#### ALERT MEMORANDUM

# SEC Finalizes Security-Based Swap Capital, Margin, and Segregation Requirements

## August 5, 2019

On June 21, 2019, the Securities and Exchange Commission (the "SEC") adopted final rules (the "Final Rules") that set forth: (1) capital and margin requirements for security-based swap ("SBS") dealers ("SBSDs") and major SBS participants ("MSBSPs") for which there is not a Prudential Regulator<sup>1</sup> ("nonbank SBSDs" and "nonbank MSBSPs"); (2) revised capital requirements for broker-dealers ("BDs") (including with respect to their SBS and swaps); (3) segregation requirements for SBSDs, MSBSPs, and BDs with respect to collateral for SBS; and (4) the cross-border application of these capital, margin, and segregation requirements.

## **OVERVIEW OF THE FINAL RULES**

<u>Capital</u>. The Final Rules' capital requirements for nonbank SBSDs are generally modeled on the net liquid asset requirements that apply to BDs under SEC Rule 15c3-1, but with a minimum net capital requirement that increases in proportion to the volume of a nonbank SBSD's SBS business and certain other modifications designed to work in conjunction with margin rules for non-cleared SBS and swaps. In addition, the Final Rules amend Rule 15c3-1 to establish capital requirements for SBS and swap positions held by BDs (including BDs *not* registered as If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

#### NEW YORK

**Colin D. Lloyd** +1 212 225 2809 <u>clloyd@cgsh.com</u>

Brandon M. Hammer +1 212 225 2635 bhammer@cgsh.com

Reshama J. Patel +1 212 225 2012 repatel@cgsh.com

Jeffrey A. White +1 212 225 2858 jewhite@cgsh.com

SBSDs) and increase the fixed-dollar minimum net capital requirements that apply to BDs that the SEC has approved to use internal models in lieu of standardized haircuts for market and credit risk ("ANC BDs").

<u>Margin</u>. The Final Rules subject nonbank SBSDs to margin requirements for non-cleared SBS that are aligned in several key respects with the global Working Group on Margin Requirements ("WGMR") framework implemented by the Commodity Futures Trading Commission (the "CFTC"), Prudential Regulators, and other G20 regulators.<sup>2</sup> However, there are some notable differences between the WGMR framework and the Final Rules, including: (1) no requirement for a nonbank SBSD to post initial margin ("IM"); (2) an exception from IM collection requirements for non-cleared SBS with specified financial market intermediaries (including other SBSDs); (3) a requirement for registered BDs (other than limited-purpose over-the-counter derivatives dealers ("OTCDDs")) that are dually registered as SBSDs ("BD-SBSDs") to use a standardized approach to calculate IM requirements for equity SBS instead of using risk-based models; (4) no exceptions from IM requirements for counterparties with less than \$8 billion in average aggregate notional amount ("AANA") of non-cleared derivatives; (5) a two-month compliance window once a \$50 million IM threshold is breached by a counterparty; and (6) a requirement to collect variation margin ("VM") from non-U.S. sovereign entities.

<sup>&</sup>lt;sup>2</sup> Margin Requirements for Non-Centrally Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (Sept. 2013) (<u>link</u>).



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<sup>&</sup>lt;sup>1</sup> The Prudential Regulators include the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Farm Credit Administration, and the Office of the Comptroller of the Currency.

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Segregation. The Final Rules subject BDs and SBSDs (including SBSDs that are banks) to omnibus segregation requirements for SBS collateral that are modeled on the BD customer protection rule, SEC Rule 15c3-3. However, the Final Rules include an exemption from these requirements for an SBSD that is not dually registered as a BD (a "standalone SBSD") or an SBSD that is an OTCDD (an "OTCDD-SBSD") if the SBSD does not clear SBS for others and provides certain notices to its SBS counterparties.

<u>Alternative Compliance Mechanism</u>. The Final Rules establish an alternative compliance mechanism for CFTC-registered swap dealers ("SDs") that dually register as standalone SBSDs (but not for BD-SBSDs or OTCDD-SBSDs). If such an SD-SBSD satisfies the segregation exemption noted above and the aggregate gross notional amount ("AGNA") of its SBS positions does not exceed the lesser of a maximum fixed-dollar amount and 10% of the combined AGNA of its SBS and swaps positions as of the SBSD's most recent fiscal quarter, the SBSD may elect to comply with the capital, margin, and segregation requirements of the CFTC, rather than those of the SEC.

<u>Cross-Border Application</u>. The SEC will treat its SBSD capital and margin requirements as "entitylevel" requirements that apply to foreign SBSDs across all their positions, not just those with U.S. counterparties. But a foreign SBSD can satisfy SEC capital and margin requirements through substituted compliance with home country requirements if the SEC determines that they are comparable to the SEC's requirements. In contrast, the Final Rules treat SBSD segregation requirements as "transaction-level" requirements, which in many instances will only apply to a foreign SBSD's SBS with U.S. counterparties, but a foreign SBSD may *not* satisfy such requirements through substituted compliance with home country requirements.

<u>Compliance Date</u>. The compliance date for the Final Rules will be the same date as when SBSDs must first register with the SEC, which the SEC set to be 18 months after the later of: (1) the effective date of final rules establishing recordkeeping and reporting requirements for SBSDs and MSBSPs; and (2) the effective date of final rules addressing the cross-border application of certain SBS requirements.

## KEY TAKEAWAYS AND NEXT STEPS

**SEC-CFTC Harmonization**. The Final Rules reflect major, and welcome, steps towards further SEC-CFTC harmonization, including: (1) an alternative compliance mechanism that will allow some dual registrants to opt for a single, unified capital, margin, and segregation framework across their SBS and swaps; (2) alignment of key margin requirements such as IM calculation methodologies (in most cases), IM thresholds, eligible collateral, and collateral haircuts; (3) relief from several net capital deductions that, as originally proposed by the SEC, would have run counter to major aspects of the CFTC's margin rules and overall WGMR framework; and (4) provisional SEC approval of risk-based models approved by other regulators. The agencies are also embarking on a further initiative to explore portfolio margining of the products they regulate, including not only SBS and swaps, but also futures and cash equities.<sup>3</sup>

**Potential Competitive Disparities**. The Final Rules could create competitive headwinds for BD-SBSDs relative to other SBSDs (*e.g.*, because a BD-SBSD cannot use a model to calculate IM requirements for an equity SBS, and an ANC BD must take a 100% deduction equal to any amount by which its current exposure exceeds 10% of its tentative net capital, including exposure to commercial end users). However, depending on the outcome of the agencies' portfolio margining initiative, a BD-SBSD may be able to offer portfolio margining of SBS with certain types of positions (cash equities, listed securities options) that other SBSDs cannot. Meanwhile, even relative to bank SBSDs, standalone SBSDs and OTCDD-SBSDs could be at an advantage because they will not be required to post IM to their clients, will not be required to collect IM from other financial market intermediaries, and will in most instances not be required to segregate the IM they collect for non-cleared SBS.

<sup>&</sup>lt;sup>3</sup> See Joint Statement on CFTC-SEC Portfolio Margining Harmonization Efforts (June 27, 2019) (<u>link</u>).

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<u>Next Steps</u>. Key areas to watch in the next 6-18 months include: (1) the CFTC-SEC portfolio margining initiative noted above; (2) finalization of the SEC's recordkeeping and reporting requirements for SBSDs and MSBSPs; (3) substituted compliance determinations by the SEC; and (4) finalization (but maybe with an intervening re-proposal?) of the CFTC's capital rules for nonbank SDs and nonbank major swap participants ("**MSPs**").

