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October 25, 2012

SEC Proposes 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 COMMITTEE No. 39-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 58-12
SEC RULES COMMITTEE No. 67-12

RE:

SEC PROPOSES CAPITAL, MARGIN, AND SEGREGATION REQUIREMENTS FOR SECURITY-BASED SWAP DEALERS AND MAJOR SECURITY-BASED SWAP PARTICIPANTS

Recently, the Securities and Exchange Commission ("SEC" or "Commission") proposed 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 to implement sections 763 and 764 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). [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. [2] 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. [3]

Comments on the proposal are due 60 days after publication in the Federal Register. We will hold a conference call on Thursday, November 15 at 2:00 pm ET to discuss the proposal and possible ICI comments. The dial-in number for the call is 888-972-9926 and the passcode is 66642. If you plan to participate, please RSVP to Ruth Tadesse via email (rtadesse@ici.org).

This memorandum describes certain aspects of the proposal that may be of particular interest to funds.

Capital Requirements

SBSDs

Under the SEC's proposal, the capital standard for SBSDs would be a net liquid asset test modeled on the broker-dealer capital standard in Rule 15c3-1 under the Exchange Act. The proposed rule would require that SBSDs perform two calculations: (1) a computation of the minimum amount of net capital the SBSD must maintain; and (2) a computation of the amount of net capital the SBSD is maintaining. [4] Generally, a stand-alone SBSD (not a broker-dealer SBSD) that has not been approved to use internal models would be required to maintain minimum net capital of not less than the greater of $20 million or 8% of the firm's risk margin amount. [5] For broker-dealer SBSDs (not approved to use internal models), the minimum net capital level must be the greater of $20 million or 8% of the firm's risk margin amount plus the financial amount required in Rule 15c3-1. [6]

In computing net capital, an SBSD would be required, among other things, to make certain adjustments to net worth such as deducting illiquid assets and taking other capital charges, including credit risk charges. In addition, an SBSD would be required to take prescribed percentage deductions ("standardized haircuts") or deductions under internal VaR models from the mark-to market value of proprietary positions. The standardized haircuts prescribe different deduction amounts for a variety of classes of securities. The SEC proposes to establish standardized haircuts for SB swaps: one for SB swaps that are credit default swaps and another for other SB swaps.

The SEC also proposes to require an SBSD to take capital charges in certain circumstances with respect to collateral of its SB swap customers and SB swap counterparties. For non-cleared SB swaps, the proposed rule would apply, among others, a capital charge to an SBSD 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. Section 3E(f) provides that a counterparty may request its collateral to be carried by an independent third-party custodian and be designated as a segregated account for and on behalf of the counterparty. 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 SBSD nor would it be capable of being liquidated promptly by the SBSD without the intervention of another party. As a result, the SEC is proposing to require that an SBSD take a capital charge equal to the margin amount less any positive equity in the account of the counterparty.

In addition, SBSDs would be required to establish a risk management control system. The Commission also proposes to include provisions setting limits on the amount of an SBSD's outstanding subordinated loans, imposing requirements on capital withdrawals, requiring subsidiary consolidation under certain circumstances, and imposing requirements for subordination of loan agreements.

MSBSPs

The SEC proposes to require MSBSPs to maintain positive "tangible net worth." The SEC proposes this standard rather than the net liquid asset test because MSBSPs may engage in a diverse range of business activities different from, and broader than, the securities activities conducted by broker-dealers or SBSDs. The tangible net worth of an MSBSP would be determined in accordance with generally accepted accounting principles in the United States, excluding goodwill and other intangible assets. All long and short positions in SB swaps, swaps and related positions would need to be marked to their market value. MSBSPs would be allowed to include property, plant, equipment, and unsecured receivables.

