

ClientAlert

Capital Markets/Derivatives

February 2013

Extension of Comment Period on SEC Capital and Margin Rules



Introduction

On October 18, 2012, the Securities and Exchange Commission (the "SEC") issued Release No. 34-68071 containing its proposed rules (the "Proposed Rules")¹ relating to the capital, margin and segregation requirements with respect to security-based swaps ("SBSs") for security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs"). The capital and margin requirements of the Proposed Rules apply to SBSDs and MSBSPs that are not subject to the supervision of a prudential regulator whereas the segregation requirements apply to all SBSDs and MSBSPs. The Proposed Rules also affect broker-dealers whether or not they are SBSDs. The original comment period for the Proposed Rules expired 60 days following publication in the Federal Register; the SEC recently extended that comment period until February 22, 2013.

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Proposed Rules—Capital Requirements

Capital Requirements for SBSDs

The Proposed Rules establish minimum capital requirements by amending Rule 15c3-1 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and creating new Rule 18a-1 of the Exchange Act. SBSDs would be required to comply with a net liquid assets test modeled on the broker-dealer capital requirements of Rule 15c3-1 although the SEC is seeking comments on alternative approaches. Pursuant to the Proposed Rules, the minimum capital requirements differ for stand-alone SBSDs and SBSDs dually registered as broker-dealers ("Broker-dealer SBSDs"). The minimum capital requirements for an SBSD also vary depending on whether such SBSD had been approved by the SEC to use internal models in calculating its regulatory capital (the "Approved Internal Models").

Stand-alone SBSDs

Stand-alone SBSDs are subject to Rule 18a-1. Such entities would be required to maintain minimum net capital of not less than the greater of US\$20 million or 8 percent of the entity's "risk margin amount" (known as the margin factor). The margin factor is the sum of (i) the greater of the total margin required to be delivered by the SBSD with respect to all SBSs cleared for SBS customers at a clearing agency or the amount of deductions that would apply to the cleared SBS pursuant to Proposed Rule 18a-1 and (ii) the total margin calculated by the stand-alone SBSD with respect to non-cleared SBSs pursuant to Proposed Rule 18a-3.

¹ Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 34-68071, Fed. Sec. L. Rep. (CCH) ¶ 80,162 (Oct. 18, 2012).

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Stand-alone SBSBs using Approved Internal Models

Such entities would be subject to the same minimum net capital test detailed above and additionally would be required to maintain at least US\$100 million in tentative net capital (which is a firm's net liquid assets, before deductions for market risk of a firm's proprietary positions).

Broker-Dealer SBSBs

Entities that are not using Approved Internal Models would be subject to the same US\$20 million minimum capital requirements as SBSBs calculated using an 8 percent margin factor. Broker-dealer SBSBs that are using Approved Internal Models ("ANC Broker-dealers") would be required to maintain a minimum tentative net capital of US\$5 billion and a minimum net capital equal to the greater of US\$1 billion (up from US\$500 million) and the amount required under Rule 15c3-1 plus an 8 percent margin factor. ANC Broker-dealers would be required to give an "early warning" to the SEC if its tentative net capital falls below US\$6 billion (up from US\$5 billion).

The following chart summarizes the minimum capital requirements in the Proposed Rules.

Type of Registrant	Tentative Net Capital	Minimum Net Capital	
		Fixed Price Minimum	Financial Ratio
Rule 18a-1:			
Stand-alone SBSB (not using Approved Internal Models)	N/A	US\$20 million	8 percent margin factor
Stand-alone SBSB (using Approved Internal Models)	US\$100 million	US\$20 million	8 percent margin factor
Rule 15c3-1:			
Broker-dealer SBSB (not using Approved Internal Models)	N/A	US\$20 million	8 percent margin factor + current Rule 15c3-1 financial ratio
ANC Broker-dealer (using Approved Internal Models)	US\$5 billion	US\$1 billion	8 percent margin factor + current Rule 15c3-1 financial ratio

The Proposed Rules require that SBSBs take a capital charge for the full amount of any unsecured receivable, including any current exposure to derivatives counterparties that is not collateralized (see Section III—Proposed Rules—Margin Requirements, below).

