



asset management group



May 12, 2016

Mr. Stephen Luparello, Director
Mr. Gary Goldsholle, Deputy Director
Division of Trading and Markets
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Standards for Covered Clearing Agencies, Securities and Exchange Commission Release No. 34-71699, File No. S7-03-14; 79 Fed. Reg. 16865 (Mar. 26, 2014)

Dear Messrs. Luparello and Goldsholle:

The Asset Management Group of the Securities Industry and Financial Markets Association (“SIFMA AMG” or “AMG”)¹ and the Investment Company Institute (“ICI”)² submit this letter to supplement prior comments³ on the proposal by the Securities and Exchange Commission (“SEC” or “Commission”) to amend Rule 17Ad-22 and add Rule 17Ab2-2 (“Proposed Rule”)⁴ under the Securities Exchange Act of 1934 (“Exchange Act”). The Proposed Rule would establish standards for the operation and governance of registered clearing agencies that meet the definition of a “covered clearing agency.”

¹ SIFMA AMG members represent U.S. asset management firms whose combined assets under management exceed \$34 trillion. The clients of AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, unit investment trusts and private funds such as hedge funds and private equity funds.

² ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$ 17.68 trillion and serve over 90 million shareholders.

³ See, e.g., Letter from Dorothy M. Donohue, Acting General Counsel, ICI, to Kevin M. O’Neill, Deputy Secretary, SEC, dated May 21, 2014, *available at* <http://www.sec.gov/comments/s7-03-14/s70314-9.pdf>.

⁴ Standards for Covered Clearing Agencies, 79 FR 16866 (Mar. 26, 2014), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2014-03-26/pdf/2014-05806.pdf> (the “Proposing Release”). Covered clearing agencies include registered clearing agencies that (1) have been designated as systemically important by the Financial Stability Oversight Council and for which the SEC is the supervisory agency; (2) provide central counterparty (“CCP”) services for security-based swaps or are involved in activities the SEC determines to have a more complex risk profile, where in either case the Commodity Futures Trading Commission is not the supervisory agency for such clearing agency; or (3) are otherwise determined to be covered clearing agencies by the SEC pursuant to procedures set forth in the Proposed Rule.

AMG and ICI are concerned that the Commission's proposed requirements for security-based swaps ("SBS") do not provide sufficient protections for collateral posted on behalf of asset manager clients, for whom AMG members act as fiduciaries, or posted on behalf of ICI member funds. These protections are significantly weaker than those historically applicable to collateral provided in connection with over-the-counter uncleared derivatives (i.e., "OTC swaps") and in connection with cleared swaps subject to regulations promulgated by the Commodity Future Trading Commission ("CFTC").

AMG and ICI believe that providing sufficient protections for collateral posted for cleared SBS is crucial to avoid undermining important portfolio management tools. Many AMG and ICI members use various derivatives contracts, including swaps and SBS, as part of the prudent management of funds and other portfolios. In particular, SBS serve as a necessary tool for hedging risks arising from portfolio investments, equitizing cash that cannot immediately be invested in direct equity holdings, managing cash positions, obtaining market exposures and adjusting the duration of a portfolio.

We believe that SBS cleared at covered clearing agencies need to be protected by adoption of a "legal segregation with operational comingling" ("LSOC") standard comparable to the LSOC approach implemented by the CFTC for cleared swaps.⁵ LSOC is necessary to protect SBS customers from unnecessary loss mutualization and uncertainty resulting from the insolvency of a broker-dealer ("BD") or standalone SBS dealer ("SBSD").

For these reasons, AMG and ICI urge the Commission to mandate LSOC at covered clearing agencies when it finalizes amendments to Rule 17Ad-22(e)(14) and make the other conforming changes to Commission regulations outlined below.

