

# Legal Update

## SEC Security-Based Swaps Capital, Margin and Segregation Rules Become Effective; *New Requirements Will Impact U.S. Markets*

The Securities and Exchange Commission (“SEC”) issued its final rule for capital, margin, and segregation (“Final Rule”) for security-based swap dealers (“SBSD”) and major security-based swap participants (“MSBSP”), which become effective today, October 21, 2019.<sup>1</sup> Compliance will be required 18 months after the effective date of the SEC’s cross-border rules proposed earlier this year.<sup>2</sup>

The SEC relied on its authority under Title VII of the Dodd-Frank Act for SBSDs and MSBSPs that do not have a prudential regulator (respectively, “Nonbank SBSDs” and “Nonbank MSBSPs”) and under Section 15 of the Exchange Act to adopt capital and segregation requirements for broker-dealers. The Final Rule also amends the SEC’s existing cross-border rule to provide a mechanism to request substituted compliance pursuant to SEC guidance.

The Final Rule will impact the security-based swaps markets as Nonbank SBSDs and their counterparties develop systems and infrastructure to comply with the security-based swaps margin, capital, and segregation requirements.

Due to significant overlap between the security-based swaps markets and commodity-based swaps market, staffs of the SEC and Commodity Futures Trading Commission (“CFTC”) closely coordinated to harmonize the agencies’ rules.<sup>3</sup> The CFTC is still

considering its own capital rules for nonbank swaps entities within its jurisdiction.

This legal update provides a general overview of selected aspects of the Final Rule.

### I. Capital

The Final Rule establishes minimum capital requirements for Nonbank SBSDs and MSBSPs, increases the minimum net capital requirement for broker-dealers that elect to use alternative net capital to compute net capital (“ANC Broker-Dealers”), and establishes capital requirements for broker-dealers that will not be registered as an SBSD or MSBSP to the extent that they trade security-based swaps.<sup>4</sup>

Nonbank SBSDs will be subject to either the existing Rule 15c3-1 or the new Rule 18a-1, which is similar to Rule 15c3-1. Nonbank SBSDs also registered as broker-dealers (other than registered OTC derivatives dealers) will be subject to Rule 15c3-1. All other Nonbank SBSDs will be subject to capital requirements in new Rule 18a-1.

#### A. TENTATIVE NET CAPITAL

Both Nonbank SBSDs that use models to compute net capital and ANC Broker-Dealers will be subject to minimum tentative net capital requirements, which is

net capital before deducting any applicable standardized haircuts or market and credit risk charges.

## B. NET CAPITAL

Minimum net capital requirements will be based on a combination of fixed-dollar amounts and financial ratios based on the type of SBSB, <sup>5</sup> as follows:

Type of Registrant	Rule	Tentative Net Capital (Net capital before haircuts)	Net Capital*	
			Fixed-Dollar	Financial Ratio
<b>Stand-alone Nonbank SBSB (not using internal models)</b>	18a-1	N/A	\$20 million	2% margin factor
<b>Stand-alone Nonbank SBSB (using internal models)<sup>6</sup></b>	18a-1	\$100 million	\$20 million	2% margin factor
<b>Broker-dealer SBSB (not using internal models)</b>	15c3-1	N/A	\$20 million	2% margin factor + Rule 15c3-1 ratio
<b>Broker-dealer SBSB (using internal models)</b>	15c3-1	\$5 billion	\$1 billion	2% margin factor + Rule 15c3-1 ratio

\* Although the initial financial ratios are set to a multiplier of 2%, the multiplier could increase to a maximum of 4% after three years, and to a maximum of 8% after five years.

## C. CALCULATION

The Final Rule contains the framework for computing net capital.<sup>7</sup> This net capital computation framework includes tailored deductions and credit risk charges, deduction of unsecured current exposures, and deduction of unsecured potential future exposures.

Nonbank SBSBs and broker-dealers must either apply standardized table-based haircuts to proprietary positions or use an SEC-approved capital model to calculate haircuts. Models will be subject to each SBSB's quantitative and qualitative risk requirements, governance and ongoing oversight.