ANC Broker-dealers and stand-alone SBSBs that use Approved Internal Models, however, are allowed to use an alternative model-based credit charge for the uncollateralized current exposure to Commercial End Users (as defined below), which would permit credit risk charges based on the uncollateralized credit exposure to the counterparty, rather than a standard 100 percent deduction that otherwise applies under Rule 15c3-1. Under the Proposed Rules, a "Commercial End User" is any person (other than a natural person) that: (i) engages primarily in commercial activities that are not financial in nature and that is not a financial entity as that term is defined in 3C(g)(3) of the Exchange Act; and (ii) is using non-cleared security-based swaps to hedge or mitigate risk relating to the commercial activities. Financial entities include swap dealers, major swap participants, commodity pools, private funds as defined by the Investment Advisers Act of 1940, employee benefit plans as defined by the Employee Retirement Income Security Act of 1974 and persons predominantly engaged in activities that are in the business of banking or financial in nature as defined in the Bank Holding Company Act of 1956.

Capital Requirements for MSBSPs

Nonbank MSBSPs may engage in a diverse range of business activities different from and broader than the securities activities of broker-dealers or SBSBs. To address this difference, the Proposed Rules establish a "tangible net worth" test and require all MSBSPs to maintain a positive tangible net worth. Pursuant to the Proposed Rules, tangible net worth is calculated as an entity's net worth as determined by generally accepted accounting principles in the United States ("US GAAP"), excluding goodwill and other intangible assets. This proposed definition allows nonbank MSBSPs to include as part of their tangible net worth assets such as property, plant and equipment and unsecured receivables that would otherwise be deducted by the net liquid assets test under Rule 15c3-1. All long and short positions in SBSs, swaps and related positions are marked to market in the tangible net worth determination. Additionally, the liabilities and obligations of all subsidiaries and affiliates that are guaranteed, endorsed or assumed (directly or indirectly) by the nonbank MSBSP are included in the tangible net worth calculation.

Risk Management Procedures for SBSBs and MSBSPs

Proposed Rule 18a-1 sets forth risk management standards by requiring both SBSBs and MSBSPs to comply with Rule 15c3-4 of the Exchange Act. As an additional risk management strategy, ANC Broker-dealers and stand-alone SBSBs using Approved Internal Models would also be subject to a new liquidity requirement based on specified stress test parameters under Proposed Rule 18a-1.

Rule 15c3-4 was adopted in 1998 as part of the OTC derivatives dealer oversight program and is extended to cover nonbank SBSDs and MSBSPs under the Proposed Rules, requiring SBSDs and MSBSPs to establish a program to document and maintain internal risk management controls that monitor market, credit, leverage, liquidity and legal and operational risks. Under Rule 15c3-4, such internal risk management programs should include the following elements:

- A risk control unit that reports directly to senior management and is independent of business trading units
- Separation of duties between personnel responsible for entering into a transaction and those responsible for recording the transaction in the books and records of the OTC derivatives dealer
- Periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent certified public accountants) of the OTC derivatives dealer's risk management systems
- Definitions of risk, risk monitoring, and risk management
- Written guidelines, approved by the OTC derivatives dealer's governing body

Under the Proposed Rules, nonbank SBSDs and nonbank MSBSPs are required to comply with Rule 15c3-4 as if they were an OTC derivatives dealer. Proposed Rule 18a-1(g) makes clear that several sections of Rule 15c3-4 that specifically limit OTC derivatives dealers from entering into certain classes of securities transactions (contained in Rule 15a-1) do not apply to nonbank SBSDs and nonbank MSBSPs. ANC Broker-dealers have been required to comply with Rule 15c3-4 since 2004 when the SEC adopted its ANC Broker-dealer oversight program.

In addition to the establishment of risk management programs under Rule 15c3-4, ANC Broker-dealers and stand-alone SBSDs using Approved Internal Models would be subject to a new liquidity requirement stress test under Proposed Rule 18a-1(f). Senior management would be required to review the assumptions underlying the stress test at least quarterly, and the results of each stress test would have to be provided to senior management within ten business days of the close of the relevant period.

Under Proposed Rule 18a-1, liquidity reserves sufficient to satisfy the liquidity stress test must be maintained, and can be in the form of cash, obligations of the United States, or obligations fully guaranteed as to principal and interest by the United States, and

must be free of encumbrances and liens at all times. The stress tests are intended to prompt firms to enter into contingency planning, and under Proposed Rule 18a-1(f)(4), ANC Broker-dealers and stand-alone SBSDs using internal models would be required to establish a written contingency funding plan in conjunction with their liquidity stress tests.

