

SEC Proposes Capital, Margin, and Segregation Rules for Security-Based Swap Dealers

November 5, 2012

On October 17, 2012, the SEC unanimously approved proposed capital, margin, and segregation rules for security-based swap dealers (“**SBSDs**”) and major security-based swap participants (“**MSBSPs**”).¹ The Proposal draws heavily on the SEC’s existing capital, margin, and segregation requirements for registered broker-dealers (“**BDs**”).

The Proposal’s capital and margin requirements would apply only to SBSBs and MSBSPs that are neither banks nor bank holding companies (“**Nonbank SBSBs**” and “**Nonbank MSBSPs**,” respectively), whereas the segregation requirements would apply to all SBSBs and MSBSPs. In addition, the Proposal would enhance the capital requirements that apply to all large BDs that have been approved to use internal models to compute net capital (“**ANC BDs**”), regardless of whether they are SBSBs. The Proposal also would introduce new liquidity requirements for all ANC BDs as well as for Nonbank SBSBs that use internal models. A summary chart of these requirements can be found at the end of this memorandum. The SEC also has prepared charts describing in greater detail how the proposed capital and margin requirements would operate, available [here](#).

The Proposal does not discuss its potential international implications; instead, the SEC noted that it intends to publish a comprehensive release for public comment on the full spectrum of cross-border issues relating to the application of Title VII of Dodd-Frank.

Comments on the Proposal are due 60 days after publication in the *Federal Register*.

Capital for Nonbank SBSBs

The SEC’s proposed capital requirement for SBSBs is a net liquid assets test modeled closely on the capital requirements for BDs. The application of the capital rules varies depending on whether the SBSB is also a registered BD (“**BD-SBSB**”) or is instead a stand-alone SBSB, and whether the SBSB is approved by the SEC to use internal models to calculate market and credit risk charges in lieu of taking standardized haircuts (as described below) on certain positions when computing its regulatory capital. Such market and credit risk charges would be less severe than the capital charges that would apply to SBSBs that are not approved to use internal models.

Stand-Alone SBSBs

Stand-alone SBSBs would be required to compute net capital by using standardized haircuts, or, with SEC approval, by using internal models.²

¹ Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (the “**Proposal**”), available [here](#).

² The SEC notes that, while some financial institutions may choose to establish stand-alone SBSBs, it anticipates that many firms will elect to conduct security-based swap (“**SBS**”) business through BD-SBSBs in order to engage in a fuller range of activities, such as acting as a dealer in other types of securities or as a broker in SBS or other securities, which must be conducted through a BD.

A stand-alone SBSBD that is not approved to use internal models to compute haircuts would be required to maintain minimum net capital of not less than the greater of \$20 million or 8% of the firm's "risk margin amount," which is defined as the sum of:

- the greater of the total margin required to be delivered by the Nonbank SBSBD with respect to SBS transactions cleared for SBS customers at a clearing agency or the amount of the deductions (as specified in the Proposal for credit default swaps ("CDS") and all other SBS) that would apply to the cleared SBS positions of the SBS customers; and
- the total margin amount calculated by the stand-alone SBSBD with respect to uncleared SBS pursuant to the Proposal (as described below).

The Proposal also contains a number of "add-ons" to minimum capital requirements in relation to the value of securities subject to repurchase obligations.

A stand-alone SBSBD that is approved to use internal models would be subject to the same minimum net capital test but also would be subject to a requirement to maintain at least \$100 million in tentative net capital (*i.e.*, net capital before deduction of haircut charges). The Proposal requests comment on whether the 8% margin factor would be practical as applied to a portfolio margin account that combines SBS and swaps. The Proposal contains detailed criteria for what qualifies as an acceptable internal model.

Dually Registered Broker-Dealer SBSBDs

A BD-SBSBD that does not use internal models would be required to maintain a minimum net capital level that is not less than the greater of \$20 million or the financial ratio amount³ required pursuant to Rule 15c3-1(a)(1) plus the 8% margin factor discussed above. Such a BD-SBSBD would use the existing standardized haircuts in Rule 15c3-1, plus new additional standardized haircuts designed specifically for SBS and swaps. These new additional standardized haircuts, discussed below, would also apply to BDs that are not registered as SBSBDs to the extent that they hold positions in SBS and swaps.

In order to use internal models to compute market risk and capital charges in lieu of using standardized haircuts, a BD-SBSBD would need to be approved by the SEC as an ANC BD and therefore would be subject to the new requirements for ANC BDs that are described below.