## D. INTERNAL RISK MANAGEMENT

Rule 15c3-4 will require Nonbank SBSBs to establish, document, and maintain a system of internal risk management controls. In addition to complying with the foregoing, Nonbank MSBSPs must maintain at all times positive tangible net worth with respect to their security-based swap and swap activities.<sup>8</sup>

## II. Margin

The Final Rule establishes margin requirements for Nonbank SBSBs and MSBSPs with respect to non-cleared security-based swaps.

### A. CALCULATION

At the close of business each day, Rule 18a-3 will require a Nonbank SBSB to calculate initial margin by applying standardized haircuts or a margin model and variation margin by marking to market with respect to each counterparty.<sup>9</sup> Any initial margin model will be subject to SEC approval, SBSB governance, and ongoing oversight.

Broker-dealer SBSBs will be required to use standardized haircuts for security-based swaps that reference equity securities and indexes (in order to maintain parity with the margin rules for cash market equity positions), and may use a margin model for other types of security-based swaps, including credit default swaps.

Nonbank SBSBs may use models for security-based swaps referencing equity securities and indexes, but models may not be used if the account holds another type of equity security.

## B. POSTING AND COLLECTING MARGIN

Nonbank SBSBs will be required to collect initial margin and/or variation margin from a counterparty if calculations pursuant to the rule require variation margin to be posted. A Nonbank SBSB must deliver variation margin if the calculation results in a requirement to post variation margin. Nonbank SBSBs will not be required by the Final Rule to post initial margin to counterparties. However, the counterparties are not prohibited from agreeing to exchange initial margin.

Nonbank MSBSPs are required by Rule 18a–3 to collect collateral from or deliver collateral to a counterparty to cover a variation margin requirement, unless an exception applies.<sup>10</sup>

Permitted collateral will include cash, securities, money market instruments, a major foreign currency, the settlement currency of the non-cleared security-based swap, or gold.<sup>11</sup> Standardized collateral haircuts will apply.

## C. EXCEPTIONS TO POSTING AND COLLECTING

Rule 18a–3 contains Nonbank SBSB exceptions for collecting and delivering initial margin or delivering variation margin under certain circumstances. The SEC provided a table to demonstrate how the delivery exceptions will apply:<sup>12</sup>

Exception	Status of Exceptions to Collecting Margin		Status of Exceptions to Delivering VM
	VM	IM	
Commercial End User	Need Not Collect	Need Not Collect	Need Not Deliver
BIS or European Stability Mechanism	Need Not Collect	Need Not Collect	Need Not Deliver
Multilateral Development Bank	Need Not Collect	Need Not Collect	Need Not Deliver
Financial Market Intermediary	Must Collect	Need Not Collect	Must Deliver
Affiliate	Must Collect	Need Not Collect	Must Deliver
Sovereign with Minimal Credit Risk	Must Collect	Need Not Collect	Must Deliver
Legacy Account	Need Not Collect	Need Not Collect	Need Not Deliver
IM Below \$50 Million Threshold	Must Collect	Need Not Collect	Must Deliver
Minimum Transfer Amount	Need Not Collect	Need Not Collect	Need Not Deliver

### III. Segregation

For cleared and non-cleared security-based swaps, segregation will be required for SBSDs and stand-alone broker-dealers. Segregation requirements for broker-dealers and broker-dealer SBSDs are codified in amendments to Rule 15c3–3.<sup>13</sup> Rule 18a–4 sets forth requirements for all other SBSDs, including firms that are registered as OTC derivatives dealers or bank SBSDs.<sup>14</sup>

#### A. OMNIBUS SEGREGATION

The Final Rule requires an SBSD or broker-dealer to segregate money, securities, and property of a security-based swap customer relating to a cleared or non-cleared security-based swap but permits assets to be commingled with money, securities, or property of other customers.<sup>15</sup>