I. Background

A. The Commission's Proposing Release Acknowledges the Risk of an Omnibus Account Structure to Customer Property But Does Not Commit to Adopting LSOC

The Exchange Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), requires (i) a BD or standalone SBSD to treat and deal with all

⁵ Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 FR 6336 (Feb. 7, 2012), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2012-02-07/pdf/2012-1033.pdf>. The LSOC model adopted by the CFTC requires each futures commission merchant ("FCM") and derivatives clearing organization ("DCO") to segregate on its books and records the cleared swaps of each individual customer and related collateral position. *See* 17 C.F.R. § 22.2 and 22.3 (2014). Each FCM and DCO is able to commingle customer collateral in one account. *See* 17 C.F.R. §22.2(c) (2014). FCMs and DCOs are also required to keep separate customer collateral from any account holding FCM or DCO property. *See* 17 C.F.R. § 22.2 and 22.3 (2014). Additionally, under the CFTC's rules, a clearinghouse may not allow the DCO to access the collateral of non-defaulting cleared swap customers to address losses of a defaulting swap customer in the event of a default of the clearing member (a "double default").

money, securities, and property of any SBS customer received to margin, guarantee, or secure SBS cleared by or through a clearing agency (including money, securities, or property accruing to the SBS customer as the result of such SBS) as belonging to the SBS customer and (ii) money, securities, and property of an SBS customer to be separately accounted for and not be commingled with the funds of the BD or SBSB or be used to margin, secure, or guarantee any trades or contracts of any SBS customer or person other than the person for whom the same are held.⁶ Although limited exceptions permit certain commingling, the Exchange Act allows the Commission, through rulemaking, to require that SBS margin be separately accounted for and treated as belonging to the SBS customer.⁷

Under the Proposed Rule, the Commission proposed amending Exchange Act Rule 17Ad-22(e)(14) to require a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to enable the segregation and portability of SBS positions of a member's customers and the collateral provided to the covered clearing agency with respect to those positions, and effectively protect such positions and related collateral from the default or insolvency of that member. In the Proposing Release, the Commission notes that segregation can be achieved either through an omnibus account structure or an individual account but that, in the case of an omnibus account structure, "where all collateral belonging to all customers of a particular member is commingled and held in a single account segregated from that of the member," such an account "may expose a customer to 'fellow-customer risk' (i.e., the risk that another customer of the same member will default) in the event of a loss that exceeds the amount of available collateral posted by the fellow customer who has defaulted and in which case the remaining commingled collateral of the member's non-defaulting members may be exposed to the loss."⁸

The Proposing Release acknowledges that an LSOC type of protection would mitigate risks to customers, noting that, "[t]o mitigate this risk, omnibus account structures can be designed in a manner that operationally commingles collateral related to customer positions while protecting customers legally on an individual basis."⁹ However, the Proposed Rule stops short of mandating that a uniform LSOC approach be adopted by all covered clearing agencies. As a result, the Proposed Rule, if adopted without minimum LSOC standards, would permit covered clearing agencies to use discretion in establishing procedures to prescribe means for holding or accounting collateral separately from the assets of the clearing agency member. This result could introduce variation among covered clearing agencies and reduce the amount of protection in cleared SBS that is currently afforded to funds and other asset manager clients. Such an approach would also introduce inconsistencies between the treatment of cleared swaps and cleared SBS.

⁶ Section 3E of the Exchange Act. 15 U.S.C. § 78c-5.

⁷ *Id.*

⁸ *Supra* note 4.

⁹ *Id.* (citing to the CFTC's final rule adopting an LSOC model for customer collateral protection with respect to cleared swaps).

B. The Commission's Proposing Release Acknowledges that Cleared SBS are Fundamentally Different from Listed Options but does not Recommend Adoption of Greater Protections

In determining the type of margin segregation regime to apply to cleared SBS, the Commission examined the existing rules applicable to cash securities and listed options held by BD customers. The Commission determined that requiring the same approach for cleared SBS would not address the differences between how such cash securities and listed options markets operate as compared to the cleared SBS market. In the Proposing Release, the Commission notes that, unlike swaps or SBS transactions, “[t]ransactions in the U.S. cash security and listed options markets are characterized by the following features: (i) customers of members generally do not have an account at a clearing agency; and (ii) the clearing agency is not able to identify which participants’ customers beneficially own the street name positions registered in the record name of the clearing agency (or its nominee) and the clearing agency has no recourse to funds of customers of members.”¹⁰

