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Key ICI Recommendations Regarding SEC's Re-Opened Proposal on Capital, Margin, and Segregation for SBSDs and MSBSPs

The SEC should adopt margin rules that are consistent with the margin rules that have been adopted by other US regulators and international regulators. The final rules should reflect that most entities that engage in SB swap dealing are not registered broker-dealers and should not disincentivize firms to act as SBSDs. Similarly, the SEC should adopt capital rules that do not penalize firms for accepting margin through tri-party custody arrangements. To achieve these objectives, the SEC should revise its approach to:

- Require bilateral exchange of collateral by SBSDs and MSBSPs and their counterparties in connection with SB swaps to mitigate systemic risk and prevent undue leveraging by SBSDs and MSBSPs;
- Ensure that final rules enable counterparties to close out and net positions, using posted collateral, upon the insolvency of an SBSD;
- Require only those counterparties that have "material swaps exposure" to post initial margin, consistent with the CFTC and prudential regimes;
- Provide for a threshold for exchange of initial margin and raise the minimum transfer amount, both consistent with existing rules of the CFTC and the prudential regulators;
- Not impose capital charges on SBSDs and MSBSPs when their counterparties elect to have their collateral held at a third-party bank custodian or ensure that any exception from the capital charge is workable.

Key arguments in support of these recommendations:

Most Entities That Engage in SB Swap Dealing are Not Registered Broker-Dealers

- Most entities that engage in SB swap dealing are not registered broker-dealers. Therefore, the SEC's concerns regarding broker-dealer liquidity are not implicated. To the extent any of these entities are broker-dealers, an approach balancing capital and bilateral margin requirements that reflect thresholds consistent with global standards would address the SEC's concerns. This type of margin regime has effectively protected swap dealers and their counterparties from systemic risk and counterparty risk.

The SEC's Approach Would Adversely Affect US Dealers and Counterparties

- Non-US SB swap dealers and banking entities comprise most of the SBSDs today and are already subject to EU margin rules or those of the US prudential regulators. Prudentially regulated SBSDs are subject to the margin regimes of their prudential regulators. Other SBSDs will need to comply with the SEC's margin rules for SB swaps.

- The SEC's proposed rules would create significant competitive disadvantages for these SBSDs by reducing the ability of parties to net exposures and requiring these firms to build bespoke operational systems for SB swaps. This would disincentivize non-prudentially regulated firms from acting as SBSDs and it would discourage other market participants from transacting with non-prudentially regulated SBSDs.
- The SEC's approach also would favor EU counterparties of European SBSDs over US counterparties if a European SBSD defaults. Because the EU rules require bilateral margining, some US counterparties of European SBSDs would end up subsidizing the EU counterparties. If the dealer fails, only the EU counterparties would have the protection of margin posted by the European SBSD.

The SEC's Approach Would Harm the US Markets and Market Participants

- The SEC's capital-based approach would create uncertainty regarding the bankruptcy regime applicable to SBSDs subject to the SEC's margin rules and the application of close-out netting. This concern would contribute to uncertainty in bankruptcy and increase the likelihood of investor losses.
    - The SEC should clarify in any final rules that SBSDs would not be subject to SIPA with respect to their swap books, which would continue to be subject to the provisions of the US Bankruptcy Code, including the close-out netting provisions and exceptions from the stay requirements.
- The SEC's proposed approach to the obligation to exchange collateral and to the thresholds that apply to collateral exchange, would impose significant operational burdens and costs on market participants, including costs to establish and document separate trading relationships for SB swaps and to transfer more margin to the SBSD.
    - The SEC's use of a variable threshold for collateral exchange, which relies on non-verifiable, non-static data, such as capital levels and total exposure, would result in uncertainty and increased operational challenges.
- If the SEC adopts an exception to the capital charge requirement for SBSDs and MSBSPs when their counterparties elect to segregate collateral (either initial or variation margin), any such exception should *not*:
    - Require an opinion on enforceability of triparty arrangements, given that the enforceability of such arrangements is well-established as a matter of existing law and practice.
    - Penalize registered fund counterparties, which under the 1940 Act must segregate their collateral, generally are unable to post collateral to a dealer, and may not allow their collateral to be rehypothecated.