## **BACKGROUND**

In October 2012, the SEC proposed capital and margin requirements for nonbank SBSDs and nonbank MSBSPs, segregation requirements for all SBSDs, amendments to existing BD net capital requirements under SEC Rule 15c3-1, and liquidity requirements for ANC BDs and SBSDs approved to use models (the "**2012 Proposal**").<sup>4</sup>

In September 2013, the WGMR released a framework for margin requirements applicable to non-centrally cleared derivatives.<sup>5</sup> In October 2015, the Prudential Regulators released margin requirements for SDs and SBSDs for which there is a Prudential Regulator ("**bank SDs**" or "**bank SBSDs**"), which were substantially based on the WGMR framework.<sup>6</sup> In December 2015, the CFTC released margin requirements for nonbank SDs and MSPs, which were also substantially based on the WGMR framework.<sup>7</sup>

In December 2016, the CFTC proposed capital requirements applicable to nonbank SDs and nonbank MSPs,<sup>8</sup> which incorporated the SEC's capital rules for nonbank SBSDs by reference. The CFTC has not yet finalized these requirements.

In October 2018, the SEC reopened the comment period on its proposed capital, margin, and segregation rules and requested additional comments on some proposed changes to those rules (the "2018 **Proposal**").<sup>9</sup>

<sup>5</sup> Margin Requirements for Non-Centrally Cleared Derivatives, supra note 2.

# **CAPITAL**

## (1) <u>Overview</u>

The Final Rules' capital requirements differ depending on (1) the registration status of the relevant BD, SBSD, or MSBSP and (2) whether the firm has been approved to use models to compute deductions from net capital for credit and market risk. BDs that are not registered as SBSDs ("**standalone BDs**") as well as BD-SBSDs, remain subject to Rule 15c3-1, as amended by the Final Rules. Standalone SBSDs, as well as OTCDD-SBSDs,<sup>10</sup> are subject to new Rule 18a-1, which is modeled on Rule 15c3-1.

Both Rule 15c3-1 and Rule 18a-1 impose a net liquid assets test. Under that test, a BD or SBSD first calculates its "tentative net capital" by taking its net worth under generally accepted accounting principles and subtracting from that amount certain illiquid assets, adding certain subordinated liabilities, and making specified additional adjustments. Then, the firm applies certain market and credit risk deductions to reach its "net capital," which must exceed a specified minimum amount.

#### (2) Minimum Net Capital Requirements

Under existing Rule 15c3-1, a BD is required to maintain net capital in excess of the greater of (1) a fixed-dollar amount (which varies depending on the nature of the BD's business and whether or not it is an ANC BD) and (2) at the election of the BD, either (a) 2% of the amount of credit it has extended to its securities customers or (b) 1/15th of its aggregate indebtedness ("**Existing Rule 15c3-1 Ratios**"). ANC

<sup>7</sup> Margin Requirements for Uncleared Swaps for [SDs] and [MSPs], 81 Fed. Reg. 636 (Jan. 6, 2016).

<sup>8</sup> *Capital Requirements of [SDs] and [MSPs]*, 81 Fed. Reg. 91252 (Dec. 16, 2016). For more details regarding this proposal, please see our Alert Memorandum at <u>link</u>.

<sup>9</sup> Capital, Margin, and Segregation Requirements for [SBSDs] and [MSBSPs] and Capital Requirements for [BDs], Exchange Act Release No. 84409 (Oct. 11, 2018), 83 Fed. Reg. 53007 (Oct. 19, 2018).

<sup>10</sup> OTCDDs are limited purpose BDs whose securities dealing activities are limited to OTC derivatives. Rule 3b-12. OTCDDs are not subject to Rule 15c3-3's omnibus segregation requirements (so long as they provide certain disclosures) and, like ANC BDs, are permitted to calculate market and credit risk charges using models.

<sup>&</sup>lt;sup>4</sup> Capital, Margin, and Segregation Requirements for [SBSDs] and [MSBSPs] and Capital Requirements for [BDs], Securities Exchange Act of 1934 ("Exchange Act") Release No. 68071 (Oct. 18, 2012), 77 Fed. Reg. 70214 (Nov. 23, 2012). In 2014, the SEC proposed an additional capital requirement for nonbank SBSDs that was inadvertently excluded from the 2012 Proposal. Recordkeeping and Reporting Requirements for [SBSDs], [MSBSPs], and [BDs]; Capital Rule for Certain [SBSDs], Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. 25194 (May 2, 2014).

<sup>&</sup>lt;sup>6</sup> Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840 (Nov. 30, 2015).

BDs must, in addition, maintain tentative net capital in excess of \$1 billion (subject to an early warning requirement set at \$5 billion).

The Final Rules largely retain these minimum net capital requirements (except for ANC BDs), but modifies the ratio-based requirements for BD-SBSDs and ANC BDs by adding a ratio equal to 2% of the SBS "risk margin amount" to the Existing Rule 15c3-1 Ratios.

The "risk margin amount" equals the sum of (1) the total IM required to be maintained by the firm at each clearing agency with respect to the SBS transactions that the firm clears for SBS customers and (2) the total IM amount calculated by the firm with respect to noncleared SBS pursuant to new Rule 18a-3 (which, for an ANC BD that is not an SBSD, would be zero).

Under the 2012 Proposal, component (1) would have been the greater of the clearing agency's IM requirement and the amount of the market risk deductions that would have applied to customers' cleared SBS positions if held by the firm as principal. However, in response to comments from market participants, the SEC limited component (1) to the total IM required by the clearing agency.

Additionally, the Final Rules raise the fixed-dollar net capital and tentative net capital minimums applicable to ANC BDs (whether registered as SBSDs or not). Under amended Rule 15c3-1, ANC BDs must maintain net capital equal to at least \$1 billion (instead of \$500 million) and tentative net capital equal to at least \$5 billion (instead of \$1 billion) and notify the SEC if its tentative net capital falls below \$6 billion (instead of \$5 billion).

As under Rule 15c3-1, standalone SBSDs and OTCDD-SBSDs will be required to maintain net capital in excess of (1) a fixed-dollar amount and (2) an amount derived by applying a financial ratio. The financial ratio is 2% of the risk margin amount, and the fixed-dollar amount will depend on whether the firm is permitted to use models. A standalone SBSD permitted to use models or an OTCDD-SBSD will be required to maintain net capital of greater than \$20 million and tentative net capital of at least \$100 million. A standalone SBSD that is not permitted to use models will be required to maintain net capital in excess of \$20 million, but will not be subject to a fixed-dollar tentative net capital requirement.

The 2% margin factor multiplier will remain at 2% for three years after the Final Rules' compliance date. After three years, the SEC may, by order, increase the multiplier to not more than 4%. After five years, if the SEC had previously issued an order raising the multiplier to 4% or less, the SEC may, by order, increase it to not more than 8%. In deciding whether or not to increase the margin factor multiplier, the SEC will consider the capital and leverage levels of the firms subject to the minimum net capital requirements as well as the risks of their SBS positions. The SEC will provide notice before issuing an order increasing the multiplier.

The 2012 Proposal had contemplated an 8% margin factor multiplier commencing on the compliance date of the Final Rules. In response to comments on the effect of the multiplier on the competitiveness of nonbank SBSDs, the SEC adopted a 2% margin factor. However, the CFTC's proposed capital rules still contemplate an 8% margin factor multiplier, and the risk margin amount would equal the sum of IM amounts for a broader range of products, including futures, cleared swaps, non-cleared swaps, cleared SBS, and non-cleared SBS. For futures, cleared swaps, and cleared SBS, both proprietary positions and positions cleared for customers would be included (except futures commission merchants ("FCMs") would not need to include proprietary futures positions in their risk margin amount calculations).

