Public Statement

Statement on the Adoption of Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants

Commissioner Hester M. Peirce

June 21, 2019

The Commission has adopted final rules governing the capital, margin, and segregation requirements applicable to security-based swap dealers (SBSDs) and major security-based swap participants under Title VII of the Dodd-Frank Act.[1] Completion of this rulemaking represents a significant milestone in the Commission's implementation of its regulatory framework for security-based swaps. I am grateful for Chairman Clayton's leadership in moving forward on these rulemakings in a way that is both expeditious and prudent. He has facilitated dialogue both within the Commission and with our colleagues at the CFTC that has been frank and productive, and the results of that dialogue are, I think, clear in these final rules.

I would also like to express my gratitude to our staff, particularly Richard Gabbert in my office, Alan Cohen and Jeff Dinwoodie in Chairman Clayton's office, and the staff in the Division of Trading and Markets and in the Division of Economic and Risk Analysis. I am particularly grateful for the many hours that Mike Macchiaroli, Tom McGowan, and Randall Roy spent working with my office and answering my many questions over the past several months. Throughout the course of our work on this release, I have been extremely impressed by their willingness to wrestle with difficult issues with persistence, patience, and passion for the well-being of our investors and markets. The final rules represent an enormous effort by the staff working tirelessly over the past eight months to develop a recommendation that addresses important policy goals entrusted to the Commission by Congress while also mitigating or eliminating many of the differences between our proposed approach and the approach reflected in the CFTC's rules, a particularly important objective given that the same market participants play significant roles in both the security-based swap and swap markets.

Finally, I appreciate the thoughtful engagement by CFTC Chairman Chris Giancarlo, Commissioner Brian Quintenz, his staff, and the CFTC staff, who helped us think carefully about the effects of our rules on what is, in many ways, a single market where many of the key players will be registered with both Commissions. In my time at the Commission, whether as a member of the staff or as a Commissioner, I have never seen the level of engagement between our two agencies that I have seen on this rulemaking over the past several months. I hope that the Commissions are able to build on this experience to tackle other areas of common concern with a similarly strong commitment to dialogue and cooperation.

Capital, margin, and segregation requirements established by Title VII are intended to ensure the financial integrity of the dealers at the center of this critically important market. Done right, these requirements should reduce the likelihood of failure and, in the event of failure, protect dealers' counterparties, other market

participants, and the financial markets. These requirements set the ground rules within which a complex, global market can operate safely and effectively.

Many of these dealers currently are not registered with the Commission, are not subject to direct capital regulation, and do not have to comply with margin and segregation rules for security-based swaps. Transitioning existing businesses to a completely new set of rules is always fraught with risks, both anticipated and unanticipated. Those risks are heightened here. Many of these firms are also engaged in *swap* dealing activities and therefore are already registered with the CFTC as swap dealers and subject to the CFTC's rules. Many of these dealers have global operations and may be subject, currently or in the future, to significant regulation in more than one foreign jurisdiction. Dealers will routinely transact with dealers or other counterparties that are subject to the rules of other domestic or foreign authorities.

The final rules take into account these navigational challenges. These rules have been calibrated to advance the statutory objectives with rigorous capital, margin, and customer protection requirements, while also reducing the differences between our requirements and the CFTC's proposed and final rules, differences that might have disrupted existing trading relationships and business models in this complex market. To take one example, the rules impose a rigorous regulatory capital regime on nonbank SBSDs that is based on the Commission's net liquid assets test. At the same time, the capital framework distinguishes between SBSDs that are also registered as full-service broker dealers—and thus serve large numbers of retail customers—and those that are not (stand-alone SBSDs). The rules are tailored to require model-approved broker-dealers that have a significant presence in our retail markets to have significantly higher capital requirements than stand-alone SBSDs. In addition, the latter group of dealers, if they satisfy certain conditions, may comply with the corresponding CFTC requirements in lieu of the Commission's capital, margin, and segregation requirements.

