer SBSDs that seek to use internal models—currently are subject to this application requirement. Consequently, the Commission staff estimates that the proposed requirements of paragraph (d) of Rule 18a–1 would result in one-time and annual hour burdens for stand-alone SBSDs.[832]

Based on its experience with ANC broker-dealers and OTC derivatives dealers, the Commission expects that stand-alone SBSDs that apply to the Commission to use internal models to calculate net capital will already have developed models to calculate market and credit risk and will already have developed internal risk management control systems. On the other hand, the Commission notes that proposed Rule 18a–1 contains additional requirements that stand-alone SBSDs may not yet have incorporated into their models and control systems.[833] Therefore, stand-alone SBSDs would incur one-time hour burdens and start-up costs in order to develop their VaR models in accordance with the requirements of proposed Rule 18a–1, as well as to submit such models along with its application under paragraph (d) of proposed Rule 18a–1 to the Commission for approval.

These estimates are based on currently approved PRA estimates for the ANC firms and OTC derivatives dealers.[834] While these estimates are averages, the burdens may vary depending on the size and complexity of each stand-alone SBSD.

The Commission staff estimates that each of the 6 stand-alone nonbank SBSDs that apply to use the internal models would spend approximately 1,000 hours to develop and submit its VaR model and the description of its risk management control system to the Commission as well as to create and compile the various documents to be included with the application and to work with the Commission staff through the application process.[835] This includes approximately 100 hours for an in-house attorney to complete a review of the application.[836] Consequently, the Commission staff estimates that the total burden associated with the application process for the stand-alone SBSDs would result in an industry-wide one-time hour burden of approximately 6,000 hours.[837] In addition, the Commission staff allocated 75% (4,500 hours) of these one-time burden hours[838] to internal burden and the

[824] 16 broker-dealer SBSDs + 9 stand-alone SBSDs = 25 nonbank SBSDs.

[825] *See* section II.A.2.a.iii. of this release (discussing minimum capital requirements for stand-alone SBSDs); section II.A.2.b.iii. of this release (discussing the use of VaR models). VaR models, while more risk sensitive than standardized haircuts, tend to substantially reduce the amount of the deductions to tentative net capital in comparison to the standardized haircuts because the models recognize more offsets between related positions than the standardized haircuts. Therefore, the Commission expects that stand-alone SBSDs that have the capability to use internal models to calculate net capital would chose to do so.

[826] 9 stand-alone SBSDs − 6 stand-alone SBSDs using internal models = 3 stand-alone SBSDs not using models.

[827] These 10 broker-dealer respondents likely would also register as SBSDs because these entities are expected to engage in a broad range of activities.

[828] 16 broker-dealers registered as SBSDs − 10 ANC broker-dealer SBSDs = 6 broker-dealer SBSDs not using internal models.

[829] 17 CFR 240.15c3–1.

[830] A broker-dealer SBSD seeking Commission authorization to use internal models to compute market and credit risk charges would apply under the existing provisions of Appendix E to Rule 15c3–1, which apply to ANC broker-dealers. *See* 17 CFR 240.15c3–1e.

[831] *See* 17 CFR 240.15c3–1e(a) and paragraph (d) of proposed Rule 18a–1. Consequently, the Commission is using the current collection of information for Appendix E to Rule 15c3–1 as a basis for this new collection of information.

[832] The requirements that would be imposed on paragraphs (d) and (e) of proposed Rule 18a–1 are consistent with the requirements of Appendix E to Rule 15c3–1.

[833] *See* sections II.A.2.b.iii., II.A.2.c., and II.A.2.d. of this release (describing requirements for VaR models and other requirements under proposed Rule 18a–1 for stand-alone SBSDs).

[834] *See OTC Derivatives Dealers,* 62 FR 67940; *OTC Derivatives Dealers,* 63 FR 59362; *Alternative Net Capital Requirements Adopting Release,* 69 FR at 34452.

[835] This estimate is based on the current hour burdens under Appendix E to Rule 15c3–1.

[836] *Id. See also OTC Derivatives Dealers,* 62 FR 67940; *Alternative Net Capital Requirements Adopting Release,* 69 FR at 34452.

[837] 6 stand-alone SBSDs × 1,000 hours = 6,000 hours.

[838] The internal hours likely would be performed by an in-house attorney (1,500 hours), a risk management specialist (1,500 hours), and compliance manager (1,500 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((in-house attorney for

Continued

remaining 25% (1,500 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.[839] The Commission staff estimates $400 per hour for external costs for retaining outside consultants, resulting in a one-time industry-wide external cost of $600,000.[840]

The Commission staff estimates that a stand-alone SBSD approved to use internal models would spend approximately 5,600 hours per year to review and update the models and approximately 160 hours each quarter, or approximately 640 hours per year, to backtest the models.[841] Consequently, the Commission staff estimates that the total burden associated with reviewing and back-testing the models for the 6 stand-alone SBSDs would result in an industry-wide annual hour burden of approximately 37,440 hours per year.[842] In addition, the Commission staff has allocated 75% (28,080)[843] of these burden hours to internal burden and the remaining 25% (9,360) to external burden to hire outside professionals to assist in reviewing, updating and backtesting the models.[844] The Commission staff estimates $400 per hour for external costs for retaining outside professionals, resulting in an industry-wide external cost of $3.7 million annually.[845]

Stand-alone SBSDs electing to file an application with the Commission to use a VaR model will incur start-up costs including information technology costs to comply with proposed Rule 18a–1. Because each stand-alone SBSD's information technology systems may be in varying stages of readiness to enable these firms to meet the requirements of the proposed rules, the cost of modifying their information technology systems could vary significantly. Based on the estimates for the ANC broker-dealers,[846] it is expected that a stand-alone SBSD would incur an average of approximately $8.0 million to modify its information technology systems to meet the VaR requirements of the proposed new Rule 18a–1, for a total one-time industry-wide cost of $48 million.[847]

Second, under paragraph (f) of proposed Rule 18a–1 and proposed new paragraph (f) of Rule 15c3–1, stand-alone SBSDs that are approved to use models to compute deductions for market and credit risk under Rule 18a–1 and ANC broker-dealers would be subject to liquidity stress test requirements. The Commission staff estimates that the proposed requirements resulting from these provisions would result in a one-time burden to applicable stand-alone SBSDs and ANC broker-dealers as they would need to develop models for the liquidity stress test, document the results of the test to provide to senior management, document differences in the assumptions used in the liquidity stress test of the firm from those used in a consolidated entity of which the firm is a part, and develop a written contingency funding plan.[848] Based on experience supervising ANC broker-dealers,[849] the Commission staff estimates that each of the 6 stand-alone SBSDs and 10 ANC broker-dealers would spend an average of approximately 200 hours to comply with these requirements, resulting in an average industry-wide one-time internal hour burden of approximately 3,200 hours.[850]

In terms of annual hour burden, the Commission staff estimates that a stand-alone SBSD or ANC broker-dealer would spend an average of approximately 50 hours[851] per month testing and documenting the results of its liquidity stress test and reviewing its contingency funding plan, resulting in a total industry-wide annual hour burden of approximately 9,600 hours.[852]

Third, under paragraph (g) of proposed new Rule 18a–1, a stand-alone SBSD would be required to comply with Rule 15c3–4 (except for certain provisions of that rule) as if it were an OTC derivatives dealer.[853] ANC broker-dealers currently are required to comply with Rule 15c3–4.[854] Nonbank SBSDs would be required to comply with Rule 15c3–4, which requires the establishment of a risk management

1,500 hours at $378 per hour) + (risk management specialist for 1,500 hours at $259 per hour) + (compliance manager for 1,500 hours at $279 per hour)) = $1,374,000. The hourly rates use for internal professionals used throughout this section IV. of the release are taken from SIFMA's *Management & Professional Earnings in the Securities Industry 2011,* modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[839] 6,000 hours × .75 = 4,500 hours; 6,000 hours × .25 = 1,500 hours. This allocation is based on the Commission's experience in implementing the ANC rules for broker-dealers. Larger firms tend to perform these tasks in-house due to the proprietary nature of these models as well as the high fixed-costs in hiring an outside consultant. However, smaller firms may need to hire an outside consultant to perform certain of these tasks.

[840] 1,500 hours × $400 per hour = $600,000. *See* PRA Analysis in *Product Definitions Adopting Release,* 77 FR at 48334 (providing an estimate of $400 an hour to engage an outside attorney). *See also Nationally Recognized Statistical Rating Organizations,* Exchange Act Release No. 64514 (May 18, 2011) 76 FR 33430, 33504 (June 8, 2012) (providing estimate of $400 per hour to engage outside attorneys and outside professionals).

[841] These hour burdens are consistent with the current hour burdens under Appendix E to Rule 15c3–1 for ANC broker-dealers.

[842] 6 Stand-alone SBSDs × [5,600 hours + 640 hours] = 37,440 hours.

[843] These functions likely would be performed by a risk management specialist (14,040 hours) and a senior compliance examiner (14,040 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((risk management specialist for 14,040 hours at $259 per hour) + (senior compliance examiner for 14,040 hours at $230 per hour)) = $6,865,560.

[844] 37,440 hours × .75 = 28,080; 37,440 hours × .25 = 9,360 hours. This allocation is based on the Commission's experience in implementing the ANC rules for broker-dealers. Larger firms tend to perform these tasks in-house due to the proprietary nature of these models as well as the high fixed-costs in hiring an outside consultant. However, smaller firms may need to hire an outside consultant to perform these tasks.

[845] 9,360 hours × $400 per hour = $3,744,000. *See* PRA Analysis in *Product Definitions Adopting Release,* 77 FR 48334 (providing an estimate of $400 an hour to engage an outside attorney). *See also Nationally Recognized Statistical Rating Organizations,* 76 FR at 33504 (providing estimate of $400 per hour to engage outside attorneys and outside professionals).

[846] *Alternative Net Capital Requirements Adopting Release,* 69 FR 34428.

[847] 6 stand-alone SBSDs × $8 million = $48 million.

[848] *See* section II.A.2.d. of this release (discussing liquidity stress test and written contingency funding plan).

[849] Based on Commission staff experience supervising the ANC broker-dealers, all of the ANC broker-dealers that are part of a holding company generally have a written contingency funding plan, generally at the holding company level. This proposed rule would require that each ANC broker-dealer and stand-alone SBSD using internal models maintain a written contingency funding plan at the entity level (in addition to any holding company plan). Therefore, the proposed hour burdens are averages for all firms, including the ANC broker-dealers, which may already conduct these activities within their organizations, and smaller firms, including stand-alone broker-dealers which may not currently undertake these proposed activities.

[850] [10 ANC broker-dealers + 6 stand-alone SBSDs] × 200 hours = 3,200 hours. Based on Commission staff experience supervising the ANC broker-dealers, the Commission staff expects that these functions would likely be performed internally by an in-house attorney (1,600 hours) and a risk management specialist (1,600). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((in-house attorney for 1,600 hours at $378 per hour) + (risk management specialist for 1,600 hours at $259 per hour)) = $1,019,200.

[851] This PRA estimate is based, in part, on the 160 hours per quarter it would take an ANC broker-dealer to review and backtest its models under the current collection of information in Rule 15c3–1. *See Alternative Net Capital Requirements Adopting Release,* 69 FR at 34452.

[852] [6 Stand-alone SBSDs + 10 ANC broker-dealers] × 50 hours × 12 months = 9,600 hours. These functions would be performed by a senior compliance examiner (4,800 hours) and a risk management specialist (4,800 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((senior compliance examiner for 4,800 hours at $230 per hour) + (risk management specialist for 4,800 hours at $259 per hour)) = $2,347,200.

[853] *See* paragraph (g) to proposed new Rule 18a–1.

[854] 17 CFR 240.15c3–1(a)(7)(iii).

control system.[855] The Commission adopted Rule 15c3–4 in 1998 as part of the OTC derivatives dealer oversight program.[856] The rule requires an OTC derivatives dealer to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.[857] It also requires OTC derivatives dealers to establish, document, and maintain procedures designed to prevent the firm from engaging in securities activities that are not permitted by OTC derivatives dealers pursuant to Rule 15a–1.[858] Rule 15c3–4 identifies a number of elements that must be part of an OTC derivatives dealer's internal risk management control system.[859] These include, for example, that the system have:

- A risk control unit that reports directly to senior management and is independent from business trading units;[860]
- Separation of duties between personnel responsible for entering into a transaction and those responsible for recording the transaction in the books and records of the OTC derivatives dealer;[861]
- Periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent certified public accountants) of the OTC derivatives dealer's risk management systems;[862] and
- Definitions of risk, risk monitoring, and risk management.[863]

Rule 15c3–4 further provides that the elements of the internal risk management control system must include written guidelines, approved by the OTC derivatives dealer's governing body, that discuss a number of matters, including for example:

- Quantitative guidelines for managing the OTC derivatives dealer's overall risk exposure;[864]
- The type, scope, and frequency of reporting by management on risk exposures;[865]
- The procedures for and the timing of the governing body's periodic review of the risk monitoring and risk management written guidelines, systems, and processes;[866]
- The process for monitoring risk independent of the business or trading units whose activities create the risks being monitored;[867]
- The performance of the risk management function by persons independent from or senior to the business or trading units whose activities create the risks;[868]
- The authority and resources of the groups or persons performing the risk monitoring and risk management functions;[869]
- The appropriate response by management when internal risk management guidelines have been exceeded;[870]
- The procedures to monitor and address the risk that an OTC derivatives transaction contract will be unenforceable;[871]
- The procedures requiring the documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions;[872] and
- The procedures authorizing specified employees to commit the OTC derivatives dealer to particular types of transactions.[873]

Rule 15c3–4 also requires management to periodically review, in accordance with the written procedures, the business activities of the OTC derivatives dealer for consistency with risk management guidelines.[874]

Based on the nature of the written guidelines described above, the Commission staff estimates that the requirement to comply with Rule 15c3–4 would result in one-time and annual hour burdens to nonbank SBSDs. The Commission staff estimates that the average amount of time a firm would spend implementing its risk management control system would be 2,000 hours,[875] resulting in an industry-wide one-time hour burden of 30,000 hours across the 15 nonbank SBSDs not already subject to Rule 15c3–4.[876]

The proposed rule would require a nonbank SBSD to consider a number of issues affecting its business environment when creating its risk management control system. For example, a nonbank SBSD would need to consider, among other things, the sophistication and experience of relevant trading, risk management, and internal audit personnel, as well as the separation of duties among these personnel, when designing and implementing its internal control system's guidelines, policies, and procedures. This would help to ensure that the control system that is implemented would adequately address the risks posed by the firm's business and the environment in which it is being conducted. In addition, this would enable a nonbank SBSD derivatives dealer to implement specific policies and procedures unique to its circumstances.

In implementing its policies and procedures, a nonbank SBSD would be required to document and record its system of internal risk management controls. In particular, a nonbank SBSD would be required to document its consideration of certain issues affecting its business when designing its internal controls. A nonbank SBSD would also be required to prepare and maintain written guidelines that discuss its internal control system, including procedures for determining the scope of authorized activities. The Commission staff estimates that each of these 15 nonbank SBSDs[877] would spend approximately 250 hours per year reviewing and updating their risk management control systems to comply with Rule 15c3–4, resulting in an industry-wide annual hour burden of approximately 3,750 hours.[878]

[855] *See* proposed new paragraph (a)(10)(ii) of Rule 15c3–1 (17 CFR 240.15c3–1); paragraph (g) of proposed new Rule 18a–1. *See also* 17 CFR 240.15c3–4.

[856] *See* 17 CFR 240.15c3–4; *OTC Derivatives Dealers,* 63 FR 59362.

[857] *See* 17 CFR 240.15c3–4.

[858] *See* 17 CFR 240.15c3–4; 17 CFR 240.15a–1.

[859] *See* 17 CFR 240.15c3–4(c).

[860] *See* 17 CFR 240.15c3–4(c)(1).

[861] *See* 17 CFR 240.15c3–4(c)(2).

[862] *See* 17 CFR 240.15c3–4(c)(3).

[863] *See* 17 CFR 240.15c3–4(c)(4).

[864] *See* 17 CFR 240.15c3–4(c)(5)(iii).

[865] *See* 17 CFR 240.15c3–4(c)(5)(iv).

[866] *See* 17 CFR 240.15c3–4(c)(5)(v).

[867] *See* 17 CFR 240.15c3–4(c)(5)(vi).

[868] *See* 17 CFR 240.15c3–4(c)(5)(vii).

[869] *See* 17 CFR 240.15c3–4(c)(5)(viii).

[870] *See* 17 CFR 240.15c3–4(c)(5)(ix).

[871] *See* 17 CFR 240.15c3–4(c)(5)(x).

[872] *See* 17 CFR 240.15c3–4(c)(5)(xi).

[873] *See* 17 CFR 240.15c3–4(c)(5)(xii).

[874] *See* 17 CFR 240.15c3–4(d).

[875] This estimates is based on the one-time burden estimated for an OTC derivatives dealer to implement is controls under Rule 15c3–1. *See OTC Derivatives Dealers,* 62 FR 67940. This also is included in the current PRA estimate for Rule 15c3–4.

[876] 25 nonbank SBSDs—10 ANC broker-dealer SBSDs = 15 nonbank SBSDs. 15 nonbank SBSDs × 2,000 hours = 30,000 hours. This number is incremental to the current collection of information for Rule 15c3–1 with regard to complying with the provisions of Rule 15c3–4 and, therefore, excludes the 10 respondents included in the collection of information for that rule. These hours would likely be performed by a combination of an in-house attorney (10,000 hours), a risk management specialist (10,000 hours), and an operations specialist (10,000 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((in-house attorney for 10,000 hours at $378 per hour) + (risk management specialist for 10,000 hours at $259 per hour) + (operations specialist for 10,000 hours at $117 per hour)) = $7,540,000.

[877] 25 nonbank SBSDs – 10 ANC broker-dealer/SBSDs = 15 nonbank SBSDs.

[878] 15 nonbank SBSDs × 250 hours = 3,750 hours. These hour burden estimates are consistent with similar collections of information under Appendix

Continued

Nonbank SBSDs may incur start-up costs to comply with the provisions of Rule 15c3–4 incorporated into proposed Rule 18a–1, including information technology costs. The information technology systems of nonbank SBSDs may be in varying stages of readiness to enable these firms to meet the requirements of the proposed rules so the cost of modifying their information technology systems could vary significantly. Based on the estimates for similar collections of information,[879] it is expected that a nonbank SBSDs would incur an average of approximately $16,000 for initial hardware and software expenses, while the average ongoing cost would be approximately $20,500 per nonbank SBSD to meet the requirements of the proposed new Rule 18a–1, for a total industry-wide initial cost of $240,000 and ongoing cost of $307,500 per year.[880]

Fourth, proposed paragraph (c)(2)(vi)(O)(*1*)(*iii*) of Rule 15c3–1 and paragraph (c)(1)(vi)(A)(*3*)(*i*) of proposed new Rule 18a–1, broker-dealer SBSDs and stand-alone SBSDs not using models would be required to use an industry sector classification system that is documented and reasonable in terms of grouping types of companies with similar business activities and risk characteristics used for credit default swap reference obligors for purposes of calculating ''haircuts'' on security-based swaps under applicable net capital rules.

As discussed above, the Commission staff estimates that 6 broker-dealer SBSDs and 3 nonbank SBSDs not using models would utilize the credit default swap haircut provisions under the proposed amendments to Rule 15c3–1 and proposed new Rule 18a–1, respectively. Consequently, these firms would use an industry sector classification system that is documented for the credit default swap reference obligors. The Commission expects that these firms would utilize external classifications systems because of reduced costs and ease of use as a result of the common usage of several of these classification systems in the financial services industry. The Commission staff estimates that nonbank SBSDs not using models would spend approximately 1 hour per year documenting these industry sectors, for a total annual hour burden of 9 hours.[881]

Fifth, under paragraph (i) of proposed new Rule 18a–1, a nonbank SBSD would be required to file certain notices with the Commission relating to the withdrawal of equity capital.[882] Broker-dealers—which would include broker-dealer SBSDs—currently are required to file these notices under paragraph (e) of Rule 15c3–1.[883] The Commission staff estimates that the notice requirements would result in annual hour burdens to stand-alone SBSDs. The Commission staff estimates that each of the 9 stand-alone SBSDs would file approximately 2 notices annually with the Commission.[884] In addition, the Commission staff estimates that it would take a stand-alone SBSD approximately 30 minutes to file these notices, resulting in an industry-wide annual hour burden of 4.5 hours.[885]

Finally, under Appendix D to proposed new Rule 18a–1, a nonbank SBSD would be required to file a proposed subordinated loan agreement with the Commission (including nonconforming subordinated loan agreements).[886] Broker-dealers—which would include broker-dealer SBSDs—currently are subject to such a requirement. The Commission staff estimates this proposed requirement would result in one-time and annual hour burdens for stand-alone SBSDs. Based on staff experience with Rule 15c3–1, the Commission staff estimates that each of the 9 stand-alone SBSDs would spend approximately 20 hours of internal employee resources drafting or updating its subordinated loan agreement template to comply with the proposed requirement, resulting in an industry-wide one-time hour burden of approximately 180 hours.[887] In addition, based on staff experience with Rule 15c3–1, the Commission staff estimates that each stand-alone SBSD would file 1 proposed subordinated loan agreement with the Commission per year and that it would take a firm approximately 10 hours to prepare and file the agreement, resulting in an industry-wide annual hour burden of approximately 90 hours.[888]

2. Proposed Rule 18a–2

Proposed new Rule 18a–2 would establish capital requirements for nonbank MSBSPs.[889] In particular, a nonbank MSBSP would be required at all times to have and maintain positive tangible net worth.[890] Because MSBSPs, by definition, will be entities that engage in a substantial security-based swap business, under the proposed rules, they would be required to comply with Rule 15c3–4,[891] which requires OTC derivatives dealers and ANC broker-dealers to establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with their business activities, including market, credit, leverage, liquidity, legal, and operational risks.[892] The Commission staff estimates that the requirement to comply with Rule 15c3–4 would result in one-time and annual hour burdens to nonbank MSBSPs. The Commission staff estimates that the average amount of time a firm would spend implementing its risk management control system would be 2,000 hours,[893] resulting in an industry-wide one-time hour burden of 10,000 hours.[894]

E to Rule 15c3–1. These hours likely would be performed by a risk management specialist. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Risk management specialist for 3,750 hours at $259 per hour = $971,250.

[879] *Risk Management Controls for Brokers or Dealers with Market Access,* Exchange Act Release No. 63421 (Nov. 3, 2010), 75 FR 69792, 69814 (Nov. 15, 2010).

[880] 15 nonbank SBSDs × $16,000 = $240,000; 15 nonbank SBSDs × $20,500 =$307,500.

[881] (3 nonbank SBSDs not using models × 1 hour) + (6 broker-dealer SBSDs × 1 hour) = 9 hours. This function would likely be performed by an internal compliance attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Internal compliance attorney for 9 hours at $322 per hour = $2,898.

[882] *See* proposed new Rule 18a–1(i).

[883] 17 CFR 240.15c3–1(e).

[884] This estimate is based on the number of notices currently filed by broker-dealers under the current collection of information under Rule 15c3–1.

[885] [9 stand-alone SBSDs × 2 notices] × 30 minutes = 4.5 hours. This estimate is based on the 30 minutes it is estimated to take a broker-dealer to file a similar notice under Rule 15c3–1. The Commission believes the stand-alone SBSDs would likely perform these functions internally using an internal compliance attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Internal compliance attorney for 4.5 hours at $322 per hour = $1,449.

[886] *See* proposed new paragraph (c)(5) to proposed Rule 18a–1. Broker-dealer SBSDs would be subject to the provisions of Appendix D to Rule 15c3–1. 17 CFR 240.15c3–1d.

[887] 9 stand-alone SBSDs × 20 hours = 180 hours. This function would likely be performed by an in-house attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: in-house attorney for 180 hours at $378 per hour = $68,040.

[888] 9 stand-alone SBSDs × 1 loan agreement × 10 hours = 90 hours. This function would likely be performed by an in-house attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: In-house attorney for 90 hours at $378 per hour = $34,020.

[889] *See* proposed new Rule 18a–2.

[890] *See* paragraph (a) of proposed new Rule 18a–2.

[891] *See* paragraph (c) of proposed new Rule 18a–2.

[892] *See* 17 CFR 240.15c3–4.

[893] This estimate is based on the one-time burden estimated for an OTC derivatives dealer to implement is controls under Rule 15c3–1. *OTC Derivatives Dealers,* 62 FR 67940. This also is included in the current PRA estimate for Rule 15c3–4.

[894] 5 MSBSPs × 2,000 hours = 10,000 hours. These hours would likely be performed by a combination of an internal compliance attorney (3,333.33 hours), a risk management specialist (3,333.33 hours), and an operations specialist

The proposed rule would require a nonbank MSBSP to consider a number of issues affecting its business environment when creating its risk management control system. For example, a nonbank MSBSP would need to consider, among other things, the sophistication and experience of relevant trading, risk management, and internal audit personnel, as well as the separation of duties among these personnel, when designing and implementing its internal control system's guidelines, policies, and procedures. This would help to ensure that the control system that is implemented would adequately address the risks posed by the firm's business and the environment in which it is being conducted. In addition, this would enable a nonbank MSBSP to implement specific policies and procedures unique to its circumstances.

In implementing its policies and procedures, a nonbank MSBSP would be required to document and record its system of internal risk management controls. In particular, a nonbank MSBSP would be required to document its consideration of certain issues affecting its business when designing its internal controls. A nonbank MSBSP would also be required to prepare and maintain written guidelines that discuss its internal control system, including procedures for determining the scope of authorized activities. The Commission staff estimates that each of the 5 MSBSPs would spend approximately 250 hours per year reviewing and updating their risk management control systems to comply with Rule 15c3–4, resulting in an industry-wide annual hour burden of approximately 1,250 hours.[895]

Because nonbank MSBSPs may not initially have the systems or expertise internally to meet the risk management requirements of proposed new Rule 18a–2, these firms would likely hire an outside risk management consultant to assist them in implementing their risk management systems. The Commission staff estimates that a nonbank MSBSP may hire an outside management consultant for approximately 200 hours to assist the firm for a total start-up cost to the nonbank MSBSP of $80,000 per MSBSP, or a total of $400,000 for all nonbank MSBSPs.[896]

Nonbank MSBSPs may incur start-up costs to comply with proposed Rule 18a–2, including information technology costs. The information technology systems of a nonbank MSBSP may be in varying stages of readiness to enable these firms to meet the requirements of the proposed rules so the cost of modifying their information technology systems could vary significantly. Based on the estimates for similar collections of information,[897] the Commission staff expects that a nonbank MSBSP would incur an average of approximately $16,000 for initial hardware and software expenses, while the average ongoing cost would be approximately $20,500 per nonbank MSBSP to meet the requirements of the proposed new Rule 18a–2, for a total industry-wide initial cost of $80,000 and ongoing cost of $102,500.[898]

3. Proposed Rule 18a–3

Proposed paragraph (e) of new Rule 18a–3 would require a nonbank SBSD to establish and implement risk monitoring procedures with respect to counterparty accounts.[899] Therefore, paragraph (e) to proposed Rule 18a–3 would result in one-time and annual hour burdens for nonbank SBSDs. In this regard, nonbank SBSDs would need to develop a comprehensive written risk analysis methodology for assessing the potential risk to the firm over a specified range of possible market movements over a specified time period that would meet the requirements of the rule.

Because these firms would already be required to comply with Rule 15c3–4,[900] the Commission staff estimates that each of the 25 nonbank SBSDs would spend an average of approximately 210 hours establishing the written risk analysis methodology, resulting in an industry-wide one-time hour burden of approximately 5,250 hours.[901] In addition, based on staff experience, the Commission staff estimates that a nonbank SBSD would spend an average of approximately 60 hours per year reviewing the written risk analysis methodology and updating it as necessary, resulting in an average industry-wide annual hour burden of approximately 1,500 hours.[902]

The 25 respondents subject to the collection of information may incur start-up costs in order to comply with this collection of information. These costs may vary depending on the size and complexity of the nonbank SBSD. In addition, the start-up costs may be less for the 16 nonbank SBSD respondents also registered as broker-dealers because these firms may already be subject to similar requirements with respect to other margin rules.[903] For the remaining 9 nonbank SBSDs, because these written procedures may be novel undertakings for these firms, the Commission staff assumes these nonbank SBSDs would have their written risk analysis methodology reviewed by outside counsel. As a result, the Commission staff estimates that these nonbank SBSDs would likely incur $2,000 in legal costs, or $18,000 in the aggregate initial burden to review and comment on these materials.[904]

4. Proposed Rule 18a–4

Under proposed new Rule 18a–4, SBSDs would be required to establish special accounts with banks and obtain written acknowledgements from, and

(3,333.33 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: ((internal compliance attorney for 3,333.33 hours at $322 per hour) + (risk management specialist for 3,333.33 hours at $259 per hour) + (operations specialist for 3,333.33 hours at $117 per hour)) = $2,326,664.34.

[895] 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. These hours would likely be performed by a risk management specialist. Therefore, the estimated internal cost for this hour burden would be calculated as follows: Risk management specialist for 1,250 hours at $259 per hour = $323,750.

[896] 5 nonbank MSBSPs × $80,000 = $400,000. *See also* PRA Analysis in *Product Definitions Adopting Release,* 77 FR at 48344 (providing an estimate of $400 an hour to engage an outside attorney); *Nationally Recognized Statistical Rating Organizations,* 76 FR at 33504 (providing estimate of $400 per hour to engage outside attorneys and outside professionals).

[897] *Risk Management Controls for Brokers or Dealers with Market Access,* 75 FR at 69814.

[898] 5 nonbank MSBSPs × $16,000 = $80,000; 5 nonbank MSBSPs × $20,500 = $102,500.

[899] *See* paragraph (e) of proposed new Rule 18a–3.

[900] *See* section II.A.2.c. of this release (describing risk management provisions of Rule 15c3–4).

[901] 25 nonbank SBSDs × 210 hours = 5,250 hours. *See generally Clearing Agency Standards for Operation and Governance,* 76 FR at 14510 (estimating 210 one-time burden hours and 60 annual hours to implement policies and procedures reasonably designed to use margin requirements to limit a clearing agency's credit exposures to participants in normal market conditions and use risk-based models and parameters to set and review margin requirements.). These hours would likely be performed internally by an assistant general counsel (1,750 hours), a compliance attorney (1,750 hours), and a risk management specialist (1,750 hours). Therefore, the estimated internal cost for this hour burden would be calculated as follows: ((assistant general counsel for 1,750 hours at $407 per hour) + (risk management specialist for 1,750 hours at $259 per hour) + (compliance attorney for 1,750 hours at $322 per hour)) = $1,729,000.

[902] 25 stand-alone SBSDs × 60 hours = 1,500 hours. These hours would likely be performed by a compliance attorney. Therefore, the estimated internal cost for this hour burden would be calculated as follows: Compliance attorney for 1,500 hours at $322 per hour = $483,000.

[903] *See, e.g.,* FINRA Rule 4210 and 4240. *See also Business Conduct Release,* 76 FR at 42445 (noting burden for paragraph (g) of proposed Rule 15Fh–3 is based on existing FINRA rules).

[904] The Commission staff estimates the review of the written risk analysis methodology would require 5 hours of outside counsel time at a cost of $400 per hour. *See also Business Conduct Release,* 76 FR at 42445.

enter into written contracts with, the banks. These special accounts would include: (1) The qualified clearing agency account under paragraph (a)(3); (2) the qualified SDSD account under paragraph (a)(4); and the special account for the exclusive benefit of security-based swap customers under paragraph (a)(7) of proposed new Rule 18a–4, (collectively, the ''special accounts''). Based on staff experience with Rule 15c3–3, the Commission staff estimates that each of the 50 SBSDs would establish six special accounts at banks (two for each type of special account). Further, based on staff experience with Rule 15c3–3, the Commission staff estimates that each SBSD would spend approximately 30 hours to draft and obtain the written acknowledgement and agreement for each account, resulting in an industry-wide one-time hour burden of approximately 9,000 hours.[905] The Commission staff estimates that 25% [906] of the 50 SBSDs or approximately 13 would establish a new special account each year because, for example, they change their banking relationship, for each type of special account. Therefore, the Commission staff estimates an industry-wide annual hour burden of approximately 1,170 hours.[907]

Paragraph (c)(1) of proposed new Rule 18a–4 would provide that the SBSD must at all times maintain in a special account, through deposits into the account, cash and/or qualified securities in amounts computed in accordance with the formula set forth in Exhibit A to Rule 18a–4,[908] modeled on the formula in Appendix A to Rule 15c3–3. Paragraph (c)(3) of proposed new Rule 18a–4 would provide that the computations necessary to determine the amount required to be maintained in the special bank account must be made on a daily basis. Variation in size and complexity between these SBSDs would make it very difficult to develop a meaningful figure for the amount of time required to calculate each reserve computation. Based on experience with the Rule 15c3–3 reserve computation PRA burden hours and with the OTC derivatives industry, the Commission staff estimates that it would take between one and five hours to compute each reserve computation, and that the average time spent across all the SBSDs would be approximately 2.5 hours. Accordingly, the Commission staff estimates that the resulting annual hour burden for paragraph (c)(3) of proposed new Rule 18a–3 would be approximately 31,250 hours.[909]

Under paragraph (d)(1) of proposed new Rule 18a–4, an SBSD or an MSBSP would be required to provide a notice to a counterparty pursuant to section 3E(f) of the Exchange Act prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the effective date of the proposed rule.[910] All 50 SBSDs and 5 MSBSPs would be required to provide these notices to their counterparties. The Commission staff estimates that these 55 entities would engage outside counsel to draft and review the notice at a cost of $400 per hour for an average of 10 hours per respondent, resulting in a one-time cost burden of $220,000 for all of these 55 entities.[911]

The number of notices sent in the first year the rule is effective would depend on the number of counterparties with which each SBSD and MSBSP engages in security-based swap transactions. The number of counterparties an SBSD and MSBSP would have would vary depending on the size and complexity of the firm and its operations. The Commission staff estimates that each of the 50 SBSDs and 5 MSBSPs would have approximately 1,000 counterparties at any given time.[912] Therefore, the Commission staff estimates that approximately 55,000 notices would be sent in the first year the rule is effective.[913] The Commission staff estimates that the each of the 50 SBSDs and 5 MSBSPs would spend approximately 10 minutes sending out the notice, resulting in an industry-wide one-time hour burden of approximately 9,167 hours.[914] The Commission staff further estimates that the 50 SBSDs and 5 MSBSPs would establish account relationships with 200 new counterparties per year. Therefore, the Commission staff estimates that approximately 11,000 notices would be sent annually,[915] resulting in an industry-wide annual hour burden of approximately 1,833 hours.[916]

Under proposed new Rule 18a–4(d)(2), an SBSD would be required to obtain agreements from counterparties that do not choose to require segregation of funds or other property pursuant to Section 3E(f) of the Exchange Act or paragraph (c)(3) of Rule 18a–4 in which the counterparty agrees to subordinate all of its claims against the SBSD to the claims of security-based swap customers of the SBSD.[917] The Commission staff estimates that an SBSD would spend, on average, approximately 200 hours to draft and prepare standard subordination agreements, resulting in an industry-wide one-time hour burden of 10,000 hours.[918] Because the SBSD would enter into these agreements with

[905] 50 SBSDs × 6 special accounts × 30 hours = 9,000 hours. A compliance attorney would likely perform this function. Therefore, the estimated internal cost for this hour burden would be calculated as follows: Compliance attorney for 9,000 hours at $322 per hour = $2,898,000.

[906] This number is based on the currently approved PRA collection for Rule 15c3–3.

[907] 13 SBSDs × 3 types of special accounts × 30 hours = 1,170 hours. A compliance attorney would likely perform this function. Therefore, the estimated internal cost for this hour burden would be calculated as follows: Compliance attorney for 1,170 hours at $322 per hour = $376,740.

[908] *See* paragraph (c)(1) of proposed new Rule 18a–4 and Exhibit A to proposed new Rule 18a–4.

[909] 50 SBSDs × 250 business days × 2.5 hours/day = 31,250 hours. This task would likely be performed by a financial reporting manager. Therefore, the estimated internal cost for this hour burden would be calculated as follows: Financial reporting manager for 31,250 hours at $309 per hour = $9,656,250.

[910] *See* paragraph (d)(1) of proposed new Rule 18a–4.

[911] [50 SBSDs + 5 MSBSPs] × $400 per hour × 10 hours = $220,000. The Commission expects that these functions would likely be performed by outside counsel with an expertise in financial services law to help ensure that counterparties are receiving the proper notice under the statutory requirement.

[912] The Commission previously estimated that there are approximately 8,500 market participants in security-based swap transactions. *See Business Conduct Release,* 76 FR at 42443. Based on the 8,500 market participants and Commission staff experience relative to the securities and OTC derivatives industry, the Commission staff estimates that each SBSD and MSBSP would have 1,000 counterparties at any given time. The number of counterparties may widely vary depending on the size of the SBSD or MSBSP. A large firm may have thousands or counterparties at one time, while a smaller firm may have substantially less than 1,000. The Commission staff also estimates, based on staff experience, that these entities would establish account relationships with approximately 200 new counterparties a year, or approximately 20% of a firm's existing counterparties.

[913] [50 SBSDs + 5 MSBSPs] × 1,000 counterparties = 55,000 notices.

[914] (55,000 notices × 10 minutes)/60 minutes = 9,167 hours. A compliance clerk would likely send these notices. Therefore, the estimated internal cost for this hour burden would be calculated as follows: Compliance clerk for 9,167 hours at $60 per hour = $550,020. The hourly rates use for internal office employees used throughout this section are taken from SIFMA's Office Salaries in the Securities Industry 2011, modified by the Commission staff to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

[915] [50 SBSDs + 5 MSBSPs] × 200 counterparties = 11,000 notices.

[916] (11,000 notices × 10 minutes)/60 minutes = 1,833 hours. A compliance clerk would likely send these notices. Therefore, the estimated internal cost for this hour burden would be calculated as follows: compliance clerk for 1,833 hours at $60 per hour = $109,980.

[917] *See* paragraph (d)(2) of proposed new Rule 18a–4.

[918] 200 hours × 50 SBSDs = 10,000 hours. An in-house attorney would likely draft these agreements because the Commission staff expects that drafting contracts would be one of the typical job functions of an in-house attorney. Therefore, the estimated internal cost for this hour burden would be calculated as follows: In-house attorney for 10,000 hours at $378 per hour = $3,780,000.

security-based swap customers, after the SBSD prepares a standard subordination agreement in-house, the Commission staff also estimates that an SBSD would have outside counsel a review the standard subordination agreements and that the review would take approximately 20 hours at a cost of approximately $400 per hour. As a result, the Commission staff estimates that each SBSD would incur one-time costs of approximately $8,000,[919] resulting in an industry-wide one-time cost of approximately $400,000.[920]

As discussed above, the Commission staff estimates that each of the 50 SBSDs would have approximately 1,000 counterparties at any given time. The Commission staff further estimates that approximately 50% of these counterparties would either elect individual segregation or waive segregation altogether.[921] The Commission staff estimates that an SBSD would spend 20 hours per counterparty to enter into a written subordination agreement, resulting in an industry-wide one-time hour burden of approximately 500,000 hours.[922] Further, as discussed the Commission staff estimates that each of the 50 SBSDs would establish account relationships with 200 new counterparties per year. The Commission staff further estimates that 50% or 100 of these counterparties would either elect individual segregation or waive segregation altogether. Therefore, the Commission staff estimates an industry-wide annual hour burden of approximately 100,000 hours.[923]

E. Collection of Information Is Mandatory

The collections of information pursuant to the proposed amendments and new rules are mandatory, as applicable, for ANC broker-dealers, SBSDs, and MSBSPs.

F. Confidentiality

The Commission expects to receive confidential information in connection with the proposed collections of information. To the extent that the Commission receives confidential information pursuant to these collections of information, the Commission is committed to protecting the confidentiality of such information to the extent permitted by law.[924]

G. Retention Period for Recordkeeping Requirements

ANC broker-dealers are required to preserve for a period of not less than three years, the first two years in an easily accessible place, certain records required under Rule 15c3–4 and certain records under Appendix E to Rule 15c3–1.[925] Rule 17a–4 specifies the required retention periods for a broker-dealer.[926] Many of a broker-dealer's records must be retained for three years; certain other records must be retained for longer periods.[927]

As noted above, the recordkeeping burdens with respect to some requirements in proposed new Rules 18a–1 through 18a–4 will be addressed in the SBSD and MSBSP recordkeeping requirements, which will the subject of a separate release.

H. Request for Comment

Pursuant to 44 U.S.C. 3306(c)(2)(B), the Commission requests comment on the proposed collections of information in order to:

- Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility;
- Evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information;
- Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
- Evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct their comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549–1090, and refer to File No. S7–08–12. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this document in the **Federal Register**; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–08–12, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street NE., Washington, DC 20549.

V. Economic Analysis

The Commission is sensitive to the costs and benefits of its rules. Some of these costs and benefits stem from statutory mandates, while others are affected by the discretion exercised in implementing the mandates. The following economic analysis seeks to identify and consider the benefits and costs—including the effects on efficiency, competition, and capital formation—that would result from the proposed capital, margin, and segregation rules for SBSDs and MSBSPs and from the proposed amendments to Rule 15c3–1. The costs and benefits considered in proposing these new rules and amendments are discussed below and have informed the policy choices described throughout this release.

[919] $400 × 20 hours = $8,000.

[920] $8,000 × 50 = $400,000.

[921] Based on discussions with market participants, the Commission staff understands that many large buy-side financial end users currently ask for individual segregation and the Commission staff assumes that many of these end users will continue to do so. However, Commission staff believes that some smaller end users may not choose to incur additional cost that may come with individual segregation. Therefore, the Commission staff estimates that approximately 50% of counterparties will either elect individual segregation or waiver segregation altogether.

[922] 50 SBSDs × 500 counterparties × 20 hours = 500,000 hours. These functions would likely be performed by a compliance attorney (250,000 hours) and a compliance clerk (250,000 hours). Therefore, the estimated internal cost for this hour burden would be calculated as follows: ((compliance attorney for 250,000 hours at $322 per hour) + (compliance clerk for 250,000 hours at $60 per hour)) = $95,500,000.

[923] 50 SBSDs × 100 counterparties × 20 hours = 100,000 hours. These functions would likely be performed by a compliance attorney (50,000 hours) and a compliance clerk 50,000 hours). Therefore, the estimated internal cost for this hour burden would be calculated as follows: ((compliance attorney for 50,000 hours at $322 per hour) + (compliance clerk for 50,000 hours at $60 per hour)) = $19,100,000.

[924] *See, e.g.,* 15 U.S.C. 78 × (governing the public availability of information obtained by the Commission); 5 U.S.C. 552 *et seq.* (Freedom of Information Act—''FOIA''). *See also* paragraph (d)(1) of proposed new Rule 18a–1(d). FOIA provides at least two pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for ''trade secrets and commercial or financial information obtained from a person and privileged or confidential.'' *5 U.S.C. 552(b)(4).* FOIA Exemption 8 provides an exemption for matters that are ''contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.'' *5 U.S.C. 552(b)(8).*

[925] *See* 17 CFR 17a–4(b)(9), (10), and (12).

[926] 17 CFR 240.17a–4.