For non-cleared security-based swap transactions, the omnibus segregation requirements are an alternative to the statutory provisions to which a counterparty can elect to have initial margin individually segregated or to waive segregation. However, pursuant to the Final Rule for stand-alone broker-dealers or broker-dealer SBSDs, counterparties that are not an affiliate of the firm cannot waive segregation.<sup>16</sup>

Under omnibus segregation requirements, an SBSD or broker-dealer must maintain:

1. possession or control over excess securities collateral; and
2. a security-based swap customer reserve account to segregate cash and/or qualified securities in an amount equal to the net cash owed to security-based swap customers, calculated on a weekly basis.<sup>17</sup>

SBSDs (other than OTC derivatives dealers) that are not broker-dealers will be exempt from the requirements of Rule 18a–4 if the firm does not clear security-based swap transactions for other persons and meets certain other conditions.

#### B. SUBSTITUTED CFTC COMPLIANCE

For purposes of segregation, Rule 18a–10 provides certain conditions by which a SBSD that is not a broker-dealer and is registered as a swap dealer that predominantly engages in swaps business may comply with the Commodity Exchange Act and CFTC’s rules instead of the SEC’s.<sup>18</sup>

### IV. Cross-Border Amendments

The Final Rule amends the SEC’s existing cross-border rule to allow foreign SBSDs and MSBSPs to request substituted compliance with respect to entity-level capital and margin requirements under Rules 18a–1, 18a–2, and 18a–3.<sup>19</sup> For the foregoing and 15c3–3, the SEC views segregation as a transaction-level requirement for which no substituted compliance will be available.

Nonetheless, Rule 18a–4 contains exceptions pursuant to which a foreign stand-alone or bank SBSD or MSBSP need not comply with the segregation requirements for certain transactions. No such exceptions are available for cross-border transactions of a stand-alone broker-dealer or a broker-dealer SBSD or MSBSP.

### V. Looking Forward

SBSDs and MSBSPs will be required to comply with the Final Rule and other SBS requirements 18 months after the effective date of the SEC’s final rule for cross-border application of certain security-based swap requirements. The SEC proposed these rules on May 10, 2019 and the applicable comment period closed on July 23, 2019.

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## Endnotes

<sup>1</sup> See *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers*, 84 Fed. Reg. 43872 (Aug. 22, 2019) available at <http://bit.ly/32pYQP>.

<sup>2</sup> See *Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements*, 84 Fed. Reg. 24206 (July 23, 2019), available at <http://bit.ly/2lWqfob>.

<sup>3</sup> See *CFTC Chairman Giancarlo Congratulates SEC on Adopting Final Rules Establishing Capital Requirements for Security-Based Swap Dealers and Margin for Uncleared Security-Based Swap Transactions*, Press Release (June 21, 2019), available at <http://bit.ly/2MqeRTQ>.

<sup>4</sup> 17 C.F.R. § 240.18a–2.

<sup>5</sup> Final Rule, *supra* note 1, at 43874–43875.

<sup>6</sup> Includes a stand-alone SBSB that is also an OTC derivatives dealer.

<sup>7</sup> Final Rule, *supra* note 1, at 43886–43887.

<sup>8</sup> Final Rule, *supra* note 1, at 43906–43907.

<sup>9</sup> Final Rule, *supra* note 1, at 43909.

<sup>10</sup> Final Rule, *supra* note 1, at 43876.

<sup>11</sup> Final Rule, *supra* note 1, at 43919; 17 C.F.R. § 240.18a–3.

<sup>12</sup> Final Rule, *supra* note 1, at 43877.

<sup>13</sup> 17 C.F.R. § 240.18a–4.

<sup>14</sup> 17 C.F.R. § 240.18a–4.

<sup>15</sup> Final Rule, *supra* note 1, at 43930.

<sup>16</sup> *Id.*

<sup>17</sup> Final Rule, *supra* note 1, at 43931.

<sup>18</sup> 17 C.F.R. § 240.18a–10.

<sup>19</sup> Final Rule, *supra* note 1, at 43879.

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