Margin posted by customers for listed options is not normally passed through to the clearing agency to cover mark-to-market exposure on the option positions. Instead, a BD clearing member will typically use its own assets to fund margin payments delivered to the clearing agency. Customer margin for short option positions is kept by the BD clearing member and held in the customer’s margin or listed options account. Commission rules allow the BD to use up to 140% of the debit balance of initial and mark-to-market margin, as well as excess margin, received from its customers to fund the BD’s business. The BD separately posts to the clearing agency the amount of margin required pursuant to the BD’s sponsored positions.¹¹ Thus, the amount of margin posted to the clearing agency may be different than the amount of margin collected and being held by the BD from its customers.

In contrast, in the case of cleared swaps, a customer posts variation margin on a daily basis with its FCM who on behalf of the customer, transfers the customer margin to the DCO to satisfy margin requirements. The DCO, in turn, passes the variation margin through to the FCM of the customer holding the position on the other side of that trade. The customer’s initial margin is also passed through to the DCO by the FCM.¹² The margin held at the DCO is subject to the CFTC’s LSOC regime.

This is a fundamental distinction between the current cash securities and listed options market on the one hand and cleared swaps on the other. As the Commission states in the Proposing

¹⁰ *Supra* note 4, at 16904. Because securities are typically held in book-entry form, the direct registration system accounts for book-entry securities are maintained by a transfer agent and not by a clearing agency. *Id.*

¹¹ This reflects, among other things, that holding global positions in the record name and custody of a clearing agency is a fundamental part of how the cash securities and options market operates in which holders hold security positions indirectly through “street name.”

¹² Excess margin, if any, posted by the customer is either held by the FCM in a segregated account or passed through to the DCO. Such excess margin cannot be used by the FCM and can only be invested according to CFTC rules.

Release, because neither portability nor segregation can occur as a practical matter for the cash securities and listed options market under current structures, the Proposed Rule should only apply to cleared SBS.¹³ In addition, given that substantially all liquidations of BDs occur pursuant to a Securities Investor Protection Act of 1970 (“SIPA”) proceeding, the Commission recognizes that cash securities and listed options positions are protected under SIPA, thus reducing the need for segregation and portability of those positions.¹⁴

In contrast, the Commission recognizes that SBS operate in a manner more comparable to swaps than listed options thus giving rise to the need for appropriate segregation to assure portability of cleared SBS positions and related customer collateral as well as the need to protect such positions and collateral from the insolvency of a BD or SBSD. The Proposing Release states that covered clearing agencies must structure their portability arrangements “in a way that makes it highly likely that the positions and collateral of a defaulting member’s customers will be effectively transferred to one or more other members.”¹⁵ Such an approach reflects the differences between how cash securities and listed markets operate on the one hand and how cleared swap markets (including cleared SBS) operate on the other. The amendment made by Dodd-Frank adding Section 3E to the Exchange Act arose from this understanding.

II. Mandating LSOC Through Commission Regulation is Necessary to Provide Sufficient Protection of Cleared SBS Customer Collateral and Avoid Confusion in a BD or SBSD Insolvency

Consistent with the objectives of Dodd-Frank, AMG and ICI believe that the clearing of SBS transactions should be encouraged and facilitated through implementation of a uniform LSOC model for holding margin in order to sufficiently protect customer collateral and to provide clarity following a BD or SBSD insolvency. Registered investment companies (“RICs”), which comprise all ICI members as well as many clients of AMG members, must limit the exposure of assets to mutualization of losses not caused by the RIC. In fact, RICs (in particular) that trade uncleared swaps and SBS typically use tri-party collateral arrangements that protect margin from FCM and BD fraud risk as well as from fellow-customer risk. Those custody arrangements must satisfy the requirements of the Investment Company Act of 1940 (“1940 Act”).¹⁶ Indeed, RICs have only been able to clear swaps on the basis of no-action relief conditioned on the clearinghouse utilizing LSOC standards, as the Commission’s Division of Investment Management has viewed LSOC as a baseline

