

MEMO# 26967

February 4, 2013

ICI Letter on SEC's Proposal on Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 16-13

DERIVATIVES MARKETS ADVISORY COMMITTEE No. 15-13

INVESTMENT ADVISER MEMBERS No. 13-13

SEC RULES MEMBERS No. 16-13 RE: ICI LETTER ON SEC'S PROPOSAL ON CAPITAL, MARGIN, AND SEGREGATION REQUIREMENTS FOR SECURITY-BASED SWAP DEALERS AND MAJOR SECURITY-BASED SWAP PARTICIPANTS

ICI has submitted a comment letter to the Securities and Exchange Commission ("SEC" or "Commission") with respect to the proposal on capital and margin requirements for security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs"), segregation requirements for SBSDs, and notification requirements with respect to segregation for SBSDs and MSBSPs. [\[1\]](#) The Dodd-Frank Act divided authority to prescribe capital and margin requirements among the SEC, the Commodity Futures Trading Commission ("CFTC"), and prudential regulators. The SEC's proposed requirements (except for segregation requirements) would only apply to SBSDs and MSBSPs that do not have a prudential regulator and are based largely on existing capital, margin, and segregation requirements for broker-dealers. [\[2\]](#) ICI's comment letter is attached and briefly summarized below.

I. Proposed Margin Requirement and Use of Thresholds

The Proposal would require SBSDs to collect collateral from their counterparties to non-cleared SB swaps to cover both current exposure and potential future exposure to the counterparty subject to certain exceptions. Under the proposed rule, MSBSPs would be required to collect and deliver collateral for current exposure but would not be required to bilaterally exchange collateral to cover potential future exposure. The letter argues that two-way margin requirements aid safety and soundness by helping a swap dealer and its counterparty offset their exposures and prevent them from building up exposures they cannot fulfill. The letter states that a two-way margining requirement is critical to the

protection of counterparties (such as registered funds) and to reduce a build-up of systemic risk at institutions that engage in a significant amount of swap transactions.

In a departure from the proposal of the prudential regulators and the CFTC, the SEC does not propose to permit the application of thresholds for initial margin (the amount under which an entity would have the option of not collecting initial margin) to different types of derivatives market participants. In the letter, we strongly recommend that the SEC permit an entity that satisfies certain criteria – limitations on the ability to leverage or being subject to other type of substantive financial regulation – to use an initial margin threshold. The letter states that the use of thresholds in appropriate circumstances may alleviate the potential liquidity impact of margin requirements for uncleared swaps.

II. Election of Independent Custodian

Uncleared Swaps

For non-cleared SB swaps, the proposed rule would apply, among others, a capital charge to an SBSB that does not hold the margin collateral because the counterparty is requiring the margin collateral to be segregated pursuant to section 3E(f) of the Exchange Act. According to the SEC, collateral held in this manner would not meet collateral requirements in the proposed rule because it would not be in the physical possession or control of the SBSB nor would it be capable of being liquidated promptly by the SBSB without the intervention of another party.

The letter requests that the Commission eliminate the capital charge requirement for SBSBs in situations in which the counterparty elects an independent custodian. Because SBSBs would be required to take a capital charge for collateral held by an independent custodian, the SBSBs would likely pass along those costs of holding extra capital on to their counterparties. The letter discusses the protections provided by an independent custodian (e.g., keeping collateral SBSB bankruptcy-remote and the custodian assuming certain responsibilities with respect to safeguarding the interests of both counterparties). Given the important protections that an independent custodian can provide, the letter expresses concern that the SEC's proposal to impose capital charges on SBSBs with respect to the collateral when a counterparty elects an independent custodian could increase costs and disadvantage such counterparties electing these protections.

Moreover, the letter states that the SEC's concern that the SBSBs may not be able to liquidate promptly collateral held by an independent custodian could be adequately addressed by requiring that the custodial arrangements contain certain provisions that are currently included in the tri-party arrangements for swaps and SB swaps to ensure prompt access to the collateral. Such terms could permit the SBSBs to provide the custodian with notice of their right to exercise exclusive control in certain circumstances, and the SBSBs can have immediate access to the collateral.

