Morgan Stanley

February 22, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers; Release No. 34-68071; File No. S7-08-12.

Ladies and Gentlemen:

We appreciate the opportunity to comment on the notice of proposed rulemaking (the "**Proposal**") published by the Securities and Exchange Commission (the "**Commission**") to establish capital, margin, and segregation requirements for security-based swap dealers ("**SBSDs**") and major security-based swap participants and capital requirements for broker-dealers.[1]

Morgan Stanley, a global financial services firm, provides products and services, including security-based swaps, to a large and diversified group of clients and customers around the world, including corporations, governments, financial institutions and individuals. Morgan Stanley & Co. LLC, a consolidated subsidiary of Morgan Stanley, is a registered broker-dealer regulated by the Commission, and we intend to register one or more consolidated subsidiaries as SBSDs with the Commission.

In addition, effective December 31, 2012, we provisionally registered six consolidated subsidiaries as swap dealers ("**SDs**") with the National Futures Association, in accordance with regulations of the Commodity Futures Trading Commission ("**CFTC**").[2] Swap and security-based swap markets are closely linked, and we believe that U.S. regulators, including the Commission and the CFTC, should adopt regulatory regimes that impose consistent capital, segregation and margin requirements on SBSDs and SDs, particularly where a single legal entity is dual-registered as both an SBSD and an SD.

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[1] 77 Fed. Reg. 70,214 (Nov. 23, 2012).

[2] Morgan Stanley & Co. LLC, Morgan Stanley & Co. International plc, Morgan Stanley Bank, N.A., Morgan Stanley Capital Group Inc., Morgan Stanley Capital Services LLC, and Morgan Stanley Derivatives Products Inc. are each provisionally registered as a swap dealer.

We strongly support the comments on the Proposal submitted by the Securities Industry and Financial Markets Association ("**SIFMA**") and the International Swaps and Derivatives Association ("**ISDA**," and together with SIFMA, the "**Associations**").[3] Our comments in this letter focus on the Commission's proposed capital regime for SBSDs. We are concerned that this proposed regime does not properly address the risks faced by SBSDs and is not comparable to the capital regimes proposed by other U.S. regulators, as directed by the Dodd-Frank Act.

We offer the following recommendations:

- ***The Commission's capital standards should be risk-based and harmonized with the capital standards of other U.S. and global regulators.*** Other U.S. regulators with authority to set capital standards for SBSDs and/or SDs – the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (collectively, the "**Prudential Regulators**") as well as the CFTC – have each proposed to impose risk-based capital regimes on all or a portion of regulated firms under their respective jurisdictions.[4] Derivatives dealers in major non-U.S. jurisdictions are likewise subject to risk-based capital regimes. The Commission's proposed capital regime, by contrast, is neither risk-based nor aligned with domestic or international standards.

- ***The Third-Party Custodian Deduction is unnecessary and should be eliminated.*** The Proposal would require a punitive capital deduction for margin collateral posted by a security-based swaps counterparty that is held by a third-party custodian (the "**Third-Party Custodian Deduction**").[5] This deduction is inconsistent with the capital regimes proposed by other U.S. regulators as well as capital regimes in other major non-U.S. jurisdictions. The deduction is unnecessary because SBSDs have a perfected first-priority security interest in collateral held by third-party custodians and SBSDs appropriately manage risk in these arrangements, including through enforceable legal agreements. Applying the deduction would also make such collateral arrangements prohibitively expensive, frustrating Congress's clear intention that such arrangements should be available to counterparties.

[3] SIFMA filed its comment letter on the Proposal with the Commission on February 22, 2013. ISDA filed its comment letter on the Proposal with the Commission on January 23, 2013.
[4] *See* 76 Fed. Reg. 27,564 (May 11, 2011) (Prudential Regulators' proposed capital rules); 76 Fed. Reg. 27,802 (May 12, 2011) (CFTC's proposed capital rules). The Farm Credit Administration and the Federal Housing Finance Agency also participated in the Prudential Regulators' notice of proposed rulemaking.
[5] Proposal §§ 15c3-1(c)(2)(xiv)(B)(2), 18a-1(c)(viii)(B)(2).