The following table summarizes the revised minimum net capital requirements:

#### TABLE 1:

Type of Registrant	Tentative Net Capital	Net Capital	
		Fixed- Dollar	Financial Ratio
Standalone SBSD (no models)	N/A	\$20 million	2% of risk margin amount
Standalone SBSD (internal models)	\$100 million	\$20 million	2% of risk margin amount
OTCDD- SBSD	\$100 million	\$20 million	2% of risk margin amount
OTCDD non-SBSD	\$100 million	\$20 million	Existing Rule 15c3-1 Ratios
BD-SBSD (no models)	N/A	\$20 million	2% of risk margin amount + Existing Rule 15c3-1 Ratios
ANC BD- SBSD	\$5 billion (\$6 billion early warning)	\$1 billion	2% of risk margin amount + Existing Rule 15c3-1 Ratios
Standalone ANC BD	\$5 billion (\$6 billion early warning)	\$1 billion	2% of risk margin amount + Existing Rule 15c3-1 Ratios

Type of Registrant	Tentative Net Capital	Net Capital	
		Fixed- Dollar	Financial Ratio
Standalone BD (no models)	N/A	Ranges from \$5k to \$250k	Existing Rule 15c3-1 Ratios

## (3) Credit Risk Deductions

The Final Rules require a BD or nonbank SBSD to take credit risk net capital deductions for: (1) IM that a BD or SBSD posts; (2) SBS or swaps VM and IM that a BD or SBSD elects not to collect pursuant to an exception or exemption under the SEC's or CFTC's margin rules; and (3) SBS or swaps VM or IM that a BD or SBSD fails to collect.

## **Deductions for Posted IM**

Under the Final Rules, a BD or SBSD must take a deduction to net capital equal to 100% of the amount of IM it delivers to a counterparty in connection with a non-cleared SBS or swap, unless:

- The IM requirement is funded by a fully executed written loan agreement with an affiliate of the BD or SBSD;
- Such loan agreement provides that the lender waives re-payment of the loan until the IM is returned to the BD or SBSD; and
- The liability of the BD or SBSD to the lender can be fully satisfied by delivering the collateral serving as IM to the lender.<sup>11</sup>

The SEC rejected comments to eliminate the need for this loan agreement if the IM is held at a third-party custodian in accordance with the WGMR framework.

In addition, the SEC clarified that no deduction is required for any margin that a BD or SBSD posts to a clearing agency or derivatives clearing organization ("**DCO**") in connection with a cleared SBS or swap or

Markets, SEC, to Kris Dailey, Vice-President, Risk Oversight and Operational Regulation, Financial Industry Regulatory Authority (Aug. 19, 2016) (<u>link</u>).

<sup>&</sup>lt;sup>11</sup> This guidance is consistent with a 2016 staff letter addressing how margin posted to a DCO must be treated under Rule 15c3-1. *See* Letter from Michael A. Macchiaroli, Associate Director, Division of Trading and

for any "clearing deposits" posted to a clearing agency or DCO.

## Deductions in Lieu of Margin for Cleared SBS or Swaps

The 2012 Proposal would have required a deduction if a BD or nonbank SBSD collected margin from a customer in respect of a cleared SBS that was less than the deduction that would have applied to the SBS had it been a proprietary position of the SBSD. The 2018 Proposal would have expanded this deduction to apply to cleared swaps as well. In the Final Rules, the SEC decided not to require such a deduction, whether for SBS or swaps, reasoning that deficiencies with clearing agency or DCO margin requirements should be addressed through direct regulation of the central counterparty.

## Deductions in Lieu of Margin for Non-Cleared SBS or Swaps

## In General

Under the Final Rules, BDs and nonbank SBSDs must treat uncollected VM for a non-cleared SBS or swap as an uncollateralized receivable subject to a 100% net capital deduction. In addition, if a BD or nonbank SBSD elects not to collect IM for a non-cleared SBS or swap pursuant to an exemption or exception in the SEC's or CFTC's margin rules (*e.g.*, for a commercial end user or legacy account), it must take a 100% net capital deduction.<sup>12</sup>

If a BD or nonbank SBSD elects not to collect IM from a counterparty under an exception or exemption in the SEC's or CFTC's margin rules, the BD or SBSD will need to calculate how much margin it would have been required to collect had the exemption or exception not applied in order to calculate the "risk margin amount" as well as these 100% credit risk deductions.

The 2018 Proposal would have required a BD or nonbank SBSD to calculate the deduction amount for swaps based on the standardized market risk haircuts in the SEC's capital rules or the amount calculated using a margin model approved by the SEC. The Final Rules provide instead that the deduction amount is only equal to the amount of the required margin under the CFTC's margin rules.

In addition, as discussed below, ANC BDs and nonbank SBSDs authorized to use models may use such models to calculate the charges for uncollected margin, instead of taking 100% deductions.

## Third-Party Custodians

The 2012 Proposal would have treated IM held at a third-party custodian (*e.g.*, in accordance with the CFTC's segregation requirements) as not collected by the SBSD for purposes of triggering a credit risk deduction. In the 2018 Proposal, the SEC proposed to allow SBSDs to take into account IM held at a third-party custodian only if the custodial arrangement satisfied conditions that were inconsistent with market practice. However, in response to comments, the Final Rules provide that margin held at a third-party custodian is considered collected by the SBSD and thus does not trigger a credit risk deduction if:

(1) The custodian is (a) a bank as defined in Section 3(a)(6) of the Exchange Act; (b) a registered U.S. clearing organization or depository that is not affiliated with the counterparty; or (c) if the collateral consists of foreign securities or currencies, a supervised foreign bank, clearing organization, or depository that is not affiliated with the counterparty and that customarily maintains custody of such foreign securities or currencies (collectively, "**Eligible Custodians**");

(2) The SBSD, counterparty, and Eligible Custodian enter into a custody agreement that provides the SBSD with the right to access the margin to satisfy the counterparty's obligations; and

(3) The SBSD maintains written documentation that the custody agreement will be legal, valid, binding, and enforceable, including in the event of the counterparty's or custodian's insolvency.

<sup>&</sup>lt;sup>12</sup> If the BD is not an SBSD, then it is not required to take this deduction in lieu of collecting IM for non-cleared SBS. If the BD or nonbank SBSD is not an SD, then it is not

required to take this deduction in lieu of collecting IM for non-cleared swaps.

The SEC clarified that an outside counsel's legal opinion is not required to satisfy requirement (3). Instead, the BD or SBSD could satisfy the written documentation requirement through its own "in-house" legal research or the legal research of a competent industry association.

#### Using Models in Lieu of 100% Deductions

Although BDs are generally required to deduct 100% of the value of unsecured receivables from their net capital, existing Rule 15c3-1 permits ANC BDs and OTCDDs instead to calculate deductions for unsecured receivables from derivatives counterparties using an SEC-approved model.

For an ANC BD, this credit risk deduction equals the sum of: (1) a counterparty exposure charge equal to the sum of the ANC BD's current exposure and maximum potential exposure to the counterparty, multiplied by a credit risk weight for the counterparty, multiplied by 8%; (2) a concentration charge if the current exposure to the particular counterparty exceeds certain thresholds; and (3) a portfolio concentration charge equal to the amount by which the aggregate current exposure of the ANC BD to all counterparties exceeds 50% of the ANC BD's tentative capital. For an OTCDD, the calculation is similar, except that maximum potential exposure is not factored into the exposure calculation and no portfolio concentration charge applies.<sup>13</sup>

Consistent with this approach, the Final Rules allow ANC BDs, OTCDDs, and SBSDs approved to use credit risk models to apply a model-based credit risk deduction when they elect not to collect IM or VM instead of the 100% deductions that would otherwise have applied. However, the Final Rules amend the portfolio concentration charge for an ANC BD to apply beginning at 10% of its tentative net capital, instead of 50%. Neither OTCDDs nor standalone SBSDs approved to use internal models are subject to such a portfolio concentration charge, though they will continue to be subject to single counterparty concentration charges.