[927] *Id.*

The Commission discusses below a baseline against which the rules may be evaluated. For the purposes of this economic analysis, the baseline is the OTC derivatives markets as they exist today prior to the effectiveness of the statutory and regulatory provisions that will govern these markets in the future pursuant to the Dodd-Frank Act. With respect to the proposed amendments to Rule 15c3–1, the baseline for purposes of this economic analysis is the current capital regime for broker-dealers under Rule 15c3–1.[928]

While the Commission does not have comprehensive information on the U.S. OTC derivatives markets, the Commission is using the limited data currently available in considering in this economic analysis the effects of the proposals, including their intended benefits and anticipated possible costs.[929] Additionally, the Commission requests that commenters identify sources of data and information as well as provide data and information to assist the Commission in analyzing the economic consequences of the proposed rules. More generally, the Commission requests comment on all aspects of this initial economic analysis, including on whether the analysis has: (1) Identified all benefits and costs, including all effects on efficiency, competition, and capital formation; (2) given due consideration to each benefit and cost, including each effect on efficiency, competition, and capital formation; and (3) identified and considered reasonable alternatives to the proposed new rules and rule amendments.

If these proposed rules and rule amendments are adopted, their benefits and costs would affect competition, efficiency, and capital formation in the security-based swap market broadly, with the impact not being limited to SBSDs and MSBSPs. Section 3(f) of the Exchange Act provides that whenever the Commission engages in rulemaking under the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[930] In addition, section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the effect such rules would have on competition.[931] Section 23(a)(2) of the Exchange Act also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[932]

As discussed more fully in section II. above, the Commission is proposing: (1) Rules 18a–1 and 18a–2, and amendments to Rule 15c3–1, to establish capital requirements for nonbank SBSDs and nonbank MSBSPs; (2) Rule 18a–3 to establish customer margin requirements applicable to nonbank SBSDs and nonbank MSBSPs for non-cleared security-based swaps; and (3) Rule 18a–4 to establish segregation requirements for SBSDs and notification requirements with respect to segregation for SBSDs and MSBSPs.[933] Some of the proposed amendments to Rule 15c3–1 would apply to broker-dealers that are not registered as SBSDs or MSBSPs to the extent that they hold positions in security-based swaps and swaps. The Commission also is proposing to amend Rule 15c3–1 to increase the minimum capital requirements for ANC broker-dealers. Finally, the Commission is proposing a liquidity requirement for ANC broker-dealers and for nonbank stand-alone SBSDs that use internal models to compute net capital.

The sections below present an overview of the OTC derivatives markets, a discussion of the general costs and benefits of the proposed financial responsibility requirements, and a discussion of the costs and benefits of each proposed amendment and new rule. The sections that follow also incorporate a consideration of the potential effects of the proposed amendments and new rules on competition, efficiency, and capital formation.

A. Baseline of Economic Analysis

1. Overview of the OTC Derivatives Markets—Baseline for Proposed Rules 18a–1 Through 18a–4

As stated above, to assess the costs and benefits of these rules, a baseline must be established against which the rules may be evaluated. For the purposes of this economic analysis, the baseline is the OTC derivatives markets[934] as they exist today prior to the effectiveness of the statutory and regulatory provisions that will govern these markets in the future pursuant to the Dodd-Frank Act.[935] The markets as they exist today are dominated, both globally and domestically, by a small number of firms, generally entities affiliated with or within large commercial banks.[936]

The OTC derivatives markets have been described as opaque because, for example, transaction-level data about OTC derivatives trading generally is not publicly available.[937] This economic analysis is supported, where possible, by data currently available to the Commission from The Depository Trust & Clearing Corporation Trade Information Warehouse (''DTCC–TIW''). This evaluation takes into account data regarding the security-based swap market and especially data regarding the activity—including activity that may be suggestive of dealing behavior—of participants in the single-name credit default swap market.[938] While a large segment of the security-based swap market is comprised of single-name credit default swaps, these derivatives do not comprise the entire security-based swap market.[939] Moreover, credit

[928] 17 CFR 240.15c3–1.

[929] Information that is available for the purposes of this economic analysis includes an analysis of the market for single-name credit default swaps performed by the Commission's Division of Risk, Strategy, and Financial Innovation. *See CDS Data Analysis.*

[930] 15 U.S.C. 78c(f).

[931] 15 U.S.C. 78w(a)(2).

[932] *Id.*

[933] The Commission is also proposing a conforming amendment to Rule 15c3–3 to clarify that broker-dealer SBSDs must comply with Rule 15c3–3 and Rule 18a–4, as applicable.

[934] OTC derivatives may include forwards, swaps and options on foreign exchange, and interest rate, equity and commodity derivatives.

[935] The baseline, however, for amendments to Rule 15c3–1 is the current financial responsibility regime for broker-dealers under this rule.

[936] *See, e.g., ISDA Margin Survey 2012.*

[937] *See* Orice M. Williams, GAO, *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps* at 2, 5, 27. *See also* Robert E. Litan, The Brookings Institution, *The Derivatives Dealers' Club and Derivatives Market Reform: A Guide for Policy Makers, Citizens and Other Interested Parties* 15–20 (Apr. 7, 2010), available at *http://www.brookings.edu/~/media/research/files/papers/2010/4/07%20derivatives%20litan/0407_derivatives_litan.pdf; Security-Based Swap Data Repository Registration, Duties, and Core Principles,* Exchange Act Release No. 63347 (Nov. 19, 2010), 75 FR 77306, 77354 (Dec. 10, 2010); IOSCO, *The Credit Default Swap Market,* Report FR05/12, (June 2012), available at *http://www.iosco.org/library/pubdocs/pdf/IOSCOPD385.pdf* (stating although the amount of public information on CDS has increased over recent years, the CDS market is still quite opaque).

[938] The *CDS Data Analysis* provides reasonably comprehensive information regarding the credit default swap activities and positions of U.S. market participants, but the Commission notes that the data does not encompass those credit default swaps that both: (i) Do not involve U.S. counterparties; and (ii) are based on non-U.S. reference entities. Reliance on this data should not be interpreted to indicate our views as to the nature or extent of the application of Title VII to non-U.S. persons; instead, it is anticipated that issues regarding the extraterritorial application of Title VII will be addressed in a separate release.

[939] In addition, it is reasonable to believe that the implementation of Title VII itself will change the security-based swap market, and, with the full implementation of Title VII—which in part is

default swaps are a small percentage of the overall OTC derivatives market, which, in addition to security-based swaps, includes foreign currency swaps and interest rate swaps.

Available information about the global OTC derivatives markets suggests that swap transactions, in contrast to security-based swap transactions, dominate trading activities, notional amounts, and market values.[940] For example, the BIS estimates that the total notional amounts outstanding and gross market value of global OTC derivatives were over $648 trillion and $27.2 trillion, respectively, as of the end of 2011.[941] Of these totals, the BIS estimates that foreign exchange contracts, interest rate contracts, and commodity contracts comprised approximately 88% of the total notional amount and 84% of the gross market value.[942] Credit default swaps, including index credit default swaps, comprised approximately 4.4% of the total notional amount and 5.8% of the gross market value. Equity-linked contracts, including forwards, swaps and options, comprised approximately an additional 1.0% of the total notional amount and 2.5% of the gross market value.[943]

Because the financial responsibility program for SBSDs and MSBSPs would apply to dealers and participants in the security-based swap markets, they are expected to affect a substantially smaller portion of the U.S. OTC derivatives markets than the proposed financial responsibility rules for swap dealers and major swap participants proposed by the CFTC and prudential regulators.[944] In addition, though the proposed capital, segregation and margin rules apply to all security-based swaps, not just single-name credit default swaps, the data on single-name credit default swaps are currently sufficiently representative of the market to help inform this economic analysis because currently an estimated 95% of all security-based swap transactions appear likely to be single-name credit default swaps.[945] The majority of these single-name credit default swaps, both in terms of aggregate total notional amount and total volume by product type, are based on corporate and sovereign reference entities.[946]

While the number of transactions is larger in single-name credit default swaps than in index credit default swaps, the aggregate total notional amount of the latter exceeds that of single-name credit default swaps.[947] For example, the total aggregate notional amount for single-name credit default swaps was $6.2 trillion, while the aggregate total notional amount for index credit default swaps was $16.8 trillion over the sample period of January 1, 2011 to December 31, 2011. For the same sample period, however, single-name credit default swaps totaled 69% of transactional volume, while index credit default swaps comprised 31% of the total transactional volume.[948] The majority of trades in both notional amount and volume for both single-name and index credit default swaps over the 2011 sample period were new trades in contrast to assignments, increases, terminations or exits.[949] The analysis of the 2011 data further shows that by total notional amount and total volume the majority of single-name and index credit default contracts have a tenor of 5 years.[950] In addition, the data from the sample period indicates that the geographical distribution of counterparties' parent country domiciles in single name contracts are concentrated in the United States, United Kingdom, and Switzerland.[951]

As described more fully in the *CDS Data Analysis,*[952] based on 2011 transaction data, Commission staff identified entities currently transacting in the credit default swap market that may register as SBSDs by analyzing various criteria of their dealing activity. The results suggest that there is currently a high degree of concentration of potential dealing activity in the single-name credit default swap market. For example, using the criterion that dealers are likely to transact with many counterparties who themselves are not dealers, the analysis of the 2011 data show that only 28 out of 1,084 market participants have three or more counterparties that themselves are not recognized as dealers by ISDA.[953] In addition, the analysis suggests that dealers appear, based on the percentage of trades between buyer and seller principals, in the majority of all trades on either one or both sides in single-name and index credit default swaps.[954]

This concentration to a large extent appears to reflect the fact that those larger entities are well-capitalized and therefore possess competitive advantages in engaging in OTC security-based swap dealing activities by providing potential counterparties with adequate assurances of financial performance.[955] As such, it is

conditioned on the implementation of the proposed financial responsibility program—more information will be available for this analysis.

[940] *See* BIS, *Statistical Release: OTC derivatives statistics at end-December 2011,* 5 (May 2012), available at *http://www.bis.org/publ/otc_hy1205.pdf* (reflecting data reported by central banks in 14 countries: Belgium, Canada, France, Germany, England, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States, Australia, and Spain).

[941] *Id.* at 12 (''Nominal or notional amounts outstanding are defined as the gross nominal or notional value of all deals concluded and not yet settled on the reporting date * * * Gross market values are defined as the sums of the absolute values of all open contracts with either positive or negative replacement values evaluated at market prices prevailing on the reporting date * * * gross market values supply information about the potential scale of market risk in derivatives transactions. Furthermore, gross market value at current market prices provides a measure of economic significance that is readily comparable across markets and products.'').

[942] *Id.*

[943] *Id.* Similarly, the OCC has found that interest rate products comprised 81% of the total notional amount of OTC derivatives held by bank dealers whereas credit derivative contracts comprised 6.4% and equity contracts comprised 1% of that notional amount. *See* OCC, *Quarterly Report on Bank Trading and Derivatives Activities, Fourth Quarter 2011,* available at *http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq411.pdf.*

[944] *See CFTC Margin Proposing Release,* 76 FR 27802; *Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564.

[945] *See Entity Definitions Adopting Release,* 77 FR at 30636. *See also Product Definitions Adopting Release,* 77 FR 48205 (defining the term *security-based swap*).

[946] Data compiled by the Commission's Division of Risk, Strategy, and Financial Innovation on credit default transactions from the DTCC–TIW between January 1, 2011 and December 31, 2011.

[947] *Id.* This data also shows the average mean and median single-name and index credit default swap notional transaction size in millions is 6.47 and 4.12, and 39.22 and 14.25, respectively.

[948] *Id.*

[949] *Id.*

[950] *Id.*

[951] *Id.*

[952] *See CDS Data Analysis.*

[953] *Id.* at Table 3c. The analysis of this transaction data is imperfect as a tool for identifying dealing activity, given that the presence or absence of dealing activity ultimately turns upon the relevant facts and circumstances of an entity's security-based swap transactions, as informed by the dealer-trader distinction. Criteria based on the number of an entity's counterparties that are not recognized as dealers nonetheless appear to be useful for identifying apparent dealing activity in the absence of full analysis of the relevant facts and circumstances, given that engaging in security-based swap transactions with non-dealers would be consistent with the conduct of seeking to profit by providing liquidity to others, as anticipated by the dealer-trader distinction.

[954] Data compiled by the Commission's Division of Risk, Strategy, and Financial Innovation on credit default transactions from the DTCC–TIW between January 1, 2011 and December 31, 2011. Additionally, according to the OCC, at the end of the first quarter of 2012, derivatives activity in the U.S. banking system continues to be dominated by a small group of large financial institutions. Four large commercial banks represent 93% of the total banking industry notional amounts and 81% of industry net current credit exposure. *See* OCC, *Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2012,* available at *http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq112.pdf.*

[955] *See, e.g.,* Craig Pirrong, *Rocket Science, Default Risk and The Organization of Derivatives*

Continued

reasonable to conclude that currently there likely are high barriers to entry in terms of capitalization in connection with security-based swap dealing activity.[956]

Other than OTC derivatives dealers, which are subject to significant limitations on their activities, broker-dealers historically have not participated in a significant way in security-based swap trading for at least two reasons. First, because the Exchange Act has not previously defined security-based swaps as ''securities,'' they have not been required to be traded through registered broker-dealers.[957] And second, a broker-dealer engaging in security-based swap activities is currently subject to existing regulatory requirements with respect to those activities, including capital, margin, segregation, and recordkeeping requirements. Specifically, the existing broker-dealer capital requirements make it relatively costly to conduct these activities in broker-dealers, as discussed in section II.A.2. of this release. As a result, security-based swap activities are currently mostly concentrated in entities that are affiliated with the parent companies of broker-dealers, but not in broker-dealers themselves.[958]

End users enter into OTC derivatives transactions to take investment positions or to hedge commercial and financial risk. These non-dealer end users of OTC derivatives are, for example, commercial companies, governmental entities, financial institutions, investment vehicles, and individuals. Available data suggests that the largest end users of credit default swaps are, in descending order, hedge funds, asset managers, and banks, which may have a commercial need to hedge their credit exposures to a wide variety of entities or may take an active view on credit risk.[959] Based on the available data, the Commission further estimates that *commercial end users* currently participate in the security-based swap markets on a very limited basis.[960]

Finally, this baseline for proposed new Rules 18a–1 through 18a–4 will be further discussed in the applicable sections of the release below.

Request for Comment

The Commission generally requests comment about its preliminary estimates of the scale and composition of the OTC derivatives market, including the relative size of the security-based swap segment of that market. In addition, the Commission requests that commenters provide data and sources of data to quantify:

1. The average daily and annual volume of OTC derivatives transactions;
2. The volume of transactions in each class of OTC derivatives (*e.g.,* interest rate swaps, index credit default swaps, single-name credit default swaps, currency swaps, commodity swaps, and equity-based swaps);
3. The total notional amount of all pending swap transactions;
4. The total current exposure of all pending swap transactions;
5. The total notional amount of all pending security-based swap transactions;
6. The total current exposure of all pending security-based swap transactions;
7. The types and numbers of dealers in OTC derivatives (*e.g.,* banks, broker-dealers, unregulated entities);
8. The capital levels of dealers, particularly those not subject to regulatory capital requirements;
9. The types and numbers of dealers in OTC derivatives dealers that engage in both a swap and security-based swap business;
10. The types and numbers of dealers in OTC derivatives that engage only in a swap business;
11. The types and numbers of dealers in OTC derivatives that engage only in a security-based swaps business;
12. The classes of end users (*e.g., commercial end users,* financial end users, and others) and the number of end users in each class;
13. The types of OTC derivatives transactions that each class of end user commonly engages in;
14. The amount of assets posted for OTC derivatives to collateralize current exposure;
15. The amount of assets posted for OTC derivatives to collateralize potential future exposure;
16. The type of assets used as collateral; and
17. The amount of assets that are held under the different types of collateral arrangements (*e.g.,* held by the dealer but not segregated, held by the dealer in omnibus segregation, held by a third-party custodian).

2. Baseline for Amendments to Rule 15c3–1

As discussed in more detail above, the Commission is proposing amendments to Rule 15c3–1.[961] These amendments would establish minimum net capital requirements for broker-dealers that register as SBSDs, increase the minimum net capital requirements for ANC broker-dealers, narrow the current treatment of credit risk charges for ANC broker-dealers to apply only to uncollateralized receivables from *commercial end users* arising from security-based swaps, and establish liquidity requirements for ANC broker-dealers and nonbank SBSDs using internal models. Some of those proposed amendments to Rule 15c3–1 would also apply to broker-dealers not registering as SBSDs or MSBSPs to the extent they hold security-based swap positions or non-security-based swap positions.

As discussed in section II.A.1. of this release, the existing broker-dealer capital requirements are contained in Rule 15c3–1 [962] and seven appendices to Rule 15c3–1.[963] The baseline for this economic analysis with respect to the proposed amendments to Rule 15c3–1 is

Markets, Working Paper 17–18 (2006), available at *http://www.cba.uh.edu/spirrong/Derivorg1.pdf* (noting that counterparties seek to reduce risk of default by engaging in credit derivative transactions with well-capitalized firms). *See also Entity Definitions Adopting Release,* 77 FR at 30739–30742.

[956] *See id.* at 18–19 (noting lack of success among new entrants into derivatives dealing market due to perception that AAA rating for subsidiary is less desirable than a slightly lower rating for a larger entity, and suggesting that there are ''economies of scale in bearing default risk'' that may induce ''substantial concentration in dealer activities''). *See also Entity Definitions Adopting Release,* 77 FR at 30739–30742.

[957] *See* definition of ''security'' in section 3(a)(10) of the Exchange Act and ''security-based swap'' in section 3(a)(68) of the Exchange Act.

[958] *See ISDA Margin Survey 2012.*

[959] This information is based on available market data from DTCC–TIW compiled by the Commission's Division of Risk, Strategy, and Financial Innovation. For example, data compiled by the Commission's Division of Risk, Strategy, and Financial Innovation on credit default transactions from the DTCC–TIW between January 1, 2011 and December 31, 2011 suggests that for single-name credit default swap transactions, dealer to dealer transactions composed 68.26% of trades between buyer and seller principals over the sample period.

[960] For example, data compiled by the Commission's Division of Risk, Strategy, and Financial Innovation on credit default transactions from the DTCC–TIW between January 1, 2011 and December 31, 2011 suggest that the total percentage of trades between buyer and seller principals over the sample period for single-name credit default swaps was only 0.03% of the total trade counterparty distribution for non-financial end users, which are composed of non-financial companies and family trusts.

[961] *See* section II.B. of this release.

[962] 17 CFR 240.15c3–1.

[963] 17 CFR 240.15c3–1a (Options); 17 CFR 240.15c3–1b (Adjustments to net worth and aggregate indebtedness for certain commodities transactions); 17 CFR 240.15c3–1c (Consolidated computations of net capital and aggregate indebtedness for certain subsidiaries and affiliates; 17 CFR 240.15c3–1d (Satisfactory subordination agreements); 17 CFR 240.15c3–1e (Deductions for market and credit risk for certain brokers or dealers); 17 CFR 240.15c3–1f (Optional market and credit risk requirements for OTC derivatives dealers); 17 CFR 240.15c3–1g (Conditions for ultimate holding companies of certain brokers or dealers).

the broker-dealer capital regime as it exists today.

Specifically, current Rule 15c3–1 requires broker-dealers to maintain a minimum level of net capital (meaning highly liquid capital) at all times.[964] The rule requires that a broker-dealer perform two calculations: (1) A computation of the minimum amount of net capital the broker-dealer must maintain;[965] and (2) a computation of the amount of net capital the broker-dealer is maintaining.[966] The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of aggregate debit items ratio.[967]

In computing net capital, the broker-dealer must, among other things, make certain adjustments to net worth such as deducting illiquid assets and taking other capital charges and adding qualifying subordinated loans.[968] ''Tentative net capital'' is defined as the amount remaining after these deductions.[969] The final step in computing net capital is to deduct from the mark-to-market values of the proprietary positions (*e.g.* in securities, money market instruments, and commodities) that are included in its tentative net capital prescribed percentages (''standardized haircuts'').[970] The standardized haircuts are designed to account for the market risk inherent in these proprietary positions and to create a buffer of liquidity to protect against other risks associated with the securities business.[971] With Commission approval, ANC broker-dealers and OTC derivative dealers are permitted to calculate deductions for market risk and credit risk from tentative net capital using internal models in lieu of the standardized haircuts.[972] Because the use of internal models to compute net capital generally can substantially reduce the deductions for proprietary positions compared to standardized haircuts and only certain risks are addressed by these internal models, current Rule 15c3–1 imposes substantially higher minimum capital requirements for ANC broker-dealers and OTC derivatives dealers as compared to other types of broker-dealers.[973] For example, under current Rule 15c3–1, ANC broker-dealers are required to at all times maintain tentative net capital of not less than $1 billion and net capital of not less than $500,000,[974] and they are required to provide notice to the Commission if their tentative net capital falls below $5 billion.[975] The current rule requires that a broker-dealer must ensure that its net capital exceeds its minimum net capital requirement at all times.[976]

Finally, the baseline of the current capital regime will be further discussed in the applicable sections of the release below.

B. Analysis of the Proposals and Alternatives

1. Overview—The Proposed Financial Responsibility Program

Generally, the financial responsibility requirements the Commission is proposing today are intended to enhance the financial integrity of SBSDs and MSBSPs. As discussed more fully below, in proposing these requirements, the Commission is seeking to appropriately consider both the potential benefits of minimizing the risk that the failure of one firm will cause financial distress to other firms and disrupt financial markets and the U.S. financial system and the potential costs to that firm, the financial markets, and the U.S. financial system if SBSDs and MSBPs are required to comply with overly restrictive capital, margin and segregation requirements. This introductory section reviews at a general level certain considerations regarding the economic analysis of the proposed rules that is set forth in greater detail below.

As discussed in section I. of the release, the current broker-dealer financial responsibility requirements serve as the template for the proposals for several reasons. First, the financial markets in which SBSDs and MSBSPs are expected to operate are similar to the financial markets in which broker-dealers operate in the sense that they are driven in significant part by dealers that buy and sell on a regular basis and that take principal risk. Second, like nonbank dealers in securities but unlike bank SBSDs, nonbank SBSDs will not be able to rely on a backstop provider of liquidity but rather need to be able to liquidate assets quickly in the event of a counterparty default. Third, the broker-dealer financial responsibility requirements have existed for many years and have facilitated the prudent operation of broker-dealers.[977] Fourth, some broker-dealers likely will be registered as nonbank SBSDs so as to be able to offer customers a broader range of services than would be permitted as a stand-alone SBSD. Therefore, establishing consistent financial responsibility requirements would avoid potential competitive disparities between stand-alone SBSDs and broker-dealer SBSDs. And fifth, by placing an emphasis on maintaining liquid assets and requiring the segregation of customer funds, the current broker-dealer financial responsibility requirements have generally been successful in limiting losses to customers due to broker-dealer defaults.[978] Consequently, the current broker-dealer financial responsibility requirements provide a reasonable template for building a financial responsibility program for SBSDs and MSBSPs.

However, the Commission recognizes that there may be other appropriate

[964] *See* 17 CFR 240.15c3–1.

[965] *See* 17 CFR 240.15c3–1(a).

[966] *See* 17 CFR 240.15c3–1(c)(2). The computation of net capital is based on the definition of ''net capital'' in paragraph (c)(2) of Rule 15c3–1. *Id.*

[967] *See* 17 CFR 240.15c3–1(a).

[968] *See* 17 CFR 240.15c3–1(c)(2)(i)–(xiii).

[969] *See* 17 CFR 240.15c3–1(c)(15).

[970] *See* 17 CFR 240.15c3–1(c)(2)(vi).

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

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

[973] *See* 17 CFR 240.15c3–1(a)(5) and (a)(7).

[974] 17 CFR 240.15c3–1(a)(7)(i).

[975] 17 CFR 240.15c3–1(a)(7)(ii).

[976] 17 CFR 240.15c3–1(a).

[977] For example, one of the objectives of the broker-dealer financial responsibility requirements is to protect customers from the consequences of the financial failure of a broker-dealer in terms of safeguarding customer securities and funds held by the broker-dealer. In this regard, SIPC, since its inception in 1971, has initiated customer protection proceedings for only 324 broker-dealers, which is less than 1% of the approximately 39,200 broker-dealers that have been members of SIPC during that timeframe. During the same period, only $1.1 billion of the $117.5 billion of cash and securities distributed for accounts of customers came from the SIPC fund rather than debtors' estates. *See SIPC 2011 Annual Report.*

[978] For example, of the more than 625,200 claims satisfied in completed or substantially completed cases since SIPC's inception in 1971, as of December 31, 2011, a total of 351 were for cash and securities whose value was greater than the limits of protection afforded by SIPA. The 351 claims, unchanged during 2011, represent less than one-tenth of one percent of all claims satisfied. The unsatisfied portion of claims, $47.2 million, is unchanged in 2011. These remaining claims approximate three-tenths of one percent of the total value of securities and cash distributed for accounts of customers in those cases. *See SIPC 2011 Annual Report.* These figures do not include the SIPA liquidations of Bernard L. Madoff Investment Securities LLC and Lehman Brothers Inc., which are not complete.

approaches to establishing financial responsibility requirements—including, for example, requirements based on the Basel Standard in the case of entities that are part of a bank holding company, as has been proposed by the CFTC.[979] Generally, the bank capital model requires the holding of specified levels of capital as a percentage of ''risk weighted assets.'' [980] In general, it does not require a full capital deduction for unsecured receivables, given that banks, as lending entities, are in the business of extending credit to a range of counterparties.

This approach could promote a consistent view and management of capital within a bank holding company structure. However, it would not be a net liquid assets standard. In addition, applying capital rules designed for banks to a non-bank entity would raise various practical and policy issues that are not directly implicated by the proposed approach. First, it would need to be clear whether a regulator with primary responsibility for the non-bank entity would defer to bank regulators with respect to the interpretation of Basel standards as applied to the entity, or instead develop its own interpretation of those standards. Further, it would need to be clear how trading and other risks of the non-bank entity and its bank affiliate or affiliates would be expected to be managed, whether such risks would be managed holistically at the holding company level or separately at the entity level, and what limitations, if any, would apply to transfers of risks from a bank to its non-bank entity affiliate, or vice versa. In addition, to the extent that bank capital standards would permit the non-bank entity to hold more illiquid assets as regulatory capital, an additional liquidity standard might be required at the entity level in order to assure that the entity maintained sufficient liquidity to support its trading activity. Similarly, if the non-bank entity were an SBSD that held assets for customers, the impact of any reduced liquidity associated with the application of bank capital standards on the ability of the entity to quickly wind down operations and distribute assets to customers would need to be considered. The Commission specifically seeks comment as to whether to adapt Basel capital standards to non-bank affiliates of banks, and how such a regime would work in practice—including how it would address the issues described above and similar challenges.

The Commission also recognizes that in determining appropriate financial responsibility requirements—whether based on current broker-dealer rules or other alternative approaches described above—it must assess and consider a number of different costs and benefits, and the determinations it ultimately makes can have a variety of economic consequences for the relevant firms, markets, and the financial system as a whole. On the one hand, the capital and margin requirements in particular are broadly intended to work in tandem to strengthen the financial system by reducing the potential for default to an acceptable level and limiting the amount of leverage that can be employed by SBSDs and other market participants. Requiring particular firms to hold more capital or exchange more margin may reduce the risk of default by one or more market participants and reduce the amount of leverage employed in the system generally, which in turn may have a number of important benefits. The failure of an SBSD could result in immediate financial loss to its counterparties or customers, particularly those that are not able to avoid losses by liquidating collateral or those that have delivered assets for custody by the SBSD. Since the primary benefit of the capital and margin requirements is to reduce the probability of a SBSD failure, potential counterparties may be more willing to transact when they have greater assurance that they will be paid following a credit event. Depending on the size of the SBSD and its interconnectedness with other market participants, such a default also could have adverse spillover or contagion effects that could create instability for the financial markets more generally, such as limiting the willingness of healthy market participants to extend credit to each other, and thus substantially reduce liquidity and valuations for particular types of financial instruments.[981] Further, to the extent that market participants generally perceive that the prudential requirements are sufficient to protect them from losses due to a counterparty's default, the security-based swap market may experience increased trading activity, reduced transaction costs, improved liquidity, enhanced capital formation, and an improved ability to manage risk.

On the other hand, as described below, higher financial responsibility requirements for individual firms also give rise to direct costs for the firms involved and potentially significant collective costs for the markets and the financial system as a whole. For example, overly restrictive requirements that increase the cost of trading by individual firms could reduce their willingness to engage in such trading, adversely affecting liquidity in the security-based swaps markets and increasing transaction costs for market participants. Similarly, capital requirements that are set high enough to limit or restrict the willingness or ability of new firms to enter the market may impair or reduce competition in the markets, which in turn could also adversely affect liquidity and price discovery and increase transaction costs. Any such reduction in liquidity or price discovery, or increase in transaction costs, could adversely affect efficiency and impose direct costs on those market participants who rely on security-based swaps to manage or hedge the risks arising from their business activities that may support or promote capital formation. Even if the cost of overly restrictive financial responsibility requirements were shouldered only by those market participants that are subject to them, the excess amount of capital or margin tied up as a result of those requirements would not be available for potentially more efficient uses, which thereby could impair effective capital allocation and formation.

Although, in establishing appropriate financial responsibility requirements that are neither insufficient nor excessive, the Commission must seek to consider these and other potential benefits and costs, the Commission notes that it is difficult to quantify such benefits and costs. For example, although the adverse spillover effects of defaults on liquidity and valuations were evident during the financial crisis,[982] it is difficult to quantify the

[979] *CFTC Capital Proposing Release,* 76 FR 27802.

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

[981] *See, e.g.,* Markus K. Brunnermeier and Lasse Heje Pedersen, *Market Liquidity and Funding Liquidity, Review of Financial Studies,* 22 Review of Financial Studies 2201 (2009); Denis Gromb and Dimitri Vayanos, *A Model of Financial Market Liquidity Based on Intermediary Capital,* 8 Journal of the European Economic Association 456 (2010).

[982] *See* aggregate derivatives claims on Lehman Brothers Special Finance initially filed by the top 30 financial institution counterparties was estimated to be approximately $22 billion, available at *http://chapter11.epiqsystems.com/LBH/document/GetDocument.aspx?DocumentId=1386611* and

effects of measures intended to reduce the default probability of the individual intermediary, the ensuing prevention of contagion, and the adverse effects on liquidity and valuation. More broadly, it is difficult to quantify the costs and benefits that may be associated with steps to mitigate or avoid a future financial crisis. Similarly, although capital, margin, or segregation requirements may, among other things, affect liquidity and transaction costs in the security-based swap markets, and result in a different allocation of capital than may otherwise occur, it is difficult to quantify the extent of these effects, or the resulting effect on the financial system more generally.

These difficulties are further aggravated by the fact that only limited public data related to the security-based swap market, in general, and to security-based swap market participants in particular, exist, all of which could assist in quantifying certain benefits and costs. It also is difficult to demonstrate empirically that the customer protections associated with the proposed financial responsibility requirements would alter the likelihood that any specific market participant would suffer injury, or the degree to which the participant would suffer injury, from participating in an under- or over-regulated security-based swap market.

In light of these challenges, much of the discussion of the proposed rules in this economic analysis will remain qualitative in nature, although where possible the economic analysis attempts to quantify these benefits and costs. The inability to quantify these benefits and costs, however, does not mean that the benefits and costs of the proposals are any less significant. In addition, as noted above, the proposed rules include a number of specific quantitative requirements—such as numerical thresholds, limits, deductions and ratios. The Commission recognizes that the specificity of each such quantitative requirement could be read by some to imply a definitive conclusion based on quantitative analysis of that requirement and its alternatives. These quantitative requirements have not been derived directly from econometric or mathematical models. Instead, they reflect a preliminary assessment by the Commission, based on qualitative analysis, regarding the appropriate financial standard for an identified issue, drawing (as noted above) from the Commission's long-term experience in administering its existing broker-dealer financial responsibility regime as well as its general experience in regulating broker-dealers and markets and from comparable quantitative requirements in its own rules and those of other regulators. Accordingly, the discussion generally describes in a qualitative way the primary costs, benefits and other economic effects that the Commission has identified and taken into account in developing these specific quantitative requirements. The Commission emphasizes that it invites comment, including relevant data and analysis, regarding all aspects of the various quantitative requirements reflected in the proposed rules.

Finally, the Commission notes that the proposals ultimately adopted, like other requirements under the Dodd-Frank Act, could have a substantial impact on international commerce and the relative competitive position of intermediaries operating in various, or multiple, jurisdictions. U.S. or foreign firms could be advantaged or disadvantaged depending on how the rules ultimately adopted by the Commission compare with corresponding requirements in other jurisdictions. Such differences could in turn affect cross-border capital flows and the ability of global firms to most efficiently allocate capital among legal entities to meet the demands of their counterparties. The Commission intends to address the potential international implications of the proposed capital, margin and segregation requirements, together with the full spectrum of other issues relating to the application of Title VII to cross-border security-based swap transactions, in a separate proposal.

a. Nonbank SBSDs

In addition to fulfilling a statutory requirement, it is expected that the proposed capital, margin and segregation rules should be beneficial to market participants by advancing market transparency, risk reduction and counterparty protection as Title VII of the Dodd-Frank Act intended.[983] It can be further expected that these benefits manifest themselves over the long-term and benefit the market as a whole. To the extent that the proposed rules increase the safety and soundness of entities that register as nonbank SBSDs and not just codify current practice, the proposals should specifically reduce the likelihood of default by an intermediary with substantial positions in security-based swaps and possible negative spillover effects. This would further imply that without the proposed rules in place, such an event could result in significant losses to counterparties whose exposures to the defaulting dealer are not sufficiently secured, which, depending on the size of individual counterparty exposures, could lead to defaults of those counterparties. Such events could then deter intermediaries from entering into financing transactions,[984] even with creditworthy counterparties, which could ultimately adversely affect valuation and liquidity in the broader financial markets.[985]

Apart from the positive impact on the safety and soundness of the security-based swap market, the proposed new rules and rule amendments could create the potential for regulatory arbitrage to the extent that they differ from corresponding rules other regulators adopt. As noted above in section I. of this release, the Commission is proposing capital and margin requirements for nonbank SBSDs that differ in some respects from the prudential regulators' proposed capital and margin requirements for bank SBSDs.[986] Depending on the final rules the Commission adopts, the financial responsibility requirements could make it more or less costly to conduct security-based swaps trading in banks as compared to nonbank SBSDs. For example, if the application of the proposed 8% margin risk factor substantially increases capital requirements for nonbank SBSDs compared to the risk-based capital requirements imposed by the prudential regulators on the same activity, bank holding companies could be incentivized to conduct these activities in their bank affiliates.[987] On the other hand, if the Commission does not require nonbank SBSDs to collect initial margin in their transactions with each other, as is generally current market practice,[988] while the prudential regulators require the collection of initial margin for the same trades as their proposed rules suggest, intermediaries could have an incentive

http://chapter11.epiqsystems.com/LBH/document/GetDocument.aspx?DocumentId=1430484.

[983] *See* section I. of this release.

[984] *See, e.g.,* Markus K. Brunnermeier and Lasse Heje Pedersen, *Market Liquidity and Funding Liquidity, Review of Financial Studies* at 22; Denis Gromb and Dimitri Vayanos, *A Model of Financial Market Liquidity Based on Intermediary Capital* at 8.

[985] *See* aggregate derivatives claims on Lehman Brothers Special Finance initially filed by the top 30 financial institution counterparties was estimated to be approximately $22 billion, available at *http://chapter11.epiqsystems.com/LBH/document/GetDocument.aspx?DocumentId=1386611* and *http://chapter11.epiqsystems.com/LBH/document/GetDocument.aspx?DocumentId=1430484.*

[986] *See* section I. of this release.

[987] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564.

[988] *See generally ISDA Margin Survey 2011.*

to conduct business through nonbank entities.[989] These differences could create competitive inequalities and affect the allocation of trading activities within a holding company structure.

The proposed financial responsibility requirements for SBSDs would also result in costs to individual market participants and may affect the amount of capital available to support security-based swap transactions generally.[990] As described in section V.B.1 immediately above, if SBSDs are required to maintain an excessive amount of capital, that amount may result in certain costs for the markets and the financial system, including the potential for the reduced availability of security-based swaps for market participants who would otherwise use such transactions to hedge the risks of their business, or engage in other activities that would promote capital formation. In addition, in some cases, these costs may include costs to financial conglomerates to restructure their security-based swap activities or move them into affiliates that register as SBSDs.[991] Nonbank SBSDs as well as other market participants would also incur costs to hire compliance personnel and to establish internal systems, procedures and controls designed to ensure compliance with the new requirements. Some of these costs were discussed in the PRA analysis in section IV of this release. Finally, the full cost impact of the proposed financial responsibility requirements will depend to some extent on other rules related to SBSDs (*e.g.,* registration) that the Commission has not yet adopted.[992]

Costs related to specific sections of the proposed new rules and rule amendments are discussed below. Some of these costs may be largely fixed in nature; other costs (such as minimum capital requirements and margin costs) may be variable as they reflect the level of the nonbank SBSD's security-based swap activity. End users also may incur increased transaction costs in connection with the proposals as SBSDs are likely to pass on the financial burden of any increased capital, margin or segregation requirements to customers.[993]

This economic analysis considers the overall benefits and costs of the proposed new rules and amendments, keeping in mind that the benefits may be distributed across market participants, accrue over the long-term, and are difficult to quantify or to measure as easily as certain costs.

Request for Comment

The Commission generally requests comment about its analysis of the general costs and benefits of the proposed rules. The Commission requests data to quantify and estimates of the costs and the value of the benefits of the proposals described above. The Commission also requests data to quantify the impact of the proposals against the baseline. In addition, the Commission requests comment in response to the following questions:

1. In general terms, how effectively would the proposed rules limit systemic risk arising from security-based swap transactions? Please explain.

2. In general, how would the proposed rules and rule amendments impact the capital of entities that would need to register as nonbank SBSDs? For example, would they require these entities to hold more capital? If so, what would be the impact of the availability of sources of funding to these entities?

3. How important is parity of treatment between nonbank SBSDs and bank SBSDs in terms of regulatory requirements, and how should parity be understood? For example, should nonbank SBSDs and bank SBSDs be required to hold the same amounts of capital to support a certain level of security-based swaps business?

4. To what extent would the proposed regulatory requirements impact the amount of liquidity provided for or required by security-based swap market participants, and to what extent will that affect the funding cost for the financial sector in particular and the economy in general? Please quantify.

b. Nonbank MSBSPs

As with their application to nonbank SBSDs, in addition to fulfilling a statutory requirement, it is expected that the proposed capital, margin and notification requirements under the segregation rules for MSBSPs will advance market transparency, risk reduction and counterparty protection as Title VII of the Dodd-Frank Act intended.[994] However, in contrast to capital and margin requirements for nonbank SBSDs, the proposed rules for nonbank MSBSPs are intended to limit the impact on counterparties of a potential default by a nonbank MSBSP, rather than to create prudential standards that would render the possibility of its failure more remote. Capital standards of the type that would apply to SBSDs[995] may not be practical for nonbank MSBSPs, depending on their individual business models and whether they are subject to any other prudential requirements. Accordingly, the proposals are intended to ensure that nonbank MSBSPs meet a minimum capital standard by maintaining a positive tangible net worth,[996] collateralize their current exposures to end users, and post collateral to counterparties that covers at least the amount of the current exposure of those counterparties to them.[997]

These proposed requirements are expected to have a relatively smaller aggregate effect than the proposed financial responsibility requirements for nonbank SBSDs because they are likely to affect relatively fewer entities. The Commission expects that only 5 or fewer entities will register as nonbank MSBSPs with the Commission.[998] Another approach, discussed further below, would subject MSBSPs to a capital regime similar to that proposed for nonbank SBSDs.

The proposed financial responsibility requirements for MSBSPs would also result in costs to individual market participants and may affect the amount of capital available to support security-based swap transactions overall and the financial markets generally. To the extent that the proposed capital and margin requirements are too restrictive, it could limit capital formation and the use of security-based swaps to hedge risks associated with the MSBSP's business activities.[999]

The proposed requirements may also impose more limited compliance burdens on MSBSPs. For example, nonbank MSBSPs as well as other market participants would also incur costs to hire compliance personnel and to establish internal systems, procedures and controls designed to ensure compliance with the new requirements.[1000] Some of these costs are discussed in the PRA analysis in section IV. of this release. Finally, the full cost impact of the proposed financial responsibility requirements will depend to some extent on other rules related to MSBSPs (*e.g.,* registration) that the Commission has not yet adopted.[1001]

[989] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564.

[990] *See* section II. of this release.

[991] *See SBSD Registration Proposing Release,* 76 FR 65784.

[992] *Id.*

[993] If the rules succeed in improving competition among dealers in the security-based swap market rules this pass-through behavior should be less of a concern.

[994] *See* section I. of this release.

[995] *See* proposed new Rule 18a–1.

[996] *See* proposed new Rule 18a–2.

[997] *See* proposed new Rule 18a–3.

[998] *See* section IV.C. of this release.

[999] *See* section II. of this release.

[1000] *See* section V.C. of this release.

[1001] *See SBSD Registration Proposing Release,* 76 FR 65784.

Costs related to specific sections of the proposed new rules and rule amendments are discussed below. Some of these costs may be largely fixed in nature; other costs (such as minimum capital requirements and margin costs) may be variable as they reflect the level of the nonbank MSBSP's security-based swap activity.

Request for Comment

The Commission generally requests comment about its analysis of the general costs and benefits of the proposed rules on MSBSPs. The Commission requests data to quantify and estimates of the costs and the value of the benefits of the proposals for MSBSPs described above.

2. The Proposed Capital Rules

a. Nonbank SBSDs and ANC Broker-Dealers

As discussed above in section II.A. of this release, proposed new Rule 18a–1 would prescribe capital requirements for stand-alone SBSDs, and proposed amendments to Rule 15c3–1 would prescribe capital requirements for broker-dealer SBSDs and increase existing capital requirements for ANC broker-dealers.[1002] The proposed amendments to Rule 15c3–1 would apply to broker-dealers that are not registered as SBSDs to the extent they hold positions in security-based swaps and swaps. In addition, the Commission is proposing liquidity requirements for ANC broker-dealers and stand-alone SBSDs that use internal models to compute net capital.[1003] Finally, the Commission is proposing to require that all nonbank SBSDs comply with Rule 15c3–4, which requires the establishment of a risk management control system.[1004]

As described above, the capital and other financial responsibility requirements for broker-dealers generally provide a reasonable template for crafting the corresponding requirements for nonbank SBSDs. For example, among other considerations, the objectives of capital standards for both types of entities are similar. Rule 15c3–1 is a net liquid assets test that is designed to require a broker-dealer to maintain sufficient liquid assets to meet all obligations to customers and counterparties and have adequate additional resources to wind-down its business in an orderly manner without the need for a formal proceeding if it fails financially. The objective of the proposed capital standards for nonbank SBSDs is the same.