Standardized Haircuts

The Proposal includes a formula for determining net capital, including new standardized haircuts for proprietary SBS that would be used by SBSBDs and BDs that are not approved to use internal models when computing net capital. The Proposal includes two sets of standardized haircuts for SBS: one for SBS that are CDS and one for all other SBS. The proposed haircuts for CDS would be based on a "maturity grid" approach, with the size of the haircut increasing as the time-to-maturity of the underlying bond and basis point spread increase. For non-CDS SBS, the applicable haircut would be the amount currently prescribed in Rule 15c3-1 for the instrument referenced by the SBS multiplied by the contract's notional amount.

Prospective SBSBDs will need to consider carefully whether the level of standardized haircuts will be so high as to call into question the practical economic feasibility of operating an SBSBD that is not authorized to use internal models.

³ Generally, this is the amount of net capital that a BD is required to maintain relative to its "aggregate indebtedness" or its "aggregate debit items" depending upon the method of net capital calculation to which the BD is subject.

Uncleared SBS Margin Requirements for Nonbank SBSDs

The Proposal would require Nonbank SBSDs to collect margin for uncleared SBS from each of its counterparties to cover current and potential future exposure (*i.e.*, variation and initial margin, respectively) to the counterparty, subject to exceptions. Under the Proposal, an SBSD would be required to perform daily margin calculations for accounts of uncleared SBS counterparties to determine the amount of current exposure in the account and the potential future exposure for the account; more frequent calculation would be required under certain circumstances. On the business day following such calculation, an SBSD would be required to collect eligible collateral from its counterparties in an amount at least equal to the negative equity (current exposure or variation margin) in the account plus the margin amount (potential future exposure or initial margin), resulting in the SBSD's counterparty maintaining a minimum level of positive net equity in the account. "Current exposure" means the current replacement value of the counterparty's positions with the SBS dealer, after giving effect to qualifying netting agreements and taking into account the value of collateral held by the SBS dealer.

The collateral collected by an SBSD must be in the form of cash, securities, or money market instruments, although prescribed haircuts would apply to securities and money market instruments. The method for determining the margin amount would be similar to the approach that an SBSD would use to determine haircuts on proprietary SBS when calculating its net capital requirement, *i.e.*, by using standardized haircuts or internal models (depending on whether the SBSD is approved to use internal models). Even if an SBSD is approved to use internal models, the margin amount for equity SBS must be determined exclusively using standard haircuts.

Exceptions from the Margin Collection Requirement for Uncleared SBS

An SBSD would not be required to collect margin from its counterparties for uncleared SBS in the following instances:

- If its counterparty is a commercial end user (as defined) using uncleared SBS to hedge or mitigate risk relating to its commercial activities;
- If the SBS was entered into prior to the effective date of the SBS margin requirement; and
- Potentially, if its counterparty is an SBSD.

With respect to SBS between two SBSDs, the SEC proposed two possible alternatives as to which it requests comment. Under the first alternative, SBSDs would only need to collect variation margin, but not initial margin, from each other. Under the second alternative, consistent with the CFTC's and banking regulators' proposed margin rules, SBSDs would be required to collect both initial and variation margin from each other.

Capital Charge in Lieu of Margin Collateral

The Proposal would impose capital charges in certain instances in which an SBSD is not required to collect or hold margin from its counterparty.

- If an SBSD does not collect sufficient margin from a counterparty to an uncleared SBS because the counterparty is a commercial end user, the SBSD would be required to take a capital charge equal to the margin amount less any positive equity in the account of the commercial end user.
- If a counterparty elects to have collateral segregated in an account at an independent third-party custodian, the SBSD must deduct the margin amount for the account of the counterparty less any positive equity in the account. This requirement is likely to be controversial because it will significantly increase the effective cost to Nonbank SBSDs of dealing with such counterparties as compared with other counterparties and also creates a potential competitive disadvantage relative to SBSDs that are banks or bank holding companies, which would not be subject to a similar requirement under the bank regulators' proposed capital and margin rules.

- If an SBSB does not collect margin from a counterparty to an uncleared SBS because the SBS was entered into prior to the effective date of the margin rule, the SBSB would be required to take a capital charge equal to the margin amount less any positive equity in the account.

Risk Management, Liquidity, and Other Requirements

Nonbank SBSBs would be required to comply with the Rule 15c3-4 risk management control system requirements that currently apply to SEC-regulated OTC derivatives dealers and establish specific risk management procedures and guidelines that are designed to address the risks of acting as a dealer in uncleared SBS. For example, SBSBs would be required to have procedures and guidelines for determining the need to collect collateral from a particular counterparty, including commercial end user counterparties.

