

CLIENT ALERT

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

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The Securities and Exchange Commission has adopted final capital, margin and segregation requirements applicable to security-based swap dealers (“SBSDs”) and major security-based swap participants (“MSBSPs”) and amended the capital and segregation requirements for registered broker-dealers dealing in security-based swaps (“SBS”) (the “Final Rules”).¹ With the adoption of the Final Rules, the SEC has taken a significant step towards implementing all of its rules relating to SBS by establishing a new compliance date (the “Compliance Date”). The Compliance Date is 18 months after the later of: (1) the effective date of the SEC’s recordkeeping and reporting rules for SBSDs and MSBSPs; and (2) the effective date of the SEC’s guidance regarding the cross-border application of the SBS requirements, both of which have yet to be finalized by the SEC.

¹ Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, SEC Rel. No. 34-86175 (June 21, 2019), available [here](#). (“Adopting Release”).

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

Background

The SEC has authority to establish capital and margin requirements for broker-dealers as well as SBSs² and MSBSPs that are not regulated by a Prudential Regulator.³

The SEC originally proposed capital and margin rules relating to SBS in 2012, 2013 and 2014 (the “Proposed Rules”). In October 2018, the SEC reopened the comment period for the Proposed Rules. The Proposed Rules relating to margin and segregation differed significantly from those adopted and implemented by the Commodity Futures Trading Commission (the “CFTC”) (the “CFTC Uncleared Margin Rules”)⁴ and the Prudential Regulators (the “Prudential Rules”), respectively.⁵

The SEC made substantial changes in the Final Rules to conform them more closely to the CFTC Uncleared Margin Rules, the Prudential Rules and the uncleared swap and SBS margin rules under EMIR (the “Swap and Other SBS Margin and Seg. Rules”). Importantly, the Final Rules also include alternative and substituted compliance provisions applicable to certain U.S. and non-U.S. SBSs that allow them to satisfy obligations under the Final Rules through compliance with the Swap and Other SBS Margin and Seg. Rules. The Final Rules apply to: (i) SBSs and MSBSPs that are not subject to regulation by a Prudential Regulator (“Non-Bank SBSs” and “Non-Bank MSBSPs”), with respect to margin, capital and segregation; (ii) SBSs and MSBSPs that are subject to regulation by a Prudential Regulator (“Bank

² The rules also cover SBSs that are over-the-counter derivatives dealers (“OTC Derivatives Dealers”). OTC Derivatives Dealers are registered with the SEC and authorized to transact in a broad range of derivatives instruments.

³ The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency are collectively referred to herein as the “Prudential Regulators.”

⁴ Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016). The CFTC also adopted segregation requirements for cleared and uncleared swaps and has proposed capital requirements for swap dealers and major swap participants. Section 4s(e)(1)(B) of the Commodity Exchange Act provides that the CFTC shall prescribe capital and margin requirements for swap dealers and major swap participants for which there is not a Prudential Regulator.

⁵ Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015). The Prudential Regulators, as part of their margin requirements for uncleared SBS, adopted a segregation requirement for collateral received as margin. The CFTC Uncleared Margin Rules and the Prudential Rules are generally consistent with the margin and segregation rules adopted by regulators in the European Union under the European Market Infrastructure Regulation (“EMIR”) which are applicable to both swaps and SBS. Final phase-in of the initial margin requirements under the CFTC Uncleared Margin Rules and the Prudential Rules had been scheduled for September 2020. However, on July 23, 2019, the Basel Committee on Banking Supervision and International Organization of Securities Commissions agreed to extend by one year the final implementation phase of initial margin requirements to September 2021 for certain counterparties. As a result, the CFTC and the Prudential Regulators may extend the final implementation phase under their rules as well.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

SBSDs” and “Bank MSBSPs”), with respect to segregation; and (iii) broker-dealers, with respect to margin, capital and segregation.⁶

Summary of the Final Rules

Net Capital Requirements

The Final Rules establish net capital requirements for SBSBs and MSBSPs with respect to SBS. The Final Rules also revise the capital requirements for broker-dealers that engage in SBS transactions⁷ and for SBSBs with respect to swaps (regulated by the CFTC). The net capital rules for SBSBs and broker-dealers are designed to ensure that a firm: (1) maintains sufficient liquid assets to meet all liabilities, including obligations to customers, counterparties, and other creditors; and (2) has adequate resources to wind down its business in an orderly manner without the need for a formal proceeding if the firm fails. SBSBs and broker-dealers must maintain net capital in excess of designated minimum levels and must also satisfy tentative net capital requirements if approved by the SEC to use proprietary models to calculate capital. The SEC noted that there likely would be significant differences between the capital requirements applicable to bank-regulated swap and SBS dealers and those applicable to Non-Bank SBSBs and broker-dealers in respect to SBS.⁸

Broker-dealers and SBSBs that are dually registered as broker-dealers are subject to capital requirements provided in Rule 15c3-1. SBSBs that are not registered as broker-dealers (“Stand-alone SBSBs”) are subject to capital requirements provided in new Exchange Act Rule 18a-1, which is structured similarly to Rule 15c3-1.⁹ The application of the SEC’s Capital rules for Non-Bank SBSBs and broker-dealers is summarized in the table below.