In addition, as discussed in section II.A.1. above, the Dodd-Frank Act divided responsibility for SBSDs and MSBSPs by providing the prudential regulators with authority to prescribe the capital and margin requirements for bank SBSDs and the Commission with authority to prescribe capital and margin requirements for nonbank SBSDs.[1005] This division also suggests it may be appropriate to model the capital requirements for nonbank SBSDs on the capital standards for broker-dealers, while the capital requirements for bank SBSDs are modeled on capital standards for banks (as reflected in the proposal by the prudential regulators).[1006]

As discussed in section II.A.1. above, certain differences in the activities of securities firms, banks, and commodities firms, differences in the products at issue, or the balancing of relevant policy choices and considerations, appear to support this distinction between nonbank SBSDs and bank SBSDs. First, based on the Commission staff's understanding of the activities of nonbank dealers in OTC derivatives, nonbank SBSDs are expected to engage in a securities business with respect to security-based swaps that is more similar to the dealer activities of broker-dealers than to the activities of banks; indeed, some broker-dealers likely will be registered as nonbank SBSDs.[1007] Second, existing capital standards for banks and broker-dealers reflect, in part, differences in their funding models and access to certain types of financial support, and those same differences also will exist between bank SBSDs and nonbank SBSDs. For example, banks obtain funding through customer deposits and can obtain liquidity through the Federal Reserve's discount window; whereas broker-dealers do not—and nonbank SBSDs will not—have access to these sources of funding and liquidity. Third, Rule 15c3–1 currently contains provisions designed to address dealing in OTC derivatives by broker-dealers and, therefore, to some extent already can accommodate this type of activity (although, as discussed below, proposed amendments to Rule 15c3–1 would be designed to more specifically address the risks of security-based swaps and the potential for increased involvement of broker-dealers in the security-based swaps markets).[1008] For these reasons, the proposed capital standard for nonbank SBSDs is a net liquid assets test modeled on the broker-dealer capital standard in Rule 15c3–1.

The net liquid assets test is designed to allow a broker-dealer to engage in activities that are part of conducting a securities business (*e.g.,* taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (*e.g.,* money owed to customers, counterparties, and creditors). For example, Rule 15c3–1 allows securities positions to count as allowable net capital, subject to standardized or internal model-based haircuts.[1009] The rule, however, does not permit most unsecured receivables to count as allowable net capital.[1010]

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

Proposed new Rule 18a–1 and the proposed amendments to Rule 15c3–1 would provide a number of benefits, as well as impose certain costs on nonbank SBSDs, broker-dealer SBSDs, and broker-dealers, which are described below. In considering costs, in cases where the Commission is proposing amendments to Rule 15c3–1, the baseline is the current broker-dealer capital regime under Rule 15c3–1.[1011] The proposed rule also will have possible effects on competition, efficiency, and capital formation, which will be discussed further below.

[1002] *See* proposed new Rule 18a–1.

[1003] *See* proposed paragraph (f) to Rule 15c3–1; paragraph (f) of proposed new Rule 18a–1.

[1004] *See* proposed new paragraph (a)(10)(ii) of Rule 15c3–1; paragraph (g) of proposed new Rule 18a–1. *See also* 17 CFR 240.15c3–4.

[1005] *See* 15 U.S.C. 78o–10, in general; 15 U.S.C. 78o–10(e)(2)(A)–(B), in particular.

[1006] The prudential regulators have proposed capital requirements for bank SBSDs and bank swap dealers that are based on the capital requirements for banks. *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27582.

[1007] *Id.*

[1008] *See* 17 CFR 240.15c3–1f and 17 CFR 240.15c3–1e. *See also Alternative Net Capital Requirements Adopting Release,* 69 FR 34428; *OTC Derivatives Dealers,* 63 FR 59362.

[1009] *See* 17 CFR 240.15c3–1(c)(2)(vi); 17 CFR 240.15c3–1e; 17 CFR 240.15c3–1f.

[1010] *See* 17 CFR 240.15c3–1(c)(2)(iv).

[1011] 17 CFR 240.15c3–1.

i. Minimum Capital Requirements

The following table provides a summary of the proposed minimum capital requirements under the proposed new Rule 18a–1 and proposed amendments to Rule 15c3–1:

Proposed Minimum Capital Requirements

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

Stand-alone SBSDs and broker-dealer SBSDs that are not approved to use internal models, that is, are neither ANC broker-dealers nor OTC derivatives dealers, would be required to maintain net capital of the larger of $20 million or 8% of the firm's margin factor. The proposed $20 million fixed-dollar minimum requirement would be consistent with the fixed-dollar minimum requirement applicable to OTC derivatives dealers and already familiar to existing market participants.[1012] OTC derivatives dealers are limited purpose broker-dealers that are authorized to trade in certain derivatives, including security-based swaps, use internal models to calculate net capital, and they are required to maintain minimum tentative net capital of $100 million and minimum net capital of $20 million.[1013] These current fixed-dollar minimums have been the minimum capital standards for OTC derivative dealers for over a decade and to date, there have been no indications that these minimums are not adequately meeting the objective of requiring OTC derivatives dealers to maintain sufficient levels of regulatory capital to account for the risks inherent in their activities.

However, the proposed $20 million fixed-dollar minimum requirement for stand-alone SBSDs not using internal models to calculate net capital would be substantially higher than the fixed-dollar minimums in Rule 15c3–1 currently applicable to broker-dealers that do not use internal models.[1014] The proposed more stringent minimum capital requirement of $20 million for stand-alone SBSDs not approved to use models reflects the facts that these firms: (1) Unlike broker-dealers, will be able to deal in security-based swaps, which, in general, pose risks that are different from, and in some respects greater than, those arising from dealing in securities; but (2) unlike OTC derivative dealers have direct customer relationships and have custody of customer funds.[1015] Therefore, without the increased requirements, a failure of a stand-alone SBSD would, ceteris paribus, be more likely than a failure of an OTC derivatives dealer and, as a consequence of the relationships with customers, would have a broader adverse impact on a larger number of market participants, including customers and counterparties.[1016] Consequently, these heightened requirements should enhance the safety and soundness of the nonbank SBSDs, and thereby reduce systemic risk, as well as increase market participants' confidence in the security-based swap markets. Stand-alone SBSDs not approved to use internal models would not, however, be subject to a minimum tentative net capital requirement, which is applied to only firms that use internal models to account for risks not fully captured by the models.[1017]

Stand-alone SBSDs using models would be required to maintain minimum net capital of the higher of $20 million or the 8% margin factor, as well as a minimum tentative net capital of $100 million, a requirement that also applies to OTC derivatives dealers. Models to calculate deductions from tentative net capital for proprietary positions take only market and credit risk into account and therefore generally lead to lower deductions and higher levels of net capital.[1018] The minimum

[1012] *See* 17 CFR 240.15c3–1(a)(5). The CFTC proposed a $20 million fixed-dollar minimum net capital requirement for FCMs that are registered as swap dealers, regardless of whether the firm is approved to use internal models to compute regulatory capital. *See CFTC Capital Proposing Release,* 76 FR 27802. Further, the CFTC proposed a $20 million fixed-dollar ''tangible net equity'' minimum requirement for swap dealers and major swap participants that are not FCMs *and are not* affiliated with a U.S. bank holding company. Finally, the CFTC proposed a $20 million fixed-dollar Tier 1 capital minimum requirement for swap dealers and major swap participants that are not FCMs *and are* affiliated with a U.S. bank holding company (the term ''Tier 1 capital'' refers to the regulatory capital requirement for U.S. banking institutions). *Id.*

[1013] *See* 17 CFR 240.15c3–1(a)(5).

[1014] For example, a broker-dealer that carries customer accounts has a fixed-dollar minimum requirement of $250,000; a broker-dealer that does not carry customer accounts but engages in proprietary securities trading (defined as more than ten trades a year) has a fixed-dollar minimum requirement of $100,000; and a broker-dealer that does not carry accounts for customers or otherwise receive or hold securities and cash for customers, and does not engage in proprietary trading activities, has a fixed-dollar minimum requirement of $5,000. *See* 17 CFR 240.15c3–1(a)(2).

[1015] *See* 17 CFR 240.3b–12; 17 CFR 240.15a–1.

[1016] The proposal is consistent with the CFTC's proposed capital requirements for nonbank swap dealers, which impose $20 million fixed-dollar minimum requirements regardless of whether the firm is approved to use internal models to compute regulatory capital. *See CFTC Capital Proposing Release,* 76 FR 27802.

[1017] OTC derivatives dealers are subject to a $100 million minimum tentative net capital requirement. ANC broker-dealers are currently subject to a $1 billion minimum tentative net capital requirement. The minimum tentative net capital requirements are designed to address risks that may not be captured when using internal models rather than standardized haircuts to compute net capital. *See OTC Derivatives Dealers,* 63 FR at 59384; *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities; Proposed Rule,* Exchange Act Release No. 48690 (Oct. 24, 2003), 68 FR 62872, 62875 (Nov. 6, 2003).

[1018] *See, e.g., Alternative Net Capital Requirements Adopting Release,* 69 FR at 34455 (describing benefits of alternative net capital requirements for broker-dealers using models stating a ''major benefit for the broker-dealer will be lower deductions from net capital for market and credit risk that we expect will result from the use of the alternative method.''). Therefore, it is likely

tentative net capital requirement for firms using models is intended to provide an additional assurance of adequate capital to reflect this concern.

However, because the tentative net capital calculation does not take account of market risk deductions, the minimum $100 million tentative net capital requirement might be a less effective standard in cases where a dealer maintains a substantial amount of less liquid positions that require relatively large deductions for market risk. As an alternative, the Commission could impose a minimum requirement that increases according to the nature and size of the positions held, for example, 25% of the market risk deductions that are required to be taken in determining actual net capital. This approach could better scale the tentative net capital requirement according to the risk of the proprietary positions held by an SBSD. On the other hand, a variable tentative net capital test would not serve as an accurate measure of risk if the model did not appropriately capture all material risks of the positions or the assumptions underlying the use of the model were no longer appropriate. The variable tentative net capital test also could increase the tentative net capital requirement in some cases to a level that could limit or discourage the entry of firms that do not presently compete in the security-based swap markets. Further, as noted above, the minimum net capital requirement in each case would increase in accordance with an increase in the amount of business conducted as a result of the 8% margin factor. The Commission is specifically seeking comment on this alternative in section II.A.1. of this release.

Under the proposed amendments to Rule 15c3–1, ANC broker-dealers would be required to maintain: (1) Tentative net capital of not less than $5 billion; and (2) net capital of not less than the greater of $1 billion or the financial ratio amount required pursuant to paragraph (a)(1) of Rule 15c3–1 *plus* the 8% margin factor.[1019] These relatively high minimum capital requirements for ANC dealers (as compared with the requirements for other types of broker-dealers) reflect the substantial and diverse range of business activities engaged in by ANC broker-dealers and their importance as intermediaries in the securities markets.[1020] Further, the heightened capital requirements reflect the fact that, as noted above, VaR models are more risk sensitive but also generally permit substantially reduced deductions to tentative net capital as compared to the standardized haircuts as well as the fact that VaR models may not capture all risks.[1021]

Based on financial information reported by the ANC broker-dealers in their monthly FOCUS Reports filed with the Commission, the six current ANC broker-dealers maintain capital levels in excess of these proposed increased minimum requirements. For example, at the end of 2011, the interquartile range of net capital and tentative net capital levels among the six ANC broker-dealers were from $1.11 billion to $7.77 billion and from $1.32 billion to $9.69 billion, respectively. Further, ANC broker-dealers are currently required to notify the Commission if their tentative net capital falls below $5 billion.[1022] This notification provision is used by the Commission to trigger increased supervision of the firm's operations and to take any necessary corrective action and is similar to corollary ''early warning'' requirements for OTC derivatives dealers.[1023] Consequently, this $5 billion ''early warning'' level currently acts as the de facto minimum tentative net capital requirement since the ANC broker-dealers seek to avoid providing this regulatory notice that their tentative net capital has fallen below the early warning level.[1024]

Although increases to minimum tentative and minimum net capital requirements are being proposed, the proposals may not present a material cost to the current ANC broker-dealers, because they already hold more than the proposed minimum requirements in the amendments to Rule 15c3–1. The more relevant number is the proposed increase in the early warning notification threshold from $5 billion to $6 billion. The existing early warning requirement for OTC derivatives dealers triggers a notice when the firm's tentative net capital falls below an amount that is 120% of the firm's required minimum tentative net capital amount of $100 million ($120 million = 1.2 × $100 million).[1025] The proposed new ''early warning'' threshold for ANC broker-dealers of $6 billion (= 1.2 × $5 billion) in tentative net capital is modeled on this requirement. In general, because the amount of actual net capital is subject to volatility commensurate with market volatility in proprietary instruments, the Commission expects ANC broker-dealers to maintain a reasonable cushion in excess of the minimum. Since, based on the Commission staff's supervision of the ANC broker-dealers, the current ANC broker-dealers report tentative net capital levels generally well in excess of $6 billion, the costs to the ANC broker-dealers to comply with this new requirement are not expected to be material.[1026] However, these costs may be prohibitive to new entrants that wish to register as broker-dealer SBSDs using internal models if they currently do not, or cannot, maintain these proposed capital levels. As noted below, such barriers to entry may prevent or reduce competition among SBSDs, which in turn can lead to higher transaction costs and less liquidity than would otherwise exist.

In addition to the proposed minimum fixed tentative and minimum net capital requirements, the proposed 8% margin factor would be part of determining a nonbank SBSD's minimum net capital requirement.[1027] The 8% margin factor is intended to establish a minimum capital requirement that scales with the level of a nonbank SBSD's security-based swap activity and to limit the amount of leverage a nonbank SBSD can employ by requiring an increase in capital commensurate with the amount of leverage extended.

The 8% margin factor ratio requirement also is similar to an existing requirement in the CFTC's net capital rule for FCMs,[1028] and the CFTC has proposed a similar requirement for swap dealers and major swap participants registered as FCMs.[1029]

that for new entrants to capture substantial volume in security-based swaps they will need to use VaR models. *See also OTC Derivatives Dealer Release,* 63 FR 59362 (discussing benefits of minimum capital requirements as an additional measure of protection).

[1019] *See* proposed amendments to paragraph (a)(7)(i) of Rule 15c3–1.

[1020] As noted above, the six ANC broker-dealers collectively hold in excess of one trillion dollars' worth of customer securities.

[1021] *See Alternative Net Capital Requirements Adopting Release,* 69 FR 34428.

[1022] 17 CFR 240.15c3–1(a)(ii).

[1023] OTC derivatives dealers are required to provide notification promptly (but within 24 hours) if their tentative net capital falls below 120% of the firm's required minimum tentative net capital amount. *See* 17 CFR 240.17a–11(c)(3). Rule 17a–11 also requires ANC broker-dealers and OTC derivatives dealers to provide same day notification if their tentative net capital falls below required minimums. *See* 17 CFR 240.17a–11(b)(2).

[1024] *See* 17 CFR 240.15c3–1(a)(7)(i).

[1025] *See* 17 CFR 240.17a–11(c)(3).

[1026] *Id.*

[1027] Since the 8% margin factor would be additive to the minimum capital requirements for ANC broker-dealers conducting a security-based swap business, the cost impact to an ANC broker-dealer using its current minimum capital requirements under Rule 15c3–1 and 15c3–1e as a baseline, would at minimum, increase by the 8% margin factor.

[1028] *See* 17 CFR 1.17(a)(1)(i)(B).

[1029] *See CFTC Capital Proposing Release,* 76 FR 27802. The 8% calculation under the CFTC's proposal relates to cleared swaps or futures transactions, whereas the 8% margin factor

Continued

Under the CFTC's proposal, an FCM would be required to maintain adjusted net capital [1030] that is equal to or greater than 8% of the risk margin required for customer and non-customer exchange-traded futures and swaps positions that are cleared by a DCO.[1031] Because exchange-traded futures, however, are generally more liquid and give rise to lower margins than non-cleared security-based swaps with the same notional amount, the proposed 8% margin factor (which includes margin for both cleared and non-cleared swaps) would require allocating substantially more capital to support a non-cleared security-based swap contract compared to a futures contract. Requiring such additional capital could impose the types of costs on these firms and the markets more generally that are described above in section V.B.1. of this release. On the other hand, applying the 8% margin factor to non-cleared security-based swaps (rather than just cleared security-based swaps) would permit the nonbank SBSD's minimum capital requirement to vary based on this aspect of its business, which can entail similar leverage and present greater credit risk than cleared security-based swaps. This would have the benefit of further promoting the goals of the financial responsibility rules described above in section V.B.1. of this release.

Based on FOCUS Report information as of year-end 2011, approximately ten broker-dealers, including the current ANC broker-dealers, maintain tentative net capital in excess of $5 billion,[1032] approximately 31 broker-dealers maintain net capital in excess of $1 billion, approximately 145 broker-dealers maintain tentative net capital in excess of $100 million, and approximately 270 broker-dealers maintain net capital in excess of $20 million.

Although the proposed increase in minimum capital and early warning requirements for ANC broker-dealers will not affect firms that already have this classification, it would reduce the number of additional firms (from 31 to 4, according to FOCUS Report data) that would currently qualify for this designation and hence represents a significant potential cost for additional registrants. As noted above, these costs may be prohibitive to new entrants that wish to register as ANC broker-dealer SBSDs using internal models. If these additional costs were not imposed or were lower, there might be greater opportunities for more competition in the security-based swap markets, which in turn could lower transaction costs and increase liquidity in these markets. However, setting capital levels that allow new entrants that do not have sufficient capital to engage in the diverse business of ANC broker dealers could be disruptive to the market. In addition, to the extent that potential new entrants are able to operate effectively in these markets as stand-alone SBSDs (i.e., swap dealers that are not registered as broker-dealers), they would be eligible for lower minimum capital requirements and competition could further increase without compromising the heightened requirements for ANC broker-dealers.

With respect to the derivatives markets in particular, it is difficult to quantify the impact of the proposed capital requirements against the baseline of the OTC derivatives markets as they exist today because prior to the adoption of Title VII, swaps and security-based swaps were by and large unregulated.[1033] As discussed above in section V.A. of this release, however, most trading in security-based swaps and other derivatives is currently conducted by large banks and their affiliates. Among these entities are the current ANC broker-dealers. Other broker-dealers affiliated with firms presently conducting business in security-based swaps may be among the 270 broker-dealers that maintain net capital in excess of $20 million. Consequently, broker-dealers presently trading in security-based swaps may not need to raise significant new amounts of capital in order to register as nonbank SBSDs. At the same time, the proposed minimum capital requirements could discourage entry by entities other than the approximately 270 broker-dealers that already have capital in excess of the required minimums.

As discussed above in section II.A.1. of this release, the Commission is seeking comment on possible modifications to the capital requirements in ways that may lessen potential compliance costs. First, to the extent that a nonbank SBSD that is approved to use models may be required to register as a broker-dealer solely to conduct certain brokerage activity, *e.g.,* sending customer orders for execution to a security-based swap execution facility, the Commission could modify the capital requirements by setting lower minimum capital requirements for such firms than apply to ANC broker-dealers. Further, the requirements for OTC derivatives dealers could be amended to allow these firms to conduct a broader range of activities. This modification could increase the ability of firms that are not capitalized at minimum capital requirements proposed for the ANC firms to use models and compete for business in security-based swaps.

The Commission also could consider modifications that would increase the flexibility for a broader group of firms to conduct a derivatives business that extends beyond security-based swaps. For example, the Commission could determine to allow a firm to register jointly as an OTC derivatives dealer and SBSD. This modification could allow the registrant to conduct a broader range of derivatives activities than dealing only in security-based swaps, and to be able to use internal models for capital purposes without being subject to much higher capital requirements that apply to ANC broker-dealers. On the other hand, there could be practical difficulties in merging the registration regimes. For example, because OTC derivatives dealers are prohibited from having custody of customers' assets, while nonbank SBSDs would be

proposed in new Rule 18a–1 would be based on cleared and non-cleared security-based swaps.

[1030] The CFTC has proposed that swap dealers and major swap participants that are also FCMs would be required to meet the existing FCM requirement to hold minimum levels of adjusted net capital, and also would be required to calculate the required minimum level as the greatest of the following: (1) A fixed dollar amount which under the CFTC's proposed rules would be $20 million; (2) the amount required for FCMs that also act as retail foreign exchange dealers; (3) 8% of the proposed risk margin; (4) the amount required by a registered futures association of which the FCM is a member; or (4) for an FCM, that is also a broker-dealer, the amount required by Commission rules. *See CFTC Capital Proposing Release,* 76 FR 27802.

[1031] *See CFTC Capital Proposing Release,* 76 FR 27802. The CFTC's proposed 8% margin requirement is intended to establish a minimum capital requirement that corresponds to the level of risk arising from the FCM's swap activity. *Id.* at 27807. One commenter objected to the inclusion of the 8% test in the CFTC's capital proposal, noting that margin and capital are complementary concepts in that both incorporate counterparty risk, and accordingly, the higher the initial margin requirement for a particular swap, the less regulatory capital a swap dealer should need to carry the client's position. The commenter believed that the CFTC's 8% charge would lead to allocations of dealer and client funding and capital to client portfolios in amounts disproportionately large in comparison to the risks of the relevant transactions. This commenter recommended to the CFTC that the CFTC defer incorporating swaps into the 8% margin multiplier for capital until after margin and capital requirements are finalized and the CFTC and market participants have had an opportunity to evaluate margin levels and the interrelationship between swap margin and capital. Letter from John M. Damgard, President, Futures Industry Association, Robert G. Pickel, Chief Executive Officer, ISDA and Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, to the CFTC (July 7, 2011) (*''FIA/ISDA/SIFMA Comment Letter to the CFTC''*).

[1032] These 10 broker-dealers also maintain tentative net capital in excess of $6.0 billion based on FOCUS Report information as of year-end 2011.

[1033] *See Product Definitions Adopting Release,* 77 FR 48207.

permitted to do so, subject to compliance with new Rule 18a–4, dual registrants could be required to maintain separate sets of compliance processes and procedures, based on product type.

Alternatively, the Commission could provide conditional relief on a case-by-case basis to allow a firm that is registered as an SBSD to conduct dealing activity in derivatives other than security-based swaps. This also could provide a means for an entity to do business in a broad set of derivative instruments, subject to the basic capital standards that would apply to SBSDs. This approach also could allow the Commission to fashion exemptive relief on a case-by-case basis, pending further consideration of how and whether to reconcile the SBSD and OTC derivatives dealer regimes. On the other hand, allowing SBSDs to deal in products that OTC derivatives dealers can deal in, without the restrictions that apply to their activities, could undermine the purpose for the restrictions. The Commission is specifically soliciting comment on these potential approaches above in section II.A.1.

ii. Standardized Haircuts

As discussed in section II.A.2.b.ii. of this release, under proposed new Rule 18a–1 and the amendments to Rule 15c3–1, a nonbank SBSD would be required to apply standardized haircuts to its proprietary positions, unless the Commission approved it to use internal models for specific positions. In general, all haircut regimes are intended to be conservative estimates of risk as they tend to overcompensate for the actual risks and hence generally impose higher costs in terms of capital compared to VaR models.[1034]

As discussed in section II.A.2.b.ii. of this release, for positions that are not security-based swaps, broker-dealer SBSDs and stand-alone SBSDs also would be required to apply the standardized haircuts currently set forth in Rule 15c3–1.[1035] Standardized ''haircuts'' for credit default swaps would be based on a maturity grid approach. Modeled after similar ''haircut'' approaches currently employed under Rule 15c3–1, the proposed approach for credit default swaps is designed to be more risk-sensitive than a haircut approach that determines market deductions based on the type of each position without recognizing offsets among securities with similar risk characteristics (the proposed rules also permit firms to reduce the required haircut for certain netted positions). The number of maturity and spread categories in the proposed grid for credit default swaps is based on staff experience with the maturity grids for other securities in Rule 15c3–1 and, in part, on FINRA Rule 4240.[1036] While the haircut grid design takes into account that positions in credit defaults swaps with larger spreads or longer tenors are riskier and hence should be supported by larger haircuts, the Commission is specifically seeking comment on the design of the grid and particularly whether the haircuts appropriately reflect the risk inherent in long and short positions of credit defaults swaps across the spread and tenor spectrum.

Security-based swaps that are not credit default swaps can be divided into two broad categories: Those that reference equity securities and those that reference debt instruments. Since each type of security-based swap can be viewed as being equivalent to a highly-levered synthetic position in the referenced instrument and therefore has the same price volatility as the referenced instrument, the standardized haircut for these categories of security-based swaps would be the deduction currently prescribed in Rule 15c3–1 applicable to the instrument referenced by the security-based swap multiplied by the contract's notional amount.[1037] It is likely that a nonbank SBSD that maintains substantial positions in such instruments would maintain portfolios of multiple instruments in such categories with offsetting long and short positions to hedge its risk.

Under the Commission's proposed standardized haircuts for these categories of security-based swaps, nonbank SBSDs would also be able to recognize the offsets currently permitted under Rule 15c3–1.[1038] In particular, as discussed below, nonbank SBSDs would be permitted to treat equity security-based swaps under the provisions of Appendix A to Rule 15c3–1, which produces a single haircut for portfolios of equity options and related positions.[1039] This method would permit a nonbank SBSD to compute deductions for a portfolio of equity security-based swaps using a comprehensive risk perspective by accounting for the risk of the entire portfolio, rather than the risk of each position within the portfolio.[1040] Appendix A provides a relatively less costly mechanism for a nonbank SBSD to calculate haircuts (in contrast to the standardized haircuts) since it is used for other equity derivatives and generally may reduce haircuts for a nonbank SBSD by allowing a swap referencing an equity security to be considered as part of a related portfolio. This, in turn, may permit a nonbank SBSD to more efficiently deploy this capital savings in other areas of its operations, as well as enhance operational efficiencies.

Similarly, nonbank SBSDs would be permitted to treat a debt security-based swap in the same manner as debt instruments are treated in the Rule 15c3–1 grids in terms of allowing offsets between long and short positions where the instruments are in the same maturity categories, subcategories, and in some cases, adjacent categories.[1041] Consequently, nonbank SBSDs could recognize the offsets and hedges that those provisions permit to reduce the deductions on portfolios of debt security-based swaps, and thereby reduce their capital costs. This, in turn, may permit a nonbank SBSD to more efficiently deploy this capital savings in other areas of its operations.

The proposed approaches, like other types of standardized haircuts, likely will require a higher amount of capital to conduct security-based swaps

[1034] Commenters to the proposed CFTC capital rule for swap dealers stated that they believe that model-based approaches are generally superior to grid-based approaches. One commenter argued that grid-based approaches are generally insufficiently risk sensitive, are not part of integrated risk management systems, and are hard to keep up-to-date to include innovative product and trading strategies. *FIA/ISDA/SIFMA Comment Letter to the CFTC.* Grid-based approaches, however, provide alternatives to firms that are unable to or chose not to use models.

[1035] *See* 17 CFR 240.15c3–1(c)(2)(vi); paragraph (c)(1)(vii) of proposed new Rule 18a–1. *See also* section II.A.2.b.vi. of this release (discussing the treatment of swaps).

[1036] *See Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Amend FINRA Rule 4240 (Margin Requirements for Credit Default Swaps),* Exchange Act Release No. 66527 (Mar. 7, 2012) (File No. SR–FINRA–2012–015) (in which FINRA amended the maturity grid in Rule 4240 in the interest of regulatory clarity and efficiency, and based upon FINRA's experience in the administration of the rule). While FINRA Rule 4240 is one reference point, the maturity grid it specifies does not appear to have been widely used by market participants, in part because a significant amount of business in the current credit default swap market is conducted by entities that are not members of FINRA.

[1037] *See* proposed new paragraph (c)(2)(vi)(O)(*2*) of Rule 15c3–1; paragraph (c)(1)(vi)(B) of proposed new Rule 18a–1. For example, if a dealer maintained a position in a security-based swap with a notional amount of $1 million that provided the dealer with long exposure to a nonconvertible debt security maturing in 2½ years (assuming no offsetting short positions), the dealer would look to Rule 15c3–1(c)(2)(vi)(F) to find the applicable haircut percentage (5%) and the firm would be required to take a capital deduction of $50,000.

[1038] *See* proposed new paragraph (c)(2)(vi)(O)(*2*) of Rule 15c3–1; paragraph (c)(1)(vi)(B) of proposed new Rule 18a–1.

[1039] *See* 17 CFR 240.15c3–1a; Appendix A to proposed new Rule 18a–1.

[1040] *See* section II.A.2.b.ii. of this release.

[1041] *See* 17 CFR 240.15c3–1(c)(2)(vi).

business, in contrast to a VaR model. While the standardized haircuts and proposed CDS grid recognize certain offsets, standardized haircuts generally result in higher costs of capital because the standardized approaches do not recognize other ways in which a nonbank SBSD may mitigate its exposures, including unwinding unprofitable trades, entering into certain hedges that would not be recognized under the proposed capital rules, and portfolio diversification. The higher amounts that may result from using the standardized haircut and a grid-based approach [1042] may be acceptable for nonbank SBSDs that occasionally trade in security-based swaps but not in a substantial enough volume to justify the initial and ongoing systems and personnel costs to develop, implement, and monitor the performance of internal models. On the other hand, firms that conduct a substantial business in securities-based swaps in general will need to use the more cost-efficient models to measure and manage the risks of their positions over time.

The benefit of the standardized haircut approach of measuring market risk, besides its inherent simplicity, is that it may reduce the likelihood of default or failure by nonbank SBSDs that have not demonstrated that they have the risk management capabilities, of which VaR models are an integral part, or capital levels to support the use of VaR models. Therefore, the standardized haircut approach, in turn, may improve customer protections and reduce systemic risk. In addition, a standardized haircut approach may reduce costs for the nonbank SBSD related to the risk of failing to observe or correct a problem with the use of VaR models that could adversely impact the firm's financial condition, because the use of VaR models would require the allocation by the nonbank SBSD of additional firm resources and personnel.

Conversely, if the proposed standardized haircuts are too conservative, they could make the conduct of security-based swaps business too costly, preventing or impairing the ability of firms to engage in security-based swaps, increasing transaction costs, reducing liquidity, and reducing the availability of security-based swaps for risk mitigation by end users.

iii. Capital Charge in Lieu of Margin Collateral

As discussed in section II.A.2.b.v. of this release, the Commission is proposing certain capital charges in lieu of margin. Generally, margin collateral is designed to serve as a buffer to account for a decrease in the market value of the counterparty's positions between the time of default and liquidation. If the amount of the margin collateral is insufficient to make up the difference, the nonbank SBSD will incur losses. The proposal requires the nonbank SBSD to hold sufficient net capital to enable it to, first, withstand such losses and to cover counterparty exposures that are not sufficiently secured with liquid collateral, and, second, to create a strong incentive for dealers to collateralize these exposures. Consequently, this proposed capital charge may serve as an alternative to margin collateral, enhance the financial soundness of the nonbank SBSD and, in turn, ultimately reduce systemic risk.

With respect to cleared security-based swaps, the rules would impose a capital charge if a nonbank SBSD collects margin collateral from a counterparty in an amount that is less than the deduction that would apply to the security-based swap if it were a proprietary position of the nonbank SBSD (*i.e.,* less than an amount determined by using the standardized haircuts in Rule 15c3–1, as proposed to be amended, and in proposed new Rule 18a–1 or a VaR model, as applicable).[1043] As discussed in section II.A.2.b.v. of this release, the proposed capital charge, therefore, is designed to protect the nonbank SBSDs against this risk, and thereby, serves to increase the safety and soundness of the nonbank SBSD.

This proposed charge, however, could impose additional capital costs on cleared transactions where the amount of the additional costs would depend on the differences between amounts required under Rule 18a–1 and margin amounts the clearing agency sets. It is difficult to estimate the cost impact of this proposal because there is currently a lack of trading for customers in cleared security-based swaps that could be used for comparative purposes.[1044] In addition, requiring nonbank SBSDs to take a capital charge equal to the difference between the haircut amount and the clearing agency margin could reduce incentives to use cleared security-based swap contracts, which would be inconsistent with the goal of reducing systemic risk. However, incentives to clear security-based swaps will be substantially affected by a variety of other factors, including the amount of margin required for non-cleared contracts, and clearing volume will also be affected by mandatory clearing determinations by the Commission under Section 763(a) of the Dodd-Frank Act. In general, it is unclear whether the additional costs to conduct business on a cleared basis would materially affect the volume of business that SBSDs conduct on an uncleared basis when they have the choice to do so.

As discussed in section II.A.2.b.v. of the release, with respect to non-cleared security-based swaps, the Commission is proposing capital charges to address three exceptions in proposed new Rule 18a–3 (nonbank SBSD margin rule), including margin not collected from *commercial end users,* margin collateral collected but segregated pursuant to section 3E(f) of the Exchange Act, and margin that has not been collected for a legacy swap.[1045] The rule is designed to reduce systemic risk by requiring capital to cover counterparty exposures, because the capital levels will serve in lieu of margin as a buffer in case of counterparty defaults. If the nonbank SBSD did not hold capital in lieu of margin, a counterparty default could lead to the default of the nonbank SBSD itself. This capital charge should have the benefit of reducing the likelihood of default of the nonbank SBSD due to under-margined counterparty exposure. Conversely it will increase the cost of capital for nonbank SBSDs that engage in non-cleared security-based swaps because they must use their own capital to support the counterparty's transaction, which in turn could reduce the liquidity of such security-based swaps. However, the proposed rule imposes a charge only if a firm fails to collect margin under Rule 18a–3, and thus no additional costs would be imposed on a nonbank SBSDs that

[1042] *See* section II.A.2.b.2. of this release.

[1043] *See* proposed paragraph (c)(2)(xiv)(A) of Rule 15c3–1; paragraph (c)(1)(viii)(A) of proposed Rule 18a–1.

[1044] *See Process for Submissions of Security-Based Swaps,* 77 FR 41602 (although the volume of interdealer CDS cleared to date is quite large, many security-based swap transactions are still ineligible for central clearing, and many transactions in security-based swaps eligible for clearing at a CCP continue to settle bilaterally. Voluntary clearing of security-based swaps in the U.S. is currently limited to CDS products. Central clearing of security-based swaps began in March 2009 for index CDS products, in December 2009 for single-name corporate CDS products, and in November 2011 for single-name sovereign CDS products. At present, there is no central clearing in the U.S. for security-based swaps that are not CDS products, such as those based on equity securities.). *Id.*

[1045] This proposed rule also provides the nonbank SBSDs certain flexibility in determining whether to collect margin from certain counterparties exempt from certain requirements of proposed Rule 18a–3 and thus attempts to appropriately consider both the concerns of *commercial end users* and other entities/transactions exempt from proposed new Rule 18a–3 and the need to enhance the financial soundness of the nonbank SBSD.

collects margin. Therefore, the proposed rule is designed to create a strong incentive for nonbank SBSDs to collect margin and collateralize counterparty exposures.

The charge for collateral segregated in individual accounts under Section 3E(f) of the Exchange Act reflects the potential that collateral collected by an SBSD but held in a third-party custodian account may not be readily liquidated immediately following a counterparty's default. Accordingly, this aspect of the rule would create an additional capital cost to SBSDs that hold collateral in independent third-party accounts.[1046] If these costs are passed on to counterparties electing an independent segregation option, they could deter counterparties from electing the option and reduce their flexibility in determining the optimal way to hold their collateral.

The third proposed capital charge would apply to margin not collected in the case of legacy non-cleared security-based swaps. This proposal should benefit nonbank SBSDs and their counterparties in that it is designed to avoid the difficulties of requiring a nonbank SBSD to renegotiate security-based swap contracts to come into compliance with the new margin collateral requirements, which would be a complex and costly task. Based on discussions with market participants, this proposal, however, may impose substantial costs in the form of capital charges on firms that have legacy contracts.[1047] Because broker-dealers, however, currently do not conduct significant business in security-based swaps, and any newly-registered SBSDs may not enter into security-based swap transactions before the effectiveness of these proposed rules and, therefore, not have any legacy security-based swaps, this cost of capital may be immaterial. However, the costs could be significant if legacy security-based swaps are assigned to a security-based swap dealer.

iv. Credit Risk Charge

As discussed in section II.A.2.b.iv. of this release, consistent with existing rules affecting broker-dealers,[1048] proposed Rule 18a–1 and the amendments to Rule 15c3–1 rule would require firms to take a 100% charge for the amount of any unsecured receivable, including any uncollateralized receivable currently owed under a security-based swap. As an alternative to taking this capital charge in lieu of margin to a *commercial end user,* as discussed in section II.A.2.b.iv. of the release, ANC broker-dealers and stand-alone SBSDs using internal models would be permitted instead to take a credit risk charge using a methodology in Appendix E to Rule 15c3–1 for uncollateralized receivables arising from security-based swaps with (and only with) *commercial end users* in lieu of the 100% deduction otherwise required by the rules.[1049]

The proposed rule is designed to provide an alternative, less costly way (in lieu of the 100% deduction otherwise required by the rules) to recognize credit exposure incurred in transactions with *commercial end users* for those nonbank SBSDs approved to use internal models. Nonbank SBSDs would be permitted to use this approach because they are required to implement processes for analyzing credit risk to OTC derivative counterparties and to develop mathematical models for estimating credit exposures arising from OTC derivatives transactions and determining risk-based capital charges for those exposures.[1050]

The rule, however, will increase costs [1051] for nonbank SBSDs that do substantial trading with *commercial end users* and do not collect margin for transactions in non-cleared security-based swaps from them. Available data suggests that *commercial end users* presently do not conduct substantial trading in non-cleared security-based swaps.[1052] Therefore, the proposed credit risk charge may not have an immediate cost impact on nonbank SBSDs when compared to the baseline of the OTC derivatives markets as they exist today. However, costs, in terms of higher capital charges and opportunity costs, could become significant if *commercial end users* begin to trade security-based swaps in greater volume and exposures to the nonbank SBSDs remain uncollateralized.

To the extent that *commercial end users* do trade in security-based swaps, the ability of a nonbank SBSD to use internal models likely would give it a significant cost advantage over nonbank SBSDs not using models once the initial infrastructure investment to use the models has been made. In addition, ANC broker-dealers currently are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (*i.e.,* they can add back the amount of the uncollateralized current exposure).[1053] This treatment would be narrowed under the proposed capital requirements for nonbank SBSDs as well as for ANC broker-dealers to the extent that it would apply only to uncollateralized receivables from *commercial end users* arising from security-based swaps. In contrast, uncollateralized receivables from other types of counterparties would be subject to a 100% deduction from net worth to limit the potential that the rules would permit a substantial amount of unsecured exposures for ANC broker-dealers and nonbank SBSDs.[1054]

According to FOCUS Reports and staff experience supervising the ANC broker-dealers, ANC broker-dealers have not engaged in a large volume of OTC derivatives transactions since the rules were adopted in 2004. Therefore, they have not had significant amounts of unsecured receivables that would be subject to the credit risk charge provisions in Appendix E to Rule 15c3–1. However, when the Dodd-Frank OTC derivatives reforms are implemented, ANC broker-dealers could significantly increase their holdings of OTC derivatives. An increase in derivatives exposure that is uncollateralized would increase the exposure of the ANC broker-dealers to their derivatives counterparties. In turn, however, this proposed amendment should strengthen the capital position of the ANC broker-

[1046] *See* discussion above in section II.A.2.b.v. of this release. *See also* discussion above in section V.B.1. of this release (discussing quantification of costs).

[1047] As discussed above in section II.B.2. of this release, this exception would be designed to address the impracticality of renegotiating contracts governing security-based swap transactions that predate the effectiveness of proposed new Rule 18a–3 in order to come into compliance with the account *equity* requirements in the rule. *See* discussion above in section V.A.1. of this release (discussing quantification of costs).

[1048] *See* 17 CFR 240.15c3–1(c)(2)(iv)(B)–(D); proposed new Rule 18a–1(c)(1)(iii)(B)–(D).

[1049] *See* paragraph (e)(2) of proposed new Rule 18a–1. Paragraph (c)(1) of Appendix E to Rule 15c3–1 requires an ANC broker-dealer to take a counterparty exposure charge in an amount equal to: (i) The net replacement value in the account of each counterparty that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default; and (ii) for a counterparty not otherwise described in paragraph (c)(1)(i) of Appendix E, the credit equivalent amount of the broker's or dealer's exposure to the counterparty, as defined in paragraph (c)(4)(i) of this Appendix E, multiplied by the credit risk weight of the counterparty, as defined in paragraph (c)(4)(vi) of Appendix E, multiplied by 8%. 17 CFR 240.15c3–1e(c)(1).

[1050] *See* Appendix E to Rule 15c3–1 and proposed new Rule 18a–1.

[1051] *See* section V.B.1. of this release (discussing quantification of costs).

[1052] *See generally CDS Data Analysis; ISDA Margin Survey 2012.*

[1053] *See* 17 CFR 240.15c3–1e(c). OTC derivatives dealers are permitted to treat such uncollateralized receivables in a similar manner. *See* 17 CFR 240.15c3–1f.

[1054] *See* proposed amendments to paragraphs (a) and (c) of Rule 15c3–1e. *See* section II.A.2.b.iv. of this release (discussing credit risk charges).

dealers, and thereby reduce the likelihood of default of one of these entities. Because ANC broker-dealers currently do not trade in significant amounts of OTC derivatives, and therefore, do not currently have significant amounts of unsecured receivables related to OTC derivatives transactions, the cost impact as compared to the baseline of the current capital regime for broker-dealers should not be material for these firms.

v. Funding Liquidity Stress Test Requirement

As discussed in section II.A.2.d. of this release, the Commission is proposing a funding liquidity stress requirement [1055] to be conducted by the ANC broker-dealers and stand-alone SBSDs that use internal models at least monthly that takes into account certain assumed conditions lasting for 30 consecutive days. These required assumed conditions would be:

- A stress event that includes a decline in creditworthiness of the firm severe enough to trigger contractual credit-related commitment provisions of counterparty agreements; [1056]
- The loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding, including intercompany advances and unfunded committed lines of credit;
- The potential for a material net loss of secured funding;
- The loss of the ability to procure repurchase agreement financing for less liquid assets;
- The illiquidity of collateral required by and on deposit at clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets;
- A material increase in collateral required to be maintained at registered clearing agencies of which the firm is a member; and
- The potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the firm, including those related to customer businesses of the firm.[1057]

These proposed minimum elements are designed to ensure that ANC broker-dealers and stand-alone SBSDs using internal models employ a stress test that is severe enough to produce an estimate of a potential funding loss of a magnitude that might be expected in a severely stressed market.

The benefit of the proposed liquidity stress test requirement is an additional level of protection against disruptions in the ability to obtain funding for a firm with significant proprietary positions in securities or derivatives.[1058] The proposed liquidity requirement is intended to increase the likelihood that a firm could withstand a general loss of confidence in the firm itself, or the markets more generally and stay solvent for up to 30 days, during which time it could either regain the ability to obtain funding in the ordinary course or else better position itself for resolution, with less collateral impact on other market participants and the financial system. As such, this proposal may reduce the likelihood and severity of a fire sale and, therefore, mitigate spillover effects and lower systemic risk.[1059] This, in turn, may increase confidence in the security-based swap markets and may lead to an increase in trading in this market.

This proposal, however, would impose additional opportunity costs of capital, and other costs on ANC broker-dealers and nonbank SBSDs directly related to the amount of the required liquidity reserve because a nonbank SBSD would be unable to deploy the assets that are maintained for the liquidity reserve in other, potentially more efficient ways.

In addition, smaller firms may incur more implementation costs, because, in general, large firms already run stress tests and maintain a liquidity reserve based on those tests.[1060] In addition, the required assumed conditions are designed to be consistent with the liquidity stress tests performed by ANC broker-dealers (based on staff experience in supervising the ANC broker-dealers) and to address the types of outflows experienced by ANC broker-dealers and other broker-dealers in times of stress. Therefore, while the opportunity cost of the liquidity requirements might be substantial, they are not expected to impose liquidity standards that are materially different from what is observed now among the ANC broker-dealers and thus should not represent an undue burden at this time.