Nonbank stand-alone SBSBs that are approved to use internal models would be required to conduct monthly liquidity stress tests, and maintain levels of liquidity based upon such tests and backup funding plans.

Nonbank stand-alone SBSBs also would be restricted from having more than 70% of their total capital represented by qualifying subordinated debt, and to notice requirements and would be subject to substantial limitations concerning large or rapid withdrawals of capital.

Collateral Segregation and Safeguards

The Proposal's collateral segregation requirements for cleared and uncleared swaps would apply to all SBSBs and MSBSPs, regardless of whether they are banks or bank holding companies.

Collateral Segregation Requirement

Consistent with the Dodd-Frank Act, the Proposal would require an SBSB or MSBSP to notify its counterparty at the beginning of an uncleared SBS transaction that such counterparty has the right to require segregation of funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty in respect of initial margin, and, upon request, must segregate such funds or property in an account carried by an independent third-party custodian. Customer collateral for cleared SBS must be segregated but may be commingled and deposited in the same one or more accounts with a bank, trust company, or clearing agency.

An SBSB would be required to obtain a subordination agreement from any counterparty that elects to waive segregation either because it elects individual segregation pursuant to the self-executing provisions of section 3E(f) of the Securities Exchange Act or agrees that the SBSB need not segregate its assets.

In cases where the counterparty does not select individual segregation and does not affirmatively waive segregation altogether, an SBSB, but not an MSBSP, would be required to treat its customer's collateral with respect to uncleared SBS in the same manner as it treats such collateral with respect to cleared SBS.

Possession and Control and Reserve Account Requirement

SBSBs also would be required to comply with segregation requirements that are modeled on the SEC's existing "customer protection rule" (Rule 15c3-3), which requires BDs to take two primary steps to safeguard securities and cash for which they act as custodian for customers:

- Maintain physical possession or control over customers' fully paid and excess margin securities; and
- Maintain a reserve of funds or qualified securities in an account at a bank that is equal in value to the net cash owed to customers.

The physical possession or control requirement would apply to securities and money market instruments carried for the account of an SBS customer that have a market value in excess of the current exposure of the SBSB to the customer.

The reserve account requirement would require the SBSB to maintain an account at a bank that is not the SBSB or an affiliate of the SBSB and that meets certain conditions designed to ensure that the cash and qualified securities deposits in the bank account are isolated from the proprietary assets of the SBSB. The SBSB must perform daily calculations to determine the amount to be maintained on deposit in this account. Haircuts would be applied to the value of certain eligible securities in the account. The daily calculation requirement is significantly more frequent than the weekly calculation that BDs that are not SBSBs are required to perform.

Capital and Margin Requirements for Nonbank MSBSPs

Nonbank MSBSPs would be subject to a positive tangible net worth requirement as determined in accordance with U.S. GAAP, excluding goodwill and other intangible assets, rather than a net liquid assets test. This capital requirement is designed to accommodate the commercial activities that may be part of a Nonbank MSBSP's core business models. A Nonbank MSBSP would be required to mark all long and short positions in SBS, swaps, and related positions to their market values, and would be required to include in its computation of tangible net worth all liabilities or obligations of a subsidiary or affiliate that the MSBSP guarantees, endorses, or assumes, either directly or indirectly.

Subject to exceptions for certain types of counterparties and accounts (commercial end users, SBSBs, and SBS legacy accounts), a Nonbank MSBSP would be required to determine on a daily basis whether it has current exposure to a counterparty or vice versa in excess of the equity in such counterparty's account. MSBSPs would be subject to bilateral variation margin requirements, so that they would be required to collect collateral from counterparties to which they have current exposure (variation margin) only and to deliver collateral to counterparties that have current exposure to them. The exchange of collateral to cover potential future exposure (initial margin) would not be required.

New Requirements for ANC BDs

The Proposal would introduce a number of new requirements for ANC BDs, regardless of whether they are also SBSBs.

Increased Capital Requirements and Early Warning Report

All ANC BDs would be subject to the following minimum net capital requirement:

- Minimum tentative net capital of \$5 billion; and
- Minimum net capital equal to the greater of \$1 billion or the financial ratio amount required pursuant to Rule 15c3-1 plus 8% of the risk margin amount described above.

The proposed \$1 billion minimum net capital amount – which represents a substantial increase over the current \$500 million minimum – would apply to all ANC BDs, regardless of whether they are SBSBs. ANC BDs would be subject to further prudential requirements, including an increase in the “early warning” notice threshold (\$6 billion) and a narrowing of the types of unsecured receivables for which they may take a credit risk charge in lieu of a 100% deduction such that the credit risk charge could be taken only for uncollateralized receivables from commercial end users arising from SBS.

