SULLIVAN & CROMWELL LLP

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SEC Reopens Comment Period on Proposed Rules Regarding Security-Based Swaps

SEC Reopens Comment Period and Requests Additional Comment on Previously Proposed Rules Regarding Capital, Margin and Collateral Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants.

SUMMARY

On October 11, 2018, the SEC held an open meeting at which it voted (4-1, with Commissioner Jackson dissenting) to reopen the comment period and request additional comment regarding certain of its previously proposed rules and guidance relating to security-based swaps.

In addition to a general request for comments on the previously proposed rules and guidance, the proposing release requests specific comment on the following proposed changes:

- To revise the treatment of cleared security-based swaps in the calculation of the risk margin amount used in determining the financial ratio component of a nonbank security-based swap dealer's minimum net capital;
- To create new risk-based thresholds for the capital charges and margin collection requirements where the amount of collateral collected by a security-based swap dealer on a cleared security-based swap is less than the clearing house requirement;
- To expand the permitted use of credit risk charges in lieu of a 100% deduction from net worth for certain security-based swap transactions;
- To eliminate the 100% capital or credit risk charge for segregated initial margin held by a bank under an enforceable control agreement;
- To provide risk-based thresholds for the collection of initial margin; and

- To permit portfolio margining.

The SEC also requests comment on:

- the application of substituted compliance with respect to foreign security-based swap dealers; and
- the compliance deadline for the registration of security-based swap dealers and major security-based swap participants.

Comments are due to the SEC on or prior to November 18, 2018.

BACKGROUND

In October 2012, the SEC proposed rules on capital, margin and collateral segregation for nonbank security-based swap dealers ("SBSDs") and nonbank major security-based swap participants ("MSBSPs"), along with amendments to the current minimum net capital requirements for broker-dealers permitted to use internal value-at-risk models (the "2012 Proposal").[1]

In addition, in May 2013, the SEC proposed rules and interpretive guidance regarding the application of the U.S. regulatory regime to cross-border security-based swap transactions (the "2013 Proposal"). The 2013 Proposal also addressed the impact of cross-border security-based swap transactions on the registration obligations of SBSDs, MSBSPs, security-based swap clearing agencies, security-based swap execution facilities and security-based swap data repositories. The 2013 Proposal also would establish a framework of "substituted compliance" under which certain participants in the security-based swap market would be able to comply with non-U.S. regulatory regimes that the SEC determined to be comparable with U.S. requirements, in lieu of the rules that would otherwise apply to these participants.[2]

Finally, in April 2014, the SEC proposed to impose an additional capital charge provision on nonbank SBSDs which would mirror the capital charge provision applicable to broker-dealers pursuant to Rule 15c3-1 for short securities differences that are unresolved for seven days or longer and for long securities differences where the securities have been sold before they are adequately resolved (the "2014 Proposal" and, collectively with the 2012 Proposal and the 2013 Proposal, the "Proposals").

The SEC has reopened the comment period on each of the Proposals to provide interested parties with an opportunity to submit comments that take into account regulatory and market developments since their

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1 For a comprehensive summary of the 2012 Proposal, please see our Memorandum to Clients, dated November 19, 2012, entitled, "Security-Based Swaps: Capital, Margin and Segregation Requirements." *Available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Proposed_Rules_on_Capital_Requirements_Margin_for_Security_Based_SDs_and_MSPs.pdf.

2 For a comprehensive summary of the 2013 Proposal, please see our Memorandum to Clients, dated June 7, 2013, entitled, "Cross-Border Security-Based Swaps." *Available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Cross_Border_Security_Based_Swaps.pdf.

original publication. The SEC is also requesting specific comments on potential modifications and additions to certain of the rules included in the 2012 Proposal.

CAPITAL REQUIREMENTS

A. REVISIONS TO THE CALCULATION OF THE 8% MARGIN FACTOR

Under the 2012 Proposal, the minimum net capital requirement for non-broker-dealer SBSDs would be equal to the greater of: (i) a fixed dollar minimum amount and (ii) a financial ratio requirement equal to 8% (the "8% Margin Factor") of the margin required for cleared and uncleared security-based swaps (the "Risk Margin Amount").

Under the 2012 Proposal, the Risk Margin Amount would be calculated as the sum of (i) 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 or the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to the proposed capital requirements and (ii) the total margin amount calculated by the nonbank SBSD with respect to non-cleared security-based swaps pursuant to the proposed margin rules.