The Final Rules' treatment of credit risk deductions reflects substantial evolution from the 2012 Proposal, which would have only allowed SBSDs to use models to calculate credit risk deductions for current exposures to commercial end users. At the same time, reducing the portfolio concentration charge threshold for ANC BDs from 50% of tentative net capital to 10% will limit the ability of such firms to enter into SBS or swaps with commercial end users and certain sovereign entities that are not subject to VM requirements.

In response to comments from market participants, the Final Rules allow the SEC to provide provisional approval for an ANC BD or SBSD to use a model that has been approved by the CFTC, the National Futures Association, a Prudential Regulator, or comparable foreign authorities.<sup>14</sup>

These provisional approvals may help to limit competitive disparities that could arise if the SEC is unable to approve all applicants' models by the compliance date.

#### **Deductions for Under-margined Accounts**

Under existing rules, a BD must take a deduction for under-margined accounts. The Final Rules similarly provide that standalone BDs and nonbank SBSDs must take a deduction equal to any margin in respect of a swap or SBS required under SEC, CFTC, clearing agency, DCO, or designated examining authority rules that the BD or SBSD fails to collect. The deduction would apply to both uncollected margin in respect of cleared and non-cleared SBS and swaps.

In response to comments, the SEC modified the Final Rules to make clear that the deduction need only be taken if the margin is not posted within the timeframe

<sup>&</sup>lt;sup>13</sup> In certain instances, informal SEC staff guidance has led firms to modify these calculations.

<sup>&</sup>lt;sup>14</sup> Comparable foreign authorities include a foreign financial authority that administers a foreign financial regulatory system with capital or margin requirements that the SEC has

found to be eligible for substituted compliance or any other foreign supervisory authority that the SEC finds has approved and monitored the use of the provisional model through a process comparable to the SEC's model approval process.

required by the relevant authority. As a result, if the BD or SBSD makes a margin call, it need only take a deduction if the margin is not delivered within the required timeframe.

The SEC clarified that the same approach to deductions for under-margined accounts applies regardless of whether the counterparty is an affiliate of the BD or nonbank SBSD.

## (4) Market Risk Deductions

Existing Rule 15c3-1and its appendices require BDs to take certain net capital deductions to account for the market risk of their proprietary positions. BDs generally calculate these deductions using standardized haircuts, except an ANC BD or OTCDD may calculate market risk deductions using approved models.

The Final Rules set out a framework for market risk deductions for a firm's proprietary SBS and swaps positions. Consistent with the SEC's existing framework, BDs and nonbank SBSDs will be permitted to calculate market risk deductions for proprietary SBS and swaps using either standardized haircuts or, if the BD or SBSD is approved to use models, market risk models. See Appendix A for the standardized haircuts applicable to SBS and swaps.

#### (5) Additional Capital-Related Requirements

In addition to the above, the Final Rules subject standalone SBSDs to many of the existing capitalrelated requirements currently applicable to BDs, including risk management requirements, limits on subordinated loans, and capital withdrawal limitations.

#### (6) Nonbank MSBSPs

Under the Final Rules, nonbank MSBSPs are required to maintain positive tangible net worth (*i.e.*, net worth exclusive of intangible assets or goodwill) and establish and maintain a risk management control system.

## **MARGIN**

In the 2012 Proposal, the SEC modeled its margin requirements for nonbank SBSDs on the margin rules applicable to BDs. These proposed requirements differed in a substantial number of respects from the WGMR framework that was ultimately adopted by other regulators, including the CFTC and Prudential Regulators.

In response to numerous comments expressing concern regarding competitive disparities between nonbank SBSDs and bank SBSDs and other market participants, as well as compliance issues that would arise if the SEC implemented its 2012 Proposal, the SEC modified its proposed margin rules to more closely align the Final Rules with the WGMR framework. However, as discussed below, some crucial differences between the regimes remain, including:

- No requirement for a nonbank SBSD to post IM;
- No requirement for a nonbank SBSD to collect IM from a financial market intermediary;
- A requirement for BD-SBSDs to use a standardized approach to calculate IM requirements for equity SBS instead of using risk-based models;
- No IM exception for counterparties with AANA below \$8 billion (although a counterparty is not required to execute IM-related documentation until two months after it exceeds the \$50 million IM threshold);
- No VM exception for sovereigns, and IM collection is required from sovereigns that present more than minimal credit risk; and
- No third-party IM segregation requirements.

We have included an appendix (Appendix B) that highlights key differences between the SEC's, the CFTC's, and the Prudential Regulators' margin rules.

## (1) Variation Margin

#### Daily VM Calculations

The Final Rules require a nonbank SBSD to calculate on a daily basis<sup>15</sup> the current exposure amount (*i.e.*, mark-to-market gains or losses) of its non-cleared SBS positions with each counterparty, regardless of whether the counterparty qualifies for a VM exception.<sup>16</sup>

## VM Requirements

Consistent with the WGMR framework, the Final Rules require nonbank SBSDs to both collect <u>and</u> post VM, unless an exception applies. The posting requirement represents a departure from the 2012 Proposal, which would have only required nonbank SBSDs to collect VM.

## VM Exceptions

Nonbank SBSDs are not required to post VM to, or collect VM from, the following counterparty types:

• <u>Commercial End Users</u>. 2015 amendments to the Exchange Act required that the SEC create an exception to its margin rules for non-cleared SBS with counterparties that are subject to an exception from clearing (*i.e.*, commercial end users).<sup>17</sup> In furtherance of this statutory exception, the Final Rules provide that an SBSD need not post or collect VM with a "commercial end user," which the Final Rules define as (1) an entity that qualifies from an exemption from the Exchange Act's mandatory clearing requirements because it is not a financial entity, <sup>18</sup> is using SBS to hedge or mitigate commercial risk, and notifies the SEC on how it generally meets its financial obligations associated with entering into non-cleared SBS or

(2) certain so-called "treasury affiliates" of such a non-financial entity.

Although broadly consistent with the CFTC's and Prudential Regulators' exclusion for nonfinancial end users, the "commercial end user" definition is narrower. Most critically, "commercial end users" do not include sovereign entities or supranational entities. In response to industry comments, the SEC excluded certain specified supranational entities from the VM and IM requirements and certain sovereigns from the IM requirements. However, a nonbank SBSD is required to post and collect VM from a sovereign and may be required to collect IM, too.

In addition, the SEC has not yet finalized its end-user clearing exception rules, perhaps because it also has not made any mandatory clearing determinations for SBS. But, in order for firms to rely on the commercial end user exception from margin rules, the SEC will either need to finalize its end-user clearing exception rules or provide guidance regarding how to apply the margin exception in the absence of those rules.

- <u>Certain Supranational Entities</u>. The Bank for International Settlements, the European Stability Mechanism, and certain multilateral development banks specified in the Final Rules.
- <u>Legacy Accounts</u>. Accounts which solely hold legacy non-cleared SBS (*i.e.*, SBS that were entered into prior to the compliance date).

<sup>17</sup> The Terrorism Risk Insurance Program Reauthorization Act of 2015, which Congress enacted after the SEC released the 2012 Proposal, amended Section 15F(e) of the Exchange Act to mandate a commercial end user exception from the margin rules.

<sup>&</sup>lt;sup>15</sup> During periods of extreme volatility and for accounts with concentrated positions, an SBSD would be required to increase the frequency of the calculations. However, an SBSD would not always be required to collect intraday margin during such periods (although it may need to do so for risk management purposes).

<sup>&</sup>lt;sup>16</sup> If a counterparty's SBS are subject to a netting agreement that the nonbank SBSD determines is enforceable, including in insolvency proceedings in each relevant jurisdiction, it may calculate the current exposure amount on a net basis.

<sup>&</sup>lt;sup>18</sup> "Financial entity" is defined in Section 3C(g)(3) of the Exchange Act and generally includes SBSDs, MSBSPs, SDs, MSPs, commodity pools, private funds, employee benefit plans, and persons predominantly engaged in activities that are in the business of banking or financial in nature.