- ***The Legacy Account Deduction is unnecessary and should be eliminated.*** The Proposal would require a capital deduction for the margin amount deficiency calculated for a legacy security-based swap account under the Proposal's margin methodology (the "**Legacy Account Deduction**").[6] This deduction is inconsistent with other regulators' capital regimes, and is unnecessary because credit risk charges appropriately capitalize counterparty risk when an SBSD has an uncollateralized exposure. The punitive impact of the deduction will be compounded by the proposed capital deduction for transactions with parties exempted from regulatory margin requirements, including commercial end users, which will negatively affect the pricing and liquidity of such transactions. Alternatively, if the Commission imposes the Legacy Account Deduction, it should only apply after a multi-year transition period, which would permit many legacy account transactions to roll off or be cleared through backloading into clearinghouses.

I. Discussion of Capital Issues

A. The Commission's capital standards should be risk-based and harmonized with the capital standards of other U.S. and global regulators.

We recommend that the Commission, like the Prudential Regulators and the CFTC, adopt risk-based regulatory capital standards for SBSDs.

International agreements and the Dodd-Frank Act direct regulators to impose comparable capital requirements on derivatives dealers. At its 2009 Pittsburgh summit, the G20 pledged to comprehensively regulate over-the-counter derivatives markets and agreed to "implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."[7] The Dodd-Frank Act, in turn, requires the Commission, the Federal Reserve and the CFTC, "to the maximum extent practicable, to establish and maintain comparable minimum capital requirements" for SBSDs and SDs.[8]

Swaps and security-based swaps present the same risk management and operational considerations and, accordingly, SBSDs and SDs should be subject to comparable and consistent capital requirements. The technical distinction between swaps and security-based swaps is a function of the jurisdictional divide between the Commission and the CFTC under the Dodd-Frank Act. Neither market participants nor regulators outside the United States recognize the distinction. A swap position will often hedge risk on a security-based swap position, such as when an equity index swap hedges a group of single-name equity positions. Regulatory regimes

[6] Proposal §§ 15c3-1(c)(2)(xiv)(B)(3), 18a-1(c)(viii)(B)(3).
[7] Leaders' Statement, the Pittsburgh Summit, September 24-25, 2009.
[8] Securities Exchange Act of 1934 § 15F(e)(3)(D)(ii), as modified by Dodd-Frank Act § 764; Commodity Exchange Act § 4s(e)(3)(D)(ii), as modified by Dodd-Frank Act § 731.

around the world recognize this by imposing unified capital requirements on swaps and security-based swaps activity.

The Commission's proposed capital rules are not comparable to the capital standards proposed by the Prudential Regulators and the CFTC. Under the Commission's proposed rules, an SBSD's minimum regulatory capital requirement would be based on a percentage of its counterparties' uncleared margin requirements. This capital requirement would be generally transaction volume-based, rising proportionally with the scale of an SBSD's dealing activity, rather than risk-based, as proposed by the Prudential Regulators. The Third-Party Custodian Deduction and the Legacy Account Deduction are also unparalleled in the Prudential Regulators' or CFTC's proposed rules.