¹³ *Supra* note 4, at 16905.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *See* Section 17 of the 1940 Act which establishes the requirements for such custodial arrangements. Additionally, Section 3E(f)(1)(B) of the Exchange Act provides that, with respect to non-cleared SBS, if requested by a counterparty (including a RIC), an SBSD must segregate the funds or other property for the benefit of the counterparty and, in accordance with such rules and regulations as the Commission may promulgate, maintain the funds or other property in a segregated account separate from the assets and other interests of the SBSD.

requirement.¹⁷ Although AMG and ICI believe that clearing of SBS transactions will help to improve market structure for certain types of SBS transactions, including single-name credit default swaps (“CDS”),¹⁸ RICs and many AMG portfolio managers may not be able to utilize fully cleared products in the absence of LSOC as the minimum standard.¹⁹

The amendment made by Dodd-Frank to the Exchange Act mandates that counterparties to cleared SBS transactions be entitled to customer protections, both before and after a BD or SBS’s bankruptcy. Although Dodd-Frank did not amend SIPA or the Bankruptcy Code to address SBS, Dodd-Frank amended the definition of “securities” in the Exchange Act to include SBS,²⁰ which is incorporated under both SIPA and the Bankruptcy Code. Section 3E(g) of the Exchange Act provides that SBS will be considered to be securities as that term is used Section 101(53A)(B) and subchapter III of chapter 7 of the Bankruptcy Code which governs stockbroker liquidations. Section 3E(g) also provides that an account holding SBS, other than a portfolio margining account referred to in Section 15(c)(3)(C) of the Exchange Act, shall be considered to be a securities account, as defined in Section 741 of subchapter III of chapter 7 of the Bankruptcy Code.²¹ Except as otherwise provided in SIPA, the Exchange Act applies to SIPA²² and SIPA expressly incorporates into a SIPA proceeding subchapters I and II of chapter 7 of the Bankruptcy Code (in each case, to the extent consistent with SIPA).²³ Therefore, although SBS are not included in the definition of “security” as defined in SIPA, SBS are included within the meaning of “security” when SIPA is referring to subchapter III of chapter 7 of the Bankruptcy Code.

¹⁷ See, e.g., Division of Investment Management No-Action Relief (December 29, 2015) (allowing for clearing of swaps provided that CME will comply with the requirements relating to the separate treatment of customer funds and property of CME and the CFTC segregation rules for swap collateral, *i.e.*, legal segregation with operational commingling), *available at*: <https://www.sec.gov/divisions/investment/noaction/2015/chicago-mercantile-exchange-122915.htm>.

¹⁸ 25 Investment Management Firms Commit to Single-Name CDS Clearing (December 16, 2015), *available at*: http://www.sifma.org/newsroom/2015/25_investment_management_firms_commit_to_single_name_cds_clearing/.

¹⁹ In order for RICs to post collateral to a clearinghouse for SBS, relief under Section 17(f) will also be required. Our expectation is that the relief previously granted by the SEC to hold collateral for cleared swaps at swap clearinghouses will be extended to SBS as well if SBS are subject to the same type of LSOC requirements applicable to cleared swaps.

²⁰ 15 U.S.C. § 78c-5.

²¹ *Id.*

²² 15 U.S.C. § 78bbb. Regarding uncleared SBS, Section 3E(f) of the Exchange Act provides that an SBS must segregate collateral at a third-party custodian in an account for the benefit of the counterparty upon such counterparty’s request. As the Commission has recognized, the objective of this provision for individual segregation is to allow the counterparty to provide collateral in a manner that will keep these assets separate from the bankruptcy estate of the SBS. See *infra* Note, at 70275. Consequently, Section 3E(g) of the Exchange Act provides that a claim to collateral for uncleared SBS is not a “customer” claim under the Bankruptcy Code unless there is a customer protection requirement under Section 15(c)(3) of the Exchange Act or a segregation requirement (which in this context means an omnibus segregation requirement).

²³ 15 USCS § 78fff(b).