The SEC declined commenters' requests to address the effect of amendments to transactions on their legacy status (*e.g.*, to replace LIBOR references).

## (2) Initial Margin

#### Daily IM Calculations

The Final Rules require a nonbank SBSD to calculate on a daily basis<sup>19</sup> the IM requirement applicable to each counterparty's SBS positions regardless of whether the counterparty qualifies for an IM exception.

Under the Final Rules, a nonbank SBSD may calculate IM requirements using either the standardized approach or an approved model.<sup>20</sup>

• Under the standardized approach, the IM requirement for an SBS equals the standardized market risk haircut applicable to the position under Rule 15c3-1 or 18a-1, whichever is applicable to the SBSD.

As industry participants noted in their comments, the standardized haircuts in the capital rules may be inadequate and inefficient for proper IM calculation and do not sufficiently recognize portfolio margining.

 Under the model-based approach, a nonbank SBSD may apply to the SEC to use an IM model, including an industry-standard model such as the ISDA "Standard Initial Margin Model" ("SIMM"),<sup>21</sup> to calculate IM requirements for non-cleared SBS, although a BD-SBSD may not use a model to calculate IM requirements for an equity SBS. The SEC expressed concern that allowing BD-SBSDs to use industry-standard models such as the SIMM to calculate IM for equity SBS could create disparities between the cash equities markets and the equity SBS market. The Final Rules, however, permit OTCDD-SBSDs and standalone SBSDs to calculate IM requirements for equity SBS using industry-standard models, as long as the counterparty's account does not contain "equity positions other than equity [SBS] and equity swaps." This raises a question as to whether OTC equity options that an OTCDD-SBSD enters into with a counterparty are "equity positions" for this purpose.

- Consistent with the WGMR framework, the IM model must use a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices and must use risk factors sufficient to cover all the material price risks inherent in the positions for which the IM amount is being calculated, including foreign exchange or interest rate risk, credit risk, equity risk, and commodity risk, as appropriate.
- As with the market and credit risk models, the SEC addressed concerns about competitive disparities that could arise if it is unable to review all model applications before the compliance date by allowing the SEC to issue temporary approval of models approved by other supervisors.

#### IM Requirements

In a departure from the WGMR framework, nonbank SBSDs are not required to post IM. This approach is, however, consistent with the BD margin framework, which does not require BDs to post collateral to counterparties.

<sup>&</sup>lt;sup>19</sup> As with VM, the Final Rules require SBSDs to increase the frequency of IM calculations during periods of extreme volatility and for accounts with concentrated positions (though it does not always require collection of intraday IM during such periods).

<sup>&</sup>lt;sup>20</sup> As with VM, if a counterparty's SBS are subject to an enforceable netting agreement, the SBSD may calculate the IM amount on a net basis.

<sup>&</sup>lt;sup>21</sup> See ISDA Publishes ISDA SIMM<sup>™</sup> 2.1, ISDA (Aug. 27, 2018), <u>https://www.isda.org/2018/08/27/isda-publishes-isda-simm-2-1/</u>.

Nonbank SBSDs are required to collect IM from each counterparty, unless one of the exceptions specified below applies.

## **Exceptions to the Collecting IM**

Nonbank SBSDs are not required to collect IM from commercial end users, legacy accounts, specified supranational entities, and the following other counterparty types:

- <u>Affiliates</u>. Unlike the CFTC's margin rules, the SEC does not define "affiliates." The Final Rules also differ from the CFTC's margin rules in that the Final Rules do not require affiliates to be subject to the same centralized risk management program as the nonbank SBSD in order to be exempt from IM requirements or impose anti-evasion requirements for transactions with foreign affiliates.
- <u>Eligible Sovereigns</u>. In order to fall within this exception, the nonbank SBSD must determine that the counterparty is a central government or agency, department, ministry, or central bank of a central government that poses only a minimal amount of credit risk pursuant to the policies and procedures or credit risk models established under the SEC's capital rules.
- *Financial Market Intermediaries.* The Final Rules define "financial market intermediaries" to include other SBSDs as well as SDs, FCMs, standalone BDs, banks, foreign banks, and foreign BDs.

The exception for financial market intermediaries represents a significant departure from the WGMR framework, which includes no analogous exception. However, it aligns with the existing BD margin requirements, which generally do not require BDs to collect margin from other BDs. In adopting the exception, the SEC pointed to the liquidity impact that IM requirements could have on financial market intermediaries and the fact that these entities would be subject to regulatory capital standards (including the SEC's capital rules), which would incentivize them to collateralize exposure to their SBS counterparties.

## IM Threshold

Nonbank SBSDs are not required to collect IM if the sum of the calculated amount of IM and all other credit exposures from non-cleared SBS and swaps between the nonbank SBSD and its affiliates and the counterparty and its affiliates is greater than \$50 million. These calculations do not, however, need to include non-cleared SBS with commercial end users and non-cleared swaps with counterparties that qualify for an exception from the CFTC's margin requirements under Section 4s(e)(4) of the Commodity Exchange Act.

The SEC largely aligned the IM threshold with the WGMR framework and the rules adopted by the CFTC and the Prudential Regulators.

Notably, however, the SEC did not adopt the \$8 billion "material swaps exposure" exception that exists under the CFTC's and Prudential Regulators' margin rules. This exception eliminates the need for SDs or bank SBSDs to collect and post IM with counterparties that engage in a *de minimis* amount of non-cleared derivatives. Unless one of the exceptions noted above applies, a nonbank SBSD would be required to collect IM from a counterparty, regardless of whether it had material swaps exposure.

After a counterparty no longer qualifies for the fixed-dollar \$50 million threshold, the nonbank SBSD can wait for up to two months to collect the requisite IM in order to provide parties time to execute agreements, establish processes for posting IM, and take other steps necessary to comply with the IM requirement.

Notably, the SEC did not address the implications of credit exposure dropping and remaining below \$50 million during the twomonth period (or thereafter).

#### (3) Segregation Requirements

Unlike the WGMR framework, the SEC's margin rules do not affirmatively require nonbank SBSDs to segregate posted or collected IM at a third-party custodian (though, as discussed below, the Final Rules do impose omnibus segregation requirements for such IM).

Under the Exchange Act, however, nonbank SBSDs are required to give counterparties the option to elect individual segregation of their IM. In the Final Rules, the SEC made clear that any such segregated IM would count as IM collected by the nonbank SBSD.

#### (4) <u>Transfer Timing and Minimum Transfer</u> <u>Amount</u>

*Timing*: Unless an exception applies, a nonbank SBSD must collect or post required margin by the end of the business day following the margin calculation. However, if the counterparty is located in a different country and is more than four time zones away, the Final Rules give the nonbank SBSD an extra business day to collect or post the required margin.

*Minimum Transfer Amount*: Under the Final Rules, nonbank SBSDs are not required to collect or post margin with a counterparty if the total margin amount (including VM and IM) would be \$500,000 or less.

*Consequences of a Failure to Collect or Post Required Margin:* In addition to the capital deduction for undermargined accounts noted above, the Final Rules require that a nonbank SBSD take prompt steps to liquidate positions in an account that does not meet margin requirements to the extent necessary to eliminate the margin deficiency.

Unlike the CFTC and the Prudential Regulators, the SEC did not expressly address the role of dispute resolution mechanisms as a means to cure margin deficiencies.

## (5) <u>Margin Eligibility Criteria and Valuation</u> <u>Requirements</u>

Under the Final Rules, eligible VM and IM includes cash, securities, money market instruments, major foreign currencies,<sup>22</sup> the settlement currency of the non-cleared SBS, and gold.