Finally, under the proposals, an ANC broker-dealer and a stand-alone SBSD using internal models would be required to establish a written contingency funding plan. The plan would need to clearly set out the strategies for addressing liquidity shortfalls in emergency situations,[1061] and would need to address the policies, roles, and responsibilities for meeting the liquidity needs of the firm and communicating with the public and other market participants during a liquidity stress event.[1062]

This proposal may reduce the likelihood of default of a nonbank SBSD that uses internal models or an ANC broker-dealer, and thus, in turn, reduce systemic risk. Based on staff experience supervising ANC broker-dealers and monitoring the ultimate holding companies of these firms, most of these entities have a written contingency funding plan, generally, at the holding company level. To the extent that these firms are required to implement a written contingency funding plan at the nonbank SBSD level or ANC level, these firms may incur personnel, technology or other operational costs to develop and implement such a plan.[1063]

vi. Risk Management Procedures

As discussed in section II.A.2.c. above, nonbank SBSDs would be required to comply with the risk management provisions of Rule 15c3–4, as if they were OTC derivatives dealers, because the risks of trading by nonbank SBSDs in security-based swaps,

[1055] *Compare* BCBS, *Basel III: International framework for liquidity risk measurement, standards and monitoring* (Dec. 2010), available at *http://www.bis.org/publ/bcbs188.pdf.*

[1056] *See Federal Reserve Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* 77 FR 594, 608 (Jan. 5, 2012) (noting that effective liquidity stress testing should be conducted over a variety of time horizons to adequately capture rapidly developing events, and other conditions and outcomes that may materialize in the near or long term).

[1057] *See* proposed new paragraph (f)(1) to Rule 15c3–1 and paragraph (f)(1) of proposed new Rule 18a–1.

[1058] *See* letter from Christopher Cox, Chairman, Commission, to Dr. Nout Wellink, Chairman, BCBS (Mar. 20, 2008), available at *http://www.sec.gov/news/press/2008/2008–48_letter.pdf* (highlighting importance of liquidity management in meeting obligations during stressful market conditions). *See also Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* 77 FR 594, 608 (Jan. 5, 2012) (proposing that liquidity stress testing must be tailored to reflect a covered company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors stating that stress testing will be directly tied to the covered company's business profile and the regulatory environment in which it operates.). The minimum factors described above are intended to specifically address factors relevant to the regulatory environment in which ANC broker-dealers and stand-alone SBSD using internal models operate.

[1059] *See* Andrei Shleifer and Robert Vishny, *Fire Sales in Finance and Macroeconomics,* 25 Journal of Economic Perspectives 29–48 (Winter 2011) (surveying literature on fire sales, which implies that if financial institutions are not liquidity restraints during fire sales, price and liquidity spirals should less likely occur).

[1060] *See* 17 CFR 240.15c3–4.

[1061] *See* proposed new paragraph (f)(4) of Rule 15c3–1; paragraph (f)(4) of proposed Rule 18a–1.

[1062] *See* proposed new paragraph (f)(4) of Rule 15c3–1; paragraph (f)(4) of proposed Rule 18a–1.

[1063] *See* section V.C. of this release.

including market, credit, operational, and legal risks, are similar to the risks faced by OTC derivatives dealers in trading other types of OTC derivatives.[1064] These requirements may reduce the risk of significant losses by nonbank SBSDs. The internal risk management control system requirements also should reduce the risk that the problems of one firm will spread because each nonbank SBSD should have a better understanding of the nonbank's exposures and the risks of those exposures. The nonbank SBSDs may incur costs in better modifying documents and their information technology systems to meet these requirements, but these costs could vary significantly among nonbank SBSDs depending on the degree to which their risk management systems are documented and on size of each firm and the types of business it engages in.[1065]

b. Capital Requirements for MSBSPs

As discussed in section II.A.3. of the release, proposed new Rule 18a–2 would require nonbank MSBSPs to have and maintain positive tangible net worth at all times.[1066] Entities that may need to register as MSBSPs may engage in a diverse range of business activities very different from, and broader than, the securities activities conducted by broker-dealers (otherwise they would be required to register as an SBSD and/or broker-dealer). Because nonbank MSBSPs, by definition, will be entities that have substantial exposure to security-based swaps, they would also be required to comply with Rule 15c3–4,[1067] which requires OTC derivatives dealers and ANC broker-dealers to establish, document, and maintain a system of internal risk management.[1068] This proposal is designed to promote sound risk management practices with respect to the risks associated with trading in OTC derivatives. Nonbank MSBSPs may incur implementation costs, such as technology costs to comply with the risk management practices proposed by the rule. These are discussed in section V.C. below.

Risk management controls at nonbank MSBSPs may promote the stability of these firms and, consequently, the stability of the entire financial system. This, in turn, may protect the financial industry from systemic risk.

The Commission could instead impose capital requirements that are the same as, or modeled on, those that are being proposed for nonbank SBSDs, which could more effectively reduce the risk of failure of MSBSPs and thereby reduce systemic risk. In general, nonbank SBSDs and MSBSPs can be expected to differ in terms of the range and types of their counterparty relationships and, by definition, MSBSPs will not maintain two-sided exposure to a range of instruments that is characteristic of dealer activity. The systemic impact of the failure of an MSBSP will depend on various factors, including the ability of its counterparties to readily liquidate assets posted by the MSBSP as collateral, without suffering a loss. Although the Commission is proposing to require MSBSPs to post collateral to eliminate their current exposure to counterparties in security-based swaps, the collateral may not be sufficient to avoid losses during a period of market volatility. At the same time, imposing a capital regime on MSBSPs that is based on a net liquid assets test could impact the ability of an MSBSP to pursue business activities and strategies unrelated to its activities involving financial instruments. For example, these entities may engage in commercial activities that require them to have substantial fixed assets to support manufacturing and/or result in them having significant assets comprised of unsecured receivables. Requiring them to adhere to a net liquid assets test could result in their having to obtain significant additional capital or engage in costly restructurings. The Commission is specifically seeking comment on this approach in section II.A.3. of this release.

As stated above, at present, entities that may be required to be registered as MSBSPs are expected to be companies that engage in a diverse range of business. For these reasons, it would be difficult to quantify how much additional capital, if any, or costs the capital requirements under proposed new Rule 18a–3 would require these entities to maintain or incur and compare these amounts against the current baseline of the OTC derivatives market as it exists today.[1069] Given that proposed new Rule 18a–2 would only require that a nonbank MSBSP maintain a positive tangible net worth at all times, and 5 or fewer entities are expected to register as nonbank MSBSPs,[1070] these costs are not expected to be material because it is not expected that these firms would have to alter their existing business practice in any substantial way to comply with the proposed positive tangible net worth test.

c. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The proposed financial responsibility requirements should reduce the risk of a failure of any major market participant in the security-based swap market, which in turn reduces the possibility of a general market failure, and thus promotes confidence for market participants to transact in security-based swaps for investment and hedging purposes. The proposed capital requirements are designed to promote confidence in nonbank SBSDs among customers, counterparties, and the entities that provide financing to nonbank SBSDs and, thereby, lessen the potential that these market participants may seek to rapidly withdraw assets and financing from SBSDs during a time of market stress. This heightened confidence is expected to increase trading activity and promote competition among dealers. The proposed financial responsibility requirements, in significant part, will affect efficiency and capital formation through their impact on competition.[1071] Specifically, markets that are competitive can, ceteris paribus, be expected to promote a more efficient allocation of capital.

Any new entrant will increase the number of competing entities, and the extent to which competition increases will depend on the number of additional entrants and their success in attracting business from established market participants. As discussed in section IV. of this release, the Commission expects up to 50 entities to register as SBSDs. The number of registered firms will depend, among other factors, on whether potential new entrants determine that the cost impact of the proposed financial responsibility requirements would allow them to compete effectively for business. To the extent that costs associated with the proposed rules are high however, they

[1064] For example, individually negotiated OTC derivative products, including security-based swaps, generally are not very liquid. Market participants face risks associated with the financial and legal ability of counterparties to perform under the terms of specific transactions. The additional exposure to credit risk, liquidity risk, and other risks makes it necessary for OTC derivatives market participants to implement a risk management control system.

[1065] *See* section V.C. of this release.

[1066] *See* paragraph (a) of proposed new Rule 18a–2.

[1067] *See* paragraph (c) of proposed new Rule 18a–2.

[1068] *See* 17 CFR 240.15c3–4.

[1069] *See* section V.A.1. of this release.

[1070] *See* section IV. of this release.

[1071] *See also Entity Definitions Adopting Release,* 77 FR at 30742.

may negatively affect competition within the security-based swap markets. This may, for example, lead smaller dealers or entities for whom dealing is not a core business to exit the market because compliance with the proposed minimum capital requirements is not feasible because of cost considerations. The same costs might also deter the entry of new SBSDs or MSBSPs into the market, and if sufficiently high, increase concentration among nonbank SBSDs.

The possibility of using VaR to calculate haircuts may permit a nonbank SBSD to more efficiently deploy capital in other parts of its operations (because VaR models could reduce capital charges and thereby could make additional capital available), which should be a factor in the decision to enter the security-based swap markets in general and through which type of registrant in particular. Because of the reduced charges for market and credit risk, a nonbank SBSD may be able to reallocate capital from the nonbank SBSD to affiliates that may receive a higher return than the nonbank SBSD.[1072] Therefore, the success of new entrants in competing for security-based swap business also will likely depend on the extent to which they obtain the Commission's approval to use a VaR model.[1073] Hence, the Commission expects a positive impact on competition especially among SBSDs that use internal models, whether they are stand-alone SBSDs or ANC broker-dealers.

However, some of the entities that presently compete in the market may opt to conduct these activities in registered broker-dealer affiliates; this development would not increase the number of competitors. But other firms that currently do not deal in security-based swaps or do not do so in any significant degree, may choose to compete either as a stand-alone SBSD or as a broker-dealer SBSD. This may increase the number of competing firms.

The proposals ultimately adopted, like other requirements established under the Dodd-Frank Act, could have a substantial impact on international commerce and the relative competitive position of intermediaries operating in various, or multiple, jurisdictions. In particular, intermediaries operating in the U.S. and in other jurisdictions could be advantaged or disadvantaged if corresponding requirements are not established in other jurisdictions or if the Commission's rules are substantially more or less stringent than corresponding requirements in other jurisdictions. This could, among other potential impacts, affect the ability of intermediaries and other market participants based in the U.S. to participate in non-U.S. markets, the ability of non-U.S.-based intermediaries and other market participants to participate in U.S. markets, and whether and how international firms make use of global ''booking entities'' to centralize risks related to security-based swaps. As discussed in section I. of this release, these issues have been the focus of numerous comments to the Commission and other regulators, Congressional inquiries, and other public dialogue.

Accordingly, substantial differences between the U.S. and foreign jurisdictions in the costs of complying with the financial responsibility requirements for security-based swaps between U.S. and foreign jurisdictions could reduce cross-border capital flows and hinder the ability of global firms to most efficiently allocate capital among legal entities to meet the demands of their counterparties. As discussed in section I. of this release, the potential international implications of the proposed capital, margin, and segregation requirements warrant further consideration.[1074] The Commission intends to publish a comprehensive release seeking public comment on the full spectrum of issues relating to the application of Title VII to cross-border security-based swap transactions and non-U.S. persons that act in capacities regulated under the Dodd-Frank Act.

The willingness of end users to trade with a nonbank SBSD dealer will depend on their evaluation of the risks of trading with that particular firm compared to more established firms, and their ability to negotiate favorable price and other terms. As discussed in section V.A. of this release, end users of security-based swaps are mostly comprised of hedge funds and other asset management and financial firms. Many of these entities are sophisticated participants that trade in substantial volume and generally post collateral for their security-based swap positions.[1075] These end users are relatively well-positioned to negotiate price and other terms with competing dealers and to take advantage of greater choice of nonbank SBSD counterparties. These same participants, when transacting in the securities markets, often trade with a variety of competing dealers, including through prime brokerage relationships. To the extent that the proposals result in increased competition, participants in the security-based swap markets should be able to take advantage of this increased competition and negotiate improved terms, resulting generally in narrower spreads and better prices.

In addition, benefits may be expected to also arise from the ability of nonbank SBSDs, which now conduct substantial business in security-based swaps, to consolidate those operations within their affiliated U.S. broker-dealers. This flexibility may yield efficiencies for clients conducting business in securities and security-based swaps, including netting benefits,[1076] a reduction in the number of account relationships required with affiliated entities, and a reduction in the number of governing agreements. These potential benefits are at some tension with benefits from an increase in the number of competitors, to the extent that netting benefits will be maximized by holding a large portfolio of positions at the same entity,[1077] rather than trading with a variety of competing dealers. Further, because the proposals would permit the conduct of a security-based swap business in an entity jointly registered as a broker-dealer SBSD,[1078] they would facilitate the potential for those firms to offer portfolio margin for a variety of positions. From the standpoint of a holding company with multiple financial affiliates, aggregating security-based swaps business in a single entity,

[1072] *See Alternative Net Capital Requirements Adopting Release,* 69 FR 34428.

[1073] *See, e.g., Alternative Net Capital Requirements Adopting Release,* 69 FR at 34455 (describing benefits of alternative net capital requirements for broker-dealers using models stating a ''major benefit for the broker-dealer will be lower deductions from net capital for market and credit risk that we expect will result from the use of the alternative method.'') Therefore, it is likely that for new entrants to capture substantial volume in security-based swaps they will need to use VaR models. *See also OTC Derivatives Dealer Release,* 63 FR 59362 (discussing benefits of minimum capital requirements as an additional measure of protection).

[1074] *See* BCBS, IOSCO, *Margin Requirements for Non-centrally-cleared Derivatives* (July 2012), available at *http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf* (consultative document seeking comment on a paper on margin requirements for non-centrally-cleared derivatives).

[1075] *See, e.g., Independent Amounts* at 6.

[1076] *See, e.g.,* paragraph (c)(5) of proposed new Rule 18a–3(c)(5). *See* letter from Stuart J. Kaswell, Executive Vice President, Managing Director and General Counsel, Managed Funds Association, to David A. Stawick, Secretary of the CFTC (July 11, 2011) (''Effective netting agreements lower systemic risk by reducing both the aggregate requirement to deliver margin and trading costs for market participants.'').

[1077] *See* Darrell Duffie and Haoxiang Zhu, *Does a Central Clearing Party Reduce Counterparty Risk,* Stanford University Working Paper (Mar. 6, 2010) (showing that netting in the context of CCPs results in significant reductions in counterparty exposures).

[1078] *See, e.g.,* amendments to Rule 15c3–1 (proposing minimum net capital requirements for broker-dealers engaging in a security-based swap business).

such as a broker-dealer SBSD, could help to simplify and streamline risk management, allow more efficient use of capital, as well as operational efficiencies, and avoid the need for multiple netting and other agreements.

While these arguments generally suggest the possibility of positive effects of the proposed rules on competition, efficiency and capital formation, financial responsibility requirements that impose too many competitive burdens pose the risk of imposing excessive regulatory costs that could deter the efficient allocation of capital. Such rules also may be expected to reduce the capital formation benefits that otherwise would be associated with security-based swaps. Specifically, financial responsibility requirements that are overly stringent may prevent entries in the security-based swap markets and thereby may either increase spreads and trading costs or even reduce the availability of security-based swaps. In both instances, end users would face higher cost to meet their business needs.

Apart from their impact on the extent of dealer competition and efficiencies for end users, the proposed new rules and rule amendments could create the potential for regulatory arbitrage to the extent that they differ from corresponding rules other regulators adopt. As noted above in section I. of this release, the proposals of the prudential regulators and the CFTC were considered in developing the Commission's proposed capital, margin, and segregation requirements for SBSDs and MSBSPs. The Commission's proposals differ in some respects from proposals of the prudential regulators and the CFTC. While some differences are based on differences in the activities of securities firms, banks, and commodities firms, or differences in the products at issue, other differences may reflect an alternative approach to balancing the relevant policy choices and considerations. Depending on the final rules the Commission adopts, the financial responsibility requirements could make it more or less costly to conduct security-based swaps trading in banks as compared to nonbank SBSDs. For example, high capital requirements may discourage certain entities from participating in the security-based swap markets, particularly if the regulatory costs for nonbank SBSDs are high. Likewise, if the application of the proposed 8% margin risk factor substantially increases capital requirements for nonbank SBSDs compared to risk-based capital requirements imposed by the prudential regulators on the same activity, bank holding companies could be incentivized to conduct these activities in their bank affiliates.[1079] These differences could create competitive inequalities and affect the allocation of trading activities within a holding company structure.

Finally, in significant part, the effect of the proposals for nonbank MSBSPs on efficiency and capital formation will also be linked to the effect of these requirements on competition,[1080] as competitive markets, ceteris paribus, can be expected to promote a more efficient allocation of capital.

Conversely, if the proposals for MSBSPs are accompanied by too many competitive burdens, the proposals risk the imposition of excessive regulatory costs that could deter the efficient allocation of capital. Such rules also may be expected to reduce the capital formation benefits that otherwise would be associated with security-based swaps. Requirements for nonbank MSBSPs that are overly stringent may prevent entries in the security-based swap markets and thereby may reduce the availability of security-based swaps, forcing end users to use less effective financial instruments to meet their business needs.

Request for Comment

The Commission generally requests comment about its analysis of the general costs and benefits of the proposed capital rules for SBSDs and MSBSPs. In addition, the Commission requests comment in response to the following questions:

1. Would the minimum capital requirements represent a barrier to entry to firms that may otherwise seek to trade security-based swaps as SBSDs? If so, which types of firms would be foreclosed?

2. Is it correct to assume that firms that have the risk management capability to act as a dealer in security-based swaps generally would also meet or be readily able to meet the proposed capital minimums?

3. To what extent will firms that receive approval to use VaR models be able to dominate trading in security-based swaps, whether because of costs to other firms in applying a haircut methodology to security-based swaps or for other reasons?

4. What would be the impact of market concentration on reduction in systemic risk? For example, would concentration of positions in a relatively few firms exacerbate systemic risk by exaggerating the impact of the failure of a single firm? Conversely, would high capital requirements better protect against systemic risk by reducing the risk of failure of a nonbank SBSD?

5. Do the proposed capital requirements for nonbank SBSDs proportionately reflect the increased risk associated with the use of internal models and trading in a portfolio of instruments, including securities, security-based swaps, and other derivatives?

6. The Commission requests comment on how much additional capital would be required, if any, as a result of the proposed 8% margin factor based on a sample portfolio of security-based swaps and how the result compares to the amount these firms currently hold against the same risk.

7. Under the proposed 8% margin factor, the relation between exposure and capital is linear. Is this type of formal approach appropriate for risks associated with security-based swaps? Should the risk margin factor be increased at higher levels of exposure, or should it increase on some other basis?

8. How would firms' current risk management practices for calculating their exposures to counterparties compare to the proposed 8% margin factor, if nonbank SBSDs were only required to comply with a fixed minimum net capital standard?

9. From a systemic risk perspective, should the proposed capital rules for nonbank SBSDs encourage the conduct of security-based swaps trading outside of broker-dealer affiliates?

10. From a systemic risk perspective, are the proposed increases in the minimum net capital (from $500 million to $1 billion) and minimum tentative net capital ($1 billion to $5 billion) requirements for ANC broker-dealers adequate? From a systematic risk perspective, is the proposed increase in the ''early warning'' level from $5 billion to $6 billion for ANC broker-dealers adequate?

11. Would the proposed CDS grid impose any additional costs on nonbank SBSDs in comparison to the current haircut charges for similar debt securities under Rule 15c3–1?

12. Would a nonbank SBSD incur additional costs resulting from the proposed liquidity stress test based on current practice? The Commission requests that commenters quantify the extent of the additional cost the proposed stress test would yield based on hypothetical firm portfolios, and provide the Commission with such data.

13. Are the factors proposed in the liquidity funding stress test adequate? If

[1079] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564.

[1080] *See also Entity Definitions Adopting Release,* 77 FR at 30742.

not, are there other factors that should be included?

14. How would proposed new Rule 18a–2 impact entities that may be required to register as MSBSPs?

15. Would proposed new Rule 18a–2 require nonbank MSBSPs to hold additional capital, in comparison to current capital levels maintained at these firms? If yes, please quantify the amount.

16. What additional costs, if any, would a nonbank MSBSP incur in making adjustments to risk management practices to conform to the specific provisions of Rule 15c3–4?

17. If stand-alone SBSDs would not be able to claim flow-through capital benefits for consolidated subsidiaries or affiliates under Rule 18a–1c, in contrast to Appendix C of existing Rule 15c3–1, would stand-alone SBSDs be competitively disadvantaged? If yes, please explain.

18. Would the Commission's proposals lead to greater competition among intermediaries for security-based swaps business, greater concentration, or neither? How important are the goals of reduction in systemic risk versus promotion of competition in crafting rules in this area, and to what extent are they competing goals? If they are not competing goals, how should the achievement of both goals inform the Commission's overall approach?

19. Will the Commission's proposals affect the competitive position of U.S. firms in the global security-based swaps market? How in general would they impact global trading in these products? How could the Commission best address any anti-competitive effects? For example, should the Commission permit U.S. firms trading with off-shore counterparties to collect margin based on the rules of the jurisdiction where the counterparty is located, provided the Commission determines that those rules are comparable to the U.S. regime? How would comparability be determined?

20. The Commission specifically requests comment on the potential impact of interagency differences in specific aspects of capital and margin requirements. Which specific aspects of the proposed rules could have the most impact in determining the type of legal entity in which trading is conducted? What would be the market or economic effects?

3. The Proposed Margin Rule—Rule 18a–3

As discussed in section II.B. of this release, pursuant to section 15F(e) of the Exchange Act, proposed new Rule 18a–3 would establish margin requirements for nonbank SBSDs and nonbank MSBSPs with respect to transactions with counterparties in non-cleared security-based swaps.[1081] As discussed in more detail below, the proposed rule would require nonbank SBSDs to collect collateral from their counterparties to non-cleared security-based swaps to cover both current exposure and potential future exposure to the counterparty (*i.e.,* the rule would require the account to have prescribed minimum levels of *equity*); however, there would be exceptions to these requirements for certain types of counterparties. Proposed new Rule 18a–3 would have a number of benefits as well as impose certain costs on nonbank SBSDs, nonbank MSBSPs, as well as other market participants, including *commercial end users.* The proposed rule also would have possible effects on competition, efficiency, and capital formation, which will be discussed further below.

The two types of credit exposure arising from OTC derivatives are current exposure and potential future exposure. The current exposure is the amount that the counterparty would be obligated to pay the dealer if all the OTC derivatives contracts with the counterparty were terminated (*i.e.,* it is the amount of the current receivable from the counterparty). This form of credit risk arises from the potential that the counterparty may default on the obligation to pay the current receivable. The potential future exposure is the amount that the current exposure may increase in the favor of the dealer in the future. This form of credit risk arises from the potential that the counterparty may default before providing the dealer with additional collateral to cover the incremental increase in the current exposure or the current exposure will increase after a default when the counterparty has ceased to provide additional collateral to cover such increases and before the dealer can liquidate the position.

Rule 18a–3 is intended to support a goal of the Dodd-Frank Act by promoting centralized clearing of sufficiently standardized products,[1082] which, in turn, may help to mitigate credit risk.[1083] Specifically, Rule 18a–3, by creating stringent margin requirements for non-cleared contracts, is meant to create incentives for participants to clear security-based swaps, where available and appropriate for their needs.[1084] Central clearing can provide systemic benefits by limiting systemic leverage and aggregating and managing risks by a central counterparty.[1085] At the same time, realization of these benefits assumes that central counterparties are appropriately capitalized and sufficiently collateralize their exposures to their clearing members. Under the proposed rule, the market will benefit from the required collateralization of non-cleared security-based swaps. Specifically, the required collateralization should improve counterparty risk management, reduce the risk of contagion from a defaulting counterparty, and ultimately reduce systemic risk.

While available data suggests that clearing of security-based swaps has been increasing, significant segments of the security-based swap markets remain uncleared, even where a CCP is available to clear the product in question on a voluntary basis.[1086] The mandatory clearing determinations made pursuant to Exchange Act section 3C(a)(1) will alter current clearing practices at the time such determinations are made. The Commission has not yet made any mandatory clearing determinations under the authority of section 3C(a)(1) of the Exchange Act and cannot estimate

[1081] *See* proposed new Rule 18a–3.

[1082] The Dodd-Frank Act seeks to ensure that, wherever possible and appropriate, derivatives contracts formerly traded exclusively in the OTC market be cleared. *See, e.g.,* Senate Committee on Banking, Housing, and Urban Affairs, *The Restoring American Financial Stability Act of 2010,* S. Rep. No. 111–176, 34 (stating that ''[s]ome parts of the OTC market may not be suitable for clearing and exchange trading due to individual business needs of certain users. Those users should retain the ability to engage in customized, non-cleared contracts while bringing in as much of the OTC market under the centrally cleared and exchange-traded framework as possible.'').

[1083] For example, when an OTC derivatives contract between two counterparties that are members of a CCP is executed and submitted for clearing, it is typically replaced by two new contracts—separate contracts between the CCP and each of the two original counterparties. At that point, the original counterparties are no longer counterparties to each other. Instead, each acquires the CCP as its counterparty, and the CCP assumes the counterparty credit risk of each of the original counterparties that are members of the CCP. *See* Stephen Cecchetti, Jacob Gyntelberg, and Mark Hollanders, *Central counterparties for over-the-counter derivatives,* BIS Quarterly Review (Sept. 2009), available at *http://www.bis.org/publ/qtrpdf/r_qt0909f.pdf.* Structured and operated appropriately, CCPs may improve the management of counterparty risk and may provide additional benefits such as multilateral netting of trades. *See also Process for Submissions of Security-Based Swaps,* 77 FR at 41603.

[1084] *See* Daniel Heller and Nicholas Vause, *Expansion of Central Clearing,* BIS Quarterly Review (June 2011) (arguing expansion of central clearing within or across segments of the derivatives markets could economize both on margin and non-margin resources).

[1085] *See Process for Submissions of Security-Based Swaps,* 77 FR 41602.

[1086] *See Process for Submissions of Security-Based Swaps,* 77 FR 41602.

at this time how much of the security-based swap markets may ultimately be subject to such determinations.

Other costs resulting from proposed new Rule 18a–3 may result from reducing the availability of liquid assets for purposes other than posting collateral. Data available to the Commission suggests that existing collateral practices vary widely by type of market participant and counterparty.[1087] For example, the *ISDA Margin Survey 2012,* which provides global estimates regarding the use of collateral in the OTC derivatives business based on a survey of ISDA members as of the end of 2011,[1088] stated that 71% of all OTC derivatives transactions were subject to collateral agreements; the average percentage was 96% for the largest dealers responding to the survey.[1089] The percent of trades subject to collateral agreements was higher, however, for credit derivatives (93.4% of all trades) and about the same as the general average for equity derivatives (72.7%).[1090]

The *ISDA Margin Survey 2011* reported on the extent of collateralization (percentage of net exposures) by type of counterparty.[1091] The amount reported for all counterparties and all OTC derivatives was 73.1%.[1092] The *ISDA Margin Survey 2011* also indicates that the collateralization levels by large dealers of their net exposures to their bank and broker-dealer dealer counterparties was 88.6%.[1093] For hedge funds, the average collateralization levels were 178%, reflecting a greater tendency to collect initial margin from those participants.[1094] Finally, exposures to non-financial corporations (37.3%) and sovereign governments (17.6%) had much lower levels of coverage.[1095]

The data from the *ISDA Margin Survey 2011* and the *ISDA Margin Survey 2012* support the premises that margin practices widely vary, that larger dealers tend to collateralize their net exposures, that exposures to financial end users tend to be collateralized with both variation (current exposure) and initial margin (potential future exposure), and that much of the exposure to non-financial end users generally is not collateralized.[1096]

Rule 18a–3 is generally modeled on the broker-dealer margin rules in terms of establishing an account *equity* requirement; requiring nonbank SBSDs to collect collateral to meet the requirement; and, subject to haircuts, allowing a range of securities for which there is a ready market to be used as collateral.[1097] The goals of modeling proposed new Rule 18a–3 on the broker-dealer margin rules are to create a framework that will limit counterparty exposure of nonbank SBSDs while promoting consistency with existing rules. This consistency may also facilitate the ability to provide portfolio margining of security-based swaps with other types of securities, and in particular single name credit default swaps along with bonds that serve as reference obligations for the credit default swaps.

In the securities markets, margin rules have been set by relevant regulatory authorities (the Federal Reserve and the SROs) since the 1930s.[1098] The requirement that an SRO file proposed margin rules with the Commission has promoted the establishment of consistent margin levels across the SROs, which mitigates the risk that SROs (as well as their member firms) will compete by implementing lower margin levels and helps ensure that margin levels are set at sufficiently prudent levels to reduce systemic risk.[1099] Basing proposed Rule 18a–3 on the broker-dealer margin rules is intended to achieve these same objectives in the market for security-based swaps. This consistency between margin requirements for securities and security-based swaps should ultimately benefit participants in the securities markets, reduce the potential for regulatory arbitrage, and lead to consistent interpretation and enforcement of applicable regulatory requirements across U.S. securities markets.

The discussion below focuses on the impact of specific provisions of proposed new Rule 18a–3 and their potential benefits and costs. With respect to certain provisions, the Commission has identified alternatives to the proposed approach and is seeking comment on the relative costs and benefits of adopting the alternatives, in comparison to the proposed approach. As to whether nonbank SBSDs should be required to collect initial margin in transactions with each other, the Commission is expressly proposing alternative formulations of the rule.

a. Calculation of Margin Amount

Proposed new Rule 18a–3 would require a nonbank SBSD to perform two calculations (and a nonbank MSBSP to perform one calculation) as of the close of each business day with respect to each account carried by the firm for a counterparty to a non-cleared security-based swap transaction.[1100] Even if the counterparty is not required to deliver collateral, the calculation(s) would assist the nonbank SBSD or the nonbank MSBSPs in managing its credit risk (and determining how much needs to be

[1087] *See, e.g., ISDA Margin Survey 2012.* Proposed new Rule 18a–3 would distinguish by counterparty type in that the rule would provide specific exemptions from the rule for certain counterparties, such as *commercial end users. See* section II.B. of this release.

[1088] *ISDA Margin Survey 2012.* The *ISDA Margin Survey 2012* also states that the estimated amount of collateral in circulation in the non-cleared OTC derivatives market at the end of 2011 was approximately $3.6 trillion, which is up 24% from last year's estimated amount of $2.9 trillion.

[1089] *Id.* The threshold for classification as a ''large'' program under the ISDA survey is more than 3,000 agreements. Overall, 84% of all OTC derivatives transactions executed by the largest dealers were subject to collateral agreements. Hedge fund exposures tend to be the most highly collateralized of all types of counterparty exposures with average collateralization levels exceeding 100% of net exposures, a figure that reflects ''Independent Amounts'' (initial margin) posted by such firms. *ISDA Margin Survey 2011* at Table 3.3.

[1090] *ISDA Margin Survey 2012* at Table 3.2. The fourteen largest reporting firms reported an average 96.1% of credit derivatives trades were subject to collateral arrangements during 2011, and 85.5% of equity derivatives trades were subject to collateral agreements. *Id.*

[1091] *See ISDA Margin Survey 2011.* This information was not reported in the *ISDA Margin Survey 2012.*

[1092] *Id.*

[1093] *Id.*

[1094] *Id.*

[1095] *Id.*

[1096] *See generally ISDA Margin Survey 2011; ISDA Margin Survey 2012.* The results of the survey, however, could be substantially different if limited only to U.S. participants, because the data contained in the *ISDA Margin Survey 2011* and *ISDA Margin Survey 2012* is global. *Id.* For example, 47% of the institutions responding to the *ISDA Margin Survey 2012* were based in Europe, the Middle East, or Africa, and 31% were based in the Americas. *ISDA Margin Survey 2012* at Chart 1.1.

[1097] Broker-dealers are subject to margin requirements in Regulation T promulgated by the Federal Reserve (12 CFR 220.1, *et seq.*), in rules promulgated by the SROs (*see, e.g.,* FINRA Rules 4210–4240), and with respect to security futures, in rules jointly promulgated by the Commission and the CFTC (17 CFR 242.400–406).

[1098] The Federal Reserve originally adopted Regulation T pursuant to section 7 of the Exchange Act shortly after the enactment of the Exchange Act. *See* 1934 Fed. Res. Bull. 675. The purposes of the Federal Reserve's margin rules include: (1) Regulation of the amount of credit directed into securities speculation and away from other uses; (2) protection of the securities markets from price fluctuations and disruptions caused by excessive margin credit; (3) protection of investors against losses arising from undue leverage in securities transactions; and (4) protection of broker-dealers from the financial exposure involved in excessive margin lending to customers. *See* Charles F. Rechlin, *Securities Credit Regulation* § 1:3 (2d ed. 2008).

[1099] Pursuant to Section 19(b)(1) of the Exchange Act, each SRO must file with the Commission any proposed change in, addition to, or deletion from the rules of the exchange electronically on a Form 19b–4 through the Electronic Form 19b–4 Filing System, which is a secure Web site operated by the Commission. 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b–4.

[1100] *See* paragraphs (c)(1)(i)(A), (B), and (c)(2)(i) of proposed new Rule 18a–3.

collateralized) and understanding the extent of its uncollateralized credit exposure to the counterparty and across all counterparties. These required calculations also would provide examiners with enhanced information about non-cleared security-based swaps, allowing the Commission and other appropriate regulators to gain ''snapshot'' information at a point in time for examination purposes.

As described in section II.B. of the release, paragraph (d) of proposed new Rule 18a–3 would prescribe a standardized method for calculating the margin amount as well as a model-based method if the non-bank SBSD is approved to use internal models.[1101] The benefits of consistent treatment of the standardized haircut and internal models as between the proposed capital rules and proposed new Rule 18a–3 may increase operational efficiencies and reduce costs at the nonbank SBSD by permitting the use of congruent systems and processes to comply with both capital and margin requirements.[1102]

As is the case with the impact of standardized haircuts on regulatory capital, as described in section II.B. of the release, nonbank SBSDs required to use standardized haircuts under Rule 18a–3(d) to determine the margin amount generally will be required to collect higher margin amounts from counterparties for non-cleared security-based swap transactions than nonbank SBSDs that are approved to use internal models will need to collect, because VaR models generally result in lower charges than the standardized haircut provisions.[1103]

In addition, this proposed requirement would impose additional operational and technology costs to install or upgrade systems needed to perform daily calculations under proposed new Rule 18a–3. These costs may vary because broker-dealers registering as nonbank SBSDs may already have systems in place, as current margin rules [1104] for securities require daily margin calculations for customer accounts, while new entrants may incur higher operational or other systems costs to comply with this requirement. Finally, secondary costs (such as reduced profits) could arise if *commercial end users* or other counterparties reduce trading in non-cleared security-based swaps because of the increased collateral requirements required by Rule 18a–3, or if these entities determine to trade instead with non-U.S. entities.

b. Account Equity Requirements

As described in section II.B. to this release, a nonbank SBSD and nonbank MSBSP generally would need to collect cash and/or securities to meet the account *equity* requirements in proposed new Rule 18a–3.[1105] This proposal recognizes that counterparties may engage in a wide range of trading strategies that include security-based swaps. Because of the relation between security-based swaps and other securities positions, permitting various types of securities to count as collateral may be more practical for margin arrangements involving security-based swaps than for other types of derivatives. This flexibility to accept a broad range of securities, along with consistency with existing margin requirements,[1106] takes advantage of efficiencies that result from correlations between securities and security-based swaps.[1107] However, it may increase the risk that SBSDs will incur a shortfall if, as a result, they hold less liquid collateral that cannot be quickly sold for an amount that covers the nonbank SBSD's exposure to the counterparty.[1108] This risk may be mitigated by the collateral haircut and other requirements regarding the liquidity of collateral under the proposed rule.[1109]

As an alternative, the Commission could limit eligible collateral to the most highly liquid categories, as proposed by the prudential regulators and the CFTC and described in section II.B.2.c. of this release.[1110] This alternative could limit the potential that an SBSD would incur a loss following default of a counterparty based on changes in market values of less liquid collateral that occur before the SBSD is able to sell the collateral, and therefore could limit the potential for a default by the SBSD to other counterparties. On the other hand, if Rule 18a–3 required a counterparty to deliver additional collateral beyond assets already held in the counterparty's account because the existing assets did not qualify as eligible collateral, the rule could have the effect of increasing the counterparty's exposure to the SBSD and draining liquidity from the counterparty in a way that may not be necessary to account for the nonbank SBSD's potential future exposure to the counterparty, and may increase costs for both the nonbank SBSD and its counterparties.[1111] Also, granting counterparties the flexibility to post a variety of collateral types to meet margin requirements may result in reduced costs for end users and could encourage increased trading of security-based swaps, thereby increasing competition. The extent of increased trading of non-cleared security-based swaps, however, may depend on the extent to which portfolio margin treatment would materially increase the amount of net equity that counterparties would have available to serve as collateral, compared to the amount that would result if they were limited to very highly liquid securities, such as U.S. Treasury securities.

i. Commercial End Users

As discussed in section II.B.2.c.i. of this release, under proposed new Rule 18a–3, a nonbank SBSD would not be required to collect cash or securities to cover the *negative equity* (current exposure) or margin amount (potential future exposure) in the account of a counterparty that is a *commercial end user.*[1112]

[1101] *See* paragraph (d) of proposed new Rule 18a–3. ''Margin amount'' is generally initial margin or potential future exposure. These terms may be used interchangeably throughout this section.

[1102] *See* proposed new Rule 18a–1; proposed new Rule 18a–3; proposed amendments to Rule 15c3–1.

[1103] *See Alternative Net Capital Requirements Adopting Release,* 69 FR 34428.

[1104] *See, e.g.,* FINRA Rule 4220 (Daily Record of Required Margin); 12 CFR 220.4.

[1105] By requiring most counterparties to deliver collateral, the proposed margin requirements are intended to prevent counterparties from employing undue leverage in their portfolios of security-based swaps, which can exacerbate the magnitude of losses in relation to the financial resources of the counterparty in the case of default.

[1106] *See* the Federal Reserve's Regulation T, 12 CFR 220.1, *et seq.* and SRO margin rules, such as FINRA Rule 4210 and CBOE Rule 12.3. The consideration in adopting final rules will be informed by the comments received.

[1107] The *ISDA Margin Survey 2012* states with regard to the types of assets used as collateral, that the use of cash and government securities as collateral remains predominant, constituting 90.4% of collateral received and 96.8% of collateral delivered. *ISDA Margin Survey 2012* at 8, Table 2.1.

[1108] Gary Gorton and Guillermo Ordoñez, *Collateral Crises,* Yale University Working Paper (Mar. 2012) (arguing that during normal times collateral values are less precise, but during volatile times are reassessed). This reassessment can possibly lead to large negative shocks in their values, which by deduction can lead to market disruptions if collateral needs to be liquidated.

[1109] *See* paragraphs (c)(3)–(c)(4) of proposed new Rule 18a–3.

[1110] Commenters argued that the scope of eligible collateral should be significantly expanded by arguing that there are other assets that are highly liquid and suitable for credit support if a counterparty fails and if eligible collateral remains narrowly defined, the liquidity of eligible assets could be highly affected and sourcing of adequate margin could become difficult. *See, e.g.,* CFTC SIFMA/ISDA Letter.

[1111] This alternative may also increase demand for highly liquid collateral and potentially cause shortages in the supply of cash and government bonds. *See* IMF, *Global Financial Stability Report: The Quest for Lasting Stability* 96 and 120 (Apr. 2012), available at *http://www.imf.org/External/Pubs/FT/GFSR/2012/01/pdf/text.pdf.*

[1112] *See* paragraph (b)(2) of proposed new Rule 18a–3 (defining the term *commercial end user*).

As discussed above in section II.A.2.b.v. of this release, this proposed exception to the requirement to collect collateral is intended to benefit *commercial end users* in order to address concerns that have been expressed by them and others that the imposition of margin requirements on commercial companies that use derivatives to mitigate the risk of business activities that are not financial in nature could unduly disrupt their ability to enter into such hedging transactions. The proposed exception for *commercial end users* also is intended to account for the different risk profiles of *commercial end users* as compared with financial end users.[1113] This exception may increase efficiencies by allowing such end users to more cost efficiently manage business risks and thereby better compete in their respective industries.

At the same time, to the extent of any dealer exposure to *commercial end users,* the proposed exception for *commercial end users* could lead to uncollateralized exposure by nonbank SBSDs to *commercial end users.* To address this concern and because collecting collateral is an important means of mitigating risk, Rule 18a–1 would require nonbank SBSDs not approved to use internal models to take a capital charge equal to the margin amount calculated for the *commercial end user* to the extent the firm does not collect cash or securities equal to that amount.[1114] Requiring a firm to hold capital in lieu of margin [1115] in these cases is designed to reflect both the needs of *commercial end users* and concerns that permitting nonbank SBSDs to assume credit exposure without the protection of margin could lead to the assumption of inappropriate risks. In this way the proposal is intended to ensure the safety and soundness of nonbank SBSDs and be proportionate to the amount of uncollateralized exposures to *commercial end users.*[1116]

The extent of the impact of the intended benefit to *commercial end users,* however, would depend on whether nonbank SBSDs choose to trade with *commercial end user* counterparties on an uncollateralized basis, notwithstanding the capital charges under Rule 18a–1. In addition, nonbank SBSDs subject to this capital charge are expected to, at least partially, pass the increased cost of capital through to *commercial end users* in the form of increased transaction pricing.[1117] Accordingly, any potential economic benefit associated with an exception from Rule 18a–3 for *commercial end users* in non-cleared security-based swaps may be offset to the extent that nonbank SBSDs determine to pass on any costs incurred as a result of the additional capital charges.[1118] In summary, the Commission does not expect those costs will be material, unless *commercial end users* begin to account for meaningful volume in non-cleared security-based swap trading.

As an alternative, the Commission could limit this proposed exception for *commercial end users* and require nonbank SBSDs to collect collateral from *commercial end users* with regard to their transactions in non-cleared security-based swaps. This alternative would protect the nonbank SBSDs by requiring that transactions with *commercial end users* be collateralized. However, in contrast to the Commission's proposal, this alternative would limit the flexibility of nonbank SBSDs and *commercial end users* to negotiate the terms of their non-cleared security-based swap transactions. In considering this approach, the Commission would need to consider the benefit of any additional protections to SBSDs against losses in transactions with *commercial end users* in light of increased costs to such end users or less accessibility to them of hedging instruments.

ii. SBSDs—Alternatives A and B

As described in section II.B. to the release, the Commission is proposing specific alternative margin requirements with respect to counterparties that are nonbank SBSDs. Under Alternative A, which would create an exception from proposed new Rule 18a–3, a nonbank SBSD would need collateral only to cover the current exposure (*negative equity*) in the account of a counterparty that is another SBSD. Under Alternative B, a nonbank SBSD would be required to collect collateral to cover both the current exposure (*negative equity*) and the potential future exposure (margin amount) in the account of a counterparty that is another SBSD [1119] and further segregate the margin amount in an account carried by an independent third-party custodian pursuant to the requirements of Section 3E(f) of the Exchange Act.[1120] Alternative B is consistent with the proposals of the prudential regulators and the CFTC.[1121]

As discussed in section V.A. above, the baseline of this economic analysis is the OTC derivatives markets as they exist today. The *CDS Data Analysis* suggests there is currently a high degree of concentration of potential dealing activity in the single-name credit default swap market. Based on discussions with market participants, the Commission staff understands that dealers in security-based swaps presently collect variation margin covering current exposure but generally do not collect initial margin covering potential future exposure from other dealers.[1122] Accordingly, relative to the existing market for security-based swaps, Alternative A would not create additional costs for dealers resulting from transactions with other dealers in security-based swaps. Alternative B would impose substantially greater costs

[1113] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27571 ("Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity."). *See also CFTC Margin Proposing Release,* 76 FR at 27735 ("The Commission believes that financial entities, which are generally not using swaps to hedge or mitigate commercial risk, potentially pose greater risk to CSEs than non-financial entities.").