⁶ Section 15F(e)(1)(B) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) requires SBSBs and MSBSPs for which there is not a Prudential Regulator to comply with capital and margin requirements prescribed by the SEC. The SEC has separate and independent authority under Section 15 of the Exchange Act to prescribe capital and segregation requirements for broker-dealers.

⁷ The new rules also modify existing broker-dealer net capital calculation requirements. Amendments to Rule 15c3-1 incorporate new adjustments for broker-dealer positions in both SBS and swaps.

⁸ The Adopting Release notes that SBSBs (other than firms registered as broker-dealers or OTC Derivatives Dealers) may elect to comply with the capital, margin and segregation requirements of the CFTC if they satisfy the conditions for “Alternative Compliance” under Rule 18a-10. The SEC indicated that this approach, which may include a bank-like capital standard for certain firms, if the CFTC’s proposed rules are adopted as proposed, would be appropriate because these firms will predominantly engage in a swaps business. See Adopting Release at n.52.

⁹ A Stand-alone SBSB may not deal in cash-market securities or options and may not maintain custody of cash or securities for retail investors.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

Summary Chart Showing Application of SEC Capital Rules for SBSs, Broker-Dealers and MSBSPs in relation to SBS

Covered Entity	Rule	General Requirement	Minimum Tentative Net Capital ¹⁰
Non-Bank Stand-alone SBS	Rule 18a-1	Minimum net capital based on the greater of \$20 million and 2% margin factor ¹¹	N/A
Non-Bank Stand-alone SBS using models	Rule 18a-1	Minimum net capital based on the greater of \$20 million and 2% margin factor	\$100 million
Broker-Dealer SBS not using models	Rule 15c3-1	Minimum net capital based on the greater of (i) \$20 million and (ii) 2% margin factor plus a specified ratio in Rule 15c3-1	N/A
Broker-Dealer/Broker-Dealer SBS approved to use models ¹²	Rule 15c3-1	Minimum net capital based on the greater of (i) \$1 billion and (ii) 2% margin factor plus a specified ratio in Rule 15c3-1 ¹³	\$5 billion
OTC Derivatives Dealer	Rule 18a-1	Minimum net capital based on the greater of \$20 million and 2% margin factor	\$100 million
Non-Bank MSBSP	Rule 18a-2	Required to have and maintain positive tangible net worth	N/A

¹⁰ "Tentative Net Capital" applies to firms that use models to calculate capital and describes a firm's net capital before deducting standardized haircuts or market and credit risk charges to proprietary positions. The amount is calculated starting with the net worth of an entity, determined in accordance with U.S. generally accepted accounting principles ("GAAP"), and after deducting illiquid assets, adding qualified subordinated loans and making specified deductions and adjustments required for SBS and other assets.

¹¹ The 2% margin factor means the amount determined by calculating the firm's exposures to its SBS customers and counterparties. The SEC reserved the right to increase the applicable percentage as described in note 16 infra.

¹² Broker-dealers that are approved to use models to calculate capital are referred to by the SEC as "alternative net capital" broker-dealers or "ANC Broker-Dealers." These firms are permitted to use proprietary models to calculate market and credit risk charges rather than applying standardized haircuts to their positions.

¹³ Rule 15c3-1 requires broker-dealers, including dually-registered Broker-Dealer SBSs, to compare the fixed-dollar amount in the rule with an amount determined by applying one of two financial ratios: (i) the 15-to-1 aggregate indebtedness to net capital ratio; or (ii) the 2% of aggregate debit items ratio, both as described in Rule 15c3-1.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

The SEC net capital rules establish a minimum net capital requirement for SBSs equal to the greater of: (i) the applicable fixed-dollar amount; and (ii) the margin factor or, for SBSs that are dually-registered as broker-dealers, the margin factor plus a ratio provided in Rule 15c3-1. Net capital is the amount that a broker-dealer or an SBS will compute based on net worth after: (i) applying haircuts (i.e., reductions from market value to account for risk)¹⁴ to their proprietary securities and commodity positions; and (ii) for firms authorized to use models, deducting market and credit risk charges. The margin factor is calculated based on the initial margin the firm is required to maintain with clearing agencies with respect to cleared SBS¹⁵ customers plus the initial margin calculated by the firm with respect to uncleared SBS counterparties, multiplied by 2%.¹⁶

When calculating net capital, SBSs and broker-dealers must take specified deductions from their net worth, including due to uncollateralized current exposure to swap and SBS counterparties. Model-approved SBSs and broker-dealers may apply a credit risk charge with respect to such uncollateralized exposures in lieu of a deduction. Model-approved broker-dealers and Broker-Dealer SBSs must take a portfolio concentration charge for uncollateralized current exposures to the extent the amounts exceed 10% of the firm's tentative net capital. Model-approved broker-dealers and Broker-Dealer SBSs and Stand-alone SBSs (including Stand-alone SBSs that are also registered as OTC Derivatives Dealers) are subject to a concentration charge for large exposures to a single counterparty, calculated in accordance with Rule 15c3-1e.¹⁷ Model-approved Broker-Dealer SBSs (as well as broker-dealers authorized to use models to calculate net capital) must provide an early warning notification to the SEC if their tentative net capital falls below \$6 billion.