- However, in order to be eligible collateral, margin must: (1) have a "ready market,"<sup>23</sup>; (2) be readily transferable; (3) not be issued by the counterparty or a party "related to" the nonbank SBSD or the counterparty;<sup>24</sup> (4) be subject to an agreement between the nonbank SBSD and the counterparty that is legally enforceable by such SBSD against the other parties to the agreement; and (5) either be (a) subject to the physical possession or control of the nonbank SBSD and able to be liquidated promptly by the SBSD without intervention by any other party or (b) carried by an Eligible Custodian.
- Nonbank SBSDs must use standardized haircuts for calculating the value of the collateral collected or posted as margin. Such SBSDs can choose to either use the standardized haircuts used for purposes of the SEC's capital rules or those in the CFTC's margin rules, so long as they apply the same haircut method to all collateral with a particular counterparty.

#### (6) Margin Requirements for Nonbank MSBSPs

Rule 18a-3 requires a nonbank MSBSP to calculate, collect, and post VM largely in accordance with the VM requirements applicable to nonbank SBSDs. However, MSBSPs are not subject to any IM posting or collection requirements.

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." Securities without a "ready market" would have a 100% standardized haircut, and thus no collateral value under the Final Rules.

<sup>24</sup> The Final Rules do not define who constitutes a party "related to" a nonbank SBSD or its counterparty, although presumably the SEC has affiliates in mind.

<sup>&</sup>lt;sup>22</sup> Unlike the CFTC and the Prudential Regulators, the SEC does not define what constitutes a "major foreign currency."

<sup>&</sup>lt;sup>23</sup> Although the Final Rules require that any collateral have a "ready market," this requirement only seems relevant to securities collateral. The Final Rules define a "ready market" to include "a recognized established securities market in which there exist independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer

#### **SEGREGATION**

#### (1) **Background**

Section 3E(b) of the Exchange Act requires the segregation of cash, securities, and property that a BD or SBSD collects to margin a cleared SBS. Section 3E(c), however, allows the SEC to implement omnibus segregation requirements for such property.

Section 3E(f), in turn, requires SBSDs to alert counterparties of their right to elect individual segregation, but it does not affirmatively require such segregation or give the SEC any express rulemaking authority to prescribe omnibus or individual segregation requirements for non-cleared SBS collateral.

Against this statutory backdrop, the SEC proposed in 2012 to amend its existing BD omnibus segregation requirements to impose similar, but separately calculated, omnibus segregation requirements for a BD's cleared and non-cleared SBS activities. The SEC additionally proposed to require non-BD SBSDs, including bank and foreign SBSDs, to comply with omnibus segregation requirements for cleared and noncleared SBS. The SEC's proposed requirements would have applied to non-cleared SBS margin, unless the counterparty affirmatively elected individual segregation or waived its rights to segregation, and in each case, entered into an agreement with the SBSD subordinating the counterparty's claims to those of SBS customers.

#### (2) Omnibus Segregation Requirements

## **Cleared SBS**

Consistent with the 2012 Proposal, the Final Rules impose omnibus segregation requirements for the cash, securities, and property received by a BD or SBSD in connection with cleared SBS. These requirements are mandatory and thus cannot be waived.

#### Non-Cleared SBS

The Final Rules also subject margin received by a BD or SBSD in connection with non-cleared SBS to omnibus segregation requirements, unless the counterparty affirmatively elects individual segregation or waives its rights to segregation. In the context of a BD, only an affiliate may waive segregation. If the counterparty does elect individual segregation or waive its right to segregation, then the SD or SBSD must obtain a subordination agreement from the counterparty.

#### Possession or Control Requirements

Under the SEC's existing omnibus segregation requirements set forth in existing Rule 15c3-3, a BD that carries customer securities and cash (a "**carrying BD**") must promptly obtain and thereafter maintain physical possession or control<sup>25</sup> of all of a customer's fully paid and excess margin securities.

Consistent with existing Rule 15c3-3, the Final Rules require standalone BDs and SBSDs to promptly obtain and thereafter maintain physical possession and control of all "excess securities collateral" carried for the accounts of SBS customers.<sup>26</sup> Subject to certain exceptions noted below, the Final Rules define "excess securities collateral" to mean securities and money market instruments carried for the account of an SBS customer that have a market value in excess of the current exposure of the BD or SBSD to the SBS customer (after reducing the current exposure by the amount of cash in the account).

Securities and money market instruments are subject to haircuts when collected for margin purposes, but the excess securities collateral definition does not take these haircuts into account. As a result, BDs and SBSDs will be required to lock up the haircut portion of securities and money market instruments they collect as VM.

<sup>&</sup>lt;sup>25</sup> Under the pre-existing rules, physical possession or control means the carrying BD cannot lend or hypothecate securities and must hold them itself or, as is more common, at a satisfactory control location.

<sup>&</sup>lt;sup>26</sup> Unlike Rule 15c3-3, the Final Rules do not define the term SBS "customer" so as to include other intermediaries such as BD or SBSDs.

The excess securities collateral definition has exceptions for securities and money market instruments held in either:

(1) a qualified clearing agency account and being used to meet a margin requirement of a clearing agency resulting from the customer's cleared SBS; or

(2) a qualified registered SBS dealer account or thirdparty custodial account and being used to meet a regulatory margin requirement of another SBSD resulting from the BD or SBSD entering into a noncleared SBS with that other SBSD to offset the risk of a non-cleared SBS transaction between the BD or SBSD and its SBS customer.

Each of these qualifying accounts must be designated as being for the exclusive benefit of SBS customers of the BD or SBSD and satisfy certain documentation requirements preventing commingling or liens of specified types.

These exceptions from possession or control requirements are quite narrow. For example, the exception for cleared SBS does not address SBS cleared at non-U.S. clearing agencies not registered with the SEC or omnibus clearing arrangements with other BDs, SBSDs, or foreign clearing members. The exception for non-cleared SBS only overs fully matched, back-to-back hedging arrangements, which are not at all common in the SBS markets, and would not even cover those arrangements in circumstances where the hedging SBS was centrally cleared but the customer-facing SBS was not.

#### **Reserve Account Requirements**

Existing Rule 15c3-3 requires a carrying BD to maintain a reserve of cash or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers, including cash obtained from the use of customer securities.

The Final Rules establish reserve account requirements for standalone BDs and SBSDs that are largely modeled on these pre-existing requirements applicable to carrying BDs. In particular, the Final Rules' reserve account calculation for SBS includes specified credit items corresponding to cash that a BD or SBSD has received from SBS customer or generated through the use of SBS customers' securities (as well as certain operational "penalty" items) and specified debit items corresponding to credit that a BD or SBSD has extended to SBS customers. In addition, the SEC also included two new SBS-specific debit items that are parallel to the exceptions from the excess securities collateral definition noted above (and thus suffering the same issues). Unlike what would have been the case under the 2012 Proposal, the Final Rules permit a BD or SBSD to perform its SBS reserve account calculation on a weekly basis, although more frequent calculations are permitted as well.

## <u>Separate Calculations for BDs That Conduct SBS</u> <u>Business</u>

As noted above, although the new omnibus segregation requirements for SBS collateral are modeled on existing Rule 15c3-3 requirements for securities customer property, the cash, securities, and property posted by an SBS customer are subject to different possession and control and reserve account calculations than the other securities customer property held by a BD, and the reserve account for SBS customers must be held separately from the reserve account for other securities customers.

Despite industry comments to allow a BD to comply with a single possession and control calculation and a single reserve account calculation, the Final Rules require BDs to comply with separate possession and control and reserve account calculations for SBS, on the one hand, and other securities positions, on the other hand. The SEC argued that separate calculations are necessary given that the requirements applicable to SBS are specifically tailored for accounts holding SBS positions.