[1114] *See* proposed paragraph (c)(2)(xiv) of Rule 15c3–1; paragraph (c)(1)(xiv) of proposed Rule 18a–1.

[1115] *See* section II.A.2.b.v. of this release (discussing proposed charge capital in lieu of margin collateral).

[1116] As discussed above in section II.A. of this release, nonbank SBSDs that have been approved to use internal models for credit risk would take a much smaller capital charge, *i.e.,* 8% of net replacement value multiplied by the counterparty factor. These firms also would be permitted to take a smaller charge with respect to the unsecured receivables from *commercial end user* counterparties, which may provide a competitive advantage for nonbank SBSDs that are capable of and have received approval to model credit risk.

[1117] Even under these conditions, a nonbank SBSD still retains the option to collect margin from its counterparties.

[1118] *See* Antonio S. Mello and John E. Parsons, *Margins, Liquidity and the Cost of Hedging,* MIT Center for Energy and Environmental Policy Research Working Paper 2012–005 (May 2012) (presenting a replication argument to show that a non-margined swap is equivalent to a package of (1) a margined swap, plus (2) a contingent line of credit). The paper concludes that a mandate to clear and therefore to margin derivatives trades forces dealers to market these two components separately, but otherwise makes no additional demand on non-financial corporations, and therefore, a clearing and margin mandate does not add any real costs to a non-financial corporation seeking to hedge its commercial risk). *Id.*

[1119] Alternative B is not an exception to the account *equity* requirements in proposed new Rule 18a–3 because it would require the nonbank SBSD to collect collateral to cover the *negative equity* and margin amount in an account of another SBSD.

[1120] *See* 15 U.S.C. 78c–5(f).

[1121] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564; *CFTC Margin Proposing Release,* 76 FR 23732.

[1122] *See generally ISDA Margin Survey 2011; ISDA Margin Survey 2012.*

to inter-dealer transactions compared to the baseline.

Alternatives A and B would both require the exchange of variation margin; the difference between the alternatives therefore is, first and foremost, whether to require nonbank SBSD counterparties to exchange initial margin. The cost impact would depend on how significant initial margin is in relation to variation margin, which will vary by type of contract, extent of market volatility, and other factors. The goal for either alternative is to reduce systemic risk without imposing undue additional cost to the extent that the ability of counterparties to trade security-based swaps is severely compromised. However, the benefit of collecting the margin amount under Alternative B would be the further protection of a nonbank SBSD from market exposure during the period of unwinding a position from a defaulting counterparty when that counterparty, by definition, would not be able to post additional variation margin.

Requiring a nonbank SBSD to post initial margin, however, could significantly impact its liquidity and therefore limit the ability of the nonbank SBSD to trade in security-based swaps. Permitting a firm to retain a pool of liquid assets that would not otherwise be used to post initial margin could permit the nonbank SBSD to use this capital more efficiently, for example by increasing its investment in information technology or increasing its investments that offer a higher rate of return. The potential benefit of Alternative B is that it would limit the aggregate amount of leverage in the financial system associated with security-based swaps. A principal purpose of Title VII of the Dodd-Frank Act, including those provisions that apply to capital and margin requirements for dealers, is to reduce systemic risk, particularly risks associated with relatively opaque bilateral, non-cleared derivative transactions. Requiring dealers to collateralize their potential future exposure to each other by exchanging both initial and variation margin may further reduce systemic risk by reducing leverage and the potential that a default by a single large dealer could translate to defaults of counterparty dealers with potential ripple effects throughout the system.

On the other hand, the requirement to exchange initial margin would not only impose costs to the extent that it would result in substantially less capital available to support the security-based swap business or other dealer activity, but also it could contribute to the instability of a nonbank SBSD. The instability stems from the possibility that assets posted to the custodian account might in the case of a counterparty default not be immediately returned to a nonbank SBSD to absorb losses or meet other liquidity demands. In this regard, the ability of a dealer counterparty to demand and obtain the return of initial margin held by a third-party custodian could be subject to various uncertainties, including the potential for counterparty disputes that might be subject to court resolution. During periods of general market instability or loss of confidence, even a brief delay in being able to access liquid assets could prove decisive.[1123]

The prudential regulators and the CFTC have received comment letters regarding the liquidity impact of their proposed rules, as well as public research reports attempting to estimate the liquidity impact.[1124] Each of these commenters used different methods, data and assumptions to arrive at a liquidity impact estimate and respond to the amount of initial margin required by the prudential regulators' and CFTC's proposed margin rules. Overall, each of these commenters concluded that the liquidity impact of the proposed initial margin rules proposed by the CFTC and the prudential regulators was significant.[1125] One such estimate, however, noted that the numbers should be viewed as an ''order of magnitude estimate'' and that ''[o]ne cannot predict which entities will use derivatives in the future nor the amounts and types of products that will be used.'' [1126] Consequently, while it is difficult to estimate the costs imposed by requiring dealers to post initial margin, commenters to the CFTC and prudential regulators' proposed margin rules and others have estimated that the cost would be significant. These estimates are discussed in detail below.[1127]

One commenter to the prudential regulators' proposed margin rule stated that imposing segregated initial margin requirements on trades between swap entities would result in a tremendous cost to the financial system in the form of a massive liquidity drain.[1128] This commenter estimated that the effect of the proposed rule would result in a cost of $428 billion in initial margin for swap dealers.[1129] Another commenter predicted that the initial margin requirements will result in a huge drain of liquid assets from the U.S. economy because they would require very large amounts of collateral to be posted as initial margin and placed in segregated custodial accounts.[1130] This commenter attempted to quantify this amount by calculating the amounts of initial margin that the firm would have to collect from 34 of its largest professional dealer counterparties by reference to the ''Lookup Table'' percentages of notional approach set forth in Appendix A to the prudential regulators' margin rulemaking.[1131] Application of this approach to the commenter's existing portfolio with those 34 counterparties yielded an estimated amount of initial margin that the firm would have to collect equal to $1.4 trillion.[1132] The commenter noted that since the interdealer initial margin requirements are reciprocal, it would also be obligated to post $1.4 trillion.[1133]

[1123] *See* Manmohan Singh, *Velocity of Pledged Collateral: Analysis and Implications,* IMF Working Paper, WP/11/256 (Nov. 2011) (stating that the decline in leverage and re-use of collateral may be viewed positively from a financial stability perspective, but from a monetary policy perspective, however, the lubrication in the global financial markets is now lower as the velocity of money-type instruments has declined.). Singh argues that the ''velocity of collateral,'' analogous to the concept of the ''velocity of money'' indicates the liquidity impact of collateral. A security that is owned by an economic agent and can be pledged as re-usable collateral leads to chains. Therefore, Singh argues that a shortage of acceptable collateral would have a negative cascading impact on lending similar to the impact on the money supply of a reduction in the monetary base. *Id.* at 16. *See also* Manmohan Singh and James Aitken, *The (sizable) Role of Rehypothecation in the Shadow Banking System,* IMF Working Paper WP/10/172 (July 2010).

[1124] *See* OCC Economics Department, *Unfunded Mandates Reform Act—Impact Analysis for Swaps Margin and Capital Rule,* (Apr. 15, 2011) (''*OCC Unfunded Mandates Report*''); *SIFMA/ISDA Comment Letter to the Prudential Regulators; J.P. Morgan Letter;* Bank of America-Merrill Lynch, *No Margin for Error, Part 3: Dodd-Frank Implements QE3,* Credit Derivatives Strategist (Nov. 5, 2011) (''*BAML Report*'').

[1125] *See* Manmohan Singh, *Collateral, Netting and Systemic Risk in the OTC Derivatives Market,* IMF Working Paper WP 10/99 (1999) (a study by the IMF arguing that moving OTC derivatives to centralized clearing would require between $170 and $220 billion in initial margin collateral).

[1126] *SIFMA/ISDA Comment Letter to the Prudential Regulators* at 38.

[1127] *See* BCBS, IOSCO, *Margin Requirements for Non-centrally-cleared Derivatives.* The Working Group on Margin Requirements is conducting a Quantitative Impact Study to better quantify the impact of the proposed margin requirements set forth in the consultative paper. *See id.* at Part C.

[1128] *SIFMA/ISDA Comment Letter to the Prudential Regulators.*

[1129] *Id.* at 36.

[1130] *J.P. Morgan Letter.*

[1131] *J.P. Morgan Letter; Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27592.

[1132] *J.P. Morgan Letter* at 5.

[1133] *Id.* In the *J.P. Morgan Letter,* however, it was noted that it is likely that most swap dealers would use the model based approach, and not the ''lookup table'', to calculate initial margin which would likely produce smaller initial margin amounts. In the letter, it was argued that there is substantial uncertainty about the model approval process and timing and accordingly the large amounts resulting from application of the lookup table are relevant. *Id.*

In addition, the OCC Unfunded Mandates Report estimated that the initial margin collected under the prudential regulators' proposed margin rule in one year could total $2.56 trillion.[1134] The report pointed out, however, that several factors are likely to reduce the impact of the proposed rule, including a move to central clearing and the fact that dealers are likely to use internal models that permit netting. The report estimated that currently roughly 20% of swap contracts trade through clearing houses.[1135] Assuming that the proportion of cleared to non-cleared swaps will at a minimum remain at one in five, the report further estimated the required funds to cover the initial margin requirement under the proposed rule to be $2.05 trillion (0.80 × $2.56 trillion).[1136]

Finally, the *BAML Report* stated that its calculations suggested that the regulatory changes may eventually result in initial margin requirements of $200 billion to $600 billion for US banks, as current derivatives portfolios turn over.[1137]

In summary, as stated above, commenters concluded that the liquidity impact of the initial margin rules proposed by the CFTC and the prudential regulators was significant.[1138] However, one commenter acknowledged that the numbers should be viewed as an ''order of magnitude estimate'' and that ''[o]ne cannot predict which entities will use derivatives in the future nor the amounts and types of products that will be used.'' [1139] The Commission seeks comment on the liquidity impact of its proposals below and in section II.B. of this release.

c. Margin Requirements for Nonbank-MSBSPs

As described in section II.B. of this release, a nonbank MSBSP would be required to calculate as of the close of each business day the amount of *equity* in the account of each counterparty to a non-cleared security-based swap.[1140] On the next business day following the calculation, the nonbank MSBSP would be required to either collect or deliver cash, securities, and/or money instruments to the counterparty depending on whether there was *negative* or *positive equity* in the account of the counterparty.[1141] Specifically, if the account had *negative equity* on the previous business day, the nonbank MSBSP would be required to collect cash, securities, and or money market instruments in an amount equal to the *negative equity.*[1142] Conversely, if the account had *positive equity* on the previous business day, the nonbank MSBSP would be required to deliver cash, securities, and/or money market instruments to the counterparty in an amount equal to the *positive equity.*[1143]

Nonbank MSBSPs are not expected to maintain two-sided markets or otherwise engage in activities that would require them to register as an SBSD.[1144] They will, however, by definition, maintain substantial positions in particular categories of security-based swaps.[1145] These positions could create significant risk to counterparties to the extent the counterparties have uncollateralized current exposure to the nonbank SBSD. In addition, they could pose significant risk to the nonbank MSBSP to the extent it has uncollateralized current exposure to its counterparties. The proposed account *equity* requirements for nonbank MSBSPs seek to address these risks by imposing a requirement that nonbank MSBSPs on a daily basis must ''neutralize'' the credit risk between the nonbank MSBSP and the counterparty either by collecting or delivering cash, securities, and/or money market instruments in an amount equal to the *positive* or *negative equity* in the account.

The collection of collateral from counterparties would strengthen the liquidity of the nonbank MSBSP by collateralizing its current exposure to counterparties. The delivery of collateral to counterparties to collateralize their current exposure to the nonbank MSBSP would lessen the impact on the counterparties if the nonbank MSBSP failed.

The requirement for nonbank MSBSPs to post current exposure to certain counterparties under proposed new Rule 18a–3 would impose an incremental opportunity cost for these nonbank MSBSPs only to the extent that they do not currently post collateral to cover current exposure. The requirement that nonbank MSBSPs collect variation margin from certain counterparties also would represent an incremental cost to those counterparties users to the extent they do not currently post such margin.

As stated above, proposed new Rule 18a–3 contains an exception for trades between nonbank MSBSPs and *commercial end users,* so those end users would not face additional costs because of this exception.

Instead of the proposed approach, the Commission could adopt margin requirements for nonbank MSBSPs that are consistent with those proposed for nonbank SBSDs, by requiring them to collect initial margin from all non-dealer counterparties. This approach could better protect the MSBSP from loss in the event of a counterparty default, and thereby lessen the possibility of a default by the MSBSP. On the other hand, such a requirement would increase the credit exposure of counterparties to the MSBSP by the amount of the initial margin that they provide to the MSBSP and could increase their risk of loss if the MSBSP were to fail and they were unsuccessful in obtaining the return of amounts owed to them. The Commission is seeking comment on this alternative.

d. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The proposed margin requirements to collect collateral from their counterparties to non-cleared security-based swaps to cover both current exposure and potential future exposure are designed to insulate security-based swap market participants from the negative fallout of a defaulting counterparty. Basing proposed Rule 18a–3 on the broker-dealer margin rules is intended to achieve those objectives in the market for security-based swaps. Moreover, the consistency between margin requirements for securities and security-based swaps should ultimately promote efficiency in the securities

[1134] *OCC Unfunded Mandates Report* at 5. The report also used the ''lookup table'' to estimate the initial margin impact of the prudential regulators' proposed margin rule, and noted the proposed rule would apply to any swap that is a national bank, a federally chartered branch or agency of a foreign bank, or a federal savings association. *Id.* at 2.

[1135] *OCC Unfunded Mandates Report* at 5.

[1136] *Id.* The report also estimated that the actual cost of the initial margin requirement is the opportunity cost of collateral that under the prudential regulators' rule must be segregated into a custodial account with a presumably lower rate of return.

[1137] *BAML Report* at 5.

[1138] *See also* Manmohan Singh, *Collateral, Netting and Systemic Risk in the OTC Derivatives Market.*

[1139] *SIFMA/ISDA Comment Letter to the CFTC* at 38.

[1140] *See* paragraph (c)(2)(i) of proposed new Rule 18a–3.

[1141] *See* paragraph (c)(2)(ii) of proposed new Rule 18a–3. As indicated, the nonbank MSBSP would need to deliver cash, securities, and/or money market instruments and, consequently, other types of assets would not be eligible as collateral.

[1142] *See* paragraph (c)(2)(ii)(A) of proposed new Rule 18a–3. In this case, the nonbank MSBSP would have current exposure to the counterparty in an amount equal to the *negative equity.*

[1143] *See* paragraph (c)(2)(ii)(B) of proposed new Rule 18a–3.

[1144] *See Entity Definitions Adopting Release,* 77 FR 30596.

[1145] *See* 15 U.S.C. 78c(a)(67); *Entity Definitions Adopting Release,* 77 FR 30596.

markets, and in turn, enhance competition in the security-based swap markets.

The proposed rule offers built-in flexibilities that should enhance the efficiency in the application of the rule. For example, granting counterparties the flexibility to post a variety of collateral types to meet margin requirements may result in increased efficiencies for end users, and could encourage increased trading of security-based swaps and thereby increase competition. Furthermore, the proposed exception for *commercial end users* is intended to account for the different risk profiles of *commercial end users* as compared with financial end users.[1146] This exception may increase efficiencies by allowing SBSDs to optimally choose to collect collateral or take a capital charge, which in turn might allow end users to more cost efficiently manage business risks and thereby better compete in their respective industries.

However, the flexibility to use models to calculate margins instead of applying the standard haircuts could have an adverse impact on competition if the differences in these margin amounts are sufficiently large. If this was the case, a nonbank SBSD not approved to use models will find it difficult to compete with an SBSD approved to use models. However, it is conceivable that SBSDs not approved to use models would tend to do business only in cleared security-based swaps and SBSDs that use models would compete in both cleared and non-cleared security-based swaps. This separation could have a negative impact on competition in non-cleared security-based swaps. If, however, SBSDs that are approved to use models manage counterparty risk more efficiently, the market for non-cleared security-based swaps might be systemically less risky than it would be if SBSDs not using models participated actively in that market. It is unclear whether the benefit from the reduction in systemic risk would outweigh the potential cost of the reduced competition.

There also is a trade-off between Alternatives A and B for SBSDs. Under Alternative A the reduced demand on posting and collecting collateral should lead to more efficient allocation of capital and hence improve competition, but it comes at the cost of being less resilient to counterparty defaults and hence might overall increase systemic risk. In addition, if the Commission does not require nonbank SBSDs to collect initial margin in their transactions with each other, as is generally current market practice,[1147] while the prudential regulators require the collection of initial margin for the same trades as their proposed rules suggest, intermediaries could have an incentive to conduct business through nonbank entities.[1148] Under Alternative B, the requirement to exchange initial margin would impose costs on the nonbank SBSD in the form of a capital charge to the extent the nonbank SBSD must post initial margin. This could result in substantially less liquidity available to the nonbank SBSD to support its security-based swap business or other dealer activity, but to the extent it limits the amount of uncleared SBSD transactions among nonbank SBSDs as a whole, it could lead to lower systemic risk. Moreover, if this requirement results in a significant increase in costs because of the required capital charge, nonbank SBSDs could be motivated to conduct trading either in bank SBSDs or offshore because they would not need to take the capital charge. Especially in the latter case, this may not only adversely affect domestic competition if the only dealers able to absorb the increased expenses are the ones currently participating in the market, it also could increase systemic risk worldwide if the regulatory environment in foreign jurisdictions are less stringent.

Request for Comment

The Commission generally requests comment about its analysis of the costs and benefits of proposed Rule 18a–3. In addition, the Commission requests comment in response to the following questions:

1. In many respects, the proposed rules reflect an interplay between capital and margin requirements. How should each set of rules take account of the other? For example, does the proposed alternative capital charge in lieu of collecting margin from *commercial end users* appropriately account for the increased exposure to the dealer? Does it over-state the exposure?

2. What would be the general market impact of requiring that dealers post both variation and initial margin in transactions with each other? Commenters are asked to supply data on the volume of interdealer transactions in security-based swaps and the aggregate dollar impact of this proposal. How does the impact of requiring dealers to exchange both variation and initial margin compare with the aggregate dollar impact of requiring that nonbank SBSDs collect only variation margin?

3. With regard to Alternatives A and B regarding interdealer margin, the Commission requests that commenters provide the following data points to the Commission:

- The relative amounts of variation and initial margin for sample dealer portfolios of security-based swaps;
- The industry dollar impact and liquidity impact of requiring lock up of initial margin for dealer portfolios; and
- How the amount of initial margin would compare to overall dealer capital.

4. The Commission also requests comment on the potential legal limitations involved in obtaining a return of collateral that has been posted to a third party custodian, the costs involved, and whether there are ways to overcome these limitations.

5. The Commission requests comment on the costs and benefits, if the Commission, as an alternative to proposed new Rule 18a–3, permitted nonbank SBSDs to apply to the Commission to use internal models solely to compute the margin amount in paragraph (d) to Rule 18a–3 (without seeking approval to use internal models for capital purposes). Would this alternative impact the Commission's oversight responsibility of nonbank SBSDs?

6. What is the cost impact, if any, of permitting nonbank SBSDs to accept securities as collateral that may be less liquid than Treasury securities in the case of severe market disruptions? Would this cost be mitigated by the haircut and collateral requirements in proposed Rule 18a–3?

7. What would be the costs and benefits of an initial margin requirement between nonbank SBSDs counterparties dependent on the firm's minimum net capital requirement (*e.g.,* based on firm size)?

8. Proposed Rule 18a–3(d) would require that firms approved to use VaR models calculate *margin* amount using a 99%, 10 business-day period. How would this proposal affect sample portfolios of security-based swaps based on existing internal firm models and current market practices, including margin practices at registered clearing

[1146] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR at 27571 (''Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity.''). *See also CFTC Margin Proposing Release,* 76 FR at 27735 (''The Commission believes that financial entities, which are generally not using swaps to hedge or mitigate commercial risk, potentially pose greater risk to CSEs than non-financial entities.'').

[1147] *See generally ISDA Margin Survey 2011.*

[1148] *See Prudential Regulator Margin and Capital Proposing Release,* 76 FR 27564.

agencies? The Commission requests data from market participants to assist it in evaluating this proposal.

9. Would the margin requirements under proposed new Rule 18a–3 incentivize counterparties to trade in cleared security-based swaps? If certain security-based swaps cannot be cleared, would the proposed margin requirements render the use of these non-cleared contracts inefficient?

10. Will nonbank MSBSPs incur operational, technology or other costs to calculate the amount of *equity* in the account of a counterparty, as required under paragraph (c)(2)(i) of proposed new Rule 18a–3?

4. Proposed Segregation Rule—Rule 18a–4

Proposed new Rule 18a–4 would establish segregation requirements for cleared and non-cleared security-based swap transactions, which would apply to bank SBSDs, nonbank stand-alone SBSDs, and broker-dealer SBSDs.[1149] The goal of proposed new Rule 18a–4 is to protect customer assets by ensuring that cash and securities that SBSDs hold for security-based swap customers are isolated from the proprietary assets of the SBSD and identified as property of such customers.[1150] This approach would facilitate the prompt return of customer property to customers either before or during liquidation proceedings if the firm fails,[1151] and is therefore expected to provide market participants who enter into security-based swap transactions with an SBSD the confidence that their accounts will remain separate from the SBSD in the event of bankruptcy.[1152] As such, proposed new Rule 18a–4 will have a number of benefits as well as impose certain costs on SBSDs and MSBSPs, as well as other market participants. The proposed rules are expected to have possible effects on competition, efficiency, and capital formation, which are discussed below.

As discussed earlier in this release, Rule 18a–4 is in substantial part modeled on provisions of Rule 15c3–3 that require a carrying broker-dealer to take two primary steps to safeguard these assets. The first step required by Rule 15c3–3 is that a carrying broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities.[1153] The second step is that a carrying broker-dealer must maintain a reserve of funds or qualified securities in a customer reserve account at a bank that is equal in value to the net cash owed to customers, computed in accordance with the Exhibit A formula.[1154] The corollary provisions of Rule 18a–4 are likewise intended to require that customer funds are adequately protected from loss in the event of the SBSD's failure. Further, this protection would be provided to customers who have not affirmatively elected to require individual account segregation of their assets under section 3E(f) of the Exchange Act.

Paragraph (a) of the proposed new rule would define key terms used in the rule.[1155] Paragraph (b) would require an SBSD to promptly obtain and thereafter maintain physical possession or control of all *excess securities collateral* (a term defined in paragraph (a)) and specify certain locations where *excess securities collateral* could be held and deemed in the SBSD's control.[1156] Paragraph (c) would require an SBSD to maintain a special account for the exclusive benefit of security-based swap customers and have on deposit in that account at all times an amount of cash and/or *qualified securities* (a term defined in paragraph (a)) determined through a computation using the formula in Exhibit A to proposed new Rule 18a–4.[1157]

Paragraph (d) of proposed new Rule 18a–4 would contain provisions that are designed to implement the individual account segregation requirements of section 3E(f) of the Exchange Act, and therefore, are not modeled specifically on Rule 15c3–3. First, it would require an SBSD and an MSBSP to provide the notice required by section 3E(f)(1)(A) of the Exchange Act prior to the execution of the first non-cleared security-based swap transaction with the counterparty.[1158] Second, it would require the SBSD to obtain subordination agreements from counterparties that opt out of the segregation requirements in proposed new Rule 18a–4 because they either elect individual segregation pursuant to the self-executing provisions of section 3E(f) of the Exchange Act[1159] or agree that the SBSD need not segregate their assets at all.[1160]

Available information suggests that customer assets related to OTC derivatives are currently not consistently segregated from dealer proprietary assets. With respect to non-cleared derivatives, available information suggests that there is no uniform segregation practice but that collateral for most accounts is not segregated.[1161] According to the *ISDA Margin Survey 2012,* where independent amounts (initial margin) is collected, ISDA members reported that most (approximately 72.2%) was commingled with variation margin and not segregated, and only 4.8% of the amount received was segregated with a third party custodian.[1162]

In the absence of a segregation requirement, the likelihood that security-based swap customers would suffer losses upon a dealer default may substantially increase. The proposed segregation requirements would limit for security-based swap customers these potential losses if an SBSD fails.[1163] The extent to which assets are in fact protected by proposed Rule 18a–4 would depend on how effective they are in practice in allowing assets to be readily returned to customers.

It is difficult to measure these benefits against the current baseline of the OTC derivatives market as it exists today, as discussed in section V.A.1. of this release. Rule 15c3–3, on which proposed Rule 18a–4 is modeled, however, may generally provide a reasonable template for crafting the corresponding requirements for nonbank SBSDs.[1164] Furthermore, the ensuing increased confidence of market participants when transacting in

[1149] *See* proposed new Rule 18a–4. *See also* section II.C. of this release for a more detailed description of the proposal. The provisions of proposed new Rule 18a–4 are modeled on the broker-dealer segregation rule, Rule 15c3–3. 17 CFR 240.15c3–3.

[1150] *See* proposed new Rule 18a–4.

[1151] *See generally* Michael P. Jamroz, *The Customer Protection Rule,* 57 Bus. Law. 1069 (May 2002). *See also* section II.C. of this release for a more detailed description of the proposal.

[1152] *See* 15 U.S.C. 78c–5.

[1153] *See* 17 CFR 240.15c3–3(d).

[1154] 17 CFR 240.15c3–3(e). The term ''qualified security'' is defined in Rule 15c3–3 to mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States. *See* 17 CFR 240.15c3–3(a)(6).

[1155] *Compare* 17 CFR 240.15c3–3(a), *with* paragraph (a) of proposed new Rule 18a–4.

[1156] *Compare* 17 CFR 240.15c3–3(b)–(d), *with* paragraph (b) of proposed new Rule 18a–4.

[1157] *Compare* 17 CFR 240.15c3–3(e), *with* paragraph (e) of proposed new Rule 18a–4.

[1158] *See* 15 U.S.C. 78c–5(f)(1)(A); paragraph (d)(1) of proposed new Rule 18a–4.

[1159] *See* 15 U.S.C. 78c–5(f)(1)–(3).

[1160] *See* 15 U.S.C. 78c–5(f)(4).

[1161] *See generally ISDA Margin Survey 2012.*

[1162] *ISDA Margin Survey 2012.* The survey also notes that while the holding of the independent amounts and variation margin together continues to be the industry standard both contractually and operationally, it is interesting to note that 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 amount received and 27.8% of independent amount delivered being segregated in some respects. *Id.* at 10. *See also Independent Amounts.*

[1163] CFTC and Commission, *Statement on MF Global about the deficiencies in customer futures segregated accounts held at the firm* (Oct. 31, 2011).

[1164] *See* 17 CFR 240.15c3–3. *See SIPC 2011 Annual Report.*

security-based swaps, as compared to the OTC derivatives market as it exists today, should enhance liquidity and generally benefit market participants.

Further, modeling the provisions of Rule 18a–4 on existing Rule 15c3–3 will generally promote consistent treatment of collateral in circumstances where a broker-dealer SBSD conducts business in securities and security-based swaps with the same counterparty, and in these cases it will facilitate the ability of firms to offer portfolio margin treatment. In addition, ''omnibus segregation'' requirements of proposed Rule 18a–4 are intended to reduce costs for SBSDs and their customers by providing a less expensive segregation alternative to individual account segregation.[1165]

Currently, because of a lack of trading in cleared security-based swaps for customers,[1166] there is no definitive baseline against which to measure the various costs associated with segregation requirements for those trades. Further, overall costs of segregating collateral for cleared security-based swaps will be heavily affected by the clearing agency rules, which will govern how margin required by, and held at, a clearing agency with respect to customer positions must be segregated.[1167]

As stated above, proposed new Rule 18a–4 also is intended to provide SBSDs and their counterparties a less expensive segregation alternative to individual account segregation. Higher costs for individual segregation derive from, among other things, higher fees charged by custodians to monitor individual account assets and to account for potentially greater legal risks and liabilities of custodians to account beneficiaries or dealers, as well as higher operational costs to account for collateral on an individual customer basis. A commenter to the CFTC raised concerns with the length of time and the costs to comply with an individual segregation mandate. Specifically, the commenter raised concerns regarding the number of collateral arrangements that would be required. The commenter estimated, based on discussion with its members, that ''a rough estimate of the time it would take to establish the necessary collateral arrangements is 1 year and eleven months, with an associated cost of $141.8 million, per covered swap entity.'' [1168] To account for these higher costs, SBSDs likely may increase fees for customers that choose individual rather than omnibus segregation. If higher fees make it prohibitively expensive for some counterparties to elect individual segregation, the proposed omnibus segregation scheme under Rule 18a–4 could be a more cost-effective solution.

Rule 18a–4 will impose on SBSDs operational costs, as well as costs related to the use of customer funds, compared to the baseline, given that dealers in general do not presently segregate customer collateral for security-based swaps, and to the extent collateral is segregated, it is not done so on the terms that would be required by proposed new Rule 18a–4. The operational costs include costs to establish qualifying bank accounts and to perform the calculations required to determine the amount that is required at any one time to be maintained in the reserve account.[1169] In cases where an SBSD is jointly registered as a broker-dealer, the costs of adapting existing systems to account for security-based swap transactions may not be material in light of the similarities between the systems and procedures required by Rule 15c3–3 and those that would be required by proposed new Rule 18a–4.

A further cost would be imposed on SBSDs to the extent that collateral they hold that could otherwise be rehypothecated would no longer be eligible for this purpose.[1170] An SBSD would incur a cost of funds equal to the borrowing cost of the dealer if the dealer was unable to use customer collateral to finance its business activities. The extent of this cost would depend on how much collateral associated with security-based swaps and held by dealers today consists of initial margin that they can rehypothecate, *i.e.,* that is not now segregated as would be required under Rule 18a–4 (the rule would not require the segregation of variation margin).[1171]

a. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The proposed segregation requirements for SBSDs are designed to protect and preserve counterparty collateral held at SBSDs. More specifically, the goal of proposed new Rule 18a–4 is to protect customer assets by ensuring that cash and securities that SBSDs hold for security-based swap customers are isolated from the proprietary assets of the SBSD and identified as property of such customers.[1172] These protections may provide market participants who enter into security-based swap transactions with an SBSD the assurance that their accounts will remain separate from the SBSD in the event of bankruptcy.[1173] These proposed protections could reduce the risk of loss of collateral to individual counterparties and, thereby, promote participation in the security-based swap markets. This may result in enhanced competition and more efficient price discovery.

Therefore, proposed segregation rules that promote, or do not unduly restrict, competition may be accompanied by regulatory benefits that minimize the risk of market failure and thus promote efficiency within the market. Such competitive markets would increase the efficiency with which market participants could transact in security-based swaps for speculative, trading, hedging and other purposes. Conversely, increased costs associated with the proposed segregation rules could result in high barriers to entry and negatively affect competition for SBSDs in the security-based swap markets.

Further, modeling the provisions of Rule 18a–4 on existing Rule 15c3–3 will generally promote consistent treatment of collateral in circumstances where a broker-dealer SBSD conducts business in securities and security-based swaps with the same counterparty, increasing efficiencies for counterparties. Finally, the proposed ''omnibus segregation'' requirements of proposed Rule 18a–4 are intended to provide a less expensive segregation alternative to individual account segregation.[1174] This proposed requirement could also result in increased efficiencies, and, in turn, facilitate capital formation through the availability of additional capital for counterparties as a result of decreased costs.

[1165] *See* section 3E(f)(1)(B) of the Exchange Act.

[1166] *See Process for Submissions of Security-Based Swaps,* 77 FR 41602.

[1167] *See Clearing Agency Standards for Operation and Governance,* 76 FR 14472.

[1168] *SIFMA/ISDA Comment Letter to the Prudential Regulators.*

[1169] *See* proposed new Rule 18a–4. *See* section V.C. of this release for a discussion of implementation costs. *See also* section V.B. of this release.

[1170] *See SIFMA/ISDA Comment Letter to the Prudential Regulators* (''First, because the collateral cannot be rehypothecated, and because the collateral amounts will be very large, CSEs will be limited to investing very large amounts of eligible collateral in assets that generate low returns.'').

[1171] *See* Manmohan Singh, *Velocity of Pledged Collateral: Analysis and Implications;* Manmohan Singh and James Aitken, *The (sizable) Role of Rehypothecation in the Shadow Banking System.*

[1172] *See* proposed new Rule 18a–4.

[1173] *See* 15 U.S.C. 78c–5.

[1174] *See* 15 U.S.C. 78c(f)(1)(B).

Request for Comment

The Commission generally requests comment about its analysis of the costs and benefits of the proposed segregation rules. In addition, the Commission requests comment in response to the following questions:

1. To what extent do counterparties presently require that their assets associated with security-based swaps be independently segregated?

2. What would be the overall market impact of a right by customers to demand individual segregation? How would costs to end users be impacted? Would those costs differ depending on the type of end user or size of its positions with the SBSD?

3. How would the existence of omnibus versus independent accounts factor into the ability easily to resolve a defaulting SBSD?

4. Would the proposed segregation requirements prove to be difficult to implement for existing contracts?

C. Implementation Considerations

As discussed above, proposed Rules 18a–1 through 18a–4, as well as the proposed amendments to Rule 15c3–1, would impose certain costs on SBSDs and MSBSPs. The Commission expects that the highest economic cost impact as a result of the proposed new rules and rule amendments would likely result from the additional capital nonbank SBSDs and nonbank SBSDs may have to hold as a result of the proposed capital rules, and the additional margin that SBSDs, MSBSPs, and other market participants may have to post and/or collect as a result of proposed margin requirements.

The proposed new rules and rule amendments, however, as discussed above, would impose certain implementation burdens and related costs on SBSDs, MSBSPs and other market participants. These costs may include start-up costs, including personnel and other costs, such as technology costs, to comply with the proposed new rules and rule amendments. As discussed in section IV.D. of this release, the Commission has estimated the burdens and related costs of these implementation requirements for SBSDs and MDBSPs.[1175] These costs are summarized below.

A stand-alone SBSD that applies to use internal models would be required under proposed new Rule 18a–1 to create and compile various documents to be included with the application, including documents related to the development of its VaR models, and to provide additional documentation to, and respond to questions from, Commission staff throughout the application process.[1176] These firms also would be required to review and backtest these models annually. The requirements are estimated to impose one-time and annual costs in the aggregate of approximately $1.97 million [1177] and $10.6 million, respectively.[1178] These firms would also incur technology costs of $48.0 million in the aggregate.[1179]

Stand-alone SBSDs that use internal models and ANC broker-dealers would be required to develop a liquidity stress test and a written contingency plan under proposed new Rule 18a–1 and proposed amendments to Rule 15c3–1, and periodically review them.[1180] These requirements would impose one-time and annual costs in the aggregate of approximately $1.0 million [1181] and $2.3 million,[1182] respectively.

Rule 18a–1 also would require stand-alone SBSDs to establish, document, and maintain a system of internal risk management controls required under Rule 15c3–4, as well as to review and update these controls.[1183] This requirement would impose one-time and annual costs in the aggregate of $7.5 million [1184] and $971,000, respectively.[1185] These firms also may incur aggregate initial and ongoing information technology costs of $240,000 and $307,500, respectively.[1186]

Finally, nonbank SBSDs and broker-dealers, as applicable, may incur one-time and ongoing costs related to filing notices and subordination agreements and documenting industry sector classifications under proposed new Rule 18a–1, and amendments to Rule 15c3–1.[1187] These requirements would impose one-time and annual costs in the aggregate of $68,040 [1188] and $38,367, respectively.[1189]

Rule 18a–2 also would require nonbank MSBSPs to establish, document, and maintain a system of internal risk management controls required under Rule 15c3–4, as well as to review and update these controls.[1190] This requirement would impose one-time and annual costs in the aggregate of $2.7 million [1191] and $324,000 [1192] for nonbank MSBSPs, respectively. These nonbank MSBSPs also may incur initial and ongoing information technology costs of $80,000 and $102,500, respectively.[1193]

Rule 18a–3 would require nonbank SBSDs to establish a written risk analysis methodology, which would need to be reviewed and updated.[1194] This requirement would impose one-time and annual costs in the aggregate of $1.7 million [1195] and $483,000, respectively.[1196]

Finally, SBSDs and MSBSPs would incur various one-time and ongoing costs in the aggregate in order to comply with the segregation and notification requirements of proposed new Rule 18a–4.[1197] Each SBSD would incur one-time and annual costs in establishing special bank accounts required by the rule. This requirement would impose one-time and annual costs of $2.9 million [1198] and $377,000 [1199] in the aggregate on SBSDs, respectively. In addition, SBSDs would be required to perform a reserve computation required by Appendix A to proposed new Rule 18a–4, which would impose on these firms annual costs in the aggregate of $9.7 million.[1200]

In addition, both SBSDs and MSBSPs would be required to prepare and send to their counterparties segregation-related notices pursuant to section 3E(f)

[1175] *See* section IV.D. of this release (discussing total initial and annual recordkeeping and reporting burden of the proposed rules and rule amendments).

[1176] *See* section IV.A.1. of this release.

[1177] This consists of external costs of $600,000, plus internal costs of $1.37 million. *See* section IV.D.1. of this release.

[1178] This consists of external costs of $3.7 million, plus internal costs of $6.9 million. *See* section IV.D.1. of this release.

[1179] *See* section IV.D.1. of this release.

[1180] *See* section IV.A.1. of this release.

[1181] *See* section IV.D.1. of this release.

[1182] *Id.*

[1183] *See* section IV.A.1. of this release.

[1184] *See* section IV.D.1. of this release.

[1185] *Id.*

[1186] *Id.*

[1187] *See* section IV.A.1. of this release.

[1188] *See* section IV.D.1 of this release (one-time cost to draft subordinated loan agreement template under Appendix D to proposed new Rule 18a–1).

[1189] *Id.* (annual costs of $2,898, $1,449 and $34,020 related to documenting industry sector classifications for credit default swap haircuts under Rule 18a–1, equity withdrawal notices under paragraph (i) under Rule 18a–1, and preparing and filing proposed subordinated loan agreements with the Commission under Appendix D to Rule 18a–1).

[1190] *See* section IV.A.2. of this release.

[1191] This consists of external costs of $400,000, plus internal costs of $2.3 million. *See* section IV.D.2. of this release.

[1192] *See* section IV.D.2. of this release.

[1193] *Id.*

[1194] *See* section IV.A.3. of this release.

[1195] *See* section IV.D.3. of this release. This consists of external costs of $18,000, plus internal costs of $1.7 million.

[1196] *Id.*

[1197] *See* section IV.A.4. of this release.

[1198] *See* section IV.D.4. of this release.

[1199] *Id.*

[1200] *Id.*

of the Exchange Act.[1201] This requirement would impose one-time and annual costs in the aggregate to SBSDs and MSBSPs of $770,000 [1202] and $110,000, respectively.[1203]

Finally, proposed new Rule 18a–4 would require each SBSD to draft, prepare, and enter into subordination agreements with certain counterparties.[1204] This requirement would impose on these firms one-time and annual costs in the aggregate of $99.7 million [1205] and $19.1 million,[1206] respectively.

D. General Request for Comment

The Commission requests data to quantify, and estimates of, the costs and the value of the benefits of the proposed rules described above. Commenters should provide estimates of these costs and benefits, as well as any costs and benefits not already defined, that may result from the adoption of the proposed rules. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposals. The Commission requests comment on any effect the proposed new rules and rule amendments may have on efficiency, competition, and capital formation, including the competitive or anticompetitive effects the proposals may have on market participants. In addition, the Commission requests comment on whether other provisions of the Dodd-Frank Act for which Commission rulemaking is required are likely to have an effect on the costs and benefits of the proposed rules. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposed rules.

VI. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act (''RFA'') [1207] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a) [1208] of the Administrative Procedure Act,[1209] as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on ''small entities.'' [1210] Section 605(b) of the RFA states that this requirement shall not apply to any proposed rule or proposed rule amendment, which, if adopted, would not have a significant economic impact on a substantial number of small entities.[1211]

For purposes of Commission rulemaking in connection with the RFA, a small entity includes: (1) When used with reference to an ''issuer'' or a ''person,'' other than an investment company, an ''issuer'' or ''person'' that, on the last day of its most recent fiscal year, had total assets of $5 million or less,[1212] or (2) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) under the Exchange Act,[1213] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[1214] Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (1) For entities in credit intermediation and related activities,[1215] firms with $175 million or less in assets; (2) for non-depository credit intermediation and certain other activities,[1216] firms with $7 million or less in annual receipts; (3) for entities in financial investments and related activities,[1217] firms with $7 million or less in annual receipts; (4) for insurance carriers and entities in related activities,[1218] firms with $7 million or less in annual receipts; and (5) for funds, trusts, and other financial vehicles,[1219] firms with $7 million or less in annual receipts.[1220]

Based on available information about the security-based swap market,[1221] the market, while broad in scope, is largely dominated by entities such as those that would be covered by the SBSD and MSBSP definitions. Subject to certain exceptions, section 3(a)(71)(A) of the Exchange Act defines *security-based swap dealer* to mean any person who: (1) Holds itself out as a dealer in security-based swaps; (2) makes a market in security-based swaps; (3) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or (4) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps. Section 3(a)(67)(A) of the Exchange Act defines *major security-based swap participant* to be any person: (1) Who is not an SBSD; and (2) who maintains a substantial position in security-based swaps for any of the major security-based swap categories, as such categories are determined by the Commission, excluding both positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; whose outstanding security-based swaps create substantial

[1201] *See* section IV.A.4. of this release.

[1202] *See* section IV.D.4. of this release. This consists of external costs of $220,000, plus internal costs of $550,020.

[1203] *Id.*

[1204] *See* section IV.A.4. of this release.

[1205] *See* section IV.D.4. of this release. This consists of external costs of $400,000, plus internal costs of $3,780,000 and $95,580,000.

[1206] *Id.*

[1207] 5 U.S.C. 601 *et seq.*

[1208] 5 U.S.C. 603(a).

[1209] 5 U.S.C. 551 *et seq.*

[1210] Although section 601(b) of the RFA defines the term ''small entity,'' the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term ''small entity'' for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0–10, 17 CFR 240.0–10. *See Statement of Management on Internal Accounting Control,* Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982).

[1211] *See* 5 U.S.C. 605(b).

[1212] *See* 17 CFR 240.0–10(a).

[1213] *See* 17 CFR 240.17a–5(d).

[1214] *See* 17 CFR 240.0–10(c).

[1215] Including commercial banks, savings institutions, credit unions, firms involved in other depository credit intermediation, credit card issuing, sales financing, consumer lending, real estate credit, and international trade financing.