SBSs and broker-dealers are required by the SEC rules to take a capital charge for initial margin they post to counterparties. Although, as described below, the Final Rules do not require SBSs and broker-dealers to post initial margin to counterparties in respect of uncleared SBS, to the extent these entities do so voluntarily or are required to post under the CFTC Uncleared Margin Rules or the Prudential Rules, the posting will be subject to a 100% capital charge.

¹⁴ The SEC prescribed standardized haircuts for uncleared SBS (other than credit default swaps ("CDS")) and uncleared swaps. However, for cleared SBS and cleared swaps, haircuts are set by the applicable clearing agency or by the margin requirements of a designated clearing organization (in the case of swaps). The SEC established separate haircuts for uncleared CDS.

¹⁵ "Cleared SBS" means SBS that are cleared by a central clearing agency. "Uncleared SBS" means SBS that are held bilaterally between two counterparties.

¹⁶ The margin factor multiplier will remain at 2% for at least three years after the Compliance Date, but then may be increased by the SEC, initially to not more than 4% and, after five years from the Compliance Date, to no more than 8% (provided that the SEC previously raised the multiplier to 4% or less).

¹⁷ See Adopting Release at 472.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

MSBSPs are subject to a tangible net worth test that is different from the requirements for SBSDs and broker-dealers. Under new Exchange Act Rule 18a-2, MSBSPs must maintain a positive tangible net worth at all times. Tangible net worth is calculated based on GAAP, excluding goodwill and other intangible assets and marking to market all long and short positions in SBS, swaps and related positions. Non-Bank MSBSPs may include as regulatory capital assets such as property, plant, equipment and unsecured receivables. The SEC indicated that the different standard is appropriate given the diverse range of business activities in which an MSBSP could be expected to engage.¹⁸

All SBSDs and MSBSPs must establish and maintain internal risk management controls consistent with Exchange Act Rule 15c3-4. The controls must include monitoring the risk of each counterparty and cleared SBS account consistent with specified requirements and conducting a periodic review of the firm's risk monitoring procedures.

Uncleared Swap Margin Requirements

Margin Requirements – Generally

The Final Rules prescribe initial and variation margin requirements for uncleared SBS. They do not address margin requirements for cleared SBS, which are set by central clearing firms.¹⁹ SBSDs and MSBSPs must calculate daily marked-to-market exposure and collect or post variation margin from or to counterparties unless an exception applies. SBSDs and MSBSPs must also collect initial margin from (but are not required to post initial margin to) uncleared SBS counterparties unless an exception applies.²⁰ Positions in uncleared SBS maintained under a master netting agreement may be netted for purposes of calculating both initial and variation margin. An SBSD that does not collect initial or variation margin from a counterparty (including an affiliate) in reliance on an exclusion or exception must take a charge against net capital equal to the amount that would have been required to be collected absent the exclusion or exception.

New Rule 18a-3 excludes from the types of counterparties from which an SBSD must collect or post variation margin or collect initial margin: (i) commercial end users; and (ii) the Bank for International Settlements, the European Stability Mechanism and specified multilateral development banks. The Rule also excludes from collection and posting requirements legacy uncleared SBS transactions (i.e., uncleared SBS transactions entered into prior to the Compliance Date). SBSDs are not required to collect initial margin from: (x) certain financial market intermediaries, including futures commission merchants, banks, foreign broker-dealers and foreign banks; (y) sovereign entities determined to have only a

¹⁸ Adopting Release at 126.

¹⁹ The rules allow for offset of cleared and uncleared SBS for purposes of calculating initial margin, to the extent the SBS transactions are within the same asset class. The SEC noted that the clearing agency's margin requirements for cleared SBS likely would permit offsets only of positions cleared by the same clearing firm. See Adopting Release at n.389.

²⁰ Rule 18a-3 does not require SBSDs to post initial margin but also does not prohibit posting. As a result, the Final Rules allow parties to mutually agree on whether or not to require an SBSD or MSBSP to post initial margin in respect to uncleared SBS.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

minimal amount of credit risk; and (z) affiliates. SBSBs must also establish written procedures and guidelines for monitoring margin risk.

Initial Margin

Initial margin is calculated using either standardized haircuts set out in the capital rule or, with SEC approval, a model.²¹ Any SBSB is eligible to obtain approval for use of a model in respect to CDS and other non-equity SBS, but only a Stand-alone SBSB may obtain approval to use a model for uncleared equity SBS.²² An SBSB that calculates initial margin using a model may use third-party-developed models, such as the ISDA SIMM model. The SEC may approve the temporary use of a model by an SBSB if the model has been approved for initial margin calculations by other regulators, such as a Prudential Regulator or the CFTC.