In response to comments suggesting that the Risk Margin Amount should reflect the lower risk associated with central clearing, the SEC requests comment on proposed rule revisions under which the calculation of the Risk Margin Amount would only include 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 in the first component of the Risk Margin Amount calculation.

B. RISK-BASED THRESHOLD FOR CAPITAL CHARGES RELATING TO CERTAIN CLEARED SECURITY-BASED SWAP TRANSACTIONS WITH INSUFFICIENT MARGIN

The 2012 Proposals included a capital charge that would apply to a nonbank SBSDs in the case of cleared security-based swap transactions where the amount of margin collected from the counterparty is less than the deduction that would apply to the security-based swap if it were a proprietary position of the nonbank SBSD. The SEC is proposing to modify this requirement to include a risk-based threshold, under which the proposed capital charge would not need to be taken.

Specifically, under the proposed modifications, the capital charge would not be required if (i) the difference between the margin collected and the applicable haircut is less than 1% of the nonbank SBSD's tentative net capital and less than 10% of the counterparty's net worth and (ii) the aggregate difference of the collected margin and the applicable deductions across all counterparties is less than 25% of the nonbank SBSD's tentative net capital.

The SEC notes that these modifications would limit the nonbank SBSD's exposure to a single counterparty; establish a concentration limit across all counterparties; and provide for a capital charge

that is scalable and more directly related to the risk to the nonbank SBSD arising from its security-based swap activities.

C. EXPANSION OF THE PERMITTED USE OF A CREDIT RISK CHARGE IN LIEU OF A 100% CAPITAL CHARGE FOR CERTAIN SECURITY-BASED SWAP TRANSACTIONS

The 2012 Proposals would require nonbank SBSDs to take a 100% deduction from net worth for uncollateralized receivables from counterparties arising from non-cleared security-based swaps, except where the counterparty is a commercial end user, in which case a nonbank SBSD approved to use internal models to calculate net capital would be permitted to take a credit risk charge in lieu of the 100% deduction.

The SEC is seeking comment on whether the permitted use of a credit risk charge should be expanded to include transactions with other types of counterparties (rather than only commercial end users). Specifically, the SEC Staff proposed that nonbank SBSDs would be permitted to apply the credit risk charge for uncollected initial margin for security-based swaps and swap transactions with any type of counterparty as well as for uncollected variation margin for transactions with a counterparty that is a commercial end user. However, the proposals also include a new risk-based threshold, which would limit the permitted credit risk charges for uncollected variation margin from commercial end users to 10%, in the aggregate, of the tentative net capital of the nonbank SBSD.

D. OMISSION OF CAPITAL CHARGE FOR CERTAIN SECURITY-BASED SWAP TRANSACTIONS WITH SEGREGATED COLLATERAL

The previously proposed rules required that nonbank SBSDs who do not hold margin from a counterparty because the margin has been segregated and held by an independent third-party custodian take a capital charge in the amount of the segregated collateral. The proposed capital charge is meant to address the nonbank SBSD's lack of physical possession or control over the collateral, which could potentially result in an inability to liquidate the collateral promptly.

In response to several comments that this charge would discourage the use of segregation and increase costs to the affected nonbank SBSDs, the SEC proposed an exception to this capital charge that would be applicable if (i) the custodian is a bank, (ii) the nonbank SBSD enters into an account control agreement with the custodian and the counterparty that provides the nonbank SBSD with direct control over the collateral, and (iii) an opinion of counsel deems the account control agreement enforceable, including in bankruptcy and insolvency. The SEC is also considering providing guidance on how nonbank SBSDs could structure account control agreements to ensure direct control of the collateral.