[1216] Including firms involved in secondary market financing, all other non-depository credit intermediation, mortgage and nonmortgage loan brokers, financial transactions processing, reserve and clearing house activities, and other activities related to credit intermediation.

[1217] Including firms involved in investment banking and securities dealing, securities brokerage, commodity contracts dealing, commodity contracts brokerage, securities and commodity exchanges, miscellaneous intermediation, portfolio management, providing investment advice, trust, fiduciary and custody activities, and miscellaneous financial investment activities.

[1218] Including direct life insurance carriers, direct health and medical insurance carriers, direct property and casualty insurance carriers, direct title insurance carriers, other direct insurance (except life, health and medical) carriers, reinsurance carriers, insurance agencies and brokerages, claims adjusting, third party administration of insurance and pension funds, and all other insurance related activities.

[1219] Including pension funds, health and welfare funds, other insurance funds, open-end investment funds, trusts, estates, and agency accounts, real estate investment trusts, and other financial vehicles.

[1220] *See* 13 CFR 121.201 (Jan. 1, 2010).

[1221] *See CDS Data Analysis.*

counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or that is a financial entity that is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking regulator; and maintains a substantial position in outstanding security-based swaps in any major security-based swap category, as such categories are determined by the Commission.[1222]

Based on feedback from industry participants about the security-based swap markets, entities that will qualify as SBSDs and MSBSPs, whether registered broker-dealers or not, will likely exceed the thresholds defining ''small entities'' set out above. Thus, it is unlikely that proposed Rules 18a–1 to 18a–4 and the amendments to Rule 15c3–1 would have a significant economic impact on any small entity.

The Commission estimates that there are approximately 808 broker-dealers that were ''small'' for the purposes Rule 0–10. The amendments to Rule 15c3–1 relating to the standardized haircuts for swaps and security-based swaps, as well as the proposed CDS maturity grid would apply to all broker-dealers with such proprietary positions. These proposed amendments, therefore, would apply to all ''small'' broker-dealers in that they would be subject to the requirements in the proposed amendments. It is likely, however, that these proposed amendments would have no, or little, impact on ''small'' broker-dealers, since most, if not all, of these firms generally would not hold these types of positions.

For the foregoing reasons, the Commission certifies that the proposed new Rules 18a–1 through 18a–4, amendments to Rule 15c3–1, and amendments to Rule 15c3–3 would not have a significant economic impact on any small entity for purposes of the RFA.

The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to illustrate the extent of the impact.

[1222] *See also Entity Definitions Adopting Release,* 77 FR 30596 (''The SEC continues to believe that the types of entities that would engage in more than a de minimis amount of dealing activity involving security-based swaps—which generally would be major banks—would not be 'small entities' for purposes of the RFA. Similarly, the SEC continues to believe that the types of entities that may have security-based swap positions above the level required to be a 'major security-based swap participant' would not be a 'small entity' for purposes of the RFA. Accordingly, the SEC certifies that the final rules defining 'security-based swap dealer' or 'major security-based swap participant' would not have a significant economic impact on a substantial number of small entities for purposes of the RFA.''). *Id.* at 30743.

VII. Statutory Basis and Text of the Proposed Amendments

Pursuant to the Exchange Act, 15 U.S.C. 78a *et seq.,* and particularly, sections 3(b), 3E, 15, 15F, 23(a), and 36 (15 U.S.C. 78c(b), 78c–5, 78o, 78o–10, 78w(a), and 78mm), thereof, the Commission is proposing to amend §§ 240.15c3–1, 240.15c3–1a, 240.15c3–1b, 240.15c3–1d, 240.15c3–1e, and 240.15c3–3, and proposing §§ 240.18a–1, 240.18a–1a, 240.18a–1b, 240.18a–1c, 240.18a–1d, 240.18a–2, 240.18a–3, 240.18a–4, and 240.18a–4a under the Exchange Act.

List of Subjects in 17 CFR Parts 240

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

Text of Amendment

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

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority citation for part 240 is revised, the sectional authorities for §§ 240.15c3–1 and 240.15c3–3 are revised, add sectional authorities for §§ 240.15c3–1a, 240.15c3–1e, 240.15c3–3, 240.18a–1, 240.18a–1a, 240.18a–1b, 240.18a–1c, 240.18a–1d, 240–18a–2, 240.18a–3 and 240.18a–4 in numerical order to read as follows.

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c–3, 78c–5, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l,* 78m, 78n, 78n–1, 78o, 78o–10 78o–4, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll,* 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.;* 12 U.S.C. 5221(e)(3), 15 U.S.C. 8302, and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Section 240.15c3–1 is also issued under 15 U.S.C. 78o(c)(3), 78o–10(d), and 78o–10(e).

Section 240.15c3–3 is also issued under 15 U.S.C. 78c–5, 78o(c)(2), 78(c)(3), 78q(a), 78w(a); sec. 6(c), 84 Stat. 1652; 15 U.S.C. 78fff.

* * * * *

Sections 240.18a–1, 240.18a–1a, 240.18a–1b, 240.18a–1c, 240.18a–1d, 240.18a–2, and 240.18a–3 are also issued under 15 U.S.C. 78o–10(d) and 78o–10(e).

Section 240.18a–4 is also issued under 15 U.S.C. 78c–5(f).

* * * * *

2. Section 240.15c3–1 is amended by:

a. Revising the center heading above paragraph (a)(7);

b. In paragraph (a)(7) removing the phrase ''and using the credit risk standards of Appendix E to compute a deduction for credit risk on certain credit exposures arising from transactions in derivatives instruments, instead of the provisions of paragraph (c)(2)(iv) of this section'' and in its place adding the phrase ''and using the credit risk standards of Appendix E to compute a deduction for credit risk for security-based swap transactions with *commercial end users* as defined in § 240.18a–3(b)(2), instead of the provisions of paragraphs (c)(2)(iv) and (c)(2)(xiv)(B)(*1*) of this section'';

c. Revising paragraph (a)(7)(i);

d. In paragraph (a)(7)(ii), remove ''$5 billion'' and in its place add ''$6 billion'';

e. Adding a center heading and paragraph (a)(10);

f. Adding paragraph (c)(2)(vi)(O);

g. Re-designating paragraph (c)(2)(xii) as paragraph (c)(2)(xii)(A) and adding new paragraph (c)(2)(xii)(B);

h. Adding paragraph (c)(2)(xiv);

i. Adding paragraph (c)(16); and

j. Adding paragraph (f).

The revisions and additions read as follows:

§ 240.15c3–1 Net capital requirements for brokers or dealers.

* * * * *

(a) * * *

Alternative Net Capital Computation For Broker-Dealers Authorized To Use Models

(7) * * *

(i) At all times maintain tentative net capital of not less than $5 billion and net capital of not less than the greater of $1 billion or the sum of the ratio requirement under paragraph (a)(1) of this section and eight percent (8%) of the risk margin amount;

* * * * *

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 (a)(7) of this section, must:

(i) At all times maintain net capital of not less than the greater of $20 million or the sum of the ratio requirement under paragraph (a)(1) of this section and eight percent (8%) of the risk margin amount; and

(ii) Comply with § 240.15c3–4 as though it were an OTC derivatives dealer with respect to all of its business

activities, except that paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of § 240.15c3–4 shall not apply.

* * * * *

(c) * * *

(2) * * *

(vi)(O) *Security-based swaps.* (*1*) *Credit default swaps.* (*i*) *Short positions (selling protection).* In the case of a security-based swap that is a short credit default swap, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

Length of time to maturity of CDS contract	Basis point spread					
	100 or less (%)	101–300	301–400	401–500	501–699	700 or more
12 months or less	1.00	2.00	5.00	7.50	10.00	15.00
13 months to 24 months	1.50	3.50	7.50	10.00	12.50	17.50
25 months to 36 months	2.00	5.00	10.00	12.50	15.00	20.00
37 months to 48 months	3.00	6.00	12.50	15.00	17.50	22.50
49 months to 60 months	4.00	7.00	15.00	17.50	20.00	25.00
61 months to 72 months	5.50	8.50	17.50	20.00	22.50	27.50
73 months to 84 months	7.00	10.00	20.00	22.50	25.00	30.00
85 months to 120 months	8.50	15.00	22.50	25.00	27.50	40.00
121 months and longer	10.00	20.00	25.00	27.50	30.00	50.00

(*ii*) *Long positions (purchasing protection).* In the case of a security-based swap that is a long credit default swap, deducting 50% of the deduction that would be required by paragraph (c)(2)(vi)(O)(*1*)(*i*) of this section if the security-based swap was a short credit default swap.

(*iii*) *Long and short positions.* (*A*) *Long and short credit default swaps.* In the case of security-based swaps that are long and short credit default swaps referencing the same entity (in the case of credit default swap securities-based swaps referencing a corporate entity) or obligation (in the case of credit default swap securities-based swaps referencing an asset-backed security), that have the same credit events which would trigger payment by the seller of protection, that have the same basket of obligations which would determine the amount of payment by the seller of protection upon the occurrence of a credit event, that are in the same or adjacent spread category, and that are in the same or adjacent maturity category and have a maturity date within three months of the other maturity category, deducting the percentage of the notional amount specified in the higher maturity category under paragraph (c)(2)(vi)(O)(*1*)(*i*) or (*ii*) on the excess of the long or short position. In the case of security-based swaps that are long and short credit default swaps referencing corporate entities in the same industry sector and the same spread and maturity categories prescribed in paragraph (c)(2)(vi)(O)(*1*)(*i*) of this section, deducting 50% of the amount required by paragraph (c)(2)(vi)(O)(*1*)(*i*) of this section on the short position plus the deduction required by paragraph (c)(2)(vi)(O)(*1*)(*ii*) of this section on the excess long position, if any. For the purposes of this section, the broker or dealer must use an industry sector classification system that is reasonable in terms of grouping types of companies with similar business activities and risk characteristics and the broker-dealer must document the industry sector classification system used pursuant to this section.

(*B*) *Long security and long credit default swap.* In the case of a security-based swap that is a long credit default swap referencing a debt security and the broker or dealer is long the same debt security, deducting 50% of the amount specified in paragraph (c)(2)(vi) or (vii) of this section for the bond, provided that the broker or dealer can deliver the debt security to satisfy the obligation of the broker or dealer on the credit default swap.

(*C*) *Short security and short credit default swap.* In the case of a security-based swap that is a short credit default swap referencing a bond or a corporate entity, and the broker or dealer is short the bond or a bond issued by the corporate entity, deducting the amount specified in paragraph (c)(2)(vi) or (vii) of this section for the bond. In the case of a security-based swap that is a short credit default swap referencing an asset-backed security and the broker or dealer is short the asset-backed security, deducting the amount specified in paragraph (c)(2)(vi) or (vii) of this section for the asset-backed security.

(*2*) *Security-based swaps that are not credit default swaps.* In the case of any security-based swap that is not a credit default swap, deducting the amount calculated by multiplying the notional amount of the security-based swap and the percentage specified in paragraph (c)(2)(vi) of this section applicable to the reference security. A broker or dealer may reduce the deduction under this paragraph (c)(2)(vi)(O)(*2*) by an amount equal to any reduction recognized for a comparable long or short position in the reference security under paragraph (c)(2)(vi) of this section and, in the case of a security-based swap referencing an equity security, the method specified in § 240.15c3–1a.

* * * * *

(xii) * * *

(B) Deducting the amount of cash required in the account of each security-based swap customer to meet the margin requirements of a clearing agency, Examining Authority, or the Commission, after application of calls for margin, marks to the market, or other required deposits which are outstanding one business day or less.

* * * * *

(xiv) *Deduction from net worth in lieu of collecting margin amounts for security-based swaps.* (A) *Cleared security-based swap transactions.* Deducting the amount of the margin difference for each account carried by the broker or dealer for another person that holds cleared security-based swap transactions. The margin difference is the amount of the deductions that the positions in the account would incur pursuant to paragraph (c)(2)(vi)(O) of this section if owned by the broker or dealer less the margin value of collateral held in the account.

(B) *Non-cleared security-based swap transactions.* (*1*) *Commercial end users.* Deducting, with respect to a counterparty that is a *commercial end user* as that term is defined in § 240.18a–3(b)(2), the margin amount calculated pursuant to § 240.18a–3(c)(1)(i)(B) for the account of the counterparty at the broker or dealer less any *positive equity* in that account as that term is defined in § 240.18a–3(b)(7).

(*2*) *Margin collateral held by third-party custodian.* Deducting, with

respect to a counterparty that is not a *commercial end user* as that term is defined in § 240.18a–3(b)(2) and that elects to have collateral segregated in an account at an independent third-party custodian pursuant to section 3E(f) of the Act (15 U.S.C. 78c–5(f)), the margin amount calculated pursuant to § 240.18a–3(c)(1)(i)(B) for the account of the counterparty less any *positive equity* in the account as that term is defined in § 240.18a–3(b)(7).

(*3*) *Security-based swap legacy accounts.* Deducting, with respect to a *security-based swap legacy account* as that term is defined in § 240.18a–3(b)(9) of a counterparty that is not a *commercial end user* as that term is defined in § 240.18a–3(b)(2), the margin amount calculated pursuant § 240.18a–3(c)(1)(i)(B) for the account less any *positive equity* in the account as that term is defined in § 240.18a–3(b)(7).

* * * * *

(16) The term *risk margin amount* means the sum of:

(i) The greater of the total margin required to be delivered by the broker or dealer with respect to security-based swap transactions cleared for security-based swap customers at a clearing agency or the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to paragraph (c)(2)(vi)(O) of this section; and

(ii) The total margin amount calculated by the broker or dealer with respect to non-cleared security-based swaps pursuant to § 240.18a–3(c)(1)(i)(B).

* * * * *

(f) *Liquidity requirements.* (1) *Liquidity stress test.* A broker or dealer whose application, including amendments, has been approved, in whole or in part, to calculate net capital under Appendix E of this section must run a liquidity stress test at least monthly, the results of which must be provided within ten business days to senior management that has responsibility to oversee risk management at the broker or dealer. The assumptions underlying the liquidity stress test must be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the broker or dealer and at least annually by senior management of the broker or dealer. The liquidity stress test must include, at a minimum, the following assumed conditions lasting for 30 consecutive days:

(i) A stress event that includes a decline in creditworthiness of the broker or dealer severe enough to trigger contractual credit-related commitment provisions of counterparty agreements;

(ii) The loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding, including intercompany advances and unfunded committed lines of credit;

(iii) The potential for a material net loss of secured funding;

(iv) The loss of the ability to procure repurchase agreement financing for less liquid assets;

(v) The illiquidity of collateral required by and on deposit at registered clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets;

(vi) A material increase in collateral required to be maintained at registered clearing agencies of which it is a member; and

(vii) The potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the broker or dealer, including those related to customer businesses of the broker or dealer.

(2) *Stress test of consolidated entity.* The broker or dealer must justify and document any differences in the assumptions used in the liquidity stress test of the broker or dealer from those used in the liquidity stress test of the consolidated entity of which the broker or dealer is a part.

(3) *Liquidity reserves.* The broker or dealer must maintain at all times liquidity reserves based on the results of the liquidity stress test. The liquidity reserves used to satisfy the liquidity stress test must be:

(i) Cash, obligations of the United States, or obligations fully guaranteed as to principal and interest by the United States; and

(ii) Unencumbered and free of any liens at all times. Securities in the liquidity reserve can be used to meet delivery requirements as long as cash or other acceptable securities of equal or greater value are moved into the liquidity pool contemporaneously.

(4) *Contingency funding plan.* The broker or dealer must have a written contingency funding plan that addresses the broker's or dealer's policies and the roles and responsibilities of relevant personnel for meeting the liquidity needs of the broker or dealer and communications with the public and other market participants during a liquidity stress event.

* * * * *

3. Section 240.15c3–1a is amended by:

a. In paragraph (a)(4), revising the first and last sentences; and

b. Adding paragraph (b)(1)(v)(C)(*5*).

The addition to read as follows:

§ 240.15c3–1a Options (Appendix A to 17 CFR 240.15c3–1).

(a) * * *

(4) The term *underlying instrument* refers to long and short positions, as appropriate, covering the same foreign currency, the same security, security future, or security-based swap, or a security which is exchangeable for or convertible into the underlying security within a period of 90 days. * * * The term *underlying instrument* shall not be deemed to include securities options, futures contracts, options on futures contracts, qualified stock baskets, or unlisted instruments (other than security-based swaps).

* * * * *

(b) * * *

(1) * * *

(v) * * *

(C) * * *

(*5*) In the case of portfolio types involving security futures and equity options on the same underlying instrument and positions in that underlying instrument, there will be a minimum charge of 25% times the multiplier for each security-future and equity option.

* * * * *

4. Section 240.15c3–1b is amended by adding a paragraph (b) to read as follows:

§ 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) *Swaps.* In the case of any swap for which the deductions in Appendix E of this section do not apply:

(i) *Credit default swaps referencing broad-based securities indices.* (A) *Short positions (selling protection).* In the case of a swap that is a short credit default swap referencing a broad-based securities index, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

Length of time to maturity of CDS contract	Basis point spread					
	100 or less (%)	101–300 (%)	301–400 (%)	401–500 (%)	501–699 (%)	700 or more (%)
12 months or less	0.67	1.33	3.33	5.00	6.67	10.00
13 months to 24 months	1.00	2.33	5.00	6.67	8.33	11.67
25 months to 36 months	1.33	3.33	6.67	8.33	10.00	13.33
37 months to 48 months	2.00	4.00	8.33	10.00	11.67	15.00
49 months to 60 months	2.67	4.67	10.00	11.67	13.33	16.67
61 months to 72 months	3.67	5.67	11.67	13.33	15.00	18.33
73 months to 84 months	4.67	6.67	13.33	15.00	16.67	20.00
85 months to 120 months	5.67	10.00	15.00	16.67	18.33	26.67
121 months and longer	6.67	13.33	16.67	18.33	20.00	33.33

(B) *Long positions (purchasing protection).* In the case of a swap that is a long credit default swap referencing a broad-based securities index, deducting 50% of the deduction that would be required by paragraph (b)(1)(i)(A) of this Appendix B if the swap was a short credit default swap.

(C) *Long and short positions.* (*1*) *Long and short credit default swaps.* In the case of swaps that are long and short credit default swaps referencing the same broad-based security index, have the same credit events which would trigger payment by the seller of protection, have the same basket of obligations which would determine the amount of payment by the seller of protection upon the occurrence of a credit event, that are in the same or adjacent spread category, and that are in the same or adjacent maturity category and have a maturity date within three months of the other maturity category, deducting the percentage of the notional amount specified in the higher maturity category under paragraph (b)(1)(i)(A) or (b)(1)(i)(B) of this Appendix B on the excess of the long or short position.

(*2*) *Long basket of obligors and long credit default swap.* In the case of a swap that is a long credit default swap referencing a broad-based securities index and the broker or dealer is long a basket of debt securities comprising all of the components of the securities index, deducting 50% of the amount specified in § 240.15c3–1(c)(2)(vi) for the component securities, provided the broker or dealer can deliver the component securities to satisfy the obligation of the broker or dealer on the credit default swap.

(*3*) *Short basket of obligors and short credit default swap.* In the case of a swap that is a short credit default swap referencing a broad-based securities index and the broker or dealer is short a basket of debt securities comprising all of the components of the securities index, deducting the amount specified in § 240.15c3–1(c)(2)(vi) for the component securities.

(*2*) *All other swaps.* (i) In the case of any swap that is not a credit default swap, deducting the amount calculated by multiplying the notional value of the swap by the percentage specified in:

(A) Section 240.15c3–1 applicable to the reference asset if § 240.15c3–1 specifies a percentage deduction for the type of asset;

(B) 17 CFR 1.17 applicable to the reference asset if 17 CFR 1.17 specifies a percentage deduction for the type of asset and § 240.15c3–1 does not specify a percentage deduction for the type of asset; or

(C) In the case of an interest rate swap, § 240.15c3–1(c)(2)(vi)(A) based on the maturity of the swap, provided that the percentage deduction must be no less than 0.5%.

(ii) A security-based swap dealer may reduce the deduction under this paragraph (b)(2)(ii) by an amount equal to any reduction recognized for a comparable long or short position in the reference asset or interest rate under § 240.15c3–1 or 17 CFR 1.17.

§ 240.15c3–1d [Amended]

5. Section 240.15c3–1d is amended by:

a. Adding to the end of the second sentence of paragraph (b)(7) the phrase ‘‘, or if, in the case of a broker or dealer operating pursuant to paragraph (a)(10) of § 240.15c3–1, its net capital would be less than either $24 million or 10% of the risk margin amount under § 240.15c3–1’’;

b. In the first sentence of paragraph (b)(8)(i), adding after the phrase ‘‘if greater, or’’ the phrase ‘‘, in the case of a broker or dealer operating pursuant to paragraph (a)(10) of § 240.15c3–1, its net capital would be less than either $24 million or 10% of the risk margin amount under § 240.15c3–1, or’’;

c. In paragraph (b)(10)(ii)(B), adding after the phrase ‘‘if greater,’’ the phrase ‘‘or, in the case of a broker or dealer operating pursuant to paragraph (a)(10) of § 240.15c3–1, its net capital is less than either $20 million or 8% of the risk margin amount under § 240.15c3–1,’’;

d. In paragraph (c)(2), adding at the end of the sentence the phrase ‘‘, or, in the case of a broker or dealer operating pursuant to paragraph (a)(10) of § 240.15c3–1, its net capital would be less than either $24 million or 10% of the risk margin amount under § 240.15c3–1’’; and

e. In paragraph (c)(5)(i)(B), adding after the phrase ‘‘if greater, or less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of this section,’’ the phrase ‘‘, or, in the case of a broker or dealer operating pursuant to paragraph (a)(10) of § 240.15c3–1, its net capital would be less than either $24 million or 10% of the risk margin amount under § 240.15c3–1,’’.

§ 240.15c3–1e [Amended]

6. Section 240.15c3–1e is amended by:

a. In the first sentence of paragraph (a) before the first ‘‘:’’, removing the phrase ‘‘transactions in derivatives instruments’’ and adding in its place the phrase ‘‘security-based swap transactions with *commercial end users* as defined in § 240.18a–3(b)(2)’’;

b. In the first sentence of paragraph (c) before the first ‘‘:’’, removing the phrase ‘‘transactions in derivatives instruments’’ and adding in its place the phrase ‘‘security-based swap transactions with *commercial end users* as defined in § 240.18a–3(b)(2)’’;

c. In paragraph (c)(2)(ii), removing the phrase ‘‘$5 billion’’ and adding in its place the phrase ‘‘$6 billion’’; and

d. In paragraph (e)(1), removing the phrase ‘‘$5 billion’’ and adding in its place the phrase ‘‘$6 billion’’.

7. Section 240.15c3–3 is amended by adding new paragraph (p) to read as follows:

§ 240.15c3–3 Customer protection—reserves and custody of securities.

* * * * *

(p) *Security-based swaps.* A broker or dealer that is registered as a security-based swap dealer pursuant to section 15F of the Act (15 U.S.C. 78o-8) must

also comply with the provisions of § 240.18a–4.

8. Section 240.18a–1 is added to read as follows:

§ 240.18a–1 Net capital requirements for security-based swap dealers for which there is not a prudential regulator.

Note to § 240.18a–1: Rule 18a–1 and its appendices do not apply to a security-based swap dealer that has a prudential regulator as such a security-based swap dealer is subject to the capital requirement of the prudential regulator. In addition, Rule 18a–1 and its appendices do not apply to a security-based swap dealer that also is registered as a broker or dealer pursuant to section 15(b) of the Act (15 U.S.C. 78o(b)) as such a security-based swap dealer is subject to the net capital requirements in § 240.15c3–1 and its appendices.

(a) *Minimum requirements.* Every registered security-based swap dealer must at all times have and maintain net capital no less than the greater of the highest minimum requirements applicable to its business under paragraphs (a)(1) or (2) of this section, and tentative net capital no less than the minimum requirement under paragraph (a)(2) of this section.

(1) A security-based swap dealer must at all times maintain net capital of not less than the greater of $20 million or eight percent (8%) of the risk margin amount.

(2) In accordance with paragraph (d) of this section, the Commission may approve, in whole or in part, an application or an amendment to an application by a security-based swap dealer to calculate net capital using the market risk standards of paragraph (d) to compute a deduction for market risk on some or all of its positions, instead of the provisions of paragraphs (c)(1)(iv), (vi), and (vii) of this section, and using the credit risk standards of paragraph (d) to compute a deduction for credit risk for security-based swap transactions with *commercial end users* as defined in § 240.18a–3(b)(2), instead of the provisions of paragraphs (c)(1)(iii) and (c)(1)(viii)(B)(*1*) of this section, subject to any conditions or limitations on the security-based swap dealer the Commission may require as necessary or appropriate in the public interest or for the protection of investors. A security-based swap dealer that has been approved to calculate its net capital under paragraph (d) of this section must at all times maintain tentative net capital of not less than $100 million and net capital of not less than the greater of $20 million or eight percent (8%) of the risk margin amount; and

(b) A security-based swap dealer must at all times maintain net capital in addition to the amounts required under paragraph (a)(1) or (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) 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*), (*2*), and (*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)(vii) and (viii) of this section and Appendices A and B, § 240.18a–1a and § 240.18a–1b, the appropriate Federal and State tax rate(s) applicable to any unrealized gain on the asset on which the deduction was computed.

(*2*) Any deferred tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section;

(*3*) Any deferred tax liability related to unrealized appreciation in value of any asset(s) which has been otherwise deducted from net worth in accordance with the provisions of this section; and

(D) Adding, in the case of future income tax benefits arising as a result of unrealized losses, the amount of such benefits not to exceed the amount of income tax liabilities accrued on the books and records of the security-based swap dealer, but only to the extent such benefits could have been applied to reduce accrued tax liabilities on the date of the capital computation, had the related unrealized losses been realized on that date.

(E) Adding to net worth any actual tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section.

(ii) *Subordinated liabilities.* Excluding liabilities of the security-based swap dealer that are subordinated to the claims of creditors pursuant to a satisfactory subordinated loan agreement, as defined in Appendix D (§ 240.18a–1d).

(iii) *Assets not readily convertible into cash.* Deducting fixed assets and assets which cannot be readily converted into cash, including, among other things:

(A) *Fixed assets and prepaid items.* Real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and other expenses; goodwill, organization expenses;

(B) *Certain unsecured and partly secured receivables.* All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to the market or other required deposits that are outstanding for more than one business day; and the market value of stock loaned in excess of the value of any collateral received therefore.

(C) *Insurance claims.* Insurance claims that, after seven (7) business days from the date the loss giving rise to the claim is discovered, are not covered by an opinion of outside counsel that the claim is valid and is covered by insurance policies presently in effect; insurance claims that after twenty (20)

business days from the date the loss giving rise to the claim is discovered and that are not accompanied by an opinion of outside counsel described above, have not been acknowledged in writing by the insurance carrier as due and payable; and insurance claims acknowledged in writing by the carrier as due and payable outstanding longer than twenty (20) business days from the date they are so acknowledged by the carrier; and

(D) *Other deductions.* All other unsecured receivables; all assets doubtful of collection less any reserves established therefore; the amount by which the market value of securities failed to receive outstanding thirty (30) calendar days exceeds the contract value of such fails to receive, and the funds on deposit in a ''segregated trust account'' in accordance with 17 CFR 270.27d–1 under the Investment Company Act of 1940, but only to the extent that the amount on deposit in such segregated trust account exceeds the amount of liability reserves established and maintained for refunds of charges required by sections 27(d) and 27(f) of the Investment Company Act of 1940; *Provided,* That any amount deposited in the ''special account for the exclusive benefit of security-based swap customers'' established pursuant to § 240.18a–4 and clearing deposits shall not be so deducted.

(E)(*1*) For purposes of this paragraph:

(*i*) The term *reverse repurchase agreement deficit* shall mean the difference between the contract price for resale of the securities under a reverse repurchase agreement and the market value of those securities (if less than the contract price).

(*ii*) The term *repurchase agreement deficit* shall mean the difference between the market value of securities subject to the repurchase agreement and the contract price for repurchase of the securities (if less than the market value of the securities).

(*iii*) As used in paragraph (c)(1)(iii)(E)(*1*) of this section, the term *contract price* shall include accrued interest.

(*iv*) Reverse repurchase agreement deficits and the repurchase agreement deficits where the counterparty is the Federal Reserve Bank of New York shall be disregarded.

(*2*)(*i*) In the case of a reverse repurchase agreement, the deduction shall be equal to the reverse repurchase agreement deficit.

(*ii*) In determining the required deductions under paragraph (c)(1)(iii)(E)(*2*)(*i*) of this section, the security-based swap dealer may reduce the reverse repurchase agreement deficit by:

(*A*) Any margin or other deposits held by the security-based swap dealer on account of the reverse repurchase agreement;

(*B*) Any excess market value of the securities over the contract price for resale of those securities under any other reverse repurchase agreement with the same party;

(*C*) The difference between the contract price for resale and the market value of securities subject to repurchase agreements with the same party (if the market value of those securities is less than the contract price); and

(*D*) Calls for margin, marks to the market, or other required deposits that are outstanding one business day or less.

(*3*)(*i*) In the case of repurchase agreements, the deduction shall be:

(*A*) The excess of the repurchase agreement deficit over 5 percent of the contract price for resale of United States Treasury Bills, Notes and Bonds, 10 percent of the contract price for the resale of securities issued or guaranteed as to principal or interest by an agency of the United States or mortgage related securities as defined in section 3(a)(41) of the Act and 20 percent of the contract price for the resale of other securities; and

(*B*) The excess of the aggregate repurchase agreement deficits with any one party over 25 percent of the security-based swap dealer's net capital before the application of paragraphs (c)(1)(vii) and (viii) of this section (less any deduction taken with respect to repurchase agreements with that party under paragraph (c)(1)(iii)(E)(*3*)(*i*)(*A*) of this section) or, if greater;

(*C*) The excess of the aggregate repurchase agreement deficits over 300 percent of the security-based swap dealer's net capital before the application of paragraphs (c)(1)(vii) and (viii) of this section.

(*ii*) In determining the required deduction under paragraph (c)(1)(iii)(E)(*3*)(*i*) of this section, the security-based swap dealer may reduce a repurchase agreement by:

(*A*) Any margin or other deposits held by the security-based swap dealer on account of a reverse repurchase agreement with the same party to the extent not otherwise used to reduce a reverse repurchase agreement deficit;

(*B*) The difference between the contract price and the market value of securities subject to other repurchase agreements with the same party (if the market value of those securities is less than the contract price) not otherwise used to reduce a reverse repurchase agreement deficit; and

(*C*) Calls for margin, marks to the market, or other required deposits that are outstanding one business day or less to the extent not otherwise used to reduce a reverse repurchase agreement deficit.

(F) *Securities borrowed.* One percent of the market value of securities borrowed collateralized by an irrevocable letter of credit.

(G) Any receivable from an affiliate of the security-based swap dealer (not otherwise deducted from net worth) and the market value of any collateral given to an affiliate (not otherwise deducted from net worth) to secure a liability over the amount of the liability of the security-based swap dealer unless the books and records of the affiliate are made available for examination when requested by the representatives of the Commission in order to demonstrate the validity of the receivable or payable. The provisions of this subsection shall not apply where the affiliate is a registered security-based swap dealer, registered broker or dealer, registered government securities broker or dealer, bank as defined in section 3(a)(6) of the Act, insurance company as defined in section 3(a)(19) of the Act, investment company registered under the Investment Company Act of 1940, federally insured savings and loan association, or futures commission merchant or swap dealer registered pursuant to the Commodity Exchange Act.

(iv) *Non-marketable securities.* Deducting 100 percent of the carrying value in the case of securities or evidence of indebtedness in the proprietary or other accounts of the security-based swap dealer, for which there is no ready market, as defined in paragraph (c)(4) of this section, and securities, in the proprietary or other accounts of the security-based swap dealer, that cannot be publicly offered or sold because of statutory, regulatory or contractual arrangements or other restrictions.

(v) Deducting from the contract value of each failed to deliver contract that is outstanding five business days or longer (21 business days or longer in the case of municipal securities) the percentages of the market value of the underlying security that would be required by application of the deduction required by paragraph (c)(1)(vii) of this section. Such deduction, however, shall be increased by any excess of the contract price of the failed to deliver contract over the market value of the underlying security or reduced by any excess of the market value of the underlying security

over the contract value of the failed to deliver contract, but not to exceed the amount of such deduction. The Commission may, upon application of the security-based swap dealer, extend for a period up to 5 business days, any period herein specified when it is satisfied that the extension is warranted. The Commission upon expiration of the extension may extend for one additional period of up to 5 business days, any period herein specified when it is satisfied that the extension is warranted.

(vi) *Security-based swaps.* Deducting the percentages specified in paragraphs (c)(1)(vi)(A) and (B) of this section (or the deductions prescribed in § 240.18a–1a) of the notional amount of any security-based swaps in the proprietary account of the security-based swap dealer.

(A) *Credit default swaps.* (*1*) *Short positions (selling protection).* In the case of a security-based swap that is a short credit default swap, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

Length of time to maturity of CDS contract	Basis point spread					
	100 or less (%)	101–300 (%)	301–400 (%)	401–500 (%)	501–699 (%)	700 or more (%)
12 months or less	1.00	2.00	5.00	7.50	10.00	15.00
13 months to 24 months	1.50	3.50	7.50	10.00	12.50	17.50
25 months to 36 months	2.00	5.00	10.00	12.50	15.00	20.00
37 months to 48 months	3.00	6.00	12.50	15.00	17.50	22.50
49 months to 60 months	4.00	7.00	15.00	17.50	20.00	25.00
61 months to 72 months	5.50	8.50	17.50	20.00	22.50	27.50
73 months to 84 months	7.00	10.00	20.00	22.50	25.00	30.00
85 months to 120 months	8.50	15.00	22.50	25.00	27.50	40.00
121 months and longer	10.00	20.00	25.00	27.50	30.00	50.00

(*2*) *Long positions (purchasing protection).* In the case of a security-based swap that is a long credit default swap, deducting 50% of the deduction that would be required by paragraph (c)(1)(vi)(A)(*1*) of this section if the security-based swap was a short credit default swap.

(*3*) *Long and short positions.* (*i*) *Long and short credit default swaps.* In the case of security-based swaps that are long and short credit default swaps referencing the same obligor or obligation, that are in the same spread category, and that are in the same maturity category or are in the next maturity category and have a maturity date within three months of the other maturity category, deducting the percentage of the notional amount specified in the higher maturity category under paragraphs (c)(1)(vi)(A)(*1*) or (*2*) on the excess of the long or short position. In the case of security-based swaps that are long and short credit default swaps referencing obligors or obligations of obligors in the same industry sector and the same spread and maturity categories prescribed in paragraph (c)(1)(vi)(A)(*1*) of this section, deducting 50% of the amount required by paragraph (c)(1)(vi)(A)(*1*) of this section on the short position plus the deduction required by paragraph (c)(1)(vi)(A)(*2*) of this section on the excess long position, if any. For the purposes of this section, the security-based swap dealer must use an industry sector classification system that is reasonable in terms of grouping types of companies with similar business activities and risk characteristics and document the industry sector classification system used pursuant to this section.

(*ii*) *Long security and long credit default swap.* In the case of a security-based swap that is a long credit default swap referencing a debt security and the security-based swap dealer is long the same debt security, deducting 50% of the amount specified in § 240.15c3–1(c)(2)(vi) or (vii) for the bond, provided that the security-based swap dealer can deliver the bond to satisfy the obligation of the security-based swap dealer on the credit default swap.

(*iii*) *Short security and short credit default swap.* In the case of a security-based swap that is a short credit default swap referencing a bond or a corporate entity and the security-based swap dealer is short the bond or a bond issued by the corporate entity, deducting the amount specified in § 240.15c3–1(c)(2)(vi) or (vii) for the bond. In the case of a security-based swap that is a short credit default swap referencing an asset-backed security and the security-based swap dealer is short the asset-backed security, deducting the amount specified in § 240.15c3–1(c)(2)(vi) or (vii) for the asset-backed security.

(B) *All other security-based swaps.* In the case of any security-based swap that is not a credit default swap, deducting the amount calculated by multiplying the notional amount of the security-based swap and the percentage specified in § 240.15c3–1(c)(2)(vi) applicable to the reference security. A security-based swap dealer may reduce the deduction under this paragraph (c)(1)(vi)(B) by an amount equal to any reduction recognized for a comparable long or short position in the reference security under § 240.15c3–1(c)(2)(vi) and, in the case of a security-based swap referencing an equity security, the method specified in § 240.18a–1a.

(vii) *All other securities, money market instruments or options.* Deducting the percentages specified in § 240.15c3–1(c)(2)(vi) of the market value of all securities, money market instruments, and options in the proprietary accounts of the security-based swap dealer.

(viii) *Deduction from net worth in lieu of collecting margin amounts for security-based swaps.* (A) *Cleared security-based swap transactions.* Deducting the amount of the margin difference for each account carried by the security-based swap dealer for another person that holds cleared security-based swap transactions. The margin difference is the amount of the deductions that the positions in the account would incur pursuant to paragraph (c)(1)(vi) of this section if owned by the security-based swap dealer less the margin value of collateral held in the account.

(B) *Non-cleared security-based swap transactions.* (*1*) *Commercial end users.* Deducting, with respect to a counterparty that is a *commercial end user* as that term is defined in § 240.18a–3(b)(2), the margin amount calculated pursuant to § 240.18a–3(c)(1)(i)(B) for the account of the counterparty less any *positive equity* in the account as that term is defined in § 240.18a–3(b)(7).

(*2*) *Margin collateral held by third-party custodian.* Deducting, with respect to a counterparty that is not a *commercial end user* as that term is defined in § 240.18a–3(b)(2) and that elects to have collateral segregated in an account at an independent third-party custodian pursuant to section 3E(f) of the Act (15 U.S.C. 78c–5(f)), the margin amount calculated pursuant to § 240.18a–3(c)(1)(i)(B) for the account of the counterparty at the security-based swap dealer less any *positive equity* in that account as that term is defined in § 240.18a–3(b)(7).

(*3*) *Security-based swap legacy accounts.* Deducting, with respect to a *security-based swap legacy account* as that term is defined in § 240.18a–3(b)(9) of a counterparty that is not a *commercial end user* as that term is defined in § 240.18a–3(b)(2), the margin amount calculated pursuant § 240.18a–3(c)(1)(i)(B) for the account less any *positive equity* in the account as that term is defined in § 240.18a–3(b)(7).

(ix) *Deduction from net worth for certain undermargined accounts.* Deducting the amount of cash required in the account of each security-based swap customer to meet the margin requirements of a clearing agency or the Commission, after application of calls for margin, marks to the market, or other required deposits which are outstanding one business day or less.

(2) The term *exempted securities* shall mean those securities deemed exempted securities by section 3(a)(12) of the Securities Exchange Act of 1934 and the rules thereunder.

(3) *Customer.* The term *customer* shall mean any person from whom, or on whose behalf, a security-based swap dealer has received, acquired or holds funds or securities for the account of such person, but shall not include a security-based swap dealer, a broker or dealer, a registered municipal securities dealer, or a general, special or limited partner or director or officer of the security-based swap dealer, or any person to the extent that such person has a claim for property or funds which by contract, agreement, or understanding, or by operation of law, is part of the capital of the security-based swap dealer.

(4) *Ready market.* The term *ready market* shall include a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.

(5) The term *tentative net capital* means the net capital of the security-based swap dealer before deductions for market and credit risk computed pursuant to this section and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in derivative instruments which would otherwise be deducted. Tentative net capital shall include securities for which there is no ready market, as defined in paragraph (c)(4) of this section, if the use of mathematical models has been approved for purposes of calculating deductions from net capital for those securities pursuant to paragraph (d) of this section.

(6) The term *risk margin amount* means the sum of:

(i) The greater of the total margin required to be delivered by the security-based swap dealer with respect to security-based swap transactions cleared for security-based swap customers at a clearing agency or the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to paragraph (c)(1)(vi) of this section; and

(ii) The total margin amount calculated by the security-based swap dealer with respect to non-cleared security-based swaps pursuant to § 240.18a–3(c)(1)(i)(B).

(d) *Application to use models to compute deductions for market and credit risk.* (1) A security-based swap dealer may apply to the Commission for authorization to compute deductions for market risk under this paragraph (d) in lieu of computing deductions pursuant to paragraphs (c)(1)(iv), (vi), and (vii) of this section and to compute deductions for credit risk pursuant to this paragraph (d) on credit exposures arising from transactions in derivatives instruments (if this paragraph (d) is used to calculate deductions for market risk on these instruments) in lieu of computing deductions pursuant to paragraph (c)(1)(iii) of this section.

(i) A security-based swap dealer shall submit the following information to the Commission with its application:

(A) An executive summary of the information provided to the Commission with its application and an identification of the ultimate holding company of the security-based swap dealer;

(B) A comprehensive description of the internal risk management control system of the security-based swap dealer and how that system satisfies the requirements set forth in § 240.15c3–4;

(C) A list of the categories of positions that the security-based swap dealer holds in its proprietary accounts and a brief description of the methods that the security-based swap dealer will use to calculate deductions for market and credit risk on those categories of positions;

(D) A description of the mathematical models to be used to price positions and to compute deductions for market risk, including those portions of the deductions attributable to specific risk, if applicable, and deductions for credit risk; a description of the creation, use, and maintenance of the mathematical models; a description of the security-based swap dealer's internal risk management controls over those models, including a description of each category of persons who may input data into the models; if a mathematical model incorporates empirical correlations across risk categories, a description of the process for measuring correlations; a description of the backtesting procedures the security-based swap dealer will use to backtest the mathematical models used to calculate maximum potential exposure; a description of how each mathematical model satisfies the applicable qualitative and quantitative requirements set forth in this paragraph (d); and a statement describing the extent to which each mathematical model used to compute deductions for market risk and credit risk will be used as part of the risk analyses and reports presented to senior management;

(E) If the security-based swap dealer is applying to the Commission for approval to use scenario analysis to calculate deductions for market risk for certain positions, a list of those types of positions, a description of how those deductions will be calculated using scenario analysis, and an explanation of why each scenario analysis is appropriate to calculate deductions for market risk on those types of positions;

(F) A description of how the security-based swap dealer will calculate current exposure;

(G) A description of how the security-based swap dealer will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable;

(H) For each instance in which a mathematical model to be used by the security-based swap dealer to calculate a deduction for market risk or to calculate maximum potential exposure for a particular product or counterparty differs from the mathematical model used by the ultimate holding company to calculate an allowance for market risk or to calculate maximum potential

exposure for that same product or counterparty, a description of the difference(s) between the mathematical models; and

(I) Sample risk reports that are provided to management at the security-based swap dealer who are responsible for managing the security-based swap dealer's risk.