The Commission's final rules are designed to mitigate, in a number of ways, potential operational challenges for SBSDs (including those that are also registered as swap dealers with the CFTC) and for their counterparties:

- ***Alternative compliance mechanism for firms predominantly engaged in swap dealing***: As already noted, the final rules permit a stand-alone SBSD[2] also registered as a swap dealer to comply with the CFTC's capital, margin, and segregation rules if the firm's business is predominantly swap dealing[3] and the firm meets certain other requirements (*e.g.*, it does not clear transactions for customers).
- ***Calibration of the margin factor***: The final rules impose a minimum net capital requirement on SBSDs that is the higher of a fixed-dollar amount and a ratio-based amount. The ratio-based amount for a broker-dealer SBSD is the sum of the existing ratio-based amount required by Rule 15c3-1 plus 2% of the firm's exposure to its security-based swap customers. The ratio-based amount for a stand-alone SBSD is just 2% of the firm's exposure to its security-based swap customers. For cleared security-based swaps, this exposure is determined by the margin required by the clearing agency, and, for non-cleared security-based swaps, by the initial margin amount for the position. The Commission may, by order, increase this margin factor percentage to no more than 8% over a five-year period.
- ***Expanded ability to apply the credit risk charges to uncollected margin***: The final rules expand an SBSD's ability to use credit risk charges for uncollected variation margin in two ways. First, for a stand-alone SBSD (including an OTC derivatives dealer also registered as an SBSD), the rules eliminate the proposed portfolio concentration charge for these exposures (broker-dealer SBSDs will be subject to a 10% cap, which is a reduction from the current 50% cap). Second, SBSDs may apply the credit risk charges to variation margin that is uncollected under any exception under either Commission's rules, not just under the exception for commercial end users as was proposed. Similarly, the final rules permit SBSDs to apply a credit risk charge to the full amount of initial margin that is uncollected under any exception under either Commission's rules.
- ***Calculation of uncollected margin for swaps using CFTC margin requirements***: The final rule provides that capital charges for uncollected margin on swap transactions are based on the amount that is uncollected under the CFTC margin requirements.
- ***Elimination of certain capital deductions for cleared positions***: The final rules do not include a capital deduction that would have been applied when the clearing agency or derivatives clearing organization (DCO) margin is less than the haircuts that would apply to the customer's positions under

the Commission's capital requirements. Similarly, under the final rules, the standardized charge for cleared proprietary positions of the SBSD is the amount of margin required by the clearing agency or DCO, rather than the proposed standardized charges under the Commission's capital requirements.

- ***Recognition of initial margin held at a third-party custodian***: The final rules provide an exception from taking a capital charge when a counterparty elects to have its initial margin held at a third-party custodian if it is held pursuant to a tri-party agreement that provides the SBSD with the right to access the collateral upon the default of the counterparty, which is intended in part to eliminate the need to repaper existing custodial arrangements that meet CFTC or other regulatory requirements.
- ***Reduction of the 1% minimum standardized haircut for interest rate swaps***: Under the final rules, the minimum standardized haircut for non-cleared interest rate swaps is 1/8 of 1% instead of 1% as proposed; the minimum standardized haircut for cleared interest rate swaps has been eliminated.
- ***Provisional approval of capital and margin models approved by other regulators***: The final rules provide that, subject to certain conditions and Commission approval, an SBSD with capital and/or margin models approved by certain other authorities may use such models provisionally if the Commission needs more time to approve its models.
- ***Requirement that SBSDs post variation margin to most counterparties***: Although the final rules do not require (but do permit) SBSDs to post initial margin to counterparties, they do require SBSDs to post variation margin.
- ***Ability to use industry models for margin***: Rather than limiting SBSDs to using models approved for calculating capital charges in calculating initial margin amounts, the final rules permit SBSDs to use industry standard models.
- ***Expansion of eligible margin collateral***: The final rules define eligible collateral to include cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold.
- ***Ability to use CFTC standardized haircuts for margin collateral***: The final rules permit an SBSD to apply the standardized haircuts in the CFTC's margin rule to take required deductions to the value of margin collateral.
- ***Expansion of margin exceptions***: Consistent with the CFTC's rules, the final rules include an exception from collecting initial margin from affiliates and from the BIS, the European Stability Mechanism, and certain multilateral development banks, in addition to the proposed exceptions for commercial end users and legacy transactions. The rules also include an exception from collecting initial margin (but not variation margin) from sovereign entities with minimal credit risk.
- ***Addition of a threshold for the collection of initial margin***: The final rules include a $50 million initial margin threshold.[4] The rules also would permit a nonbank SBSD to defer collecting initial margin from a counterparty for two months after the month in which the counterparty does not qualify for the $50 million threshold exception for the first time. The rule, however, does not have a material swaps exposure exception.
- ***Increase in the minimum transfer amount***: To be consistent with the CFTC and prudential regulators, the final rules set the minimum transfer amount at $500,000, rather than $100,000 as proposed.
- ***Additional time to collect margin for cross-border transactions***: The final rules, in contrast to the proposal to collect margin at noon on the following business day, provide that SBSDs will have until the end of the next business day to collect margin and an additional day if the counterparty is located in a different country and more than four time zones away from the SBSD.