As is the case under the CFTC Uncleared Margin Rules and the Prudential Rules in respect to initial margin on uncleared swaps, SBSBs are required to collect initial margin from each uncleared SBS counterparty in respect of which their exposure, calculated based on the rule, exceeds a \$50 million threshold. The Final Rules provide that an SBSB is not required to collect initial margin if the initial margin amount plus other credit exposure resulting from uncleared SBS and swaps, aggregated across all uncleared SBS and swap exposures between the SBSB and its affiliates and the counterparty and its affiliates, does not exceed \$50 million. However, unlike the CFTC Uncleared Margin Rules and Prudential Rules in regard to initial margin on uncleared swaps, this requirement is not conditioned on the counterparty having \$8 billion in “material swaps exposure.”²³ As noted above, unlike the CFTC Uncleared Margin Rules and the Prudential Rules, SBSBs and MSBSPs are not required to post initial margin to a counterparty (although they may voluntarily agree to do so).

An SBSB may defer collecting the initial margin amount for up to two months following the month in which a counterparty in uncleared SBS no longer qualifies for the \$50 million threshold. If an SBSB elects to defer collection in reliance on the threshold, the SBSB must take a capital charge for all uncollected amounts. Under the CFTC Uncleared Margin Rules there is no similar transition period. Rather, swap dealers are expected to have the documentation and processes in place

²¹ Under the standardized approach, haircuts differ based on asset class.

²² SBSBs that are broker-dealers are not eligible for SEC approval to use models in respect to SBS that are “equity swaps,” even if they are otherwise authorized to use models to calculate initial margin. The Adopting Release contemplates that non-broker-dealer, Non-Bank SBSBs may be able to use a model to calculate initial margin in a portfolio-margined account that includes both SBS and CFTC-regulated swaps on equities, provided that the counterparty does not hold equity securities positions in the account.

²³ Under the CFTC Uncleared Margin Rules and the Prudential Rules, covered swap entities (including SBSBs that are regulated by a Prudential Regulator) generally are required to exchange initial margin with any swap entity or financial end user having “material swaps exposure.” A financial end user that, together with its margin affiliates, does not exceed the \$8 billion threshold during the relevant calculation period, is not required to post or collect initial margin with respect to such swaps.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

governing the posting, collection and custody of initial margin once the amount of initial margin exchangeable between a swap dealer and a counterparty exceeds the \$50 million threshold.²⁴

Minimum Transfer Amount

Both variation margin and initial margin are subject to a \$500,000 minimum transfer amount. Under the applicable provisions, if the combined amount of margin required to be collected from or delivered to a counterparty is less than or equal to \$500,000, the SBSB or MSBSP need not collect or deliver the margin. Once the \$500,000 threshold is exceeded in respect to either initial or variation margin, collateral equal to the full amount of the applicable margin requirement must be collected and delivered. An SBSB or MSBSP that relies on the \$500,000 minimum transfer amount exception must take a deduction from net capital in an amount equal to the uncollected margin amount.

Eligible Collateral and Delivery Times

Eligible assets are comprised of cash, securities, money market instruments, major foreign currencies, the settlement currency of the uncleared SBS transaction and gold. In order for securities and other eligible assets to be posted and collected as margin for SBS, the assets must: (i) have a “ready market”; (ii) be readily transferable; and (iii) not consist of securities and/or money market instruments issued by the counterparty or a party related to the Non-Bank SBSB or Non-Bank MSBSP, or to the counterparty. The assets must also be the subject of an enforceable netting and collateral agreement with the counterparty, although, unlike under the CFTC Uncleared Margin Rules and the Prudential Rules, the agreement is not required to constitute an eligible master netting agreement.

SBSBs must apply standardized haircuts in valuing collateral. They may use those contained in either the SEC’s net capital rules or the CFTC Uncleared Margin Rules, but selection of haircuts must be consistent with respect to each counterparty.²⁵ The value of the collateral must meet or exceed the applicable margin requirement after applying the standardized haircuts.²⁶

SBSBs and MSBSPs must collect or deliver collateral by the close of business on the business day following the day on which the margin call is made. However, if the counterparty is located in a different country and is in a time zone that is more than four time zones away from the SBSB or MSBSP, collateral may be collected or delivered by the close of business on the second business day following the day the margin call is made.

²⁴ See CFTC Letter No. 19-16 (July 9, 2019). The CFTC staff requires swap dealers to closely monitor as the amount of initial margin approaches the \$50 million initial margin threshold and take appropriate steps to ensure that the required initial margin documentation is in place at such time as the threshold is reached.

²⁵ The haircuts specified by the SEC are similar but not identical to those required by the CFTC and the Prudential Regulators.

²⁶ Because MSBSPs are not subject to a capital standard that uses haircuts, they are not required to apply standardized haircuts to the variation margin they receive from counterparties. See Adopting Release at 207.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

Margin Requirements for MSBSPs

Margin requirements for MSBSPs are similar to those for SBSs, except that the \$50 million threshold does not apply. In addition, the exclusion for collection of initial margin with respect to sovereign entities that have only minimal credit risk does not apply. MSBSPs are not eligible to use models to calculate initial margin.