The Prudential Regulators' capital regime is based on international consensus. The Prudential Regulators established capital requirements for over-the-counter derivatives positions in 1989, in accordance with the first Basel Accord.[9] As the derivatives market has expanded and evolved, the Prudential Regulators, in accordance with revised Basel Accord standards, have revised these capital rules, most significantly by adoption of a market risk amendment to impose additional capital requirements for large trading positions and through the development of an advanced approaches capital regime capturing the risks and activities of large, complex banking organizations. After the recent financial crisis, the Prudential Regulators proposed additional changes to their risk-based capital regimes, again modeled on revisions to international Basel Accord standards.[10]

The CFTC recognized that the Prudential Regulators' capital standards would be appropriate for SDs that are consolidated subsidiaries of bank holding companies ("**BHCs**"). Specifically, the CFTC proposed that capital requirements for SDs that are non-Futures Commission Merchant subsidiaries of BHCs would be based on the minimum risk-based ratios set forth in the Federal Reserve's capital regulations, calculated as if the SD subsidiary were itself a BHC.[11] The CFTC noted that these subsidiaries would be subject to "comparable capital regulations applicable to their parent U.S. bank holding companies, including the same credit risk and market risk capital requirements" and that its proposal would "remove incentives for registrants to engage in regulatory arbitrage." The CFTC also observed that the BHC standards sufficiently account for credit and market risks and "meet the statutory requirement of ensuring the safety and soundness of the SD."[12]

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[9] *See* 54 Fed. Reg. 4,186 (Jan. 27, 1989).
[10] *See* 77 Fed. Reg. 52,792 (Aug. 30, 2012); 77 Fed. Reg. 52,888 (Aug. 30, 2012); 77 Fed. Reg. 52,978 (Aug. 30, 2012).
[11] 17 C.F.R. § 23.101(a)(2)(ii) (proposed).
[12] 76 Fed. Reg. 27,802, 27,806 (May 12, 2011).

Rather than proposing SBSD capital requirements that are comparable to those proposed by other U.S. regulators, the Commission instead proposed SBSD capital standards based on its broker-dealer capital regime.[13] Basing SBSD capital standards on the capital regime for broker-dealers is not appropriate, however. SBSDs and SDs operate in the same markets with the same counterparties and should be subject to comparable capital requirements, but broker-dealers operate in different markets, face different categories of counterparties and enter into transactions with different risk profiles. By statute, SBSDs—like SDs—must confirm that their counterparties are eligible contract participants.[14] By contrast, broker-dealers face the general public, including retail investors.

Furthermore, Congress required SBSDs—and SDs—to provide counterparties with notice of their right to segregate collateral at an independent third-party custodian.[15] Broker-dealers, by contrast, are generally restricted from using such custodial arrangements.[16] The Third-Party Custodian Deduction, if implemented, would either discourage counterparties from exercising their statutory right to segregate collateral because pricing would reflect associated capital charges or would drive the security-based swap market into bank or foreign SBSDs for which the capital deduction is inapplicable. Consistency and harmonization between the Commission's capital rules and the capital regimes of other regulators of the same products will ensure a level playing field and maximum customer choice.

B. *The Third-Party Custodian Deduction is unnecessary and should be eliminated.*

We recommend that the Commission, like the Prudential Regulators and the CFTC, impose no capital deduction for collateral held by a third-party custodian.

The Proposal would impose punitive capital charges on an SBSD's fully collateralized positions where collateral is held by a third-party custodian, based on the Commission's concern about the SBSD's ability to access the collateral.[17] The risk to the SBSD, however, is not *whether* the custodian will deliver the collateral (capital risk), but *when* the custodian will deliver

[13] *See* Proposal, 77 Fed. Reg. at 70,247, 70,303.
[14] Securities Exchange Act § 15F(h)(3)(A), as modified by Dodd-Frank Act § 764; *see also* Commodity Exchange Act § 4s(h)(3)(A), as modified by Dodd-Frank § 731 (imposing the same duty on SDs).
[15] Securities Exchange Act §§ 3E(f)(1)(A), (f)(3)(A), as amended by Dodd-Frank Act § 763(d); Commodity Exchange Act §§ 4s(l)(1)(A), (l)(3)(A), as amended by Dodd-Frank Act § 724(c).
[16] While it is generally not permissible for customers of a broker-dealer to hold their margin collateral away from the broker-dealer, the Commission historically has permitted it when not allowing the practice would be inconsistent with other applicable law. More specifically, when faced with the conflict between the custodial requirements of the Investment Company Act of 1940 and the capital requirements under the Securities Exchange Act of 1934 and rules promulgated thereunder, the Commission has allowed broker-dealers to hold collateral for U.S. registered mutual funds at custodian banks while reflecting it in the customer's broker-dealer margin account. They have done so because the broker-dealer otherwise would face a significant punitive charge for allowing its client to comply with its applicable rules.
[17] *See* Proposal, 77 Fed. Reg. at 70,246-47.