Proposed Rules—Margin Requirements

Margin Requirements for SBSDs

The Proposed Rules require SBSDs to collect collateral from their counterparties to non-cleared SBSs (excluding Commercial End Users, see below). Such collateral is used to cover the current exposure (known as variation margin) and potential future exposure (known as initial margin). The Proposed Rules require an SBSD to calculate daily (or more frequently during periods of extreme volatility) the amount of initial and variation margin that it must demand from its counterparty. On the business day following such calculation, the SBSD must collect cash, securities or money market instruments from its counterparty at least equal (subject to applicable haircuts) to the amount of required margin. The Proposed Rules set forth detailed methodology to determine the amount of required margin based on whether the SBSs are credit default swaps or non-credit default swaps. If the SBSD uses Approved Internal Models, however, it would be permitted to use its value-at-risk model to determine margin for those SBSs for which the SBSD had been approved except that equity SBSs must be calculated using standardized haircuts. Note that the SEC has not limited the types of eligible collateral to cash in US dollars and US securities in the same way as the CFTC and the prudential regulators; the SEC has asked for comments on whether it should narrow the definition of eligible collateral. In addition, the SEC has asked for comment on whether a minimum transfer amount of US\$100,000 should be set—i.e., that no collection or delivery of margin would be required unless the amount to be delivered or collected was in excess of US\$100,000.

Exceptions

Exceptions to the margin requirements apply to SBSs with Commercial End Users and accounts holding legacy SBSs entered into before the effective date of the Proposed Rules. Capital charges would however apply to any SBSs that are under-collateralized. Where the counterparty is a Commercial End User or where an SBS counterparty has elected to have its collateral segregated with a third party, the SBSD would be charged an amount equal to the margin it should have collected after deducting any "positive equity" in the account of such SBS counterparty.

The Proposed Rules set forth two possible alternatives to the margin requirements for SBS transactions between SBSDs, and the SEC has requested comments to these alternatives. The alternatives are as follows: (1) SBSDs each collect only variation margin from the other or (2) SBSDs each collect both initial margin and variation margin from the other but the collateral covering the initial margin is held in an independent third-party account. Alternative (2) is consistent with the current margin proposals from the prudential regulators and the CFTC.²

Margin Requirements for MSBSPs

The Proposed Rules require MSBSPs to calculate daily the current exposure that such MSBSP or its counterparty to a non-cleared SBS has to each other. On the next business day following such calculation, an MSBSP with current exposure must collect variation margin in the form of cash, securities and/or money market instruments in an amount equal to its current exposure from its counterparty; or must deliver variation margin to the extent that its counterparty has current exposure to the MSBSP. No initial margin is required to be provided. Note that, unlike in the case of an SBSD, an MSBSP may be required to deliver variation margin to its counterparty if the counterparty has exposure to such MSBSP. An MSBSP is not required to collect margin from a Commercial End User (and, unlike the position for SBSDs, no capital charge would apply) but must deliver collateral to a Commercial End User to collateralize such end user's exposure to the MSBSP. With respect to SBSs between an MSBSP and an SBSD, the MSBSP is not required to collect margin from an SBSD but (pursuant to Proposed Rule 18a-3) is required to post variation margin to its SBSD counterparty.

Risk Management Procedures for SBSDs

The Proposed Rules set forth risk management standards that require nonbank SBSDs to monitor the risk of each account of its counterparty to a non-cleared SBS and establish, maintain and document procedures and guidelines for monitoring such risks. Under Proposed Rule 18a-3(e), the risk monitoring procedures must include at a minimum, procedures and guidelines for:

- Obtaining and reviewing account documentation and financial information necessary for assessing the amount of current and potential future exposure to a given counterparty permitted by the SBSD
- Determining, approving and periodically reviewing credit limits for each counterparty, and across all counterparties

- Monitoring credit risk exposure to the SBSD from non-cleared SBSs, including the type, scope, and frequency of reporting to senior management
- Using stress tests to monitor potential future exposure to a single counterparty and across all counterparties over a specified range of possible market movements over a specified time period
- Managing the impact of credit exposure related to non-cleared SBSs on the SBSD's overall risk exposure
- Determining the need to collect collateral from a particular counterparty, including whether that determination was based upon the creditworthiness of the counterparty and/or the risk of the specific non-cleared SBS with the counterparty
- Monitoring the credit exposure resulting from concentrated positions with a single counterparty and across all counterparties, and during periods of extreme volatility
- Maintaining sufficient equity in the account of each counterparty to protect against the largest individual potential future exposure of a non-cleared SBS carried in the account of the counterparty as measured by computing the largest maximum possible loss that could result from the exposure