Segregation Requirements

Omnibus Segregation Generally

Section 3E(b) of the Exchange Act requires that, for cleared SBS, money, securities and property of an SBS customer must be separately accounted for and not commingled with the funds of the broker-dealer or SBS or used to margin, secure or guarantee any trades or contracts of any SBS customer or person other than the person for whom the money, securities or property are held. Notwithstanding the fact that the focus of Section 3E(b) is on segregation requirements for *cleared* SBS, the Final Rules establish omnibus segregation as the default method of segregation for *both* cleared *and* uncleared SBS.²⁷ The SEC's omnibus segregation structure requires an SBS or broker-dealer to segregate money, securities and property of SBS customers (or counterparties, in the case of uncleared SBS) from the funds of the SBS or broker-dealer, but allows the SBS or broker-dealer to commingle the assets of one or more SBS customers or counterparties with money, security and property of other SBS customers or counterparties. Under "omnibus segregation," uncleared SBS customers and counterparties may elect to hold collateral at an independent custodian and in some cases may waive omnibus segregation.²⁸ This default requirement applies to all SBSs, including Bank SBSs and foreign SBSs.

Under the omnibus segregation requirements, an SBS or broker-dealer must: (i) promptly obtain and maintain physical possession or control of all excess securities collateral (i.e., securities and money market instruments that are not being used to meet a variation margin posting requirement of the customer) carried for the SBS accounts of SBS customers; and (ii) maintain a special reserve account for SBS customers (which is separate from the reserve account for traditional securities customers) to segregate cash and/or qualified securities in an amount equal to the net cash owed to customers holding SBS positions through the SBS or broker-dealer.²⁹ The special reserve account must be designated "Special Reserve Account for the Exclusive Benefit of the Security-Based Swap Customers of [name of SBS or broker-dealer]." In addition, the bank must provide a written acknowledgement that the funds and other property held in the account are

²⁷ The segregation requirements for broker-dealers and Broker-Dealer SBSs are codified in amendments to Rules 15c3-3 and 15c3-3b.

²⁸ Counterparties of broker-dealers and Broker-Dealer SBSs may not waive segregation unless they are affiliated with the broker-dealer or Broker-Dealer SBS. In this regard, the SEC noted that waiver of segregation may result in there being insufficient assets to satisfy claims of all persons determined to be "customers" of the broker-dealer or Broker-Dealer SBS under a liquidation proceeding under the Securities Investor Protection Act.

²⁹ The reserve account posting requirements must be calculated weekly in accordance with the formula set forth in Rule 15c3-3b and Rule 18a-4a.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

being held for the exclusive benefit of the SBS customers in accordance with the SEC rules and will be maintained separately from other accounts maintained by the SBSD or broker-dealer at the bank. Finally, the bank and SBSD or broker-dealer must enter into a written agreement that provides that funds and other property in the account at no time will: (i) be used directly or indirectly as security for a loan or other extension of credit to the SBSD or broker-dealer; or (ii) be subject to any right, charge, security interest, lien or claim in favor of the bank or person claiming through the bank.

There are two exceptions under which excess securities collateral can be held in a manner that is not in the possession or control of an SBSD or a broker-dealer: (i) the collateral is being used to meet a margin requirement of a clearing agency resulting from a cleared SBS transaction of the same customer; or (ii) the collateral is being used to meet a margin requirement of an SBSD or broker-dealer entering into an uncleared SBS transaction with the SBSD to offset the risk of an uncleared SBS transaction between the first SBSD or broker-dealer and the customer.

The omnibus segregation requirements do not apply to MSBSPs. Counterparties to MSBSPs on uncleared SBS may require that initial margin be held at a third-party custodian.

Cleared SBS

Omnibus segregation is required for cleared SBS, and SBS customers may not elect to post margin through an independent custodian or waive segregation. Broker-dealers and SBSDs are allowed to hold customer property related to cleared SBS through one or more commingled accounts at a bank, trust company or clearing agency.

Uncleared SBS

Section 3E(f) of the Exchange Act provides that a counterparty to an uncleared SBS may elect to have initial margin held at an independent, third-party custodian and requires an SBSD and MSBSP to notify the uncleared SBS counterparty of this right. If the counterparty does elect to use a third-party custodian, the SBSD must obtain a subordination agreement from the counterparty. An SBSD will not be required to take a capital charge if a counterparty elects to post collateral with a third-party custodian if the following requirements are met:³⁰ (i) the custodian is a U.S. bank, registered clearing organization or depository not affiliated with the counterparty; (ii) in the alternative, the custodian is a supervised foreign bank, clearing organization or depository not affiliated with the counterparty and the collateral consists of foreign securities or currencies and the entity customarily maintains custody of the particular type of foreign securities or currencies; (iii) the collateral is held under an account control agreement governing the terms under which the custodian holds and releases the pledged collateral, and the control agreement is a legal, valid, binding and enforceable agreement under the laws of the relevant jurisdictions, including in the event of the counterparty's bankruptcy, and provides the SBSD the right to access the collateral to satisfy the counterparty's obligations; and (iv) the SBSD maintains written documentation

³⁰ These requirements also appear to apply in the event that the parties agree to allow variation margin to be held at a third-party custodian in order to allow the Non-Bank SBSD to avoid having to take a capital charge.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

memorializing its analysis that a court or administrative authority would find the custodial agreement to be legal, valid, binding and enforceable against the counterparty.³¹

Section 3E(f)(4) of the Exchange Act provides that, if a counterparty does not choose to require segregation of funds or other property, the SBS or MSBSP must send a report to the counterparty on a quarterly basis stating that the firm's back office procedures relating to margin and collateral are in compliance with the agreement of the counterparties. As noted above, non-affiliated counterparties of broker-dealers/Broker-Dealer SBSs are not allowed to waive segregation of uncleared SBS.