This statutory difference means that, following a BD or SBSB insolventcy, while portability may not occur for cash securities and listed positions, the customers holding such cash securities and listed positions will nevertheless benefit from SIPA insurance protection. On the other hand, the customers holding cleared SBS positions will not benefit from SIPA coverage, necessitating, the need to assure portability and protection for cleared SBS positions on the same basis as is provided by CFTC rules for cleared swaps. To the extent consistent with SIPA, a SIPA trustee would be subject to the same duties as a trustee in a case under chapter 7 of title 11 of the United States Code. This includes the trustee's duties under subchapter IV of chapter 7 of the Bankruptcy Code—the commodity broker liquidation provisions. The incorporation of the trustee's duties under subchapter IV of chapter 7 of the Bankruptcy Code effectively creates three estates in a joint BD/FCM insolventcy: a general estate, a SIPA customer estate and an FCM customer estate.

In the same way that SIPA incorporates the trustee's duties under subchapter IV of chapter 7 to create an FCM customer estate, following the enactment of Dodd-Frank, we believe that SIPA must be read to incorporate pursuant to subchapter III an additional SBS customer estate--the functional equivalent of the FCM estate--for cleared SBS positions. That is, it would appear that the intent of Congress was to give SBS customers priority against the claims of general creditors of a BD or stand-alone SBSB in the context of the 1934 Act and the Bankruptcy Code, with such claims nevertheless remaining separate under SIPA from other BD customer claims and thus having treatment comparable to the protections afforded to cleared swaps. This outcome is possible because the amendments made by Dodd-Frank treat SBS as securities in all contexts other than with respect to SIPA insurance coverage.

Just as a SIPA trustee can create a separate FCM customer estate, the treatment of SBS as securities for purposes of the 1934 Act but not for purposes of SIPA, allows the SIPA trustee to treat the rights of SBS customers separately from the treatment of other customer claims. Therefore, AMG and ICI believe that LSOC is necessary to provide sufficient protection of customer collateral, to facilitate porting of SBS customer positions and to avoid confusion in a BD or SBSB insolventcy, particularly in the case of a jointly registered BD/FCM. After giving effect to an appropriate LSOC segregation regime, customers with cleared SBS positions, together with any cash or securities held with respect to such positions, should be considered and dealt with separately from SIPA covered customer claims; that is, in the same manner in which cleared swaps are separately handled in a BD/FCM insolventcy. LSOC treatment would provide the necessary clarity for this complex division and handling of different customer estates.

AMG and ICI believe that unintended consequences and market uncertainty would arise if cleared SBS positions and cleared swap positions are not handled in a comparable manner following a BD/FCM insolventcy. Although exceptions will certainly exist, it is likely that a dealer insolventcy will involve an entity jointly registered as a BD and an FCM. Customers holding cleared swap and cleared SBS positions would be surprised if their protection and portability rights with respect to these two asset classes differed in any material respects. Moreover, the regulatory distinction made in the U.S. between swaps governed by the CFTC and SBS governed by the Commission is not a distinction found in the rest of the world and is a legal distinction that could unnecessarily confuse funds and portfolio manager that utilize both types of swaps as part of a prudent hedging and investment strategy. Providing different protections for collateral posted for cleared swaps and SBS exacerbate the unnecessary and confusing distinction. In fact, asset managers typically trade swaps and SBS on behalf of funds and other clients from the same desk or unit, especially in the case of

CDS. Index swaps and certain tranching CDS are already being cleared under the CFTC's LSOC model. However, under the Proposed Rule, the clearing system applicable to single name CDS or tranches comprising an index could differ significantly from the system applicable to CDS indices and other cleared swaps. There is a market expectation that the same type of LSOC regime will apply regardless of whether the position held by a customer is designated as a cleared swap or as a cleared SBS.

