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Sent: Wednesday, October 27, 2010 3:38 PM
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Cc: Radhakrishnan, Ananda <ARadhakrishnan@CFTC.gov>; Smith, Thomas J. <tsmith@CFTC.gov>; Bentsen, Ken <kbentsen@sifma.org>; Strupp, Cory <cstrupp@sifma.org>
Subject: Capital, Margin and Segregation Requirements
Attach: SIFMA Comment on Capital, Margin and Segregation Requirements.pdf

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Attached please find a comment on capital, margin and segregation requirements from the Securities Industry and Financial Markets Association.

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SIFMA
Securities Industry and Financial Markets Association

October 27, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington DC 20581

Dear Ms. Murphy and Mr. Stawick:

The Capital Steering Committee (the "**Committee**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to provide to the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**" and, together with the CFTC, the "**Commissions**") comments on capital adequacy and customer protection issues raised by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"). We particularly appreciate the opportunity to comment prior to proposed rulemaking by the Commissions in these important areas.

Many of the financial institutions represented by the Committee's membership conduct securities and futures businesses through entities registered with both Commissions. Further, many of the financial institutions represented on the Committee offer clients over-the-counter ("**OTC**") derivative products through broker-dealers ("**BDs**"), futures commission merchants ("**FCMs**") and affiliates of BDs and FCMs subject to the supervision or oversight of other regulatory bodies. The current expectation among our members is that these financial institutions will register with the Commissions as "swap dealers" and "security-based swap dealers" (collectively, "**Swap Dealers**") for their dealing activities in swaps and security-based swaps (collectively, "**Swaps**"), respectively.

In this letter, we discuss a number of our questions and concerns regarding capital adequacy and customer protection issues under Dodd-Frank. In particular, these questions and concerns relate to:

- implementation and transition;
- structural issues;
- capital requirements;
- segregation/customer protection requirements;
- margin requirements; and
- treatment of existing transactions.

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

Implementation and Transition

In implementing Dodd-Frank, we encourage the Commissions to harmonize and make consistent their rules and regulations. The Committee believes that consistent sets of regulations would facilitate more efficient and sound Swaps markets.

Further, the Committee believes that a diverse population of firms will register as Swap Dealers. The population will include at least several large financial institutions with BDs currently applying the SEC's model-based alternative net capital standard. The population will also include small and large BDs operating under the SEC's basic methodology for computing capital requirements and some dealers yet to be formed. Many of these future Swap Dealers are (or will be) subsidiaries of holding companies subject to consolidated supervision – some by domestic regulatory bodies and some by foreign regulatory bodies.

Given the enormity of the tasks firms face in establishing Swap Dealers and registering with the Commissions, the Committee would ask the Commissions to be flexible in their approach for the approval of applications – recognizing where possible the broader regulatory experiences of applicants.

Structural Issues

Financial institutions have started to explore the entity structure through which they will engage in Swap activities upon implementation of Dodd-Frank. The Committee has identified two structural issues that are critical to its members' evaluations of approaches for complying with Dodd-Frank: 1) the registration of full-service BDs and FCMs as Swap Dealers and 2) the clearing arrangements for standalone Swap Dealers not currently registered as BDs or FCMs. The Committee recommends that the Commissions allow firms maximum flexibility in determining their organizational structures to allow for the efficient use of existing operational and systems capabilities.

The Committee believes that, to the extent possible, the Commissions' rules should accommodate arrangements whereby Swap activities can be combined with non-Swap activities in a registered BD and FCM. Combining these activities within a single entity would allow a BD or an FCM to avoid unnecessarily limiting the range of products available to clients and to achieve operational and funding efficiencies. As a result, the Committee recommends that the Commissions enable full-service BDs and FCMs to register as Swap Dealers. Further, the Committee assumes that the Commissions will permit a single entity to register as both a security-based swap dealer and a swap dealer. We believe this is necessary to avoid fragmentation into separate entities transactions that are currently conducted as a single business.

In addition, the Committee recommends that the Commissions permit standalone Swap Dealers to choose to (i) establish and maintain clearance and settlement capabilities for principal transactions; (ii) establish and maintain clearance and settlement capabilities for principal and agency transactions (in which case, the CFTC would require the standalone Swap Dealer to register as an FCM); or (iii) clear principal and/or agency transactions through an affiliated or an unaffiliated BD or FCM.

The Committee would note that a number of factors, including those mentioned above, will influence decisions as to the structuring or restructuring of financial institutions to comply with Dodd-Frank. Among other factors are the structures of central clearance facilities and the basis upon which these facilities will assign responsibility and liability in the event of default.

Capital Requirements

Introduction

The Committee met with representatives of the SEC's Division of Trading and Markets (the "**Division**") on September 8, 2010, and, in response to that discussion, the Committee would offer the following comments regarding the determination of capital requirements for the market and credit exposures associated with principal and agency positions in Swaps. The Division indicated that the Commissions may rely upon the structures of SEC Rule 15c3-1 (Net Capital Requirements for Brokers or Dealers) and CFTC Rule 1.17 (Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers). We note the Commissions have treated the two rules as interdependent for many years.