Cleared Swaps

In addition, the letter requests that the Commission permit a counterparty to request collateral for a cleared SB swap to be held by a third-party custodian. For similar reasons as a counterparty would request an additional level of protection for the collateral for uncleared SB swaps, a counterparty should be permitted to request this protection for collateral posted for cleared SB swaps.

III. Collateral and Excess Collateral

Excess Securities Collateral

SBSDs would be required to perform two calculations as of the close of each business day with respect to each account carried by the firm for a counterparty. On the next business day following the calculations, the SBSD would be required to collect cash, securities, and/or money market instruments from the counterparty in an amount at least equal to the negative equity (current exposure) in the account plus the margin amount (potential future exposure). The proposed rule would require the SBSD to take prompt steps to liquidate securities and money market instruments in the account to the extent necessary to eliminate an account equity deficiency. The Proposal is currently silent with respect to situations in which there is a positive equity in the account (in addition to the margin amount). The letter seeks confirmation that customers of SBSDs are permitted to withdraw the positive equity in their accounts. The letter states that customers may prefer not to have more of their funds accumulate at the SBSD than necessary to meet the required margin requirements.

Eligible Collateral

Under the Proposal, an SBSD may only collect cash, securities, and/or money market instruments, and other types of assets are not eligible as collateral. The Proposal also would impose a haircut on collateral equal to the amounts of the deductions required under SEC Rule 15c3-1 and proposed Rule 18a-1 in setting the collateral value for purposes of the minimum collateral requirement. The letter supports the SEC's approach in providing a broader range of assets that would be eligible as collateral than the analogous CFTC provision, which would only permit cash and government securities.;

IV. SB Swap Customer Reserve Account

The SEC proposes an alternative omnibus or "commingled" segregation approach for uncleared SB swaps under which an SBSD would be required to segregate securities and funds relating to uncleared SB swaps. Unless a counterparty either elects individual segregation or waives segregation, the counterparty would be an SB swap customer and entitled to share ratably with other SB swap customers in the fund of customer property held by the SBSD if it is liquidated. [3] The letter supports this general approach, which would provide a counterparty of an SBSD to an uncleared swap to be treated as a "customer" and be afforded certain additional protections.

Under the proposed omnibus segregation requirements, an SBSD also would be required to maintain a special account for the exclusive benefit of SB swap customers (separate from any other bank account of the SBSD). Such an account would be required to meet certain conditions to ensure that cash and qualified securities deposited are isolated from the proprietary assets of the SBSD and identified as property of the SB swap customers.

Under the proposal, an SBSD would be prohibited from using credits except for specified purposes, including using credits for debits of customers. The Proposal, however, does not segregate the amount owed to each customer, and the amount of funds in the account that an SBSD may use to finance other customers' debits under the reserve formula is not limited to the amount held for that particular customer. The letter expresses concern that in the event of an SBSD's bankruptcy and shortfall of funds, there may not be sufficient funds available for other customers and non-defaulting customers would be subject to fellow customer risk. The letter strongly urges the Commission to revise the segregation requirements to prohibit the use of one customer's funds to margin or secure another

customer's positions.

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[Attachment](#)

endnotes

[1] Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, (Oct. 18, 2012) (“Proposal”), available at <http://www.sec.gov/rules/proposed/2012/34-68071.pdf>. The Commission also proposed to increase the minimum net capital requirements for broker-dealers permitted to use the alternative internal model-based method for computing net capital.

[2] Proposed new Rule 18a-4 under the Securities Exchange Act of 1934 (“Exchange Act”), which would establish segregation requirements with respect to cleared and non-cleared security-based (“SB”) swaps, would apply to all types of SBSDs (including those for which there is a prudential regulator).

[3] If a counterparty of an SBSD waives segregation, the counterparty agrees that cash, securities, and money market instruments delivered to the SBSD can be used by the SBSD for proprietary purposes and forgoes the protections of segregation.