Under the proposal, MSBSPs would be required to comply with the internal risk management control systems requirements under Rule 15c3-4 under the Exchange Act with respect to their SB swap and swap activities.& Rule 15c3-4 generally requires the establishment, documentation, and maintenance of a system of internal risk management controls to assist in managing risks, including market, credit, leverage, liquidity, legal and operational risks.

Margin Requirements

The Commission is proposing to establish margin requirements for SBSDs and MSBSPs with respect to non-cleared SB swaps. The proposed rule would be based on the margin rules applicable to broker-dealers and is intended to promote consistency with existing rules and to facilitate the portfolio margining of SB swaps with other types of securities. The proposed rules establish minimum margin requirements for non-cleared SB swaps, and SBSDs and MSBSPs could establish higher margin requirements as well as place limitations on the types of instruments they will accept as collateral.

SBSDs

The proposed rule 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. Instead of using the terms “initial” margin and “variation” margin, the Commission’s proposal discusses the “equity” and “margin” amounts to refer to current exposure and potential future exposure, respectively.

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. [7] The first calculation would be the amount of “equity” in the account, which would mean the total current fair market value of securities positions in an account of a counterparty plus any credit balance and less any debit balance in the account after applying a qualifying netting agreement with respect to gross derivatives payables and receivables. The negative equity in an account would be equal to the SBSD’s current exposure to the counterparty. The second calculation would be to determine a “margin” amount for the account to address potential future exposure. The proposed rule would prescribe a standardized method and an internal model-based method for calculating the margin amount. [8]

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 proposed rule, however, would not require that the liquidations be completed within a specific timeframe.

The Commission would place limitations on the collateral that could be collected by SBSDs. An SBSD may only collect cash, securities, and/or money market instruments, and other types of assets are not eligible as collateral. The fair market value of securities and money market instruments held in the account of a counterparty would need to be reduced by the amount of the deductions the SBSD would apply to the positions with the amount of deductions increasing for securities and money market instruments with greater market risk.

The Commission also is proposing certain additional requirements for eligible collateral (modeled on the existing collateral requirements in Appendix E to Rule 15c3-1 under the Exchange Act). These proposed requirements include, among others, that the collateral must: (1) be subject to the physical possession or control of the SBSD; (2) be liquid and transferable; (3) be capable of being liquidated promptly by the SBSD without intervention by any other party; and (4) not consist of securities issued by the counterparty and any other parties to the agreement. The collateral agreement between the SBSD and the counterparty must be legally enforceable by the SBSD against the counterparty and any other parties to the agreement.

With respect to margin requirements for transactions between SBSD counterparties, the Commission proposes two alternatives. Under the first alternative, an SBSD would not need to collect margin amounts (and only would need to collect the negative equity in the account) of a counterparty that is another SBSD. Under the second alternative, an SBSD would be required to collect to collateralize both the negative equity and the margin amounts in the account of a counterparty that is another SBSD. In the discussion about these two alternatives, the SEC notes the comments submitted on the proposals of prudential regulators and the CFTC (including ICI's comments) that supported bilateral margining and argued that it should be extended to require SBSDs and SDs to exchange margin collateral with all counterparties. In addition, the SEC requests comments on whether the rule should have a two-tiered approach with respect to the account equity requirement for financial end users based on whether they are low risk or high risk similar to the proposed approach of the prudential regulators and the CFTC. [9]

MSBSPs

The proposed rule would require an MSBSP to collect collateral from counterparties to which the MSBSP has current exposure and deliver collateral to counterparties that have current exposure to the MSBSP subject to certain exceptions. MSBSPs would be required to collect and deliver collateral for current exposure but the proposed rule would not require bilateral exchange of collateral to cover potential future exposure.

An MSBSP would be required to calculate as of the close of business each day the amount of equity in each account of a counterparty and to calculate equity more frequently during periods of extreme volatility and for accounts with concentrated positions.; On the next business day following the calculation, the MSBSP would be required to either collect or deliver cash, securities, and/or money market instruments to the counterparty depending on whether there was negative or positive equity in the account of the counterparty. MSBSPs also would not be required to calculate a margin amount.