III. The Commission Should Mandate LSOC for Cleared SBS Transactions by Adopting a Single LSOC Standard in its Final Rule and Making Additional Conforming Changes to Commission Regulations

In order to implement LSOC for SBS positions, SIFMA AMG and ICI recommend that the Commission take the following actions:

1. **Revise Proposed Rule 17Ad-22(e)(14).** Rule 17ad-22(e)(14) should require a single LSOC approach for cleared SBS and should require that a covered clearing agency's policies and procedures enable the segregation and portability of positions of clearing member customers and the collateral provided to the covered clearing agency with respect to those positions. To give effect to such a requirement, Rule 17ad-22(e)(14) should mandate that both initial and variation margin related to cleared SBS be passed to the covered clearing agency and held in an LSOC-like account and should require that all excess margin be held in either a segregated account that is subject to an LSOC-like regime or at the covered clearing agency if so requested by the customer.
2. **Amend SIPA Rules.** Clarify through rulemaking applicable to SIPA that notwithstanding the fact that SBS are "securities" for purposes of the Exchange Act and that an account that holds SBS (other than a portfolio margining account) is a "securities account" for purposes of the 1934 Act, any cleared SBS positions and related cash and property held subject to the Commission's LSOC and segregation requirements (i) will not be treated as "customer property" under SIPA for purposes of SIPA insurance coverage, (ii) will not be treated as general unsecured creditor claims of the BD and (iii) will, instead, be treated separately in a manner substantially similar to the treatment of cleared swaps pursuant to the Commission's mandated LSOC regime.²⁴

New Section 3E of the Exchange Act and the Commission's Rules issued pursuant to Section 15(c)(3)(C) of the Exchange Act include provisions that are designed to protect customers by segregating their securities and cash from the BD's proprietary business

²⁴ Pursuant to Section 3(e)(3) of SIPA, the "Commission may, by such rules as it determines to be necessary or appropriate in the public interest or to carry out the purposes of this Act, require SIPC to adopt, amend, or repeal any SIPC bylaw or rule, whenever adopted." Additionally, Section 36 of the Exchange Act authorizes the Commission to conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from certain provisions of the Exchange Act or certain rules or regulations thereunder, by rule, regulation, or order, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. 15 U.S.C. 78mm(a)(1).

activities. If the BD fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed BD is liquidated in a formal proceeding under SIPA, the securities and cash should be isolated and readily identifiable as “customer property” and, consequently, available to be distributed to customers ahead of other creditors. Through its rulemaking authority, the Commission can clarify that securities and cash being held with respect to SBS positions will be entitled to the same type of protection regardless of the fact that such securities and cash would not be entitled to the benefits of SIPA protection.

Such clarification would be consistent with the conditional relief previously granted by the Commission with respect to CDS held in customer accounts maintained in accordance with Section 4d(f) of the CEA (“4d(f) Accounts”).²⁵ As a result of that relief, any customer protection treatment otherwise available with respect to securities transactions under the Exchange Act, SIPA or the stockbroker liquidation provisions will not be available for CDS held in a 4d(f) Account.

3. **Revise Proposed Rule 18a-4.** The Commission has proposed Rule 18a-4 (“Proposed Rule 18a-4”) that addresses margin segregation requirement with respect to SBS customers of SBSDs.²⁶ Proposed Rule 18a-4 sets forth the requirements for how cash, securities, and money market instruments of a customer with cleared SBS must be segregated when an SBS commingles those assets with the cash and securities of other customers (“omnibus segregation”) pursuant to section 3E(c)(1) of the Exchange Act. Proposed Rule 18a-4 would require an SBS to treat SBS accounts separately from other securities accounts and, consequently, an SBS would need to perform separate possession and control and reserve account computations for SBS accounts and other securities accounts. As the Commission notes, this approach would keep separate the segregated customer property related to SBS from customer property related to other securities, including property of retail securities customers.²⁷

AMG and ICI agree with this approach. However, Proposed Rule 18a-4 should be revised to require that the omnibus segregation requirements set forth in the Rule be implemented

²⁵ See Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With Portfolio Margining of Swaps and Security-Based Swaps, 77 Fed. Reg. 75211 (Dec. 19, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-12-19/pdf/2012-30553.pdf> (“Exemptive Order”). Section 724 of Dodd-Frank added provisions to Section 4d of CEA that perform functions similar to those in Section 3E of the Exchange Act in creating a segregation framework for swap customers. “Accordingly, in order to permit collateral related to cleared security-based swaps to be commingled with that related to cleared swaps for purposes of portfolio margining and to operate under the segregation framework for swaps, a broker-dealer would need relief from the applicable provisions of Section 3E and Section 15(c)(3) of the Exchange Act as well as Rule 15c3-3 thereunder.” *Id.* at 75213, note 27.