The increase in the capital and tentative net capital requirements would not likely be significant for existing ANC BDs all of which currently maintain capital in excess of these requirements, but the increase may present a major hurdle for others firms, including those BD-SBSBs that wish to use internal models.

ANC BDs also would be required to perform liquidity stress tests, maintain liquidity reserves to address funding needs, and establish a written contingency funding plan, consistent with the requirements described above that apply to stand-alone SBSBs using internal models.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Summary Chart of SEC Capital, Margin and Segregation Requirements for SBSDs, MSBSPs, and BDs

	Capital Requirement (Rule 18a-1)	Uncleared Margin Requirement (Rule 18a-3)	SBS Requirement	Collateral Segregation, Possession and Control, Account, Subordination Agreement Requirements (Rule 18a-4)	Internal Management Control Requirements (Rules 18a-1(g) / 18a-2)	Risk Liquidity Tests, Reserves, Contingency Funding Requirements (Rule 18a-1)	Stress Liquidity and Plan	Debt-Equity Ratio, Capital Withdrawal, Subsidiary Consolidation, and Early Warning Notice Requirements (Rule 18a-1)
Bank SBSDs, MSBSPs	N/A but most comply with banking regulators' rules	N/A but most comply with banking regulators' rules		Apply	N/A	N/A		N/A
Stand-Alone Nonbank SBSDs Not Using Internal Models	The greater of \$20 million or 8% margin factor for SBS	Apply		Apply	Apply	N/A		Apply
Stand-Alone Nonbank SBS Using Internal Models	The greater of \$20 million or 8% margin factor for SBS, and minimum tentative net capital of \$100 million	Apply		Apply	Apply	Apply		Apply
BD-SBSDs Not Using Internal Models	N/A, but 15c3-1 is modified so that the capital requirement is the greater of \$20 million or 8% margin factor for SBS plus current Rule 15c3-1 ratio	Apply		Apply	Apply	N/A but must comply with Rule 15c3-1 and FINRA Rules		N/A but must comply with Rule 15c3-1 and FINRA Rules
BD-SBSDs Using Internal Models (must apply to become ANC BDs)	N/A, but 15c3-1 is modified so that the capital requirement is the greater of \$20 million or 8% margin factor for SBS plus current Rule 15c3-1 ratio, and minimum tentative net capital	Apply		Apply	Apply	N/A but must comply with Rule 15c3-1 and FINRA Rules		N/A but must comply with Rule 15c3-1 and FINRA Rules

	Capital Requirement (Rule 18a-1)	Uncleared Margin Requirement (Rule 18a-3)	SBS Requirement	Collateral Segregation, Possession and Control, Account, Subordination Agreement Requirements (Rule 18a-4)	Internal Management Control Requirements (Rules 18a-1(g) / 18a-2)	Risk	Liquidity Tests, Reserves, Contingency Funding Requirements (Rule 18a-1)	Stress Liquidity and Plan	Debt-Equity Ratio, Capital Withdrawal, Subsidiary Consolidation, and Early Warning Notice Requirements (Rule 18a-1)
	of \$5 billion								
Nonbank MSBSPs	Positive net worth test	Apply		Apply (but requirements differ from nonbank SBSDs)	N/A		N/A		Apply
ANC BDs that are not SBSDs	N/A, but 15c3-1 is modified so that the capital requirement is the greater of \$1 billion or 8% margin factor plus current Rule 15c3-1 ratio, and minimum tentative net capital of \$5 billion ⁴	N/A but must comply with SRO margin rules		N/A but must comply with Rule 15c3-5 and related requirements	Apply (15c3-4 only)		N/A but must comply with Rule 15c3-1 and FINRA Rules		N/A but must comply with Rule 15c3-1 and FINRA Rules
Non-SBSD, Non-ANC BDs	N/A, but must comply with Rule 15c3-1 ⁵	N/A but must comply with SRO margin rules		N/A but must comply with Rule 15c3-5 and related requirements	N/A		N/A but must comply with Rule 15c3-1 and FINRA Rules		N/A but must comply with Rule 15c3-1 and FINRA Rules

⁴ This represents a \$500 million increase over the current minimum capital requirement. The early warning notice threshold would also increase from \$5 billion to \$6 billion.

⁵ The Proposal would modify Rule 15c3-1 to provide for new additional haircuts for swaps and SBS.