Unlike SBSDs, MSBSPs would not be required to reduce the fair market value of securities and money market instruments held in the account of a counterparty (or delivered to a counterparty) for purposes of determining whether the level of equity in the account meets the minimum requirement. MSBSPs also would be subject to certain additional collateral requirements discussed above for SBSDs (modeled on the existing collateral requirements in Appendix E to Rule 15c3-1 under the Exchange Act). MSBSPs also would be required to take prompt steps to liquidate securities and money market instruments in the account to the extent necessary to eliminate an account equity deficiency but the proposed rule would not mandate a specific timeframe for completion of the liquidation.

Risk Monitoring and Procedures

An SBSD would be required to monitor the risk of each account of a counterparty to a non-cleared SB swap and establish, maintain, and document procedures and guidelines for monitoring the risk of such accounts. The SBSD also would be required to review at reasonable periodic intervals its non-cleared SB swap activities for consistency with the risk monitoring procedures and guidelines. The proposed rule provides certain minimum requirements for the risk monitoring procedures and guidelines.

Segregation

The Commission proposes to establish segregation requirements for SBSDs with respect to cleared and non-cleared SB swaps. Segregation requirements are designed to distinguish customer property from the proprietary assets of an SBSD to protect customer property under the U.S. Bankruptcy Code and to prevent an SBSD from using customer property to make proprietary investments. The proposed rule would prescribe detailed requirements for how cash, securities, and money market instruments of a customer with cleared SB swaps must be segregated when an SBSD commingles those assets with the cash and securities of other customers.

For uncleared SB swaps, the SEC proposes to establish an alternative omnibus or “commingled” segregation approach, which would be the default under which an SBSD would be required to segregate securities and funds relating to non-cleared SB swaps in the absence of a counterparty electing individual segregation or affirmatively waiving segregation. The omnibus segregation requirement would not apply to MSBSPs: if an MSBSP holds collateral from a counterparty with respect to non-cleared SB swaps, it would not be required to segregate the collateral unless the counterparty required individual segregation under section 3E(f).

Possession and Control of Excess Securities Collateral

The proposed omnibus segregation requirements would require an SBSD to obtain promptly and thereafter maintain physical possession or control of all excess securities collateral and would specify five locations where excess securities collateral could be held. The proposed rule would define “excess securities collateral” as securities and money market instruments carried for the account of an SB swap customer that have a market value in excess of the current exposure of the SBSD to the customer excluding securities and money market instruments (1) held in a qualified clearing agency account to meet a margin requirement resulting from a SB swap transaction of the customer and (2) held in a qualified registered SBSD account to meet margin requirement of the other SBSD resulting from a hedging transaction to mitigate the risk of a non-cleared SB swap transaction with the customer. The exceptions are subject to certain enumerated conditions.

The Commission also would require that each business day an SBSD must determine from its books and records the quantity of excess securities collateral that the firm had in possession and control as of the close of the previous business day and the quantity of excess securities collateral the firm did not have in possession or control on that day.

SB Swap Customer Reserve Account

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). A “special account for the exclusive benefit of SB swap customers” would be defined as an account at a bank that is not the SBSD or an affiliate of the SBSD that meets 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. The SEC would require the SBSD to maintain cash and/or qualified securities in amounts computed in accordance with the formula in Exhibit A to proposed Rule 18a-4. The formula would require SBSDs to add up various credit items and debit items, and an SBSD would need to maintain an amount by which the total credits exceed the total debits after applying certain deductions specified in the proposed rule. The proposed rule would require the computations to be made daily as of the close of the previous business day and any deposits required must be made on the next business day following the computation no later than one hour after the opening of the bank that maintains the account.