Notwithstanding these significant changes, our rules do continue to differ from the CFTC's rules in some important ways. For example, they do not require SBSDs to post initial margin, and an SBSD will be required to take a capital deduction for initial margin that it posts away, unless it has certain financing arrangements in place. They also require SBSDs to take capital deductions for various swap exposures. However, I believe that, taken together, the changes in the final rules described above will help facilitate this market's transition to a new regulatory framework while avoiding unnecessary disruptions to current trading relationships and continuing to permit firms to engage in security-based swap and swap business out of a single entity.

Much work remains to be done. Over the coming months, I hope to see the Commission move forward with the two remaining releases that we need to complete before the clock starts ticking on our compliance timetable. I speak, of course, of the recordkeeping and reporting requirements for SBSDs and the various cross-border amendments and guidance that we proposed last month.

I recognize that, as we work on finalizing these rules and head toward the Registration Compliance Date, the market will continue to evolve in response to both regulatory and non-regulatory developments, including the possible adoption of capital rules by the CFTC. In the adopting release for these rules, the Commission has committed itself to monitoring these developments so that it can "consider modifications to the requirements that it is adopting today as circumstances dictate, such as the need to further harmonize with other regulators to minimize the risk of unnecessary market fragmentation, or to address other market developments." I encourage market participants to keep the Commission informed as the market continues to change, and I look forward to continuing our dialogue with colleagues at the CFTC and other regulators.

Speaking of other regulators, I encourage our fellow regulatory authorities in countries where potential SBSDs are located to consider whether they should seek a substituted compliance determination in connection with one or more of our adopted rules. This process is new for the Commission, and I anticipate that it will require us to address many challenging questions along the way. Early submission of these requests will allow for timely and careful consideration, so I look forward to beginning these conversations in the very near future.

Finally, I look forward to continuing to work with the CFTC and our respective staffs as we move forward on other Title VII rulemakings. In particular, I look forward to the opportunity to start grappling with the thorny legal issues surrounding portfolio margining of swaps and security-based swaps, as well as, potentially, other products in our markets.

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[1] The capital and margin requirements being adopted today will apply to *nonbank* SBSDs and *nonbank* major security-based swap participants. SBSDs and major security-based swap participants that are banks are subject to the capital and margin requirements of the prudential regulators. The segregation requirements being adopted today apply to both bank and nonbank SBSDs, though the requirements are tailored in some respects to address commenters' concerns about application of these rules to banks and to non-U.S. person registrants. Certain of these requirements also will apply to broker-dealers not registered as SBSDs.

[2] Under the final rules, OTC derivatives dealers also registered as SBSDs are treated as stand-alone SBSDs for most purposes, but they are not eligible for this alternative compliance mechanism.

[3] The alternative compliance mechanism is available to firms with security-based swaps activity that falls below a percentage-based or a fixed-dollar threshold. Specifically, the aggregate gross notional amount of the SBSD's outstanding security-based swap positions cannot exceed (1) 10% of the combined aggregate gross notional amount of the security-based swap and swap positions of the SBSD, or, (2) until at least three years after the compliance date of the rule, $250 billion. Absent further Commission action, the threshold would decrease to $50 billion on the third anniversary of the compliance date for the rule. The final rule does not make this relief available for SBSDs that are also registered as broker-dealers.

[4] The threshold is based on swaps and security-based swaps exposure, consistent with the prudential regulators' requirement.