However, separate calculations will present challenges for portfolio margining of SBS with cash securities and listed options positions (*e.g.*, because of the need to allocate debit and credit items separately as between SBS versus other securities positions) and could create uncertainty regarding the applicability of the protections of the Securities Investor Protection Act of 1970 ("**SIPA**") to cleared SBS collateral. In addition, the SEC did not make amendments to existing Rule 15c3-3 definitions (*e.g.*, the definition of "customer") or the BD hypothecation rules (Rules 8c-1 or 15c2-1) to clarify whether or how they might apply to SBS customers, especially considering that the Exchange Act defines SBS as a type of "security."

#### (3) Exemption for SBSDs That Do Not Clear SBS

In response to comments that omnibus segregation requirements would in many instances fail to provide protection to customers due to the different insolvency regimes that apply to SBSDs that are not BDs, the SEC adopted an exemption from omnibus segregation requirements for an OTCDD, a standalone SBSD, or bank SBSD that:

- Does not (1) effect transactions in cleared SBS for or on behalf of another person; (2) have any open transactions in cleared SBS executed for or on behalf of another person; and (3) hold or control any money, securities, or other property to margin, guarantee, or secure a cleared SBS transaction executed for or on behalf of another person (including money, securities, or other property accruing to another person as a result of a cleared SBS transaction);<sup>27</sup>
- Provides written notice to a duly authorized individual of the counterparty regarding the right to segregate IM at an independent third-party custodian prior to the execution of the first non-cleared SBS transaction with the counterparty occurring after the compliance date of the Final Rules; and
- Discloses in writing before engaging in the first non-cleared SBS transaction with the counterparty that any collateral received by the SBSD for non-cleared SBS will not be subject to a segregation requirement and regarding how a claim of the counterparty for the collateral would be treated in a bankruptcy or other formal liquidation proceeding of the SBSD.

The below table summarizes the segregation requirements:

#### TABLE 2:

Type of Registrant	Cleared SBS Collateral	Non-cleared SBS Collateral
Standalone SBSD	Mandatory omnibus segregation	No segregation, as long as SBSD does not clear SBS for customers and provides requisite notice/disclosure Customer may elect third-party segregation
Bank SBSD	Mandatory omnibus segregation	No segregation, as long as SBSD does not clear SBS for customers and provides requisite notice/disclosure Customer may elect third-party segregation
OTCDD- SBSD	Mandatory omnibus segregation	No segregation, as long as SBSD does not clear SBS for customers and provides requisite notice/disclosure Customer may elect third-party segregation
OTCDD non-SBSD	N/A	No segregation, but must provide certain disclosures to counterparties, including that SIPA does not protect the customer

condition will not limit clearing activities at most non-U.S. SBS clearing agencies.

<sup>&</sup>lt;sup>27</sup> For these purposes, a "cleared SBS" is defined solely to include an SBS that is directly or indirectly submitted to and cleared by an SEC-registered clearing agency, and so this

Type of Registrant	Cleared SBS Collateral	Non-cleared SBS Collateral
BD-SBSD	Mandatory omnibus segregation	Omnibus segregation, which only affiliates can waive Customer may elect third-party segregation
Standalone BD	Mandatory omnibus segregation	Omnibus segregation, which only affiliates can waive Customer may elect third-party segregation

## (4) <u>Notice and Subordination Requirements for</u> <u>Non-Cleared SBS Counterparties</u>

As mentioned above, Section 3E(f) of the Exchange Act requires an SBSD to provide notice to counterparties of their right to elect individual segregation at a third party custodian. The Final Rules adopt a notice requirement in furtherance of this provision, pursuant to which an SBSD must notify a duly authorized individual of the counterparty in writing prior to the execution of the first non-cleared SBS transaction with that counterparty after the compliance date of the Final Rules about the right to segregate non-cleared SBS collateral at an independent third-party custodian. This requirement does not apply to standalone BDs.

The CFTC's segregation requirements similarly require a SD or MSP to notify a counterparty of its right to require any IM that the counterparty posts to be segregated at the beginning of the first swap transaction that provides for the exchange of IM. In addition, the relevant CFTC rules address the requirements for segregated IM, the investment of segregated IM, and the statutory requirement for an SD or MSP to report to a counterparty that does not elect segregation that the back office procedures of the SD or MSP relating to margin and collateral requirements are in compliance with the parties' agreement. The Final Rules do not address these requirements, even though the Exchange Act will impose them.

The Final Rules also require a BD-SBSD to obtain subordination agreements from any counterparty that elects individual segregation or waives segregation with respect to non-cleared SBS. The counterparty must agree to subordinate its claim with respect to any funds or property held at a third party custodian to the claims of SBS customers.

## (5) Segregation Requirements for MSBSPs

Omnibus segregation requirements do not apply to MSBSPs. However, if an MSBSP requires IM from a counterparty with respect to non-cleared SBS, the counterparty can request that the collateral be held at a third-party custodian. In furtherance of this, the above notice requirements applicable to SBSDs apply to MSBSPs.

## ALTERNATIVE COMPLIANCE MECHANISM

The Final Rules permit certain jointly registered SDs and SBSDs to comply with the capital, margin, and segregation requirements of the Commodity Exchange Act (the "**CEA**") and the CFTC's rules in lieu of complying with the SEC's capital, margin, and segregation requirements, provided that the following conditions and requirements are met:

- The firm must be registered with the SEC as a standalone SBSD (*i.e.*, it cannot be a BD or OTCDD) and registered with the CFTC as an SD;
- The firm must be exempt from the SEC's omnibus segregation requirements pursuant to the exemption for SBSDs that do not clear SBS;
- The AGNA of the firm's outstanding SBS positions, as of the most recently ended quarter of the firm's fiscal year, must not exceed the lesser of:
  - \$250 billion for the first three years following the Final Rules' compliance date, and then \$50 billion (subject to the SEC's ability to modify this threshold to something other than \$50 billion); and

- (2) 10% of the combined AGNA of the firm's open SBS and swap positions.
- The firm must comply with the CFTC's capital, margin, and segregation requirements applicable to SDs and treat SBS and related collateral pursuant to those requirements to the extent the requirements do not specifically address SBS and related collateral; and
- The firm must provide a written disclosure to its counterparties (after it begins operating pursuant to the alternative compliance mechanism but before the first transaction with the counterparty after it begins operating pursuant to the alternative compliance mechanism) that the firm is complying with the applicable capital, margin, and segregation requirements of the CEA and the CFTC's rules in lieu of the SEC's analogous rules.

A firm may elect to operate pursuant to this alternative compliance mechanism as part of the process of applying to register as an SBSD. If the firm chooses to do so, it must provide written notice to the SEC and CFTC during the registration process. A firm may also make the election after it has already registered as an SBSD. In this case, the firm must provide written notice to the SEC and the CFTC of its intent to operate pursuant to the alternative compliance mechanism and continue to comply with the SEC's rules for two months after the end of the month in which the firm provides the notice or for such shorter period of time that the SEC grants.

## **CROSS-BORDER APPLICATION**

## (1) Capital and Margin Requirements

Capital and margin requirements will be treated as entity-level requirements for both SBSDs and MSBSPs, meaning that these requirements will apply to a non-U.S. firm's transactions with non-U.S. persons in addition to its transactions with U.S. persons. However, SBSD and MSBSP capital and margin requirements are available for substituted compliance determinations.

• In making its substituted compliance determinations, the SEC will take a holistic approach, focusing on regulatory outcomes as a whole rather than on requirement-by-requirement similarity.

- Therefore, the local law does not necessarily need to impose a net liquid assets requirement; rather, the SEC will consider whether the local law ensures the safety and soundness of registrants "in a manner that is comparable" to the analogous SEC rules.<sup>28</sup>
- The SEC may also assess comparability in conjunction with other Exchange Act comparability analyses.