The Commission proposes that “qualified securities” for purposes of the special account would be defined as: (1) obligations of the United States; (2) obligations fully guaranteed as to principal and interest by the United States; and (3) general obligations of any state or subdivision of a state that are not traded flat or are not in default, were part of an initial offering of $500 million or greater, and were issued by an issuer that has published audited financial statements within 120 days of its most recent fiscal year-end.

Special Provisions for Non-Cleared SB Swap Counterparties

The proposed rule would require an SBSD to obtain subordination agreements from counterparties that opt out of the omnibus segregation requirements because they either elect individual segregation pursuant to section 3E(f) of the Exchange Act or agree that the SBSD need not segregate their assets at all. The SEC would require that an SBSD or MSBSP provide notice regarding the opportunity to elect individual segregation in writing to a counterparty prior to the execution of the first non-cleared SB swap transaction with the counterparty occurring after the effective date of the rule.

An SBSD would need to obtain a conditional subordination agreement from a counterparty that elects individual segregation. If individual segregation is not effective in keeping the counterparty’s assets bankruptcy remote, then the counterparty should be treated as an SB swap customer with a pro rata priority claim to customer property.

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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) (“Proposing Release”), 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] The prudential regulators have proposed capital and margin requirements for bank swap dealers (“SDs”), bank SBSDs, bank major swap participants (“MSPs”), and bank MSBSPs. See Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564 (May 11, 2011). The CFTC also has proposed capital and margin requirements for non-bank SDs and nonbank MSPs. See Capital Requirements of Swap Dealers and Major Swap Participants, 76 FR 27802 (May 12, 2011); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011). The CFTC also has adopted segregation requirements for cleared swaps and proposed segregation requirements for non-cleared swaps. See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provision, 77 FR 6336 (Feb. 7, 2012); Protection of Collateral of Counterparties to Non-Cleared Swaps; Treatment of Securities in a Portfolio Margining Account in Commodity Broker Bankruptcy, 75 FR 75432 (Dec. 3, 2010).

[3] 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).

[4] The SEC proposes to impose different minimum net capital requirements based on the type of SBSD: (1) stand-alone SBSDs that are not approved to use internal models; (2) broker-dealer SBSDs that not approved to use internal models; (3) stand-alone SBSDs that are approved to use internal models; and (4) broker-dealer SBSDs that are approved to use internal models.

[5] A stand-alone SBSD that has been approved to use internal models would be required to maintain a minimum tentative net capital level of not less than $100 million and a minimum net capital level of not less than the greater of $20 million or 8% of the firm’s risk margin amount. The term “risk margin amount” would be defined as the sum of: (1) the greater of the total margin required to be delivered by the SBSD with respect to SB swap transactions cleared for SB swap customers at a clearing agency or the amount of the deductions that would apply to the cleared SB swap positions of the SB swap customers and (2) the total margin amount calculated by the stand-alone SBSD with respect to non-cleared SB swaps.

[6] A broker-dealer SBSD that seeks to compute net capital using internal models would need to apply to the Commission for approval to operate as an “ANC broker-dealer.” An ANC broker-dealer is a broker-dealer that has been approved by the SEC to use internal value-at-risk (“VaR”) models to determine market risk charges for proprietary securities and derivatives positions and to take a credit risk charge in lieu of a 100% charge for unsecured receivables related to OTC derivatives transactions. A broker-dealer SBSD that is approved to use internal models would be required to maintain tentative net capital of not less than $5 billion and (2) net capital of not less than the greater of $1 billion or the financial ratio amount required in Rule 15c3-1 plus 8% of the firm’s risk margin amount.

[7] An SBSD would be required to increase the frequency of the calculations during periods of extreme volatility and for accounts with concentrated positions.

[8] The proposed rule would define the standardized methodology for determining margin amounts for each class of SB swap.

[9] Proposals by the prudential regulators and the CFTC would permit application of thresholds to certain financial end users under which the financial end users would not be

required to post initial margin. Under the proposals, to qualify, these entities would, among other things, have to be subject to capital requirements. See supra note 2.