SBSs Exempt from SEC Segregation Requirements

A Stand-alone SBS (including a Bank SBS) is exempt from the SEC's segregation requirements if it satisfies all of the following requirements: (i) the entity does not effect transactions in cleared SBS or clear SBS for customers; (ii) the entity does not have open cleared SBS positions executed for or on behalf of others; and (iii) the entity does not hold or control assets in connection with margining, guaranteeing or securing cleared SBS executed for or on behalf of a customer or other person. An exempt SBS must notify all SBS counterparties that they may elect to require segregation of the assets delivered to the SBS to margin uncleared SBS transactions prior to commencement of trading in uncleared SBS with such persons. The exempt SBS must provide written disclosure to SBS counterparties notifying them: (i) that margin collateral received and held by the Stand-alone SBS will not be subject to a segregation requirement; and (ii) of the manner in which a claim of the counterparty for collateral would be treated in a bankruptcy or liquidation proceeding of the Stand-alone SBS.

Alternative Compliance

New Rule 18a-10 provides that an SBS that is not also registered with the SEC as a broker-dealer or an OTC Derivatives Dealer but is registered with the CFTC as a swaps dealer may comply with the CFTC's capital, margin and segregation requirements instead of those provided by the SEC under Rules 18a-1, 18a-3 and 18a-4 if: (i) the entity does not clear SBS transactions for other persons and is thus exempt from the segregation requirements of Rule 18a-4 for cleared SBS; and (ii) the aggregate gross notional amount of the firm's outstanding SBS positions does not exceed the lesser of (as of the most recently ended fiscal year quarter): (A) \$250 billion;³² and (B) 10% of the combined aggregate gross notional amount of the firm's open SBS and swap positions. An eligible entity would be required to comply with the

³¹ Rule 18a-3(c)(4)(ii)(B) contemplates that a counterparty may hold initial margin posted to an SBS or MSBSP at an independent custodian. However, MSBSPs are not required to take a capital charge for such postings and, as a result, are not subject to the enforceability procedures applicable to SBSs.

³² This maximum applies for the first three years that the rule is in effect and then drops to \$50 billion, unless the SEC issues an order to maintain or lower the maximum fixed dollar amount to less than \$250 billion but greater than \$50 billion.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

CFTC Uncleared Margin Rules and the CFTC's capital rules for both swaps and SBS. The entity would also be required to treat SBS transacted by it and related collateral as though the SBS were swaps subject to the CFTC's rules.

An SBSB operating under Rule 18a-10 must disclose in writing to each counterparty to an uncleared SBS that it is complying with the applicable capital, margin and segregation requirements of the CFTC prior to the first SBS transaction carried out by it in reliance on the alternative compliance rules. A firm must satisfy the conditions of Rule 18a-10 at all times and, if the firm can no longer comply or fails to meet a condition of the Rule, it must notify the SEC and the CFTC. An SBSB that falls out of compliance with the alternative compliance rules generally has a period of two months to come into compliance with the SEC's rules applicable to SBSBs.

A newly-registered SBSB that intends to operate under Rule 18a-10 beginning on the date of its registration must provide the SEC and the CFTC with prior written notice of its intent to operate under the Rule. An SBSB that intends to operate under Rule 18a-10, beginning on a date after the date of its registration as an SBSB, must provide the SEC and the CFTC with prior written notice thereof and continue to comply with the SEC's rules for at least two months after the end of the month in which the SBSB provided notice (or such shorter period as the SEC may designate by order).³³

Cross-Border Application and Substituted Compliance

Under the Final Rules, capital and margin requirements are treated as entity-level requirements for which substituted compliance is available to non-U.S. SBSBs and MSBSPs, regardless of the jurisdiction of the counterparty. The Adopting Release notes that any substituted compliance determination would be fact-specific, taking into account the effectiveness of the supervisory compliance program administered and the enforcement authority exercised by the foreign regulatory authority. The Adopting Release also indicates that the SEC will take a "holistic" approach that focuses on regulatory outcomes.

In determining whether substituted compliance is available with respect to the capital requirements, the SEC intends to consider (among other possible factors) whether capital requirements of the foreign financial regulatory system are designed to help ensure the safety and soundness of registrants in a manner comparable to the applicable provisions arising under the Exchange Act and its rules and regulations. In determining whether substituted compliance is available with respect to the margin requirements, the SEC indicated that it intends to consider (among other possible factors) whether the foreign financial regulatory system requires registrants to adequately cover their current and potential future exposure to uncleared derivatives counterparties, and ensures registrants' safety and soundness, in a manner comparable to the applicable provisions arising from the Exchange Act and its rules and regulations. The Final Rules also enumerate factors that would be considered with respect to substituted compliance for MSBSP capital and margin requirements.