(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) The Commission may approve the application or an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission may require if the Commission finds the approval to be necessary or appropriate in the public interest or for the protection of investors, after determining, among other things, whether the security-based swap dealer has met the requirements of this paragraph (d) and is in compliance with other applicable rules promulgated under the Act;

(6) A security-based swap dealer shall amend its application to calculate certain deductions for market and credit risk under this paragraph (d) and submit the amendment to the Commission for approval before it may change materially a mathematical model used to calculate market or credit risk or before it may change materially its internal risk management control system;

(7) As a condition for the security-based swap dealer to compute deductions for market and credit risk under this paragraph (d), the security-based swap dealer agrees that:

(i) It will notify the Commission 45 days before it ceases to compute deductions for market and credit risk under this paragraph (d); and

(ii) The Commission may determine by order that the notice will become effective after a shorter or longer period of time if the security-based swap dealer consents or if the Commission determines that a shorter or longer period of time is necessary or appropriate in the public interest or for the protection of investors; and

(8) Notwithstanding paragraph (d)(7) of this section, the Commission, by order, may revoke a security-based swap dealer's exemption that allows it to use the market risk standards of this paragraph (d) to calculate deductions for market risk, and the exemption to use the credit risk standards of this paragraph (d) to calculate deductions for credit risk on certain credit exposures arising from transactions in derivatives instruments if the Commission finds that such exemption is no longer necessary or appropriate in the public interest or for the protection of investors. In making its finding, the Commission will consider the compliance history of the security-based swap dealer related to its use of models, the financial and operational strength of the security-based swap dealer and its ultimate holding company, and the security-based swap dealer's compliance with its internal risk management controls.

(9) *VaR models.* To be approved, each value-at-risk (''VaR'') model must meet the following minimum qualitative and quantitative requirements:

(i) *Qualitative requirements.* (A) The VaR model used to calculate market or credit risk for a position must be integrated into the daily internal risk management system of the security-based swap dealer;

(B) The VaR model must be reviewed both periodically and annually. The periodic review may be conducted by the security-based swap dealer's internal audit staff, but the annual review must be conducted by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*); and

(C) For purposes of computing market risk, the security-based swap dealer must determine the appropriate multiplication factor as follows:

(*1*) Beginning three months after the security-based swap dealer begins using the VaR model to calculate market risk, the security-based swap dealer must conduct backtesting of the model by comparing its actual daily net trading profit or loss with the corresponding VaR measure generated by the VaR model, using a 99 percent, one-tailed confidence level with price changes equivalent to a one business-day movement in rates and prices, for each of the past 250 business days, or other period as may be appropriate for the first year of its use;

(*2*) On the last business day of each quarter, the security-based swap dealer must identify the number of backtesting exceptions of the VaR model using clean profit and loss, that is, the number of business days in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the actual net trading loss, if any, exceeds the corresponding VaR measure; and

(*3*) The security-based swap dealer must use the multiplication factor indicated in Table 1 of this paragraph (d) in determining its market risk until it obtains the next quarter's backtesting results;

TABLE 1—MULTIPLICATION FACTOR BASED ON THE NUMBER OF BACKTESTING EXCEPTIONS OF THE VAR MODEL

Number of exceptions	Multiplication factor
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

(*4*) For purposes of incorporating specific risk into a VaR model, a security-based swap dealer must demonstrate that it has methodologies in place to capture liquidity, event, and default risk adequately for each position. Furthermore, the models used to calculate deductions for specific risk must:

(*i*) Explain the historical price variation in the portfolio;

(*ii*) Capture concentration (magnitude and changes in composition);

(*iii*) Be robust to an adverse environment;

(*iv*) Capture name-related basis risk;

(*v*) Capture event risk; and

(*vi*) Be validated through backtesting.

(*5*) For purposes of computing the credit equivalent amount of the security-based swap dealer's exposures

to a counterparty, the security-based swap dealer must determine the appropriate multiplication factor as follows:

(*i*) Beginning three months after it begins using the VaR model to calculate maximum potential exposure, the security-based swap dealer must conduct backtesting of the model by comparing, for at least 80 counterparties with widely varying types and sizes of positions with the firm, the ten business day change in its current exposure to the counterparty based on its positions held at the beginning of the ten-business day period with the corresponding ten-business day maximum potential exposure for the counterparty generated by the VaR model;

(*ii*) As of the last business day of each quarter, the security-based swap dealer must identify the number of backtesting exceptions of the VaR model, that is, the number of ten-business day periods in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the change in current exposure to a counterparty exceeds the corresponding maximum potential exposure; and

(*iii*) The security-based swap dealer will propose, as part of its application, a schedule of multiplication factors, which must be approved by the Commission based on the number of backtesting exceptions of the VaR model. The security-based swap dealer must use the multiplication factor indicated in the approved schedule in determining the credit equivalent amount of its exposures to a counterparty until it obtains the next quarter's backtesting results, unless the Commission determines, based on, among other relevant factors, a review of the security-based swap dealer's internal risk management control system, including a review of the VaR model, that a different adjustment or other action is appropriate.

(ii) Quantitative requirements.

(A) For purposes of determining market risk, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices;

(B) For purposes of determining maximum potential exposure, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a one-year movement in rates and prices; or based on a review of the security-based swap dealer's procedures for managing collateral and if the collateral is marked to market daily and the security-based swap dealer has the ability to call for additional collateral daily, the Commission may approve a time horizon of not less than ten business days;

(C) The VaR model must use an effective historical observation period of at least one year. The security-based swap dealer must consider the effects of market stress in its construction of the model. Historical data sets must be updated at least monthly and reassessed whenever market prices or volatilities change significantly; and

(D) The VaR model must take into account and incorporate all significant, identifiable market risk factors applicable to positions in the accounts of the security-based swap dealer, including:

(*1*) Risks arising from the non-linear price characteristics of derivatives and the sensitivity of the market value of those positions to changes in the volatility of the derivatives' 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.* (A) As a condition for the security-based swap dealer to use this paragraph (d) to calculate certain of its capital charges, the Commission may impose additional conditions on the security-based swap dealer, which may include, but are not limited to restricting the security-based swap dealer's business on a product-specific, category-specific, or general basis; submitting to the Commission a plan to increase the security-based swap dealer's net capital or tentative net capital; filing more frequent reports with the Commission; modifying the security-based swap dealer's internal risk management control procedures; or computing the security-based swap dealer's deductions for market and credit risk in accordance with paragraphs (c)(1) (iii), (iv), (vii), or (viii) as appropriate. If the Commission finds it is necessary or appropriate in the public interest or for the protection of investors, the Commission may impose additional conditions on the security-based swap dealer, if:

(*1*) The security-based swap dealer is required by § 240.18a–8 to provide notice to the Commission that the security-based swap dealer's tentative net capital is less than $100 million;

(*2*) The security-based swap dealer fails to meet the reporting requirements set forth in § 240.18a–8;

(*3*) Any event specified in § 240.18a–8 occurs;

(*4*) There is a material deficiency in the internal risk management control system or in the mathematical models used to price securities or to calculate deductions for market and credit risk or allowances for market and credit risk, as applicable, of the security-based swap dealer;

(*5*) The security-based swap dealer fails to comply with this paragraph (d); or

(*6*) The Commission finds that imposition of other conditions is necessary or appropriate in the public interest or for the protection of investors.

(e) *Models to compute deductions for market risk and credit risk.* (1) *Market risk.* A security-based swap dealer whose application, including amendments, has been approved under paragraph (d) of this section, shall compute a deduction for market risk in an amount equal to the sum of the following:

(i) For positions for which the Commission has approved the security-based swap dealer's use of VaR models, the VaR of the positions multiplied by the appropriate multiplication factor determined according to paragraph (d) of this section, except that the initial multiplication factor shall be three, unless the Commission determines, based on a review of the security-based swap dealer's application or an amendment to the application under paragraph (d) of this section, including a review of its internal risk management control system and practices and VaR models, that another multiplication factor is appropriate;

(ii) For positions for which the VaR model does not incorporate specific risk, a deduction for specific risk to be determined by the Commission based on a review of the security-based swap dealer's application or an amendment to the application under paragraph (d) of this section and the positions involved;

(iii) For positions for which the Commission has approved the security-based swap dealer's application to use scenario analysis, the greatest loss resulting from a range of adverse movements in relevant risk factors, prices, or spreads designed to represent a negative movement greater than, or equal to, the worst ten-day movement of

the four years preceding calculation of the greatest loss, or some multiple of the greatest loss based on the liquidity of the positions subject to scenario analysis. If historical data is insufficient, the deduction shall be the largest loss within a three standard deviation movement in those risk factors, prices, or spreads over a ten-day period, multiplied by an appropriate liquidity adjustment factor. Irrespective of the deduction otherwise indicated under scenario analysis, the resulting deduction for market risk must be at least $25 per 100 share equivalent contract for equity positions, or one-half of one percent of the face value of the contract for all other types of contracts, even if the scenario analysis indicates a lower amount. A qualifying scenario must include the following:

(A) A set of pricing equations for the positions based on, for example, arbitrage relations, statistical analysis, historic relationships, merger evaluations, or fundamental valuation of an offering of securities;

(B) Auxiliary relationships mapping risk factors to prices; and

(C) Data demonstrating the effectiveness of the scenario in capturing market risk, including specific risk; and

(iv) For all remaining positions, the deductions specified in § 240.15c3–1(c)(2)(vi), § 240.15c3–1(c)(2)(vii), and applicable appendices to § 240.15c3–1.

(2) *Credit risk.* A security-based swap dealer whose application, including amendments, has been approved under paragraph (d) of this section with respect to positions in security-based swaps may compute a deduction for credit risk on security-based swap transactions with *commercial end users* as defined in § 240.18a–3(b)(2) in an amount equal to the sum of the following:

(i) A counterparty exposure charge in an amount equal to the sum of the following:

(A) The net replacement value in the account of each counterparty that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default; and

(B) For a counterparty not otherwise described in paragraph (e)(2)(i)(A) of this section, the *credit equivalent amount* of the security-based swap dealer's exposure to the counterparty, as defined in paragraph (e)(2)(iv)(A) of this section, multiplied by the credit risk weight of the counterparty, as determined in accordance with paragraph (e)(2)(iv)(F) of this section, multiplied by 8%;

(ii) A concentration charge by counterparty in an amount equal to the sum of the following:

(A) For each counterparty with a credit risk weight of 20% or less, 5% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the security-based swap dealer;

(B) For each counterparty with a credit risk weight of greater than 20% but less than 50%, 20% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the security-based swap dealer; and

(C) For each counterparty with a credit risk weight of greater than 50%, 50% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the security-based swap dealer; and

(iii) A portfolio concentration charge of 100% of the amount of the security-based swap dealer's aggregate current exposure for all counterparties in excess of 50% of the tentative net capital of the security-based swap dealer.

(iv) *Terms.* (A) The *credit equivalent amount* of the security-based swap dealer's exposure to a counterparty is the sum of the security-based swap dealer's *maximum potential exposure* to the counterparty, as defined in paragraph (e)(2)(iv)(B) of this section, multiplied by the appropriate multiplication factor, and the security-based swap dealer's *current exposure* to the counterparty, as defined in paragraph (e)(2)(iv)(C) of this section. The security-based swap dealer must use the multiplication factor determined according to paragraph (d)(9)(i)(C)(*5*) of this section, except that the initial multiplication factor shall be one, unless the Commission determines, based on a review of the security-based swap dealer's application or an amendment to the application approved under paragraph (d) of this section, including a review of its internal risk management control system and practices and VaR models, that another multiplication factor is appropriate;

(B) The *maximum potential exposure* is the VaR of the counterparty's positions with the security-based swap dealer, after applying netting agreements with the counterparty meeting the requirements of paragraph (e)(2)(iv)(D) of this section, taking into account the value of collateral from the counterparty held by the security-based swap dealer in accordance with paragraph (e)(2)(iv)(E) of this section, and taking into account the current replacement value of the counterparty's positions with the security-based swap dealer;

(C) The *current exposure* of the security-based swap dealer to a counterparty is the current replacement value of the counterparty's positions with the security-based swap dealer, after applying netting agreements with the counterparty meeting the requirements of paragraph (e)(2)(iv)(D) of this section and taking into account the value of collateral from the counterparty held by the security-based swap dealer in accordance with paragraph (e)(2)(iv)(E) of this section;

(D) *Netting agreements.* A security-based swap dealer may include the effect of a netting agreement that allows the security-based swap dealer to net gross receivables from and gross payables to a counterparty upon default of the counterparty if:

(*1*) The netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings;

(*2*) The gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and

(*3*) For internal risk management purposes, the security-based swap dealer monitors and controls its exposure to the counterparty on a net basis.

(E) *Collateral.* When calculating maximum potential exposure and current exposure to a counterparty, the fair market value of collateral pledged and held may be taken into account provided:

(*1*) The collateral is marked to market each day and is subject to a daily margin maintenance requirement;

(*2*) The security-based swap dealer maintains physical possession or sole control of the collateral;

(*3*) The collateral is liquid and transferable;

(*4*) The collateral may be liquidated promptly by the firm without intervention by any other party;

(*5*) The collateral agreement is legally enforceable by the security-based swap dealer against the counterparty and any other parties to the agreement;

(*6*) The collateral does not consist of securities issued by the counterparty or a party related to the security-based swap dealer or to the counterparty;

(*7*) The Commission has approved the security-based swap dealer's use of a VaR model to calculate deductions for market risk for the type of collateral in accordance with paragraph (d) of this section; and

(*8*) The collateral is not used in determining the credit rating of the counterparty.

(F) *Credit risk weights of counterparties.* A security-based swap

dealer that computes its deductions for credit risk pursuant to paragraph (e)(2) of this section shall apply a credit risk weight for transactions with a counterparty of either 20%, 50%, or 150% based on an internal credit rating the security-based swap dealer determines for the counterparty.

(*1*) As part of its initial application or in an amendment, the security-based swap dealer may request Commission approval to apply a credit risk weight of either 20%, 50%, or 150% based on internal calculations of credit ratings, including internal estimates of the maturity adjustment. Based on the strength of the security-based swap dealer's internal credit risk management system, the Commission may approve the application. The security-based swap dealer must make and keep current a record of the basis for the credit risk weight of each counterparty;

(*2*) As part of its initial application or in an amendment, the security-based swap dealer may request Commission approval to determine credit risk weights based on internal calculations, including internal estimates of the maturity adjustment. Based on the strength of the security-based swap dealer's internal credit risk management system, the Commission may approve the application. The security-based swap dealer must make and keep current a record of the basis for the credit risk weight of each counterparty; and

(*3*) As part of its initial application or in an amendment, the security-based swap dealer may request Commission approval to reduce deductions for credit risk through the use of credit derivatives.

(f) *Liquidity requirements.* (1) *Liquidity stress test.* A security-based swap dealer that computes net capital under paragraph (a)(2) of this Rule 18a–1 must perform a liquidity stress test at least monthly, the results of which must be provided within ten business days to senior management that has responsibility to oversee risk management at the security-based swap dealer. The assumptions underlying the liquidity stress test must be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the security-based swap dealer and at least annually by senior management of the security-based swap dealer. The liquidity stress test must include, at a minimum, the following assumed conditions lasting for 30 consecutive days:

(i) A stress event includes a decline in creditworthiness of the broker or dealer severe enough to trigger contractual credit-related commitment provisions of counterparty agreements;

(ii) The loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding, including intercompany advances and unfunded committed lines of credit;

(iii) The potential for a material net loss of secured funding;

(iv) The loss of the ability to procure repurchase agreement financing for less liquid assets;

(v) The illiquidity of collateral required by and on deposit at clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets;

(vi) A material increase in collateral required to be maintained at registered clearing agencies of which it is a member; and

(vii) The potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the security-based swap dealer, including those related to customer businesses of the security-based swap dealer.

(2) *Stress test of consolidated entity.* The security-based swap dealer must justify and document any differences in the assumptions used in the liquidity stress test of the security-based swap dealer from those used in the liquidity stress test of the consolidated entity of which the security-based swap dealer is a part.

(3) *Liquidity reserves.* The security-based swap dealer must maintain at all times liquidity reserves based on the results of the liquidity stress test. The liquidity reserves used to satisfy the liquidity stress test must be:

(i) Cash, obligations of the United States, or obligations fully guaranteed as to principal and interest by the United States; and

(ii) Unencumbered and free of any liens at all times.

Securities in the liquidity reserve can be used to meet delivery requirements as long as cash or other acceptable securities of equal or greater value are moved into the liquidity pool contemporaneously.

(4) *Contingency funding plan.* The security-based swap dealer must have a written contingency funding plan that addresses the security-based swap dealer's policies and the roles and responsibilities of relevant personnel for meeting the liquidity needs of the security-based swap dealer and communications with the public and other market participants during a liquidity stress event.

(g) *Internal risk management control systems.* A security-based swap dealer must comply with § 240.15c3–4 as if it were an OTC derivatives dealer with respect to all of its business activities, except that paragraphs (c)(5)(xiii) and (xiv) and (d)(8) and (9) of § 240.15c3–4 shall not apply.

(h) *Debt-equity requirements.* No security-based swap dealer shall permit the total of outstanding principal amounts of its satisfactory subordination agreements (other than such agreements which qualify under this paragraph (h) as equity capital) to exceed 70 percent of its debt-equity total, as hereinafter defined, for a period in excess of 90 days or for such longer period which the Commission may, upon application of the security-based swap dealer, grant in the public interest or for the protection of investors. In the case of a corporation, the debt-equity total shall be the sum of its outstanding principal amounts of satisfactory subordination agreements, par or stated value of capital stock, paid in capital in excess of par, retained earnings, unrealized profit and loss or other capital accounts. In the case of a partnership, the debt-equity total shall be the sum of its outstanding principal amounts of satisfactory subordination agreements, capital accounts of partners (exclusive of such partners' securities accounts) subject to the provisions of paragraph (i) of this section, and unrealized profit and loss. *Provided, however,* that a satisfactory subordinated loan agreement entered into by a partner or stockholder which has an initial term of at least three years and has a remaining term of not less than 12 months shall be considered equity for the purposes of this paragraph (h) if:

(1) It does not have any of the provisions for accelerated maturity provided for by paragraphs (b)(8)(i), (9)(i), or (9)(ii) of Appendix D of this section and is maintained as capital subject to the provisions restricting the withdrawal thereof required by paragraph (i) of this section; or

(2) The partnership agreement provides that capital contributed pursuant to a satisfactory subordination agreement as defined in Appendix D of this section shall in all respects be partnership capital subject to the provisions restricting the withdrawal thereof required by paragraph (i) of this section.

(i) *Notice provisions relating to limitations on the withdrawal of equity capital.* (1) No equity capital of the security-based swap dealer or a

subsidiary or affiliate consolidated pursuant to Appendix C of this section may be withdrawn by action of a stockholder or a partner or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, employee or affiliate without written notice given in accordance with paragraph (i)(1)(iv) of this section:

(i) Two business days prior to any withdrawals, advances or loans if those withdrawals, advances or loans on a net basis exceed in the aggregate in any 30 calendar day period, 30 percent of the security-based swap dealer's excess net capital. A security-based swap dealer, in an emergency situation, may make withdrawals, advances or loans that on a net basis exceed 30 percent of the security-based swap dealer's excess net capital in any 30 calendar day period without giving the advance notice required by this paragraph, with the prior approval of the Commission. Where a security-based swap dealer makes a withdrawal with the consent of the Commission, it shall in any event comply with paragraph (i)(1)(ii) of this section; or

(ii) Two business days after any withdrawals, advances or loans if those withdrawals, advances or loans on a net basis exceed in the aggregate in any 30 calendar day period, 20 percent of the security-based swap dealer's excess net capital.

(iii) This paragraph (i)(1) does not apply to:

(A) Securities or commodities transactions in the ordinary course of business between a security-based swap dealer and an affiliate where the security-based swap dealer makes payment to or on behalf of such affiliate for such transaction and then receives payment from such affiliate for the securities or commodities transaction within two business days from the date of the transaction; or

(B) Withdrawals, advances or loans which in the aggregate in any thirty calendar day period, on a net basis, equal $500,000 or less.

(iv) Each required notice shall be effective when received by the Commission in Washington, 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 Appendix C of this section may be withdrawn by action of a stockholder or a partner or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, employee or affiliate, if after giving effect thereto and to any other such withdrawals, advances or loans and any Payments of Payments Obligations (as defined in Appendix D of this section) under satisfactory subordinated loan agreements which are scheduled to occur within 180 days following such withdrawal, advance or loan if:

(i) The security-based swap dealer's net capital would be less than 120 percent of the minimum dollar amount required by paragraph (a) of this section; and

(ii) The total outstanding principal amounts of satisfactory subordinated loan agreements of the security-based swap dealer and any subsidiaries or affiliates consolidated pursuant to Appendix C of this section (other than such agreements which qualify as equity under paragraph (h) of this section) would exceed 70% of the debt-equity total as defined in paragraph (h) of this section.

(3) *Temporary restrictions on withdrawal of net capital.* (i) The Commission may by order restrict, for a period up to twenty business days, any withdrawal by the security-based swap dealer of equity capital or unsecured loan or advance to a stockholder, partner, member, employee or affiliate under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors if the Commission, based on the information available, concludes that such withdrawal, advance or loan may be detrimental to the financial integrity of the security-based swap dealer, or may unduly jeopardize the security-based swap dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the security-based swap dealer to loss.

(ii) An order temporarily prohibiting the withdrawal of capital shall be rescinded if the Commission determines that the restriction on capital withdrawal should not remain in effect. A hearing on an order temporarily prohibiting withdrawal of capital will be held within two business days from the date of the request in writing by the security-based swap dealer.

(4) *Miscellaneous provisions.* (i) Excess net capital is that amount in excess of the amount required under paragraph (a) of this section. For the purposes of paragraphs (i)(1) and (2) of this section, a security-based swap dealer may use the amount of excess net capital and deductions required under paragraphs (c)(1)(vii) and (viii) and Appendix A of this section reported in its most recently required filed Form X–18A–7 for the purposes of calculating the effect of a projected withdrawal, advance or loan relative to excess net capital or deductions. The security-based swap dealer must assure itself that the excess net capital or the deductions reported on the most recently required filed Form X–18A–7 have not materially changed since the time such report was filed.

(ii) The term equity capital includes capital contributions by partners, par or stated value of capital stock, paid-in capital in excess of par, retained earnings or other capital accounts. The term equity capital does not include securities in the securities accounts of partners and balances in limited partners' capital accounts in excess of their stated capital contributions.

(iii) Paragraphs (i)(1) and (2) of this section shall not preclude a security-based swap dealer from making required tax payments or preclude the payment to partners of reasonable compensation, and such payments shall not be included in the calculation of withdrawals, advances, or loans for purposes of paragraphs (i)(1) and (2) of this section.

(iv) For the purpose of this paragraph (i), any transactions between a security-based swap dealer and a stockholder, partner, employee or affiliate that results in a diminution of the security-based swap dealer's net capital shall be deemed to be an advance or loan of net capital.

9. Section 240.18a–1a is added to read as follows:

§ 240.18a–1a Options (Appendix A to 17 CFR 240.18a–1).

(a)(1) *Definitions.* The term *unlisted option* means any option not included in the definition of listed option provided in § 240.15c3–1(c)(2)(x).

(2) The term *option series* refers to listed option contracts of the same type (either a call or a put) and exercise style, covering the same underlying security with the same exercise price, expiration date, and number of underlying units.

(3) The term *related instrument* within an option class or product group refers to futures contracts and options

on futures contracts covering the same underlying instrument. In relation to options on foreign currencies, a related instrument within an option class also shall include forward contracts on the same underlying currency.

(4) The term *underlying instrument* refers to long and short positions, as appropriate, covering the same foreign currency, the same security, security future, or security-based swap, or a security which is exchangeable for or convertible into the underlying security within a period of 90 days. If the exchange or conversion requires the payment of money or results in a loss upon conversion at the time when the security is deemed an underlying instrument for purposes of this Appendix A, the security-based swap dealer will deduct from net worth the full amount of the conversion loss. The term underlying instrument shall not be deemed to include securities options, futures contracts, options on futures contracts, qualified stock baskets, or unlisted instruments (other than security-based swaps).

(5) The term *options class* refers to all options contracts covering the same underlying instrument.

(6) The term *product group* refers to two or more option classes, related instruments, underlying instruments, and qualified stock baskets in the same portfolio type (see paragraph (b)(1)(ii) of this section) for which it has been determined that a percentage of offsetting profits may be applied to losses at the same valuation point.

(b) The deduction under this Appendix A must equal the sum of the deductions specified in paragraph (b)(1)(iv)(C) of this section.

Theoretical Pricing Charges

(1)(i) *Definitions.* (A) The terms *theoretical gains and losses* mean the gain and loss in the value of individual option series, the value of underlying instruments, related instruments, and qualified stock baskets within that option's class, at 10 equidistant intervals (valuation points) ranging from an assumed movement (both up and down) in the current market value of the underlying instrument equal to the percentage corresponding to the deductions otherwise required under § 240.15c3–1 for the underlying instrument (see paragraph (b)(1)(iii) of this section). Theoretical gains and losses shall be calculated using a theoretical options pricing model that satisfies the criteria set forth in paragraph (b)(1)(i)(B) of this section.

(B) The term *theoretical options pricing model* means any mathematical model, other than a security-based swap dealer's proprietary model, the use of which has been approved by the Commission. Any such model shall calculate theoretical gains and losses as described in paragraph (b)(1)(i)(A) of this section for all series and issues of equity, index and foreign currency options and related instruments, and shall be made available equally and on the same terms to all security-based swap dealers. Its procedures shall include the arrangement of the vendor to supply accurate and timely data to each security-based swap dealer with respect to its services, and the fees for distribution of the services. The data provided to security-based swap dealers shall also contain the minimum requirements set forth in paragraphs (b)(1)(iv)(C) of this section and the product group offsets set forth in paragraphs (b)(1)(iv)(B) of this section. At a minimum, the model shall consider the following factors in pricing the option:

(*1*) The current spot price of the underlying asset;

(*2*) The exercise price of the option;

(*3*) The remaining time until the option's expiration;

(*4*) The volatility of the underlying asset;

(*5*) Any cash flows associated with ownership of the underlying asset that can reasonably be expected to occur during the remaining life of the option; and

(*6*) The current term structure of interest rates.

(C) The term *major market foreign currency* means the currency of a sovereign nation for which there is a substantial inter-bank forward currency market.

(D) The term *qualified stock basket* means a set or basket of stock positions which represents no less than 50% of the capitalization for a high-capitalization or non-high-capitalization diversified market index, or, in the case of a narrow-based index, no less than 95% of the capitalization for such narrow-based index.

(ii) With respect to positions involving listed option positions in its proprietary or other account, the security-based swap dealer shall group long and short positions into the following portfolio types:

(A) Equity options on the same underlying instrument and positions in that underlying instrument;

(B) Options on the same major market foreign currency, positions in that major market foreign currency, and related instruments within those options' classes;

(C) High-capitalization diversified market index options, related instruments within the option's class, and qualified stock baskets in the same index;

(D) Non-high-capitalization diversified index options, related instruments within the index option's class, and qualified stock baskets in the same index; and

(E) Narrow-based index options, related instruments within the index option's class, and qualified stock baskets in the same index.

(iii) Before making the computation, each security-based swap dealer shall obtain the theoretical gains and losses for each option series and for the related and underlying instruments within those options' class in the proprietary or other accounts of that security-based swap dealer. For each option series, the theoretical options pricing model shall calculate theoretical prices at 10 equidistant valuation points within a range consisting of an increase or a decrease of the following percentages of the daily market price of the underlying instrument:

(A) +(−)15% for equity securities with a ready market, narrow-based indexes, and non-high-capitalization diversified indexes;

(B) +(−)6% for major market foreign currencies;

(C) +(−)20% for all other currencies; and

(D) +(−)10% for high-capitalization diversified indexes.

(iv)(A) The security-based swap dealer shall multiply the corresponding theoretical gains and losses at each of the 10 equidistant valuation points by the number of positions held in a particular option series, the related instruments and qualified stock baskets within the option's class, and the positions in the same underlying instrument.

(B) In determining the aggregate profit or loss for each portfolio type, the security-based swap dealer will be allowed the following offsets in the following order, provided, that in the case of qualified stock baskets, the security-based swap dealer may elect to net individual stocks between qualified stock baskets and take the appropriate deduction on the remaining, if any, securities:

(*1*) First, a security-based swap dealer is allowed the following offsets within an option's class:

(*i*) Between options on the same underlying instrument, positions covering the same underlying instrument, and related instruments within the option's class, 100% of a position's gain shall offset another position's loss at the same valuation point;

(*ii*) Between index options, related instruments within the option's class, and qualified stock baskets on the same index, 95%, or such other amount as designated by the Commission, of gains shall offset losses at the same valuation point;

(*2*) Second, a security-based swap dealer is allowed the following offsets within an index product group:

(*i*) Among positions involving different high-capitalization diversified index option classes within the same product group, 90% of the gain in a high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in a different high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class;

(*ii*) Among positions involving different non-high-capitalization diversified index option classes within the same product group, 75% of the gain in a non-high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in another non-high-capitalization diversified market index option, related instruments, and qualified stock baskets within that index option's class or product group;

(*iii*) Among positions involving different narrow-based index option classes within the same product group, 90% of the gain in a narrow-based market index option, related instruments, and qualified stock baskets within that index option's class shall offset the loss at the same valuation point in another narrow-based market index option, related instruments, and qualified stock baskets within that index option's class or product group;

(*iv*) No qualified stock basket should offset another qualified stock basket; and

(*3*) Third, a security-based swap dealer is allowed the following offsets between product groups: Among positions involving different diversified index product groups within the same market group, 50% of the gain in a diversified market index option, a related instrument, or a qualified stock basket within that index option's product group shall offset the loss at the same valuation point in another product group;

(C) For each portfolio type, the total deduction shall be the larger of:

(*1*) The amount for any of the 10 equidistant valuation points representing the largest theoretical loss after applying the offsets provided in paragraph (b)(1)(iv)(B) if this section; or

(*2*) A minimum charge equal to 25% times the multiplier for each equity and index option contract and each related instrument within the option's class or product group, or $25 for each option on a major market foreign currency with the minimum charge for futures contracts and options on futures contracts adjusted for contract size differentials, not to exceed market value in the case of long positions in options and options on futures contracts; plus

(*3*) In the case of portfolio types involving index options and related instruments offset by a qualified stock basket, there will be a minimum charge of 5% of the market value of the qualified stock basket for high-capitalization diversified and narrow-based indexes; and

(*4*) In the case of portfolio types involving index options and related instruments offset by a qualified stock basket, there will be a minimum charge of 7½% of the market value of the qualified stock basket for non-high-capitalization diversified indexes.

(*5*) In the case of portfolio types involving security futures and equity options on the same underlying instrument and positions in that underlying instrument, there will be a minimum charge of 25% times the multiplier for each security-future and equity option.

10. Section 240.18a–1b is added to read as follows:

§ 240.18a–1b Adjustments to net worth for certain commodities transactions (Appendix B to 17 CFR 240.18a–1).

(a) Every registered security-based swap dealer in computing net capital pursuant to § 240.18a–1 shall comply with the following:

(1) Where a security-based swap dealer has an asset or liability which is treated or defined in paragraph § 240.18a–1, the inclusion or exclusion of all or part of such asset or liability for net capital shall be in accordance with § 240.18a–1, except as specifically provided otherwise in this Appendix B. Where a commodity related asset or liability is specifically treated or defined in 17 CFR 1.17 and is not generally or specifically treated or defined in § 240.18a–1 or this Appendix B, the inclusion or exclusion of all or part of such asset or liability for net capital shall be in accordance with 17 CFR 1.17.

(2) In computing net capital as defined in paragraph (c)(1) of § 240.18a–1, the net worth of a security-based swap dealer shall be adjusted as follows with respect to commodity-related transactions:

(i) *Unrealized profit or loss for certain commodities transactions.* (A) Unrealized profits shall be added and unrealized losses shall be deducted in the commodities accounts of the security-based swap dealer, including unrealized profits and losses on fixed price commitments and forward contracts; and

(B) The value attributed to any commodity option which is not traded on a contract market shall be the difference between the option's strike price and the market value for the physical or futures contract which is the subject of the option. In the case of a long call commodity option, if the market value for the physical or futures contract which is the subject of the option is less than the strike price of the option, it shall be given no value. In the case of a long put commodity option, if the market value for the physical commodity or futures contract which is the subject of the option is more than the striking price of the option, it shall be given no value.

(ii) Deduct any unsecured commodity futures or option account containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only: *Provided, however,* Deficits or debit ledger balances in unsecured customers', non-customers' and proprietary accounts, which are the subject of calls for margin or other required deposits need not be deducted until the close of business on the business day following the date on which such deficit or debit ledger balance originated;

(iii) Deduct all unsecured receivables, advances and loans except for:

(A) Management fees receivable from commodity pools outstanding no longer than thirty (30) days from the date they are due;

(B) Receivables from foreign clearing organizations;

(C) Receivables from registered futures commission merchants or brokers, resulting from commodity futures or option transactions, except those specifically excluded under paragraph (a)(2)(ii) of this Appendix B.

(iv) Deduct all inventories (including work in process, finished goods, raw materials and inventories held for resale) except for readily marketable spot commodities; or spot commodities which adequately collateralize indebtedness under 17 CFR 1.17(c)(7);

(v) Guarantee deposits with commodities clearing organizations are not required to be deducted from net worth;

(vi) Stock in commodities clearing organizations to the extent of its margin value is not required to be deducted from net worth;

(vii) Deduct from net worth the amount by which any advances paid by the security-based swap dealer on cash commodity contracts and used in computing net capital exceeds 95 percent of the market value of the commodities covered by such contracts.

(viii) Do not include equity in the commodity accounts of partners in net worth.

(ix) In the case of all inventory, fixed price commitments and forward contracts, except for inventory and forward contracts in the inter-bank market in those foreign currencies which are purchased or sold for further delivery on or subject to the rules of a contract market and covered by an open futures contract for which there will be no charge, deduct the applicable percentage of the net position specified below:

(A) Inventory which is currently registered as deliverable on a contract market and covered by an open futures contract or by a commodity option on a physical—No charge.

(B) Inventory which is covered by an open futures contract or commodity option—5% of the market value.

(C) Inventory which is not covered—20% of the market value.

(D) Fixed price commitments (open purchases and sales) and forward contracts which are covered by an open futures contract or commodity option—10% of the market value.

(E) Fixed price commitments (open purchases and sales) and forward contracts which are not covered by an open futures contract or commodity option—20% of the market value.

(x) Deduct for undermargined customer commodity futures accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or, if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin, or other required deposits which are outstanding three business days or less. If there are no such maintenance margin requirements or clearing organization margin requirements on such accounts, then deduct the amount of funds required to provide margin equal to the amount necessary after application of calls for margin, or other required deposits outstanding three days or less to restore original margin when the original margin has been depleted by 50 percent or more. *Provided,* To the extent a deficit is deducted from net worth in accordance with paragraph (a)(2)(ii) of this Appendix B, such amount shall not also be deducted under this paragraph (a)(2)(x). In the event that an owner of a customer account has deposited an asset other than cash to margin, guarantee or secure his account, the value attributable to such asset for purposes of this paragraph shall be the lesser of (A) the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or (B) the market value of such asset after application of the percentage deductions specified in paragraph (a)(2)(ix) of this Appendix B or, where appropriate, specified in paragraph (c)(1)(iv), (vi), or (vii) of § 240.18a–1 of this chapter;

(xi) Deduct for undermargined non-customer and omnibus commodity futures accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or, if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin, or other required deposits which are outstanding two business days or less. If there are no such maintenance margin requirements or clearing organization margin requirements, then deduct the amount of funds required to provide margin equal to the amount necessary after application of calls for margin, or other required deposits outstanding two days or less to restore original margin when the original margin has been depleted by 50 percent or more. *Provided,* To the extent a deficit is deducted from net worth in accordance with paragraph (a)(2)(ii) of this Appendix B such amount shall not also be deducted under this paragraph (a)(2)(xi). In the event that an owner of a non-customer or omnibus account has deposited an asset other than cash to margin, guarantee or secure his account, the value attributable to such asset for purposes of this paragraph shall be the lesser of (A) the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or (B) the market value of such asset after application of the percentage deductions specified in paragraph (a)(2)(ix) of this Appendix B or, where appropriate, specified in paragraph (c)(1)(iv), (vi), or (vii) of § 240.18a–1 of this chapter;

(xii) In the case of open futures contracts and granted (sold) commodity options held in proprietary accounts carried by the security-based swap dealer which are not covered by a position held by the security-based swap dealer or which are not the result of a ''changer trade'' made in accordance with the rules of a contract market, deduct:

(A) For a security-based swap dealer which is a clearing member of a contract market for the positions on such contract market cleared by such member, the applicable margin requirement of the applicable clearing organization; (B) For a security-based swap dealer which is a member of a self-regulatory organization, 150% of the applicable maintenance margin requirement of the applicable board of trade or clearing organization, whichever is greater; or

(C) For all other security-based swap dealers, 200% of the applicable maintenance margin requirement of the applicable board of trade or clearing organization, whichever is greater; or

(D) For open contracts or granted (sold) commodity options for which there are no applicable maintenance margin requirements, 200% of the applicable initial margin requirement; *Provided,* the equity in any such proprietary account shall reduce the deduction required by this paragraph (a)(2)(xii) if such equity is not otherwise includable in net capital.

(xiii) In the case of a security-based swap dealer which is a purchaser of a commodity option which is traded on a contract market, the deduction shall be the same safety factor as if the security-based swap dealer were the grantor of such option in accordance with paragraph (a)(2)(xii), but in no event shall the safety factor be greater than the market value attributed to such option.

(xiv) In the case of a security-based swap dealer which is a purchaser of a commodity option not traded on a contract market which has value and such value is used to increase net capital, the deduction is ten percent of the market value of the physical or futures contract which is the subject of such option but in no event more than the value attributed to such option.

(xv) A loan or advance or any other form of receivable shall not be considered ''secured'' for the purposes of paragraph (a)(2) of this Appendix B unless the following conditions exist:

(A) The receivable is secured by readily marketable collateral which is otherwise unencumbered and which can be readily converted into cash: *Provided, however,* That the receivable will be considered secured only to the extent of the market value of such collateral after application of the percentage deductions specified in

paragraph (a)(2)(ix) of this Appendix B; and

(B)(1) The readily marketable collateral is in the possession or control of the security-based swap dealer; or

(2) The security-based swap dealer has a legally enforceable, written security agreement, signed by the debtor, and has a perfected security interest in the readily marketable collateral within the meaning of the laws of the State in which the readily marketable collateral is located.

(xvi) The term *cover* for purposes of this Appendix B shall mean cover as defined in 17 CFR 1.17(j).

(xvii) The term *customer* for purposes of this Appendix B shall mean customer as defined in 17 CFR 1.17(b)(2). The term *non-customer* for purposes of this Appendix B shall mean non-customer as defined in 17 CFR 1.17(b)(4).

(b) Every registered security-based swap dealer in computing net capital pursuant to § 240.18a–1 shall comply with the following:

(1) *Swaps.* Where a swap-related asset or liability is specifically treated or defined in 17 CFR 1.17 and is not generally or specifically treated or defined in § 240.15c3–1 or this Appendix B, the inclusion or exclusion of all or part of such asset or liability for net capital shall be in accordance with 17 CFR 1.17.

(i) *Credit default swaps referencing broad-based securities indices.* (A) *Short positions (selling protection).* In the case of a swap that is a short credit default swap referencing a broad-based securities index, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

Length of time to maturity of CDS contract	Basis point spread					
	100 or less (%)	101–300 (%)	301–400 (%)	401–500 (%)	501–699 (%)	700 or more (%)
12 months or less	0.67	1.33	3.33	5.00	6.67	10.00
13 months to 24 months	1.00	2.33	5.00	6.67	8.33	11.67
25 months to 36 months	1.33	3.33	6.67	8.33	10.00	13.33
37 months to 48 months	2.00	4.00	8.33	10.00	11.67	15.00
49 months to 60 months	2.67	4.67	10.00	11.67	13.33	16.67
61 months to 72 months	3.67	5.67	11.67	13.33	15.00	18.33
73 months to 84 months	4.67	6.67	13.33	15.00	16.67	20.00
85 months to 120 months	5.67	10.00	15.00	16.67	18.33	26.67
121 months and longer	6.67	13.33	16.67	18.33	20.00	33.33

(B) *Long positions (purchasing protection).* In the case of a swap that is a long credit default swap referencing a broad-based securities index, deducting 50% of the deduction that would be required by paragraph (b)(1)(i)(A) of this Appendix B if the swap was a short credit default swap.

(C) *Long and short positions.* (*1*) *Long and short credit default swaps.* In the case of swaps that are long and short credit default swaps referencing the same obligor or obligation, that are in the same spread category, and that are in the same maturity category or are in the next maturity category and have a maturity date within three months of the other maturity category, deducting the percentage of the notional amount specified in the higher maturity category under paragraph (b)(1)(i)(A) of this Appendix B on the excess of the long or short position.

(*2*) *Long basket of obligors and long credit default swap.* In the case of a swap that is a long credit default swap referencing a broad-based securities index and the security-based swap dealer is long a basket on the same underlying obligors, deducting 50% of the amount specified in § 240.15c3–1(c)(2)(vi) for the components of the basket, provided the security-based swap dealer can deliver the components of the basket to satisfy the obligation of the security-based swap dealer on the credit default swap.

(*3*) *Short basket of obligors and short credit default swap.* In the case of a swap that is a short credit default swap referencing a broad-based securities index and the security-based swap dealer is short a basket on the same underlying obligors, deducting the amount specified in § 240.15c3–1(c)(2)(vi) for the components of the basket.

(2) *All other swaps.* (i) In the case of any swap that is not a credit default swap, deducting the amount calculated by multiplying the notional value of the swap by the percentage specified in:

(A) § 240.15c3–1 applicable to the reference asset if § 240.15c3–1 specifies a percentage deduction for the type of asset;

(B) 17 CFR 1.17 applicable to the reference asset if 17 CFR 1.17 specifies a percentage deduction for the type of asset and § 240.15c3–1 does not specify a percentage deduction for the type of asset; or

(C) In the case of an interest rate swap, § 240.15c3–1(c)(2)(vi)(A) based on the maturity of the swap, provided that the percentage deduction must be no less than 1%.

(ii) A security-based swap dealer may reduce the deduction under this paragraph (b)(2)(ii) by an amount equal to any reduction recognized for a comparable long or short position in the reference asset or interest rate under 17 CFR 1.17 or § 240.15c3–1.

11. Section 240.18a–1c is added to read as follows:

§ 240.18a–1c Consolidated Computations of Net Capital for Certain Subsidiaries and Affiliates of Security-Based Swap Dealers (Appendix C to 17 CFR 240.18a–1).

Every security-based swap dealer in computing its net capital pursuant to § 240.18a–1 shall include in its computation all liabilities or obligations of a subsidiary or affiliate that the security-based swap dealer guarantees, endorses, or assumes either directly or indirectly.

12. Section 240.18a–1d is added to read as follows:

§ 240.18a–1d Satisfactory Subordinated Loan Agreements (Appendix D to 17 CFR 240.18a–1).

(a) *Introduction.* (1) This Appendix sets forth minimum and non-exclusive requirements for satisfactory subordinated loan agreements. The Commission may require or the security-based swap dealer may include such other provisions as deemed necessary or appropriate to the extent such provisions do not cause the subordinated loan agreement to fail to meet the minimum requirements of this Appendix D.

(2) *Certain definitions.* For purposes of § 240.18a–1 and this Appendix D:

(i) The term ''*subordinated loan agreement*'' shall mean the agreement or

agreements evidencing or governing a subordinated borrowing of cash.

(ii) The term ''*Payment Obligation*'' shall mean the obligation of a security-based swap dealer to repay cash loaned to the security-based swap dealer pursuant to a subordinated loan agreement and ''Payment'' shall mean the performance by a security-based swap dealer of a Payment Obligation.