²⁶ Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214 (Nov. 23, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf>.

²⁷ *Id.* at 70277.

pursuant to an LSOC type of regime consistent with the LSOC standards to be utilized by clearing agencies and as was implemented by the CFTC.²⁸ In addition, Proposed Rule 18a-4 should require that such LSOC requirements also apply with respect to excess margin (i.e., “excess securities”).²⁹ On that basis, all required margin for cleared SBS positions would be held under an LSOC regime at a covered clearing agency and all excess margin would either be held at the covered clearing agency or in a segregated account subject to the identification and recordkeeping requirements of LSOC. Finally, Proposed Rule 18a-4 should require that the omnibus segregation requirements accommodate the ability to hold swaps in SBS customer accounts to facilitate a portfolio margin treatment for related or offsetting positions in the account.

4. ***Amend Exchange Act Rule 15c3-3.*** Rule 15c3-3 requires that a BD obtain and maintain physical possession or control of all fully-paid securities and excess margin securities of a customer.³⁰ This requirement is designed to protect customers by segregating their securities and cash from the property of the BD. BDs may satisfy this requirement by holding such securities at a bank or at a clearing agency. Fully-paid securities are securities held in a cash account and margin equity securities carried in a margin or special account that have been fully paid. Excess margin securities are a customer’s margin securities having a market value in excess of 140% of the total of the debit balances in the customer’s non-cash accounts.

As part of their obligation to maintain physical possession or control of customers’ fully paid and excess margin securities, BDs are required to deposit into a reserve account at a bank an amount equal to their net monetary obligation to customers or in respect of the customers’ securities positions. Securities held subject to a lien to secure obligations of the BD are not within the BD’s physical possession or control. In addition, Rule 15c2-1 allow BDs to rehypothecate customer securities in a manner that allows those securities to be subject to a lien or liens but by an amount that exceeds the customer’s aggregate indebtedness to the BD.

²⁸ AMG and ICI believe that allowing an SBSBD (whether or not it is a joint BD/SBSD) to use customer assets being held in connection with SBS positions as margin or excess margin, may be incompatible with implementation of an LSOC regime and, accordingly, the Commission should clarify Proposed Rule 18a-4 to prohibit such use. *See* the discussion of Rule 15c3-3 below.

²⁹ Proposed Rule 18a-4 would define the term excess securities collateral to mean 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 SBSBD to the customer, excluding: (1) securities and money market instruments held in a qualified clearing agency account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the clearing agency resulting from SBS transactions of the customer; and (2) securities and money market instruments held in a qualified registered SBSBD account but only to the extent the securities and money market instruments are being used to meet a margin requirement of the other SBSBD resulting from the SBSBD entering into a non-cleared security-based swap transaction with the other SBSBD to offset the risk of a non-cleared security-based swap transaction between the SBSBD and the customer. *Id* at 70279.

³⁰ *See* 17 CFR 240.15c3-3.

Proposed Rule 18a-4 includes a conforming amendment to add new paragraph (p) to Rule 15c3-3 to state that a BD that is registered as an SBSB pursuant to section 15F of the Exchange Act must also comply with the provisions of Rule 18a-4. This proposed amendment would clarify that a joint BD/SBSB must comply with both Rule 15c3-3 and Rule 18a-4. AMG and ICI agree with this proposed conforming amendment. However, as proposed, the amendment stops short of the steps necessary to implement an LSOC regime. Rule 15c-3 was implemented under a listed options regime which allows a BD to finance customer positions under one set of margin requirements and, in turn, to post its own assets to a clearing agency pursuant to a different set of margin requirements. As part of this structure, as noted above, the BD can also use customer margin to support the cost of customer financing and a portion of excess margin for the BD's own business. Such an approach is likely inconsistent with the steps necessary to give effect to an LSOC structure (as well as the objective of Section 3E of the Exchange Act) and, accordingly, Rule 15c3-3 must also be clarified to prohibit the use by a BD of customer margin and excess margin being held in connection with SBS positions in a manner that is inconsistent with LSOC.³¹