³³ The SEC may impose conditions in connection with granting a shorter period.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

Under the Final Rules, the segregation requirements of Exchange Act Section 3E and Rule 18a-4 are deemed to be transaction-level requirements for which substituted compliance is not available. However, a foreign Stand-alone SBS or Bank SBS may avail itself of an exception for certain transactions.

Under the Final Rules, the segregation requirements of Section 3E of the Exchange Act (and rules and regulations thereunder) apply to foreign Bank SBSs, Stand-alone SBSs and MSBSPs as follows:

Covered Entity	Counterparty is a U.S. person	Counterparty is not a U.S. person
A foreign bank SBS that has a U.S. branch or agency	SEC's segregation rules apply to cleared and uncleared SBS transactions	SEC's segregation rules do not apply to cleared or uncleared SBS transactions unless the foreign bank SBS holds funds or other property arising out of a transaction by such person with a U.S. branch or agency of the foreign SBS
A foreign bank SBS that does not have a U.S. branch or agency	SEC's segregation rules apply to cleared and uncleared SBS transactions	SEC's segregation rules do not apply
A foreign non-bank SBS which is not also registered as a broker-dealer	<ul style="list-style-type: none"> SEC's segregation rules apply to cleared SBS, if the foreign SBS has received or acquired or holds funds or other property for at least one SBS customer that is a U.S. person with respect to a cleared SBS transaction with such U.S. person SEC's segregation rules apply to uncleared SBS with respect to funds or other property such foreign SBS has received or acquired or holds for an SBS counterparty that is a U.S. person with respect to an uncleared SBS transaction with such U.S. person 	SEC's segregation rules do not apply to uncleared transactions with non-U.S. person customers/counterparties
A foreign MSBSP	SEC's segregation rules apply to cleared and uncleared transactions	SEC's segregation rules do not apply

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

Under the Final Rules, a foreign SBSD must disclose in writing to its SBS counterparties that are U.S. persons, the potential treatment of funds or other property segregated by the foreign SBSD in an insolvency proceeding under U.S. bankruptcy law and any applicable foreign insolvency laws. This disclosure, which does not apply to MSBSPs, must be provided prior to receiving, acquiring or holding funds or other property for the SBS counterparty with respect to an SBS.

SEC Monitoring: Close-Out Netting

In the Adopting Release, the SEC stated that it intends to monitor the impact of the capital, margin and segregation requirements on broker-dealers, SBSDs and MSBSPs. The SEC also noted that it would monitor developments in the swaps and SBS markets, including adoption and implementation by the CFTC of capital requirements for swap dealers, and may consider modification of the Final Rules in light of further developments.³⁴ The SEC noted that data to be monitored was expected to include capital levels, liquidity, leverage, scale of SBS and swap activities conducted by broker-dealers and SBSDs, types and amount of collateral held and risk management controls established by firms. The SEC also indicated that it expects that uncleared SBS should be able to be margined alongside uncleared swaps with the same counterparty under master netting agreements used to facilitate close-out netting across swap and uncleared SBS positions.

Implementation Schedule

The Final Rules become effective 60 days after publication in the Federal Register. However, compliance with the Final Rules is not required until the Compliance Date. In connection with adopting the Final Rules, the SEC adopted a new Compliance Date, which also triggers compliance with other SEC rules applicable to SBS and entities transacting in SBS. As noted above, the Compliance Date is eighteen (18) months after the later of: (i) the effective date of final rules establishing recordkeeping and reporting requirements for SBSDs; and (ii) the effective date of final rules addressing the cross-border application of certain SBSD requirements. The SEC also extended temporary exemptive relief in respect of financial responsibility requirements, segregation for uncleared SBS³⁵ and credit default swap portfolio margin programs in light of its adoption of the new Compliance Date.

³⁴ Adopting Release at 9.

³⁵ Compliance with Section 3E(f) of the Exchange Act is currently subject to temporary exemptive relief. That relief includes an exemption for SBSDs and MSBSPs from the segregation requirements for uncleared SBS in Section 3E(f) of the Exchange Act, as well as an exemption providing that no SBS contract entered into on or after July 16, 2011, shall be void or considered voidable by reason of Section 29(b) of the Exchange Act because any person that is a party to the contract violates Section 3E(f) of the Exchange Act. Both of these exemptions will expire on the Compliance Date.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

Completed Rule Sets Applicable to SBS

SBSD/MSBSP Registration

Section 15F(a) of the Exchange Act prohibits any person from acting as an SBSD or MSBSP without registering as such with the SEC. Pursuant to the SEC's SBSD registration rules, which were adopted in 2015, each person that is subject to registration as an SBSD or MSBSP as a result of its SBS activity will be required to register with the SEC. An applicant must file Form SBSE, which is similar to Form BD, to register. An applicant must also complete a Form SBSE-C, which includes certifications as follows: (i) a senior officer must certify that, after due inquiry, he or she has reasonably determined that the SBSD has developed and implemented written policies and procedures reasonably designed to prevent violations of the federal securities laws and the rules thereunder, and that he or she has documented the process by which he or she reached such determination; and (ii) the chief compliance officer ("CCO") of the applicant (or his or her designee) must certify that the CCO neither knows, nor in the exercise of reasonable care should have known, that any person associated with the SBSD or MSBSP who effects or is involved in effecting SBS on its behalf is subject to a statutory disqualification,³⁶ unless otherwise specifically provided by rule, regulation or SEC order.