the collateral (liquidity risk), as is recognized by the Basel framework.[18] SBSDs appropriately manage this risk by establishing first-priority security interests in the collateral, by entering into effective legal agreements for delivery of the collateral, and by otherwise appropriately managing the liquidity risk of these collateral arrangements.

The risk of an SBSD suffering a significant delay in the delivery of collateral held by a third-party custodian—much less a total loss of collateral—is remote and would only arise after the occurrence of a specific series of events. First, a counterparty would need to default on its security-based swap obligations to the SBSD. Second, the SBSD would need to close out the security-based swaps with the counterparty and any net loss associated with the close-out would have to exceed the amount of variation margin already collected directly by the SBSD. Finally, the custodian itself would have to be unable or unwilling to deliver the collateral to the SBSD.

The market has developed strong, enforceable legal agreements to manage this remote risk. Traditionally, when an SBSD has collected collateral from its counterparty and placed the collateral with a custodian, typically pursuant to a bilateral contract between the SBSD and the counterparty, the SBSD has a perfected first-priority security interest in the collateral and the counterparty has no privity of contract with the custodian. If counterparty default occurred on the underlying security-based swap, the SBSD would have the exclusive relationship with the custodian through which to seek return of the collateral to cover the amount of the counterparty's default.

Since the financial crisis, many market participants have entered into new custodial arrangements that put the counterparty into contractual privity with the custodian. The SBSD remains, however, the party with the first-priority security interest in the collateral. In these new arrangements, the custodian agrees to follow the instructions of the SBSD with respect to the collateral, except in clearly defined circumstances where the SBSD is in default. Generally, these agreements permit the SBSD to provide a "Notice of Exclusive Control" to the custodian, which legally entitles the SBSD, as the secured party, to demand delivery of the collateral at its sole direction. Market practice and industry efforts continue to strengthen these agreements, including at present through an ISDA effort to standardize third-party custodian documentation, to better protect against the remote risk of delays of even a small number of days.

Although the mechanics of the two arrangements described above differ, the SBSD has the same ability to establish a security interest in the collateral held by the third-party custodian and the rights of the SBSD to the collateral are legally enforceable in the event of counterparty default. In the first situation, where the counterparty has no privity of contract with the custodian, the Commission's concern that the SBSD cannot promptly liquidate the collateral is

[18] *See Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (January 2013 version)* ¶¶ 16, 31 (providing that, for liquidity stress-testing purposes, assets held by a third-party custodian are not deemed high quality liquid assets and therefore are unavailable to meet regulatory liquidity requirements).

misplaced, since the SBSD has the exclusive legal right to require return of the collateral from the custodian. In the second situation, where a tri-party agreement exists, the agreement is structured to allow the parties to specify the exact triggers under which the SBSD may direct the custodian to deliver the collateral, such as counterparty default. In both situations, the SBSD has a first-priority security interest in the collateral. Requiring a capital deduction would be unnecessary, punitive and inconsistent with the proposed capital regimes of the Prudential Regulators and the CFTC, particularly in light of the remote risk to the SBSD and the Dodd-Frank statutory mandate to offer third-party segregation to counterparties.