The Committee is aware of efforts within the broader regulatory community to revise capital adequacy standards and related regulations. The Committee would appreciate the opportunity to discuss with the Commissions the degree to which these revised standards may be relevant to and appropriate for Swaps and Swap Dealers once the standards are in final form and once we and the Commissions have reviewed the computational methods used.

Principal Positions

During the course of the September 8th meeting, the Committee and the Division discussed the merits of the Commissions relying upon the computational approach of Appendix E of SEC Rule 15c3-1 for assessing the market risks associated with principal positions in Swaps. A number of Committee members have experience with Appendix E and believe the model-based computational approach within Appendix E has several positive attributes. First, the approach recognizes hedges in the computation of capital charges as a function of the statistical correlation of price movements between instruments. The approach provides incentives for effective hedging. Second, to recognize the characteristics and risks associated with individual instrument types, Appendix E allows for add-ons to bring capital charges to levels the SEC views as commensurate with identified risks.

Additionally, Appendix E provides that the SEC may allow a BD to utilize a scenario analysis for computing capital requirements for instruments for which model-based computations plus add-ons are not adequate to capture market risks. The scenario analyses must reflect "the greatest loss resulting from a range of adverse movements in relevant risk factors, prices or spreads designed to represent a negative movement greater than, or equal to, the worst ten-day movement over the four years preceding calculation of the greatest loss." Finally, in concept and in application, Appendix E's computational methodology – including reliance upon add-ons and scenario analyses to align capital charges and risks – is broadly consistent with methodologies relied upon by other domestic and international regulators.

The Committee would note that the reporting provisions of Dodd-Frank should make prices for derivative products more available and the pricing of derivative products more transparent and that the greater availability of pricing information facilitates the application of models in the computation of capital requirements.

Minimum Capital Requirements and Early Warning Levels

The Committee believes that caution should be exercised before applying the Commissions' current approaches for establishing minimum capital requirements for BDs and FCMs to the Swaps market. Currently, the Commissions apply percentages to amounts representing the sum total of client exposures to derive minimum net capital requirements and early warning levels. To our knowledge, the Commissions have yet to collect data that would allow for an evaluation of the appropriateness of current methodologies for computing minimum capital requirements or provide a basis for the derivation of other methodologies. The evaluation of data is particularly important because the size of the markets for Swaps suggests that the application to Swaps of the existing methodologies pertaining to futures positions and securities margin accounts could produce minimum capital requirements and early warning levels disproportionately large in relation to the risks and liquidity requirements associated with these businesses. The Committee would be glad to provide the Commissions with data the Commissions would find helpful in their efforts to test or establish minimum capital requirement computation methodologies.

Margin Deficiencies

The Committee understands that the Commissions are considering imposing capital charges in cases where margin calls for Swaps are not met on T + 1. This timeframe is significantly shorter than the timeframe currently in place with respect to futures and securities accounts. The Committee understands that the Commissions are considering a shortened timeframe in recognition of potential difficulties in covering exposures associated with instruments less liquid than common stocks or listed futures contracts. The Committee appreciates that the shortened time period may help identify potential credit problems at an early stage and will cause Swap Dealers to allocate capital to these businesses to allow for operational issues and delays.

The Committee has two observations. First, the Committee believes the Commissions should recognize the abbreviated timeframe as a factor in differentiating minimum capital requirements for Swaps and Swap Dealers from the current minimum capital requirements applicable to BDs and FCMs. Second, the Committee would recommend that the Commissions reconsider the shortened timeframe with respect to those Swaps for which there is a liquid market or for which an effective hedge is readily available.

<u>Segregation/Customer Protection Requirements</u>

Introduction

Dodd-Frank requires the Commissions to develop rules for the segregation of client assets collateralizing Swaps. With reference to existing relationships between clients and FCMs and FCMs and clearing facilities, the Committee would expect that the segregation of margin posted with respect to centrally cleared Swaps would be achieved through the deposits of customer assets in designated accounts at the clearinghouses.

To date, Committee members have received little information regarding the Commissions' views toward segregation requirements for uncleared Swaps. We understand that clients may elect to require Swap Dealers to segregate client assets representing initial margin supporting uncleared Swaps with an independent third party custodian. We believe Dodd-Frank implies Congressional intent that segregation not be required for uncleared Swaps for variation margin or for initial margin where the customer does not elect segregation. The Committee is not aware of an industry-wide standard for third-party custody of margin, and third-party arrangements raise

additional risks for Swap Dealers (*e.g.*, prior liens by third-party custodians and questionable perfection of Swap Dealers' security interests). Therefore, to facilitate firms' efforts to establish the infrastructure necessary to comply with Dodd-Frank, the Committee would recommend that the Commissions provide industry members with their views regarding the treatment of collateral supporting uncleared Swaps at an early date.