E. PROPOSED EXCEPTION TO THE CAPITAL CHARGE REQUIRED BY NONBANK SBSDS FOR INITIAL MARGIN DELIVERED TO A COUNTERPARTY

The 2012 Proposal would require nonbank SBSDs to deduct from net worth the value of initial margin delivered to a counterparty when computing net capital. The SEC is seeking comment on a proposed

exception to this requirement under which the nonbank SBSD would not need to take the deduction if (i) the initial margin requirement is funded by a fully executed written loan agreement with an affiliate of the broker-dealer, (ii) the loan agreement provides that the lender waives repayment of the loan until the initial margin is returned to the broker-dealer; and (iii) the broker-dealer's liability to the lender can be fully satisfied by delivering the collateral serving as initial margin to the lender.[3]

MARGIN REQUIREMENTS

A. UNIFORM INDUSTRY MODEL FOR THE CALCULATION OF INITIAL MARGIN

The 2012 Proposals would require nonbank SBSDs to perform daily calculations for each account of its counterparties to determine appropriate initial margins to be collected from those counterparties. As discussed in our November 19, 2012 Memorandum to Clients, nonbank SBSDs approved to use internal models would be permitted to use their internal value-at-risk models to determine appropriate margin amounts for debt security-based swaps, but would be required to use the standardized deduction for equity security-based swaps.

The proposing release requests comment on modifications to the proposed rules which would permit nonbank SBSDs to apply to use models (other than the proprietary capital models) to compute initial margin for non-equity security-based swaps. Specifically, the proposal contemplates the use of a standard industry model for the calculation of initial margin. The SEC notes that this proposal follows the widespread adoption of an industry-developed uniform model for the calculation of initial margin by swap dealers subject to regulation by the CFTC.

B. RISK-BASED THRESHOLD FOR MARGIN COLLECTION ON SECURITY-BASED SWAP TRANSACTIONS

Nonbank SBSDs under the 2012 proposal would be required to calculate and collect initial and variation margin from each counterparty. The proposing release requests comment on modifications to the proposed rules which would allow nonbank SBSDs to elect not to collect initial margin to the extent that the margin amount does not exceed the lesser of (i) one percent (1%) of the SBSD's tentative net capital or (ii) ten percent (10%) of the net worth of the counterparty. The SEC notes that this proposed change is intended to establish a threshold that is scalable and has a more direct relation to the risk to the nonbank SBSD arising from its security-based swap activities.

C. MARGIN COLLECTION ALTERNATIVES IN TRANSACTIONS WITH A SBSD COUNTERPARTY

The 2012 Proposal set forth two alternative proposals for the requirements to collect margin when a nonbank SBSD's counterparty is another SBSD. Under the first alternative, nonbank SBSDs would be

[3] The SEC staff previously has granted no-action relief from taking such deduction to a broker-dealer when these proposed conditions were satisfied. *See* Letter from Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, to Kris Dailey, Vice President, Risk Oversight and Regulation, FINRA (Aug. 19, 2016).

required to collect variation margin, but not initial margin, to address negative equity in the account of another SBSD ("Alternative A"). Under the second alternative, SBSDs would be required to collect variation and initial margin in all transactions with other SBSDs and the initial margin collected would need to be held with an independent third-party custodian ("Alternative B").

The SEC is seeking additional comment on Alternatives A and B and, with respect to Alternative A, whether the exception under Alternative A should apply to a broader class of counterparties, including broker-dealers, banks, futures commission merchants, foreign banks, or foreign brokers or dealers.

D. PORTFOLIO MARGINING

In response to various comments on the 2012 Proposals, the SEC is seeking comment on whether the rules should be revised to permit portfolio margining of security-based swaps, swaps and related positions. The proposed revisions would provide a means for nonbank SBSDs to hold swaps in a security-based swap account in order to provide a means to portfolio margin security-based swaps with swaps and related positions (and concomitantly, swap dealers would be permitted to hold security-based swaps in swap accounts for portfolio margining purposes). The SEC solicits comments on proposals to define:

- "related instrument" within an option class or product group to include futures contracts, options on futures contracts and swaps covering the same underlying currency and, in the case of an option on a foreign currency, forward contracts in the same underlying currency; and
- "underlying instrument" as long and short positions covering the same foreign currency, security, security future, security-based swap or a security convertible or exchangeable for the underlying security within 90 days, but not securities options, futures contracts or options on futures contracts, qualified stock baskets or unlisted instruments (other than security-based swaps) or swaps.