Other Rule Sets Triggered by Compliance Date

The SEC adopted business conduct requirements, which require SBSDs and MSBSPs to: (i) verify that a counterparty to an SBS transaction is an eligible contract participant and determine whether it is a special entity; (ii) disclose to the counterparty material information about the SBS, including material risks, characteristics, incentives and conflicts of interest; (iii) provide the counterparty with information concerning the daily mark of the SBS, as well as concerning the ability to require clearing of the SBS; (iv) communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith; (v) establish a supervisory and compliance infrastructure; and (vi) designate a CCO to fulfill the described duties and prepare an annual compliance report. SBSDs also must satisfy suitability obligations in respect of any recommendation made regarding SBS and establish, maintain and enforce policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each known counterparty that are necessary to conduct business with that counterparty.

The SEC has also adopted rules requiring SBSDs and MSBSPs to promptly and electronically submit a trade acknowledgement containing all of the terms of the transaction to its counterparty by no later than the end of the first business day following the day of execution and to promptly verify or dispute the terms of trade acknowledgements received from its counterparty in SBS transactions. An SBSD or MSBSP also must adopt and maintain written policies and procedures reasonably designed to obtain verification of the terms outlined in any trade acknowledgement that it

³⁶ SEC Rule of Practice 194 establishes a process for an SBSD or MSBSP to apply to the SEC for relief from the statutory disqualification prohibition in Exchange Act Section 15F(b)(6) and provides an exclusion for an SBSD or MSBSP from the prohibition in Exchange Act Section 15F(b)(6) with respect to associated persons.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

provides. The final rules exempt certain transactions that are processed through a registered clearing agency, or executed on an SBS execution facility or national securities exchange. The final rules also provide an exemption from the requirements of Exchange Act Rule 10b-10 for broker-dealers who are SBSDs or MSBSPs and address the potential availability of substituted compliance in connection with these requirements.

Status of Pending SEC Rulemakings in Respect to SBS

As of the date of publication of this Client Alert, two SEC rulemakings remain outstanding: (i) rules with respect to recordkeeping and reporting for SBSDs; and (ii) cross-border rules.

Recordkeeping and reporting requirements for SBSDs were proposed in 2014. The proposal would add new Exchange Act rules and amend existing Exchange Act rules, including Rules 17a-3, 17a-4, 17a-5 and 17a-11, to incorporate recordkeeping, reporting and notification requirements applicable to SBSDs (and MSBSPs), securities count requirements applicable to SBSDs and additional recordkeeping requirements applicable to broker-dealers to account for their SBS and swap activities.

The SEC also proposed rules addressing the cross-border application of certain SBSD requirements in May 2019. These proposed rules include rules and/or guidance regarding SBS transactions “arranged, negotiated, or executed” by personnel located in the United States; the cross-border scope of the SBSD *de minimis* exception; the certification and opinion of counsel requirements of Exchange Act Rule 15Fb2-1; the questionnaire and application requirements of Rule 18a-5; and the cross-border application of the statutory disqualification prohibition within Section 15F(b)(6) of the Exchange Act.

Next Steps

Firms trading in SBS need to begin planning how they will implement the SEC’s final SBS rules. For firms conducting a dealing business, they need to determine whether or not they are required to register.³⁷ A firm engaged in a dealing business (either alone or together with its affiliates) will not be required to register as an SBSD if the SBS positions held by the person or its affiliates over the previous 12 months do not exceed: (i) \$8 billion aggregate gross notional amount of CDS entered into with all counterparties; (ii) \$400 million aggregate gross notional amount of SBS (other than CDS); and (iii) \$25 million aggregate gross notional amount of SBS entered into with “special entity” counterparties. End users and other counterparties that are not engaging in a dealing business should expect entities subject to the SEC’s Final Rules to request documentation to ensure compliance with the SEC’s new margin and segregation requirements for SBS as well

³⁷ Dealing activities by a firm include: (i) holding itself out as a dealer in SBS; (ii) making a market in SBS; (iii) regularly entering into SBS with counterparties as an ordinary course of business for the firm’s own account; and (iv) engaging in activity causing oneself to be known as a dealer or market maker in SBS.

SEC Adopts Final Capital, Margin and Segregation Rules for Security-Based Swaps

as other SBS-related rules. End users and other counterparties should also be aware of whether an SBSB acts as a swap dealer, so as to facilitate netting of swap and SBS positions.

As you assess the implications of the SEC's suite of rules that govern trading of SBS, including those relating to capital, margin and segregation set forth in the Final Rules, please reach out to your relationship lawyers at Willkie Farr & Gallagher LLP to assist you with the planning.

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