The Committee further recommends that the Commissions consider the suggestions set out in the ISDA Pre-Proposal Letter to the CFTC dated October 8, 2010, specifically the recommendations that (i) rules allow the parties to choose to segregate collateral with a third-party custodian under either a tri-party or a bilateral custody arrangement; (ii) rules clarify that the notice required (under Section 4s(l)(1)(A) of the Commodity Exchange Act) to be given by a Swap Dealer or a major swap/security-based swap participant to its counterparty regarding the counterparty's right to require segregation need only be given once, rather than on entry into every uncleared swap; and (iii) the Commissions engage in close collaboration to avoid inconsistent requirements for transactions typically governed by a common agreement.

Operational Risk and Funding Inefficiencies

While neither Commission has offered formal guidance with respect to the relationship of existing customer protection regimes to customer protection regimes for Swaps, the Committee's understanding of the Commissions' views is that the current regimes and the Swap regimes will be separate and distinct. For example, the Committee's current understanding is that collateral posted in support of a security-based swap would not be protected under the Securities Investor Protection Act ("**SIPA**"), as security-based swaps have not been added to the definition of "security" in SIPA. Further, to our knowledge, the CFTC has yet to indicate formally whether collateral posted in support of a swap would fall within its own existing customer protection regulations. The Committee believes that separate customer protection regimes for Swaps, in combination with the existing regimes for the segregation and protection of customers' assets, will complicate greatly the movement and control of customers' other assets and, as a result, contribute to operational risk and funding inefficiencies. As a result, the Committee recommends including Swaps in existing customer protection regimes to the extent possible.

Portfolio Margining

Separate systems of segregation and customer protection for Swaps could also interfere with portfolio margining. Dodd-Frank provides the basis for the Commissions to expand the framework within which customers and other clients carrying positions in products regulated by both Commissions could avail themselves of the benefits of portfolio margining. The Committee believes that broad application of portfolio margining would allow U.S. investors to hedge market and credit risk more efficiently and effectively. Further, the broader application of portfolio margining in the U.S. would provide investors in the U.S. advantages available in some foreign jurisdictions. However, a dichotomy in segregation and customer protection regimes, as discussed above, would greatly complicate, if not prevent, the expansion of portfolio margining opportunities for U.S. investors. For this reason also, the Committee would urge the Commissions to include Swaps in the existing customer protection regimes to the extent possible.

<u>Margin Requirements</u>

Dodd-Frank requires the Commissions to supervise or set margin requirements for cleared and uncleared Swaps entered into by Swap Dealers and major swap/security-based swap participants. As mentioned above, Dodd-Frank allows latitude for the Commissions to expand the framework

within which BDs and FCMs could offer portfolio margining capabilities to clients. Portfolio margining affords clients the opportunity to reduce margin requirements by hedging risks within a portfolio. For example, a client could reduce the risk of holding a position in a given common stock by entering into a security-based swap on that common stock. As a result, less margin should be required of the customer.

In a hedged portfolio, therefore, a Swap Dealer may obtain less overall margin from a client than a clearinghouse would require the Swap Dealer to post to the clearinghouse with respect to the customer's Swap position if not taking into consideration other positions of the client. To address this potential disparity in margin and to facilitate the development of portfolio margining, the Committee would recommend that Swap Dealers be permitted to meet the margin requirements of clearinghouses through the rehypothecation of collateral deposited by clients in support of Swaps, as long as the Swap Dealer reflects such rehypothecation in computing customer reserve requirements.

Treatment of Existing Transactions

Many BDs, FCMs and affiliates of BDs and FCMs hold positions in OTC derivative transactions that, upon effectiveness of Title VII, will be Swaps. Firms executed these transactions under agreements stipulating collateral requirements and rehypothecation rights that may be inconsistent with requirements under regulations to be imposed by the Commissions in implementing Dodd-Frank. To avoid potential cash flow and operational issues, the Committee recommends that the Commissions permit financial institutions flexibility in the transition to the regimes currently under development. Given the size, complexity and maturity structures of existing OTC derivatives books, firms will need adequate time to address clients' concerns and trading exposures and Swap Dealers' funding, capital and operational constraints. The documentation and re-documentation of clients' accounts and transaction agreements in and of itself is a task of significant dimension. Additionally, the Committee recommends that the Commissions permit Swap Dealers to address clients' concerns on a client-by-client basis to allow financial institutions to align actions taken with clients' needs and circumstances.

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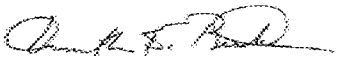
The Committee thanks the Commissions for the opportunity to comment in advance of their rulemaking on capital adequacy and customer protection issues raised by Dodd-Frank. The Committee's members would appreciate the opportunity to further comment on these topics, as well as other related rulemakings the Commissions will undertake under Title VII of the Dodd-Frank Act. If you have any questions, please do not hesitate Kyle Brandon of SIFMA at 212-313-1280 or the undersigned at 202-962-7400.

Respectfully submitted,



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