SEGREGATION REQUIREMENTS

A. CROSS-BORDER TREATMENT OF SEGREGATION REQUIREMENTS

The 2013 Proposal treated segregation as a transaction-level requirement and applied the segregation requirement to foreign security-based swap dealers and foreign major security-based swap participants depending on whether they were registered as a broker-dealer, a U.S. branch or agency of a foreign bank or neither and whether the security-based swap was cleared. Under the 2013 Proposal, a foreign SBSD or a U.S. branch or agency of a foreign bank would need to comply with the segregation requirements with respect to security-based swap transactions with U.S. security-based swap customers but not with foreign security-based swap customers. The SEC requests comments on whether a foreign SBSD that is not a broker-dealer and is a foreign bank should be required to comply with the segregation requirements:

- with respect to U.S.-security-based customers, all customers (regardless of which branch or agency the customer's transactions arise out of); or

- with respect to a foreign security-based swap customer, if the foreign SBSD holds funds or other property arising out of a transaction entered into by such customer with a U.S. branch or agency of the foreign SBSD.

B. EXTENSION OF SEGREGATION AND CUSTOMER RESERVE FORMULA REQUIREMENTS TO BROKER-DEALERS NOT REGISTERED AS SBSDS.

The SEC has proposed an amendment to Rule 15c3-3 that would permit broker-dealers that are not registered as SBSDs but engage in security-based swap activities to use segregation requirements and a customer reserve formula that parallels those applicable to SBSDs.

C. MODIFICATIONS TO THE DEFINITION OF EXCESS SECURITIES COLLATERAL

As discussed in our November 19, 2012 Memorandum to Clients, the 2012 Proposal would require a SBSD to maintain possession and control of all customer securities held by the SBSD that exceed the current exposure of the SBSD to the customer (the "Excess Securities Collateral"), subject to two exceptions. The second of these exceptions excludes from the definition of Excess Securities Collateral any collateral that is held in a qualified SBSD account to the extent the securities are being used to meet a margin requirement of the other SBSD resulting from a transaction to hedge the risk of uncleared-security-based swap transactions with the customer.

The prudential-regulator rules applicable to a bank SBSD require the initial margin posted by a SBSD to the bank SBSD to be held by a third-party custodian (rather than directly by the bank SBSD). The SEC has proposed revisions to the definition of excess securities collateral to expand the second exception to include collateral for such transactions held by a third-party custodian in accordance with the rules applicable to bank SBSDs.

D. INCREASED THRESHOLD TRIGGERING DEDUCTION OF FUNDS IN CUSTOMER RESERVE ACCOUNT AT A SINGLE BANK

The 2012 Proposal would require a SBSD to deduct from the amount of funds held in a customer reserve account at a single bank the amount of funds deposited that exceeds ten percent (10%) of the equity capital of the bank as reported by the bank in its most recent call report. The ten percent (10%) threshold included in the 2012 Proposal was consistent with the analogous threshold included in the then-proposed amendments to Rule 15c3-3. The Rule 15c-3-3 threshold was subsequently increased to fifteen percent (15%) and the SEC is requesting comment on whether the SBSD threshold should also be increased to fifteen percent (15%) to be consistent.

SUBSTITUTED COMPLIANCE DETERMINATIONS

Under the 2013 Proposal, substituted compliance with the capital and margin requirements would be available to foreign nonbank SBSDs not registered as broker-dealers upon receipt of a substituted compliance determination from the SEC. The SEC requests comment on the impact of the proposed

modifications to the 2012 Proposals with respect to substituted compliance determinations and more generally on what factors should be considered when making substituted compliance determinations.

Among other areas on which the SEC requests comment is whether, in making a comparability determination, the SEC should consider whether the foreign rules include a net liquid asset test that requires the foreign SBSD to have an amount of highly liquid assets that exceeds the foreign SBSD's unsubordinated liabilities.

COMPLIANCE DATE

Currently the compliance date for the registration of SBSDs and MSBSPs is the latest of:

- six months after the publication of the final rules on capital, margin and segregation requirements;
- the compliance date of final rules establishing recordkeeping and reporting requirements for SBSDs and MSBSPs;
- the compliance date for the final rules establishing business conduct standards; or
- the compliance date for final rules establishing a process for registered SBSDs and MSBSPs to make an application to the SEC to allow an associated person who is subject to statutory disqualification to effect or be involved in effecting security-based swap transactions (the last such date, the "Registration Compliance Date").

The SEC requests comment on whether a longer period, such as 18 months after the date of the final rules specified in the definition of Registration Compliance Date, would be more appropriate or a shorter period would be more appropriate. Further, the SEC requests comments on the possible phase-in of initial margin requirements.

PUBLIC COMMENT

The SEC will accept public comment on the proposed rules until November 18, 2018.

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