5. ***Relief of Section 4d(f) Accounts.*** As noted above, pursuant to the Commission's Exemptive Order, the Commission has previously granted conditional exemptive relief from compliance with certain provisions of the Exchange Act for registered clearing agencies and derivatives clearing organizations and BD/FCMs, to offer a program to commingle and portfolio margin customer positions in cleared CDS, which include both swaps and SBS, in a segregated account established and maintained in accordance with Section 4d(f) of the CEA.³² The Commission should make such relief permanent for purposes of implementation of an LSOC regime and to facilitate portfolio margining and insolvency treatment consistent with the treatment granted to swaps.

The Exemptive Order also allows the Commission to provide temporary approval of a BD/FCM's margin methodology while the methodology is being evaluated prior to granting final approval, and to allow margin calculations to be made on the same basis as allowed for cleared swaps. However, the Commission has taken a much different view from both its prior assessment of initial margin requirements for BDs' proprietary CDS portfolios and from the CFTC's customer initial margin requirements. In making the Exemptive Order permanent, the Commission should eliminate the disparities between its approach and that of the CFTC.

SIFMA AMG's and ICI's recommendations are consistent with Dodd-Frank's effective amendment (15 U.S.C. § 78c-5(g)) of the stockbroker liquidation provisions of the Bankruptcy Code (i.e., § 741) to treat SBS as "securities" and accounts holding cleared SBS as "securities accounts" for purposes of the Code; requirements of Section 3E of the Exchange Act with respect to segregation; and the CFTC's approach for the treatment of cleared swaps. These recommendations also provide

³¹ As the Commission recognizes, it has authority under Section 15(c)(3) of the Exchange Act to prescribe segregation requirements for BDs. See 15 U.S.C. 78o(c)(3).

³² *Supra* note 25. Section 713(a) of Dodd-Frank provides explicit authority for such exemptive relief to facilitate portfolio margining programs.

certainty for clearing agencies and eliminate need to develop a separate regime for SBS. The recommendations eliminate inconsistencies that would result in treating counterparties as FCM customers for purposes of cleared swaps but as non-customer creditors (or as SIPA-insured customers) for purposes of cleared SBS and allow for efficiencies and uniformity of approach in porting both cleared swap positions and SBS positions to solvent dealers. The recommendations facilitate portfolio margining and netting of positions in order to reduce systemic risk and are consistent with Commission's prior approach of allowing positions to be held in 4d(f) Accounts with respect to jointly registered BD/FCMs. Further, in the case of an insolvency of a jointly registered BD/FCM (which would likely be the case), the recommendations eliminate the inconsistent and non-supportable approach of requiring a trustee to treat cleared swaps differently from cleared SBS.

Should you have any questions or wish to discuss these matters further, please do not hesitate to contact us. For SIFMA AMG, you may contact Tim Cameron at [REDACTED], [REDACTED] or Laura Martin at [REDACTED], [REDACTED]. For ICI you may contact David Blass at [REDACTED], [REDACTED], or Jennifer Choi at [REDACTED], [REDACTED]. You may also contact Joel Telpner at [REDACTED], [REDACTED].

Respectfully submitted,

/s/ Timothy W. Cameron
Timothy W. Cameron, Esq.
Asset Management Group – Head
Securities Industry and Financial Markets
Association

/s/ Laura Martin
Laura Martin, Esq.
Asset Management Group – Managing
Director and Associate General Counsel
Securities Industry and Financial Markets
Association

/s/ David W. Blass
David W. Blass, Esq.
General Counsel
Investment Company Institute

/s/ Jennifer S. Choi
Jennifer S. Choi, Esq.
Associate General Counsel
Investment Company Institute

cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar
Mr. Brent Fields, Secretary
Mr. David Grim, Director, Division of Investment Management