It is intended that the procedures and guidelines that a nonbank SBSD establishes pursuant to Proposed Rule 18a-3(e) would be part of the broader risk management program that will be required by Rule 15c3-4 (discussed above). Additionally, although Rule 18a-3 will not require nonbank SBSDs to collect initial margin and variation margin from Commercial End Users, the SEC intends that nonbank SBSDs would use their risk management procedures to determine appropriate credit limits and periodically adjust collateral requirements for such Commercial End Users.

Segregation

Segregation Requirements for SBSDs

In order to ensure that cash and securities posted to margin SBSs are protected as customer property for the purposes of stockbroker liquidations provisions under the US Bankruptcy Code, section 3E(g) of the Exchange Act provides that an SBS will be considered as a "security." In addition to this provision, the Dodd-Frank Act established segregation requirements for cleared and uncleared SBSs and gave the SEC authority to adopt rules with respect to segregation. With respect to non-cleared SBSs, section 3E(f)(1)(A) of the Exchange Act provides that an SBSD and an MSBSP are required to notify counterparties

² Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564 (May 11, 2011); Capital Requirements of Swap Dealers and Major Swap Participants, 76 FR 27802 (May 12, 2011); and Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011).

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at the beginning of a non-cleared SBS that the counterparty has the right to require segregation of the funds or collateral that it provides to secure its obligations. Such segregation right applies only to initial margin and not to variation margin. The segregation requirements in the Proposed Rules are modeled on the current broker-dealer segregation provisions contained in Rule 15c3.

Proposed Rule 18a-4 provides for protection of customer property by requiring that all counterparty collateral must be segregated from the assets of the SBS. Such segregated customer property can be commingled with the assets of other customers of the SBS unless the customer requests that its collateral be segregated in an account with a third-party custodian. Proposed Rule 18a-4 applies to all types of SBSs (i.e., to bank SBSs, stand-alone SBSs and broker-dealer SBSs). The segregation requirements of Proposed Rule 18a-4 do not apply to MSBSPs, though, as noted above, MSBSPs are required to segregate assets if requested by a counterparty, as provided for by section 3E. The Proposed Rules will also amend Rule 15c3-3 to clarify that broker-dealers that are registered as SBSs must comply with both the segregation requirements of Rule 15c3-3 and Proposed Rule 18a-4.

Under Proposed Rule 18a-4, SBSs would be required to maintain possession and control of all Excess Securities Collateral (as defined below) that has been provided to the SBS by its customers. "Excess Securities Collateral," as used in the Proposed Rules, means any securities of the customer held by the SBS in excess of the SBS's variation margin of the customer's accounts excluding (1) securities held by a clearing agency but only to the extent such securities are being used to meet a margin requirement of the clearing agency resulting from an SBS transaction of the customer and (2) securities held by another SBS but only to the extent such securities are being used to meet a margin requirement of the other SBS resulting from a hedging transaction to mitigate the risk of a non-cleared SBS transaction with the customer. An SBS will be deemed to be in control of the Excess Securities Collateral so long as it is held in certain specified locations as provided for by Proposed Rule 18a-4(b). An SBS will be deemed to be in control if the securities or money market instruments are: (i) represented by certificates in the custody or control of a clearing corporation or national securities exchange; (ii) are the subject of a bona fide item of transfer; (iii) are in the custody or control of a bank; iv) are held in or are in transit between offices of the SBS; or (v) are held in a location approved of by the SEC upon application of the SBS.

In order to determine the quantity of Excess Securities Collateral to be held in the SBS's control, each SBS will be required to determine from their books and records the quantity of Excess Securities Collateral in its possession and control as of the close of the previous business day. The SBS would only be allowed to use the Excess Securities Collateral to finance transactions with the customer and not to finance its own business.

Under Proposed Rule 18a-4, an SBS would also be required to maintain a reserve of funds or qualified securities in a bank account, for the benefit of the SBS's customers, in an amount equal in value to the net cash owed to the SBS's SBS customers and calculated pursuant to a specified formula in Proposed Rule 18a-4a.

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