C. The Legacy Account Deduction is unnecessary and should be eliminated.

We recommend that the Commission, like the Prudential Regulators and the CFTC, impose no capital deduction for under-margined legacy positions. In the alternative, we recommend that the Legacy Account Deduction apply only after an appropriate transition period.

The Legacy Account Deduction is inconsistent with the proposed capital regimes of the Prudential Regulators and the CFTC and would result in unwarranted variations in regulated entities' capital requirements, which could lead to market fragmentation. While the Proposal would not require an SBSD to collect margin on legacy accounts, the Legacy Account Deduction would effectively force an SBSD to require its legacy counterparties to post collateral or require the SBSD to take a punitive capital charge. Either outcome would result in significant market disruptions.

The Legacy Account Deduction is duplicative of other charges, and is therefore unnecessary. An SBSD's uncollateralized exposure to counterparties is already captured in credit risk charges, which when combined with the Legacy Account Deduction may result in capital requirements that exceed the SBSD's maximum potential loss to the counterparty upon any default. Further, SBSDs will backload many uncleared positions into clearinghouses as clearinghouse capacity expands, which will also reduce uncollateralized exposure. In addition, the punitive impact of the Legacy Account Deduction will be compounded by the proposed capital deduction for transactions with parties exempted from regulatory margin requirements, including commercial end users, which will negatively affect the pricing and liquidity of transactions with these counterparties.[19]

Regulatory margin requirements have not previously existed for security-based swaps. In many cases, based on their own risk analysis, SBSDs have collected initial margin, recognizing that they should collateralize their credit and market risk on these transactions. These collateral arrangements, however, are previously negotiated commercial contracts that do not provide for the ability of an SBSD to demand additional margin from the counterparty, except pursuant to

[19] Proposal §§ 15c3-1(c)(2)(xiv)(B)(1), 18a-1(c)(viii)(B)(1).

specific triggers. Recognizing this, the Commission has not required SBSDs to collect margin on legacy accounts, citing the "impracticality of renegotiating contracts governing security-based swap transactions that predate the effectiveness" of the Proposal.[20]

Even while recognizing the impracticality of mandating that SBSDs collect regulatory-specified margin amounts on legacy accounts, the Proposal would nonetheless require an SBSD to take a capital deduction for the full amount of any under-margined legacy accounts. Any SBSD with a legacy account portfolio is thus placed in the untenable position of requiring legacy account counterparties to post regulatory margin for old trades (which the Commission itself recognizes is impractical) or take a punitive capital deduction equal to the amount of any deficiency (which may force some market participants to cease engaging in any new security-based swaps activity in order to avoid the capital consequences of registration as an SBSD).

In the alternative, if the Commission imposes the Legacy Account Deduction, the Commission should recognize appropriate transitional arrangements before the deduction would apply. The Commission would need to recognize an appropriate transition period before the effective date of margin requirements, followed by a second transition period before the Legacy Account Deduction would apply. In combination, these transition periods would mitigate the market disruptions of imposing potentially large capital charges, allow SBSDs to backload many uncleared positions into clearinghouses, and would require SBSDs to account for risk on uncollateralized exposures through credit risk charges. Appropriate transitional arrangements would also mitigate the harm caused by un-harmonized capital regimes among the Commission, the Prudential Regulators and the CFTC.

[20] Proposal, 77 Fed. Reg. at 70,269.

II. Conclusion

We appreciate the opportunity to comment on the Proposal. Please contact Sebastian Crapanzano at (212) 761-8627 or sebastian.crapanzano@morganstanley.com or Soo-Mi Lee at (212) 762-4795 or soo-mi.lee@morganstanley.com if discussion of any points raised in our comment letter would be helpful.

Respectfully submitted,

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cc: Hon. Elisse B. Walter, Chairman
Hon. Luis A. Aguilar, Commissioner
Hon. Troy A. Paredes, Commissioner
Hon. Daniel M. Gallagher, Commissioner
Mr. John Ramsay, Acting Director, Division of Trading and Markets
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