In the 2018 Proposal, the SEC asked for comments on whether the SEC should condition substituted compliance on whether foreign nonbank SBSDs maintain liquid assets in excess of unsubordinated liabilities. In the Final Rules, the SEC did not adopt this condition, but neither did it rule out imposing it in the future.

## (2) Segregation Requirements

In contrast to the capital and margin requirements, the SEC will treat segregation requirements as transaction-level requirements and will not be eligible for substituted compliance.

The applicability of these requirements to a foreign SBSD depends on whether the SBSD is a bank (*i.e.*, a foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, or credit union) or not.

#### Foreign Bank SBSD

A foreign bank SBSD only needs to comply with SEC segregation requirements with respect to a:

- U.S. person (regardless of which branch or agency the customer's transactions arises out of); and
- Non-U.S. person, if the foreign bank SBSD holds funds or other property arising out of a transaction had by such person with a U.S. branch or agency of the foreign SBSD.

<sup>&</sup>lt;sup>28</sup> See Final Rules at 281.

## Foreign Non-Bank SBSD

A foreign standalone SBSD only needs to comply with SEC segregation requirements respect to:

- If the SBSD clears at least one SBS for a U.S. person, all cleared SBS transactions; and
- Non-cleared SBS transactions entered into with U.S. persons.

The Final Rules do not squarely address whether a foreign non-bank SBSD that clears SBS exclusively for foreign customers and enters into non-cleared SBS with U.S. counterparties would be eligible for the Final Rules' exemption from segregation requirements.

Regardless of whether it is a bank or not, a foreign SBSD must disclose in writing to a U.S. SBS customer, prior to accepting any assets from the person with respect to an SBS, the potential treatment of assets segregated by the foreign SBSD in insolvency proceedings under U.S. bankruptcy law and applicable foreign insolvency laws.

## Foreign MSBSP

A foreign MSBSP will be subject to SEC segregation requirements with respect to U.S. counterparties.

## **COMPLIANCE DATE**

The compliance date for SBSD and MSBSP registration requirements and the Final Rules is 18 months after the later of: (1) the effective date of final rules establishing recordkeeping and reporting requirements for SBSDs and MSBSPs; and (2) the effective date of final rules addressing the cross-border application of certain SBS requirements.

The SEC will consider substituted compliance requests that are submitted prior to the compliance date for its capital and margin requirements.

Following the SEC's release of the Final Rules, the WGMR announced an extension by one year of the final implementation of the margin rules.<sup>29</sup> By virtue of this extension, counterparties with AANA of less than €0 billion for March, April, and May will not be brought in scope until September 1, 2021. As a result, it is possible that the compliance date of the SEC's margin rules will precede the final compliance date of the WGMR framework. The SEC has not indicated how it would address such a disparity.

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<sup>29</sup> Margin Requirements for Non-Centrally Cleared Derivatives, Basel Committee on Banking Supervision and International Organization of Securities Commissions (July 2019), <u>https://www.bis.org/bcbs/publ/d475.pdf</u>.

# APPENDIX A

# Capital Rules – Standardized Haircuts

Product Standardized Haircut			
Product			
Cleared SBS or swap (other than equity SBS or swaps)	The applicable clearing agency's or DCO's IM requirement		
Non-cleared credit default swap (" <b>CDS</b> ")	As set forth in two grids (one for SBS and one for swaps) and based on: (1) whether the firm is buying or selling protection; (2) the length of time to maturity of the CDS; and (3) the amount of the current offered basis point spread on the CDS, with certain reductions permitted if the firm has offsetting CDS or securities positions		
Non-cleared SBS other than CDS or equity SBS or swaps	The product of the notional amount of the SBS and the amount of the standardized haircut percent that applies to the underlier of the SBS, with certain reductions permitted in accordance with the rules recognizing deductions for offsetting long or short securities		
Non-cleared swap that is not a CDS, an interest rate swap, or an equity swap	The product of the notional amount of the swap and a certain percent, which is determined as follows: if Rule 15c3-1 prescribes a standardized haircut for the underlier of the swap, that deduction applies; if not, and CFTC Rule 1.17 prescribes a standardized haircut for the swap, such haircut applies, in each case with certain reductions permitted in accordance with the rules recognizing deductions for offsetting long or short positions in the reference asset or interest rate		
Non-cleared interest rate swap	The product of the notional amount of the swap and a certain percent, which is determined by referencing the standardized haircuts in the existing rules for U.S. government securities with comparable maturities to the swap's maturity. However, the percentage deduction must be no less than one eighth of one percent of the amount of a long position that is netted against a short position in the case of a non-cleared interest rate swap with a maturity of three months or more		
Equity SBS or equity swaps	If an SBS or swap, including a cleared SBS or swap, references an equity security or equity index, the firm may calculate market risk charges on a portfolio basis with other equity positions under Appendix A to Rule 15c3-1		

#### **APPENDIX B**

	SEC	CFTC	Prudential Regulators
General Margin Requirement	Post and collect VM but only collect IM	Post and collect both VM and IM	Post and collect both VM and IM
Models for IM Calculations	Can use industry-standard models to calculate IM, except BDs (other than OTCDDs) cannot use models for equity SBS	Can use industry-standard models to calculate IM, including for equity swaps	Can use industry-standard models to calculate IM, including for equity swaps
Timing Requirements	Exchange margin by the close of the end of the following business day, or two business days later if counterparty is located in a different country and is more than four time zones away	Exchange margin by the close of the end of the following business day. However, (1) if each party is in a different calendar day at the time the parties enter into the trade, the day of execution is the latter of the two dates; and (2) if the trade is entered into on a day that is not a business day in the location of a party, then the trade is deemed to have been entered into on the immediately succeeding business day that is a business day for both parties	Exchange margin by the close of the end of the following business day. However, (1) if each party is in a different calendar day at the time the parties enter into the trade, the day of execution is the latter of the two dates; and (2) if the trade is entered into on a day that is not a business day in the location of a party, then the trade is deemed to have been entered into on the immediately succeeding business day that is a business day for both parties
Third-Party IM Segregation	Optional	Required	Required
Exception for Commercial End Users	No VM or IM requirement	No VM or IM requirement	No VM or IM requirement
Exception for Sovereigns and Supranational Entities	<ul> <li>No VM or IM requirement for supranational entities</li> <li>VM posting and collection required for sovereigns</li> <li>No IM collection required for sovereigns that present minimal credit risk</li> </ul>	No VM or IM requirement	No VM or IM requirement

# Margin Rules – Key Differences Between the SEC's, CFTC's, and Prudential Regulators' Regimes

	SEC	CFTC	Prudential Regulators
Exception for Financial Market Intermediaries	VM posting and collection only	VM and IM posting and collection required	VM and IM posting and collection required
Exception for Affiliates	VM posting and collection only	<ul> <li>VM posting and collection required</li> <li>IM posting and collection not required, provided that certain conditions are met</li> </ul>	<ul> <li>VM posting and collection required</li> <li>IM collection required unless applicable threshold is not breached</li> </ul>
IM Threshold	<ul> <li>Collect IM only if greater than \$50 million in exposure across all affiliates and counterparty's affiliates, calculated across all SBS and swaps (but excluding those with certain end users)</li> <li>2-month compliance window once threshold breached</li> </ul>	• Collect IM only if greater than \$50 million in exposure across all affiliates and counterparty's affiliates, calculated across all swaps (but excluding those with certain end users)	• Collect IM only if greater than \$50 million in exposure across all affiliates and counterparty's affiliates, calculated across all SBS and swaps (but excluding those with certain end users)
Minimum Transfer Amount	VM and IM obligations combined must exceed \$500,000 to trigger collection of margin	VM and IM obligations combined must exceed \$500,000 to trigger collection of margin	VM and IM obligations combined must exceed \$500,000 to trigger collection of margin
Documentation	No documentation requirement	Must have documentation in place to comply with rules	Must have documentation in place to comply with rules