(iii) The term ''*lender*'' shall mean the person who lends cash to a security-based swap dealer pursuant to a subordinated loan agreement.

(b) *Minimum requirements for subordinated loan agreements.* (1) Subject to paragraph (a) of this section, a subordinated loan agreement shall mean a written agreement between the security-based swap dealer and the lender, which 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 Appendix D.

(3) *Effective subordination.* The subordinated loan agreement shall effectively subordinate any right of the lender to receive any Payment with respect thereto, together with accrued interest or compensation, to the prior payment or provision for payment in full of all claims of all present and future creditors of the security-based swap dealer arising out of any matter occurring prior to the date on which the related Payment Obligation matures consistent with the provisions of § 240.18a–1 and § 240.18a–1d, except for claims which are the subject of subordinated loan agreements that rank on the same priority as or junior to the claim of the lender under such subordinated loan agreements.

(4) *Proceeds of subordinated loan agreements.* The subordinated loan agreement shall provide that the cash proceeds thereof shall be used and dealt with by the security-based swap dealer as part of its capital and shall be subject to the risks of the business.

(5) *Certain rights of the security-based swap dealer.* The subordinated loan agreement shall provide that the security-based swap dealer shall have the right to deposit any cash proceeds of a subordinated loan agreement in an account or accounts in its own name in any bank or trust company;

(6) *Permissive prepayments.* A security-based swap dealer at its option but not at the option of the lender may, if the subordinated loan agreement so provides, make a Payment of all or any portion of the Payment Obligation thereunder prior to the scheduled maturity date of such Payment Obligation (hereinafter referred to as a ''Prepayment''), but in no event may any Prepayment be made before the expiration of one year from the date such subordinated loan agreement became effective. No Prepayment shall be made, if, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated loan agreements then outstanding the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such Prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such Prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the security-based swap dealer, either its net capital would fall below $24 million, its net capital would fall below 10% of the risk margin amount under § 240.18a–1, or, if the security-based swap dealer is approved to calculate net capital under § 240.18a–1(d), its tentative net capital would fall to an amount below $120 million. Notwithstanding the above, no Prepayment shall occur without the prior written approval of the Commission.

(7) *Suspended repayment.* The Payment Obligation of the security-based swap dealer in respect of any subordinated loan agreement shall be suspended and shall not mature if, after giving effect to Payment of such Payment Obligation (and to all Payments of Payment Obligations of such security-based swap dealer under any other subordinated loan agreement(s) then outstanding that are scheduled to mature on or before such Payment Obligation) either its net capital would fall below $24 million, its net capital would fall below 10% of the risk margin amount under § 240.18a–1, or, if the security-based swap dealer is approved to calculate net capital under § 240.18a–1(d), its tentative net capital would fall to an amount below $120 million. The subordinated loan agreement may provide that if the Payment Obligation of the security-based swap dealer thereunder does not mature and is suspended as a result of the requirement of this paragraph (b)(7) for a period of not less than six months, the security-based swap dealer shall thereupon commence the rapid and orderly liquidation of its business, but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of § 240.18a–1 and § 240.18a–1d.

(8) *Accelerated maturity—obligation to repay to remain subordinate.* (i) Subject to the provisions of paragraph (b)(7) of this appendix, a subordinated loan agreement may provide that the lender may, upon prior written notice to the security-based swap dealer and the Commission given not earlier than six months after the effective date of such subordinated loan agreement, accelerate the date on which the Payment Obligation of the security-based swap dealer, together with accrued interest or compensation, is scheduled to mature to a date not earlier than six months after the giving of such notice, but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of §§ 240.18a–1 and 240.18a–1d.

(ii) Notwithstanding the provisions of paragraph (b)(7) of this appendix, the Payment Obligation of the security-based swap dealer with respect to a subordinated loan agreement, together with accrued interest and compensation, shall mature in the event of any receivership, insolvency, liquidation, bankruptcy, assignment for the benefit of creditors, reorganization whether or not pursuant to the bankruptcy laws, or any other marshalling of the assets and liabilities of the security-based swap dealer but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of § 240.18a–1 and § 240.18a–1d.

(9) *Accelerated maturity of subordinated loan agreements on event of default and event of acceleration—obligation to repay to remain subordinate.* (i) A subordinated loan agreement may provide that the lender may, upon prior written notice to the security-based swap dealer and the Commission of the occurrence of any Event of Acceleration (as hereinafter defined) given no sooner than six months after the effective date of such subordinated loan agreement, accelerate the date on which the Payment Obligation of the security-based swap dealer, together with accrued interest or compensation, is scheduled to mature,

to the last business day of a calendar month which is not less than six months after notice of acceleration is received by the security-based swap dealer and the Commission. Any subordinated loan agreement containing such Events of Acceleration may also provide, that if upon such accelerated maturity date the Payment Obligation of the security-based swap dealer is suspended as required by paragraph (b)(7) of this Appendix D and liquidation of the security-based swap dealer has not commenced on or prior to such accelerated maturity date, then notwithstanding paragraph (b)(7) of this appendix the Payment Obligation of the security-based swap dealer with respect to such subordinated loan agreement shall mature on the day immediately following such accelerated maturity date and in any such event the Payment Obligations of the security-based swap dealer with respect to all other subordinated loan agreements then outstanding shall also mature at the same time but the rights of the respective lenders to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of this Appendix D. Events of Acceleration which may be included in a subordinated loan agreement complying with this paragraph (b)(9) shall be limited to:

(A) Failure to pay interest or any installment of principal on a subordinated loan agreement as scheduled;

(B) Failure to pay when due other money obligations of a specified material amount;

(C) Discovery that any material, specified representation or warranty of the security-based swap dealer which is included in the subordinated loan agreement and on which the subordinated loan agreement was based or continued was inaccurate in a material respect at the time made;

(D) Any specified and clearly measurable event which is included in the subordinated loan agreement and which the lender and the security-based swap dealer agree:

(*1*) Is a significant indication that the financial position of the security-based swap dealer has changed materially and adversely from agreed upon specified norms; or

(*2*) Could materially and adversely affect the ability of the security-based swap dealer to conduct its business as conducted on the date the subordinated loan agreement was made; or

(*3*) Is a significant change in the senior management of the security-based swap dealer or in the general business conducted by the security-based swap dealer from that which obtained on the date the subordinated loan agreement became effective;

(E) Any continued failure to perform agreed covenants included in the subordinated loan agreement relating to the conduct of the business of the security-based swap dealer or relating to the maintenance and reporting of its financial position; and

(ii) Notwithstanding the provisions of paragraph (b)(7) of this appendix, a subordinated loan agreement may provide that, if liquidation of the business of the security-based swap dealer has not already commenced, the Payment Obligation of the security-based swap dealer shall mature, together with accrued interest or compensation, upon the occurrence of an Event of Default (as hereinafter defined). Such agreement may also provide that, if liquidation of the business of the security-based swap dealer has not already commenced, the rapid and orderly liquidation of the business of the security-based swap dealer shall then commence upon the happening of an Event of Default. Any subordinated loan agreement which so provides for maturity of the Payment Obligation upon the occurrence of an Event of Default shall also provide that the date on which such Event of Default occurs shall, if liquidation of the security-based swap dealer has not already commenced, be the date on which the Payment Obligations of the security-based swap dealer with respect to all other subordinated loan agreements then outstanding shall mature but the rights of the respective lenders to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of this Appendix (D). Events of Default which may be included in a subordinated loan agreement shall be limited to:

(A) The net capital of the security-based swap dealer falling to an amount below either of $20 million or 8% of the risk margin amount under § 240.18a–1, or, if the security-based swap dealer is approved to calculate net capital under § 240.18a–1(d), its tentative net capital falling below $100 million, throughout a period of 15 consecutive business days, commencing on the day the security-based swap dealer first determines and notifies the Commission, or the Commission first determines and notifies the security-based swap dealer of such fact;

(B) The Commission revoking the registration of the security-based swap dealer;

(C) The Commission suspending (and not reinstating within 10 days) the registration of the security-based swap dealer;

(D) Any receivership, insolvency, liquidation, bankruptcy, assignment for the benefit of creditors, reorganization whether or not pursuant to bankruptcy laws, or any other marshalling of the assets and liabilities of the security-based swap dealer. A subordinated loan agreement that contains any of the provisions permitted by this paragraph (b)(9) shall not contain the provision otherwise permitted by 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) Every security-based swap dealer shall immediately notify the Commission if, after giving effect to all Payments of Payment Obligations under subordinated loan agreements then outstanding that are then due or mature within the following six months without reference to any projected profit or loss of the security-based swap dealer, either its net capital would fall below $24 million, its net capital would fall below 10% of the risk margin amount under § 240.18a–1, or, if the security-based swap dealer is approved to calculate net capital under § 240.18a–1(d), its tentative net capital would fall to an amount below $120 million.

(3) *Certain legends.* If all the provisions of a satisfactory subordinated loan agreement do not appear in a single instrument, then the debenture or other evidence of indebtedness shall bear on its face an appropriate legend stating that it is issued subject to the provisions of a satisfactory subordinated loan agreement which shall be adequately referred to and incorporated by reference.

(4) *Revolving subordinated loan agreements.* A security-based swap dealer shall be permitted to enter into a revolving subordinated loan agreement that provides for prepayment within less than one year of all or any portion of the Payment Obligation thereunder at the option of the security-based swap dealer upon the prior written approval of the Commission. The Commission, however, shall not approve any prepayment if:

(i) After giving effect thereto (and to all Payments of Payment Obligations

under any other subordinated loan agreements then outstanding, the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the security-based swap dealer, either its net capital would fall below $24 million, its net capital would fall below 10% of the risk margin amount under § 240.18a–1, or, if the security-based swap dealer is approved to calculate net capital under § 240.18a–1(d), its tentative net capital would fall to an amount below $120 million; or

(ii) Pre-tax losses during the latest three-month period equaled more than 15% of current excess net capital.

Any subordinated loan agreement entered into pursuant to this paragraph (c)(4) shall be subject to all the other provisions of this Appendix D. Any such subordinated loan agreement shall not be considered equity for purposes of paragraph (h) of § 240.18a–1, despite the length of the initial term of the loan.

(5) *Filing.* Two copies of any proposed subordinated loan agreement (including nonconforming subordinated loan agreements) shall be filed at least 30 days prior to the proposed execution date of the agreement with the Commission. The security-based swap dealer shall also file with the Commission a statement setting forth the name and address of the lender, the business relationship of the lender to the security-based swap dealer, and whether the security-based swap dealer carried an account for the lender for effecting transactions in security-based swaps at or about the time the proposed agreement was so filed. All agreements shall be examined by the Commission prior to their becoming effective. No proposed agreement shall be a satisfactory subordinated loan agreement for the purposes of this section unless and until the Commission has found the agreement acceptable and such agreement has become effective in the form found acceptable.

13. Section 240.18a–2 is added to read as follows:

§ 240.18a–2 Capital requirements for major security-based swap participants for which there is not a prudential regulator.

(a) Every major security-based swap participant for which there is not a prudential regulator must at all times have and maintain positive tangible net worth.

(b) The term *tangible net worth* means the net worth of the major security-based swap participant as determined in accordance with generally accepted accounting principles in the United States, excluding goodwill and other intangible assets. In determining net worth, all long and short positions in security-based swaps, swaps, and related positions must be marked to their market value. A major security-based swap participant must include in its computation of tangible net worth all liabilities or obligations of a subsidiary or affiliate that the participant guarantees, endorses, or assumes either directly or indirectly.

(c) Every major security-based swap participant must comply with § 240.15c3–4 as though it were an OTC derivatives dealer with respect to its security-based swap and swap activities, except that paragraphs (c)(5)(xiii) and (xiv) and (d)(8) and (9) of § 240.15c3–4 shall not apply.

14. Section 240.18a–3 is added to read as follows:

§ 240.18a–3 Non-cleared security-based swap margin requirements for security-based swap dealers and major security-based swap participants for which there is not a prudential regulator.

(a) Every security-based swap dealer and major security-based swap participant for which there is not a prudential regulator must comply with this section.

(b) *Definitions.* For the purposes of this section:

(1) The term *account* means an account carried by a security-based swap dealer or major security-based swap participant for a counterparty that holds non-cleared security-based swaps.

(2) The term *commercial end user* means any person (other than a natural person) that:

(i) Engages primarily in commercial activities that are not financial in nature and that is not a *financial entity* as that term is defined in 3C(g)(3) of the Act (15 U.S.C. 78o–3(g)(3)); and

(ii) Is using non-cleared security-based swaps to hedge or mitigate risk relating to the commercial activities.

(3) The term *counterparty* means a person with whom the security-based swap dealer or major security-based swap participant has entered into a non-cleared security-based swap transaction.

(4) The term *equity* means the total current fair market value of securities positions in an account of a counterparty (excluding the time value of an over-the-counter option), plus any credit balance and less any debit balance in the account after applying a qualifying netting agreement with respect to gross derivatives payables and receivables.

(5) The term *margin* means the amount of positive equity in an account of a counterparty.

(6) The term *negative equity* means equity of less than $0.

(7) The term *positive equity* means equity of greater than $0.

(8) The term *non-cleared security-based swap* means a security-based swap that is not, directly or indirectly, cleared by a clearing agency registered pursuant to section 17A of the Act.

(9) The term *security-based swap legacy account* means an account that holds no security-based swaps entered into after the effective date of this section and that only is used to hold security-based swaps entered into prior to the effective date of this section and collateral for those security-based swaps.

(c) *Margin requirements.* (1) *Security-based swap dealers.* (i) *Calculation required.* A security-based swap dealer must calculate with respect to each account of a counterparty as of the close of each business day:

(A) The amount of equity in the account of the counterparty; and

(B) The margin amount for the account of the counterparty calculated pursuant to paragraph (d) of this section.

(ii) *Account equity requirements.* Except as provided in paragraph (c)(1)(iii) of this section, a security-based swap dealer must collect from a counterparty by noon of each business day cash, securities, and/or money market instruments in an amount at least equal to, as applicable:

(A) The negative equity in the account calculated as of the previous business day; and

(B) The margin amount calculated under paragraph (c)(1)(i)(B) of this section as of the previous business day to the extent that amount is greater than the amount of positive equity in the account on the previous business day.

(iii) *Exceptions.* (A) *Commercial end users.* The requirements of paragraph (c)(1)(ii) of this section do not apply to an account of a counterparty that is a commercial end user.

Alternative A to § 240.18a–3(c)(1)(iii)(B)

(B) *Security-based swap dealers.* The requirements of paragraph (c)(1)(ii)(B) of this section do not apply to an account of a counterparty that is a security-based swap dealer.

Alternative B to § 240.18a–3(c)(1)(iii)(B)

(B) *Security-based swap dealers.* Cash, securities and money market

instruments posted by a counterparty that is a security-based swap dealer to meet the requirements of paragraph (c)(1)(ii)(B) of this section must be carried by an independent third-party custodian pursuant to the requirements of section 3E(f) of the Act.

(C) *Counterparties that require third-party custodians.* The requirements of paragraph (c)(1)(ii)(B) of this section do not apply to an account of a counterparty that is not a commercial end user and that requires the cash, securities, and money market instruments delivered to meet the margin amount to be carried by an independent third-party custodian pursuant to the requirements of section 3E(f) of the Act, provided cash, securities, and money market instruments necessary to meet the requirements of paragraph (c)(1)(ii)(B) of this section are delivered to the independent third-party custodian.

(D) *Security-based swap legacy accounts.* The requirements of paragraph (c)(1)(ii)(B) of this section do not apply to a legacy security-based swap account of a counterparty that is not a commercial end user.

(2) *Major security-based swap participants.* (i) *Calculation required.* A major security-based swap participant must calculate as of the close of each business day the amount of equity in the account of each counterparty.

(ii) *Account equity requirements.* Except as provided in paragraph (c)(2)(iii) of this section, a major security-based swap participant must by noon of each business day:

(A) Collect from a counterparty cash, securities and/or money market instruments in an amount equal to the negative equity in the account calculated on the previous business day pursuant to paragraph (c)(2)(i) of this section; and

(B) Deliver to a counterparty cash, securities and/or money market instruments in an amount equal to the positive equity in the account calculated on the previous business day pursuant to paragraph (c)(2)(i) of this section.

(iii) *Exceptions.* (A) *Transactions with commercial end users.* The requirements of paragraph (c)(2)(ii)(A) of this section do not apply to a counterparty that is a commercial end user.

(B) *Transactions with security-based swap dealers.* The requirements of paragraph (c)(2)(ii)(A) of this section do not apply to a counterparty that is a security-based swap dealer.

Note to paragraph (c)(2)(iii)(B): A security-based swap dealer must collect from a counterparty that is a major security-based swap participant cash, securities, and/or money market instruments as required by paragraph (c)(1)(ii) of this section.

(C) *Security-based swap legacy accounts.* The requirements of paragraph (c)(2)(ii) of this section do not apply to a legacy security-based swap account of a counterparty that is not a commercial end user.

(3) *Deductions for securities held as collateral.* The fair market value of securities and money market instruments held in the account of a counterparty must be reduced by the amount of the deductions the security-based swap dealer would apply to the securities and money market instruments pursuant to § 240.15c3–1 or § 240.18a–1, as applicable, for the purpose of determining whether the level of equity in the account meets the requirement of paragraph (c)(1)(ii) of this section.

(4) *Collateral requirements.* A security-based swap dealer and a major security-based swap participant when calculating the amount of equity in the account of a counterparty may take into account cash and the fair market value of securities and money market instruments pledged and held as collateral in the account provided:

(i) The collateral is subject to the physical possession or control of the security-based swap dealer or the major security-based swap participant;

(ii) The collateral is liquid and transferable;

(iii) The collateral may be liquidated promptly by the security-based swap dealer or the major security-based swap participant without intervention by any other party;

(iv) The collateral agreement between the security-based swap dealer or the major security-based swap participant and the counterparty is legally enforceable by the security-based swap dealer or the major security-based swap participant against the counterparty and any other parties to the agreement;

(v) The collateral does not consist of securities issued by the counterparty or a party related to the security-based swap dealer, the major security-based swap participant, or to the counterparty; and

(vi) If the Commission has approved the security-based swap dealer's use of a VaR model to compute net capital, the approval allows the security-based swap dealer to calculate deductions for market risk for the type of collateral.

(5) *Qualified netting agreements.* A security-based swap dealer or major security-based swap participant may include the effect of a netting agreement that allows the security-based swap dealer or major security-based swap participant to net gross receivables from and gross payables to a counterparty upon the default of the counterparty, for the purposes of the calculations required pursuant to paragraphs (c)(1)(i)(A) 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) *Minimum transfer amount.* Notwithstanding any other provision of this rule, a security-based swap dealer or major security-based swap participant is not required to collect or deliver cash, securities or money market instruments pursuant to this section with respect to a particular counterparty unless and until the total amount of cash, securities or money market instruments that is required to be collected or delivered, and has not yet been collected or delivered, with respect to the counterparty is greater than $100,000.

(7) *Frequency of calculations increased.* The calculations required pursuant to 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.

(8) *Liquidation.* A security-based swap dealer and major security-based swap participant must take prompt steps to liquidate securities and money market instruments in an account that does not meet the account equity requirements of this section to the extent necessary to eliminate the account equity deficiency.

(d) *Calculating margin amount.* A security-based swap dealer must calculate the margin amount required by paragraph (c)(1)(i)(B) of this section for non-cleared security-based swaps as follows:

(1) *Standardized approach.* (i) *Credit default swaps.* For credit default swaps, the security-based swap dealer must use the method specified in § 240.18a–1(c)(1)(vi)(A) or, if the security-based swap dealer is registered with the Commission as a broker or dealer, the method specified in § 240.15c3–1(c)(2)(vi)(O)(*1*).

(ii) *All other security-based swaps.* For security-based swaps other than credit default swaps, the security-based swap dealer must use the method specified in § 240.18a–1(c)(1)(vi)(B) or, if the security-based swap dealer is registered with the Commission as a broker or dealer, the method specified in § 240.15c3–1(c)(2)(vi)(O)(*2*).

(2) *Model approach.* For security-based swaps other than equity security-based swaps, a security-based swap dealer authorized by the Commission to compute net capital pursuant to § 240.18a–1(d) or § 240.15c3–1e may use its internal market risk model subject to the requirements in § 240.18a–1(d) or § 240.15c3–1e in lieu of using the methods required in paragraphs (d)(1)(i) and (ii) of this section.

(e) *Risk monitoring and procedures.* A security-based swap dealer must monitor the risk of each account and establish, maintain, and document procedures and guidelines for monitoring the risk of accounts as part of the risk management control system required by § 240.15c3–4. The security-based swap dealer must review, in accordance with written procedures, at reasonable periodic intervals, its non-cleared security-based swap activities for consistency with the risk monitoring procedures and guidelines required by this section. The security-based swap dealer also must determine whether information and data necessary to apply the risk monitoring procedures and guidelines required by this section are accessible on a timely basis and whether information systems are available to adequately capture, monitor, analyze, and report relevant data and information. The risk monitoring procedures and guidelines must include, at a minimum, procedures and guidelines for:

(1) Obtaining and reviewing account documentation and financial information necessary for assessing the amount of current and potential future exposure to a given counterparty permitted by the security-based swap dealer;

(2) Determining, approving, and periodically reviewing credit limits for each counterparty, and across all counterparties;

(3) Monitoring credit risk exposure to the security-based swap dealer from non-cleared security-based swaps, including the type, scope, and frequency of reporting to senior management;

(4) Using stress tests to monitor potential future exposure to a single counterparty and across all counterparties over a specified range of possible market movements over a specified time period;

(5) Managing the impact of credit exposure related to non-cleared security-based swaps on the security-based swap dealer's overall risk exposure;

(6) Determining the need to collect collateral from a particular counterparty, including whether that determination was based upon the creditworthiness of the counterparty and/or the risk of the specific non-cleared security-based swap contracts with the counterparty;

(7) Monitoring the credit exposure resulting from concentrated positions with a single counterparty and across all counterparties, and during periods of extreme volatility; and

(8) Maintaining sufficient equity in the account of each counterparty to protect against the largest individual potential future exposure of a non-cleared security-based swap carried in the account of the counterparty as measured by computing the largest maximum possible loss that could result from the exposure.

15. Section 240.18a–4 is added to read as follows:

§ 240.18a–4 Segregation requirements for security-based swap dealers and major security-based swap participants.

(a) *Definitions.* For the purposes of this section:

(1) The term *cleared security-based swap* means any security-based swap that is, directly or indirectly, submitted to and cleared by a clearing agency registered with the Commission pursuant to section 17A of the Act (15 U.S.C. 78q–1);

(2) The term *excess securities collateral* means securities and money market instruments carried for the account of a security-based swap customer that have a market value in excess of the current exposure of the security-based swap dealer to the customer, excluding:

(i) Securities and money market instruments held in a qualified clearing agency account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the clearing agency resulting from a security-based swap transaction of the customer; and

(ii) Securities and money market instruments held in a qualified registered security-based swap dealer account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the other security-based swap dealer resulting from the security-based swap dealer entering into a non-cleared security-based swap transaction with the other security-based swap dealer to offset the risk of a non-cleared security-based swap transaction between the security-based swap dealer and the customer.

(3) The term *qualified clearing agency account* means an account of a security-based swap dealer at a clearing agency established to hold funds and other property in order to purchase, margin, guarantee, secure, adjust, or settle cleared security-based swap transactions for the security-based swap customers of the security-based swap dealer that meets the following conditions:

(i) The account is designated ''Special Clearing Account for the Exclusive Benefit of the Cleared Security-Based Swap Customers of [name of security-based swap dealer]'';

(ii) The clearing agency has acknowledged in a written notice provided to and retained by the security-based swap dealer that the funds and other property in the account are being held by the clearing agency for the exclusive benefit of the security-based swap customers of the security-based swap dealer in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the security-based swap dealer with the clearing agency; and

(iii) The account is subject to a written contract between the security-based swap dealer and the clearing agency which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the clearing agency or any person claiming through the clearing agency, except a right, charge, security interest, lien, or claim resulting from a cleared security-based swap transaction effected in the account.

(4) The term *qualified registered security-based swap dealer account* means an account at another security-based swap dealer registered with the Commission pursuant to section 15F of the Act that is not an affiliate of the security-based swap dealer and that meets the following conditions:

(i) The account is designated ''Special Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of security-based swap dealer]'';

(ii) The account is subject to a written acknowledgement by the other security-based dealer provided to and retained by the security-based swap dealer that the funds and other property held in the account are being held by the other security-based swap dealer for the exclusive benefit of the security-based

swap customers of the security-based swap dealer in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the security-based swap dealer with the other security-based swap dealer;

(iii) The account is subject to a written contract between the security-based swap dealer and the other security-based swap dealer which provides that the funds and other property in the account shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the other security-based swap dealer or any person claiming through the other security-based swap dealer, except a right, charge, security interest, lien, or claim resulting from a non-cleared security-based swap transaction effected in the account; and

(iv) The account and the assets in the account are not subject to any type of subordination agreement between the security-based swap dealer and the other security-based swap dealer.

(5) The term *qualified security* means:

(i) Obligations of the United States;

(ii) Obligations fully guaranteed as to principal and interest by the United States; and

(iii) General obligations of any State or subdivision of a State that:

(A) Are not traded flat and are not in default;

(B) Were part of an initial offering of $500 million or greater; and

(C) Were issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year-end.

(6) The term *security-based swap customer* means any person from whom or on whose behalf the security-based swap dealer has received or acquired or holds funds or other property for the account of the person with respect to a cleared or non-cleared security-based swap transaction. The term does not include a person to the extent that person has a claim for funds or other property which by contract, agreement or understanding, or by operation of law, is part of the capital of the security-based swap dealer or is subordinated to all claims of security-based swap customers of the security-based swap dealer.

(7) The term *special account for the exclusive benefit of security-based swap customers* means an account at a bank that is not the security-based swap dealer or an affiliate of the security-based swap dealer and that meets the following conditions:

(i) The account is designated ''Special Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of security-based swap dealer]'';

(ii) The account is subject to a written acknowledgement by the bank provided to and retained by the security-based swap dealer that the funds and other property held in the account are being held by the bank for the exclusive benefit of the security-based swap customers of the security-based swap dealer in accordance with the regulations of the Commission and are being kept separate from any other accounts maintained by the security-based swap dealer with the bank; and

(iii) The account is subject to a written contract between the security-based swap dealer and the bank which provides that the funds and other property in the account shall at no time be used directly or indirectly as security for a loan or other extension of credit to the security-based swap dealer by the bank and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

(b) *Physical possession or control of excess securities collateral.* (1) A security-based swap dealer must promptly obtain and thereafter maintain physical possession or control of all excess securities collateral carried for the accounts of security-based swap customers.

(2) A security-based swap dealer has *control* of excess securities collateral only if the securities and money market instruments:

(i) Are represented by one or more certificates in the custody or control of a clearing corporation or other subsidiary organization of either national securities exchanges, or of a custodian bank in accordance with a system for the central handling of securities complying with the provisions of §§ 240.8c–1(g) and 240.15c2–1(g) the delivery of which certificates to the security-based swap dealer does not require the payment of money or value, and if the books or records of the security-based swap dealer identify the security-based swap customers entitled to receive specified quantities or units of the securities so held for such security-based swap customers collectively;

(ii) Are the subject of bona fide items of transfer; provided that securities and money market instruments shall be deemed not to be the subject of bona fide items of transfer if, within 40 calendar days after they have been transmitted for transfer by the security-based swap dealer to the issuer or its transfer agent, new certificates conforming to the instructions of the security-based swap dealer have not been received by the security-based swap dealer, the security-based swap dealer has not received a written statement by the issuer or its transfer agent acknowledging the transfer instructions and the possession of the securities or money market instruments, or the security-based swap dealer has not obtained a revalidation of a window ticket from a transfer agent with respect to the certificate delivered for transfer;

(iii) Are in the custody or control of a bank as defined in section 3(a)(6) of the Act, the delivery of which securities or money market instruments to the security-based swap dealer does not require the payment of money or value and the bank having acknowledged in writing that the securities and money market instruments in its custody or control are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank;

(iv)(A) Are held in or are in transit between offices of the security-based swap dealer; or

(B) Are held by a corporate subsidiary if the security-based swap dealer owns and exercises a majority of the voting rights of all of the voting securities of such subsidiary, assumes or guarantees all of the subsidiary's obligations and liabilities, operates the subsidiary as a branch office of the security-based swap dealer, and assumes full responsibility for compliance by the subsidiary and all of its associated persons with the provisions of the Federal securities laws as well as for all of the other acts of the subsidiary and such associated persons; or

(v) Are held in such other locations as the Commission shall upon application from a security-based swap dealer find and designate to be adequate for the protection of customer securities.

(3) Each business day the security-based swap dealer must determine from its books and records the quantity of excess securities collateral in its possession and control as of the close of the previous business day and the quantity of excess securities collateral not in its possession and control as of the previous business day. If the security-based swap dealer did not obtain possession or control of all excess securities collateral on the previous business day as required by this section and there are securities or money market instruments of the same issue and class in any of the following non-control locations:

(i) Securities or money market instruments subject to a lien securing an obligation of the security-based swap dealer, then the security-based swap dealer, not later than the next business

day on which the determination is made, must issue instructions for the release of the securities or money market instruments from the lien and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;

(ii) Securities or money market instruments held in a qualified clearing agency account, then the security-based swap dealer, not later than the next business day on which the determination is made, must issue instructions for the release of the securities or money market instruments by the clearing agency and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;

(iii) Securities or money market instruments held in a qualified registered security-based swap dealer account maintained by another security-based swap dealer, then the security-based swap dealer, not later than the next business day on which the determination is made, must issue instructions for the release of the securities or money market instruments by the other security-based swap dealer and must obtain physical possession or control of the securities or money market instruments within two business days following the date of the instructions;

(iv) Securities or money market instruments loaned by the security-based swap dealer, then the security-based swap dealer, not later than the next business day on which the determination is made, must issue instructions for the return of the loaned securities or money market instruments and must obtain physical possession or control of the securities or money market instruments within five business days following the date of the instructions;

(v) Securities or money market instruments failed to receive more than 30 calendar days, then the security-based swap dealer, not later than the next business day on which the determination is made, must take prompt steps to obtain physical possession or control of the securities or money market instruments through a buy-in procedure or otherwise;

(vi) Securities or money market instruments receivable by the security-based swap dealer as a security dividend, stock split or similar distribution for more than 45 calendar days, then the security-based swap dealer, not later than the next business day on which the determination is made, must take prompt steps to obtain physical possession or control of the securities or money market instruments through a buy-in procedure or otherwise; or

(vii) Securities or money market instruments included on the books or records of the security-based swap dealer as a proprietary short position or as a short position for another person more than 10 business days (or more than 30 calendar days if the security-based swap dealer is a market maker in the securities), then the security-based swap dealer must, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities or money market instruments.

(c) *Deposit requirement for special account for the exclusive benefit of security-based swap customers.* (1) A security-based swap dealer must maintain a special account for the exclusive benefit of security-based swap customers that is separate from any other bank account of the security-based swap dealer. The security-based swap dealer must at all times maintain in the special account for the exclusive benefit of security-based swap customers, through deposits into the account, cash and/or qualified securities in amounts computed in accordance with the formula set forth in § 240.18a–4a. In determining the amount maintained in a special account for the exclusive benefit of security-based swap customers, the security-based swap dealer must deduct:

(i) The percentage of the value of a general obligation of a State or subdivision of a State specified in § 240.15c3–1(c)(2)(vi);

(ii) The aggregate value of general obligations of a State or subdivision of a State to the extent the amount of the obligations of a single issuer exceeds 2% of the amount required to be maintained in the special account for the exclusive benefit of security-based swap customers;

(iii) The aggregate value of all general obligations of a State or subdivision of a State to the extent the amount of the obligations exceeds 10% of the amount required to be maintained in the special account for the exclusive benefit of security-based swap customers; and

(iv) The amount of funds held at a single bank to the extent the amount exceeds 10% of the equity capital of the bank as reported by the bank in its most recent Consolidated Reports of Condition and Income.

(2) It is unlawful for a security-based swap dealer to accept or use credits identified in the items of the formula set forth in § 240.18a–4a except to establish debits for the specified purposes in the items of the formula.

(3) The computations necessary to determine the amount required to be maintained in the special account for the exclusive benefit of security-based swap customers must be made daily as of the close of the previous business day and any deposit required to be made into the account must be made on the next business day following the computation no later than 1 hour after the opening of the bank that maintains the account. The security-based swap dealer may make a withdrawal from the special account for the exclusive benefit of security-based swap customers only if the amount remaining in the account after the withdrawal is equal to or exceeds the amount required to be maintained in the account pursuant to paragraph (c)(1) of this section.

(4) A security-based swap dealer must promptly deposit into a special account for the exclusive benefit of security-based swap customers funds or qualified securities of the security-based swap dealer if the amount of funds and/or qualified securities in one or more special accounts for the exclusive benefit of security-based swap customers falls below the amount required to be maintained pursuant to this section.

(d) *Requirements for non-cleared security-based swaps.* (1) *Notice.* A security-based dealer and a major security-based swap participant must provide the notice required pursuant to section 3E(f)(1)(A) of the Act (15 U.S.C. 78c–5(f)) to a counterparty in writing prior to the execution of the first non-cleared security-based swap transaction with the counterparty occurring after the effective date of this section.

(2) *Subordination.* (i) *Counterparty that elects to have individual segregation at an independent third-party custodian.* A security-based swap dealer must obtain an agreement from a counterparty that chooses to require segregation of funds or other property pursuant to section 3E(f) of the Act (15 U.S.C. 78c–5(f)) in which the counterparty agrees to subordinate all of its claims against the security-based swap dealer to the claims of security-based swap customers of the security-based swap dealer but only to the extent that funds or other property provided by the counterparty to the independent third-party custodian are not treated as *customer property* as that term is defined in 11 U.S.C. 741 in a liquidation of the security-based swap dealer.

(ii) *Counterparty that elects to have no segregation.* A security-based swap dealer must obtain an agreement from a

counterparty that does not choose to require segregation of funds or other property pursuant to section 3E(f) of the Act (15 U.S.C. 78c–5(f)) or paragraph (c)(3) of this section in which the counterparty agrees to subordinate all of its claims against the security-based swap dealer to the claims of security-based swap customers of the security-based swap dealer.

16. Section 240.18a–4a is added to read as follows:

RULE 18A–4A—FORMULA FOR DETERMINING THE AMOUNT TO BE MAINTAINED IN THE SPECIAL ACCOUNT FOR THE EXCLUSIVE BENEFIT OF SECURITY-BASED SWAP CUSTOMERS

	Credits	Debits
1. Free credit balances and other credit balances in the accounts carried for security-based swap customers	$_____	
2. Monies borrowed collateralized by securities in accounts carried for security-based swap customers	$_____	
3. Monies payable against security-based swap customers' securities loaned	$_____	
4. Security-based swap customers' securities failed to receive	$_____	
5. Credit balances in firm accounts which are attributable to principal sales to security-based swap customers	$_____	
6. Market value of stock dividends, stock splits and similar distributions receivable outstanding over 30 calendar days	$_____	
7. Market value of short security count differences over 30 calendar days old	$_____	
8. Market value of short securities and credits (not to be offset by longs or by debits) in all suspense accounts over 30 calendar days.	$_____	
9. Market value of securities which are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the 40 days.	$_____	
10. Debit balances in accounts carried for security-based swap customers, excluding unsecured accounts and accounts doubtful of collection.	.....	$_____
11. Securities borrowed to effectuate short sales by security-based swap customers and securities borrowed to make delivery on security-based swap customers' securities failed to deliver.	.....	$_____
12. Failed to deliver of security-based swap customers' securities not older than 30 calendar days	.....	$_____
13. Margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in accounts carried for security-based swap customers.	.....	$_____
14. Margin related to security future products written, purchased or sold in accounts carried for security-based swap customers required and on deposit in a qualified clearing agency account at a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q–1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1).	.....	$_____
15. Margin related to cleared security-based swap transactions in accounts carried for security-based swap customers required and on deposit in a qualified clearing agency account at a clearing agency registered with the Commission pursuant to section 17A of the Act (15 U.S.C. 78q–1).	.....	$_____
16. Margin related to non-cleared security-based swap transactions in accounts carried for security-based swap customers required and held in a qualified registered security-based swap dealer account at another security-based swap dealer.	.....	$_____
Total Credits	$_____	
Total Debits	.....	$_____
Excess of Credits over Debits	$_____	

Note A. Item 1 shall include all outstanding drafts payable to security-based swap customers which have been applied against free credit balances or other credit balances and shall also include checks drawn in excess of bank balances per the records of the security-based swap dealer.

Note B. Item 2 shall include the amount of options-related or security futures product-related Letters of Credit obtained by a member of a registered clearing agency or a derivatives clearing organization which are collateralized by security-based swap customers' securities, to the extent of the member's margin requirement at the registered clearing agency or derivatives clearing organization.

Note C. Item 3 shall include in addition to monies payable against security-based swap customer's securities loaned the amount by which the market value of securities loaned exceeds the collateral value received from the lending of such securities.

Note D. Item 4 shall include in addition to security-based swap customers' securities failed to receive the amount by which the market value of securities failed to receive and outstanding more than thirty (30) calendar days exceeds their contract value.

Note E. (1) Debit balances in accounts shall be reduced by the amount by which a specific security (other than an exempted security) which is collateral for margin requirements exceeds in aggregate value 15 percent of the aggregate value of all securities which collateralize all accounts receivable; provided, however, the required reduction shall not be in excess of the amount of the debit balance required to be excluded because of this concentration rule. A specified security is deemed to be collateral for an account only to the extent it is not an excess margin security.

(2) Debit balances in special omnibus accounts, maintained in compliance with the requirements of section 4(b) of Regulation T under the Act (12 CFR 220.4(b)) or similar accounts carried on behalf of another security-based swap dealer, shall be reduced by any deficits in such accounts (or if a credit, such credit shall be increased) less any calls for margin, marks to the market, or other required deposits which are outstanding 5 business days or less.

(3) Debit balances in security-based swap customers' accounts included in the formula under item 10 shall be reduced by an amount equal to 1 percent of their aggregate value.

(4) Debit balances in accounts of household members and other persons related to principals of a security-based swap dealer and debit balances in cash and margin accounts of affiliated persons of a security-based swap dealer shall be excluded from the Reserve Formula, unless the security-based swap dealer can demonstrate that such debit balances are directly related to credit items in the formula.

(5) Debit balances in accounts (other than omnibus accounts) shall be reduced by the amount by which any single security-based swap customer's debit balance exceeds 25% (to the extent such amount is greater than $50,000) of the broker-dealer's tentative net capital (*i.e.,* net capital prior to securities haircuts) unless the security-based swap dealer can demonstrate that the debit balance is directly related to credit items in the Reserve Formula. Related accounts (*e.g.,* the separate accounts of an individual, accounts under common control or subject to cross guarantees) shall be deemed to be a single security-based swap customer's accounts for purposes of this provision.

If the Commission is satisfied, after taking into account the circumstances of the concentrated account including the quality, diversity, and marketability of the collateral securing the debit balances in accounts subject to this provision, that the concentration of debit balances is appropriate, then the Commission may, by order, grant a partial or plenary exception from this provision.

The debit balance may be included in the reserve formula computation for five

business days from the day the request is made.

(6) Debit balances of joint accounts, custodian accounts, participations in hedge funds or limited partnerships or similar type accounts or arrangements of a person who would be excluded from the definition of security-based swap customer (''non-security-based swap customer'') which persons includible in the definition of security-based swap customer shall be included in the Reserve Formula in the following manner: if the percentage ownership of the non-security-based swap customer is less than 5 percent then the entire debit balance shall be included in the formula; if such percentage ownership is between 5 percent and 50 percent then the portion of the debit balance attributable to the non-security-based swap customer shall be excluded from the formula unless the security-based swap dealer can demonstrate that the debit balance is directly related to credit items in the formula; if such percentage ownership is greater than 50 percent, then the entire debit balance shall be excluded from the formula unless the security-based swap dealer can demonstrate that the debit balance is directly related to credit items in the formula.

Note F. Item 13 shall include the amount of margin required and on deposit with Options Clearing Corporation to the extent such margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by security-based swap customers' securities.

Note G. (a) Item 14 shall include the amount of margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q–1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1) for security-based swap customer accounts to the extent that the margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by security-based swap customers' securities.

(b) Item 14 shall apply only if the security-based swap dealer has the margin related to security futures products on deposit with:

(1) A registered clearing agency or derivatives clearing organization that:

(i) Maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least $2 billion, at least $500 million of which must be in the form of security deposits. For purposes of this Note G, the term ''security deposits'' refers to a general fund, other than margin deposits or their equivalent, that consists of cash or securities held by a registered clearing agency or derivative clearing organization;

(ii) Maintains at least $3 billion in margin deposits; or

(iii) Does not meet the requirements of paragraphs (b)(1)(i) through (b)(1)(ii) of this Note G, if the Commission has determined, upon a written request for exemption by or for the benefit of the security-based swap dealer, that the security-based swap dealer may utilize such a registered clearing agency or derivatives clearing organization. The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances, if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors; and

(2) A registered clearing agency or derivatives clearing organization that, if it holds funds or securities deposited as margin for security futures products in a bank, as defined in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)), obtains and preserves written notification from the bank at which it holds such funds and securities or at which such funds and securities are held on its behalf. The written notification shall state that all funds and/or securities deposited with the bank as margin (including security-based swap customer security futures products margin), or held by the bank and pledged to such registered clearing agency or derivatives clearing agency as margin, are being held by the bank for the exclusive benefit of clearing members of the registered clearing agency or derivatives clearing organization (subject to the interest of such registered clearing agency or derivatives clearing organization therein), and are being kept separate from any other accounts maintained by the registered clearing agency or derivatives clearing organization with the bank. The written notification also shall provide that such funds and/or securities shall at no time be used directly or indirectly as security for a loan to the registered clearing agency or derivatives clearing organization by the bank, and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank. This provision, however, shall not prohibit a registered clearing agency or derivatives clearing organization from pledging security-based swap customer funds or securities as collateral to a bank for any purpose that the rules of the Commission or the registered clearing agency or derivatives clearing organization otherwise permit; and

(3) A registered clearing agency or derivatives clearing organization that establishes, documents, and maintains:

(i) Safeguards in the handling, transfer, and delivery of cash and securities;

(ii) Fidelity bond coverage for its employees and agents who handle security-based swap customer funds or securities. In the case of agents of a registered clearing agency or derivatives clearing organization, the agent may provide the fidelity bond coverage; and

(iii) Provisions for periodic examination by independent public accountants; and

(4) A derivatives clearing organization that, if it is not otherwise registered with the Commission, has provided the Commission with a written undertaking, in a form acceptable to the Commission, executed by a duly authorized person at the derivatives clearing organization, to the effect that, with respect to the clearance and settlement of the security-based swap customer security futures products of the broker-dealer, the derivatives clearing organization will permit the Commission to examine the books and records of the derivatives clearing organization for compliance with the requirements set forth in § 240.15c3–3a, Note G. (b)(1) through (3).

(c) Item 14 shall apply only if a security-based swap dealer determines, at least annually, that the registered clearing agency or derivatives clearing organization with which the security-based swap dealer has on deposit margin related to security futures products meets the conditions of this Note G.

By the Commission.

Dated: October 18, 2012.

Elizabeth M. Murphy,

Secretary.

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