

MEMORANDUM

TO: File Number S7-08-12

FROM: Timothy C. Fox
Special Counsel
Office of Financial Responsibility, Division of Trading and Markets
U.S. Securities and Exchange Commission

DATE: January 10, 2014

RE: Meeting with SIFMA Representatives

On January 10, 2014, Commission staff met in person with representatives of the Securities Industry and Financial Markets Association (“SIFMA”) to discuss the proposed rules and rule amendments on capital, margin, and segregation requirements for security-based swap dealers and major security-based swap participants and capital requirements for broker-dealers (release number 34-68071).

Commission staff included Mark Attar, Michelle Danis, Timothy Fox, Ray Lombardo, Cara Lubit, Michael Macchiaroli, Thomas McGowan, Carrie O’Brien, John Ramsay, Randall Roy, Christian Sabella, Sheila Swartz, Lourdes Toro, Sean Wilkoff, and Charles Wilson. In addition, Bill Wollman and Marshall Levinson of the Financial Industry Regulatory Authority attended the meeting.

SIFMA representatives at the meeting included Thomas Favia (Goldman Sachs), Christopher Gallo (J.P. Morgan), Keith Huebsch (Bank of America), Sarah McAvoy (Bank of America), Andrew Nash (Morgan Stanley), Richard Seitz (Bank of America), Mary Kay Scucci (SIFMA), Erik Soderberg (Morgan Stanley), Bill Tirrell (Bank of America), Claudia Toni-Smith (Goldman Sachs), and Chris Van Woert (Goldman Sachs).

SEC Liquidity Presentation

January 10, 2014



Agenda

- Introductions
- Executive Summary
 - SIFMA liquidity proposal
- Responses to Commission Information Requests
 - Global regulatory liquidity overview
 - SEC/FED/EBA/PRA
 - Intraday liquidity usage
 - Business-as-Usual (BAU)
 - Stress Scenarios
 - Liquidity generation options
- Appendix
 - Proposed Edits to Rule 18a-1

Executive Summary

- SIFMA group met with the Commission in September 2013 to discuss the liquidity proposed rulemaking for ANC Rule Broker-Dealers (B-Ds) and Security-Based Swap Dealers (SBSDs).
 - The Commission requested more information on other liquidity management regulatory regimes
 - The SIFMA group expressed a desire to align the Commission’s liquidity rulemaking for B-Ds and SBSBs with the forthcoming Liquidity Coverage Ratio (LCR) rulemaking that will apply to firms on a consolidated basis
- The Federal Reserve released its LCR proposed rulemaking in October 2013
 - *See* 78 Fed. Reg. 71,818 (Nov. 29, 2013)
- In today’s meeting, the SIFMA group proposes to:
 - Discuss how the Commission’s proposed liquidity rulemaking can be aligned with the Federal Reserve’s LCR proposed rulemaking; and
 - Provide information to the Commission responsive to the information requests from September 2013

SIFMA Liquidity Proposal

- **Liquid asset standards.** The Commission's liquidity rulemaking for B-Ds and SBSBs should rely on the High Quality Liquid Asset (HQLA) standard adopted by the Federal Reserve in the LCR regime.
- **Intraday liquidity.** The Commission's liquidity rulemaking for B-Ds and SBSBs should permit firms to draw down liquidity resources on an intraday basis but require them to comply with end-of-day standards.
- **Holdco/Subsidiary Alignment.** Under appropriate circumstances, the Commission should recognize HQLAs held by a B-D/SBSB's parent company as supporting the subsidiary entity's liquidity.
 - Requirements:
 - (1) Parent company is subject to LCR on a consolidated basis
 - (2) Parent company has submitted a resolution plan to the Federal Reserve and FDIC
 - (3) The resolution plan anticipates the B-D/SBSB receiving liquidity support in the event of material financial distress at the Parent company
 - (4) The Federal Reserve / FDIC have not objected to the Parent company's resolution plan
- **Proposed Text.** See draft revisions to Rule 18a-1 in Appendix

Advantages of SIFMA Liquidity Proposal

- (1) Ensures appropriate liquidity support for the entire organization
- (2) Aligns regulatory frameworks of Commission, Federal Reserve and FDIC as well as the liquidity and resolution regimes
- (3) Addresses Commission's concern that a B-D/SBSD would not have appropriate liquidity reserves in a financial crisis
- (4) Permits a financial institution to manage liquidity on a consolidated basis while protecting both the holdco and Commission-regulated subsidiaries
- (5) Permits a B-D/SBSD to manage liquidity on an intraday basis to meet normal and stressed funding requirements

Global regulatory liquidity overview

Liquidity Risk Monitoring	Interpretation of Proposed SEC Liquidity Rules	Fed NPR Guidance	EBA Basel Guidance	PRA BIPRU ¹ Guidance
Definition of liquid assets	<ul style="list-style-type: none"> ■ Cash ■ Obligations of the United States ■ Obligations fully guaranteed as to principal and interest by the United States 	<ul style="list-style-type: none"> ■ Custody cash held at Federal Reserve and other central banks ■ Securities issued or unconditionally guaranteed by the U.S. Department of the Treasury or by a sovereign entity, central bank, Bank for International Settlements, International Monetary Fund, European Central Bank and European Community, or a multilateral development bank with a 0% risk weight per regulatory capital rules (100% HQLA weight) ■ Securities issued by a U.S. government sponsored enterprise or guaranteed by a sovereign entity or multilateral bank, with a risk weight no greater than 20% per regulatory capital rules (85% HQLA weight) ■ Non-financial publicly traded investment grade corporate bonds (50% HQLA weight) ■ Non-financial S&P 500 and equivalent publicly traded common equity shares (50% HQLA weights) 	<ul style="list-style-type: none"> ■ Cash ■ Sovereign, Central bank, Multilateral development bank and agency debt (100% to 85% HQLA weight) ■ Non-financial high quality corporate/ covered bonds (85% to 50% HQLA weight) ■ Residential mortgage backed securities (75% HQLA weight) ■ Non-financial exchange traded, centrally cleared and constituent of a major stock index common equity shares (50% HQLA weight) 	<ul style="list-style-type: none"> ■ High quality debt securities issued by a government or central banks ■ Securities issued by a designated multilateral development bank ■ Reserves in the form of sight deposits with an eligible central bank

¹ Banking and Investment Firm Prudential Sourcebook

Global regulatory liquidity overview (cont'd)

Liquidity Risk Monitoring	Interpretation of Proposed SEC Liquidity Rules	Fed NPR Guidance	EBA Basel Guidance	PRA BIPRU ¹ Guidance
Maintaining liquidity reserves – under stress period	<ul style="list-style-type: none"> ■ Liquidity reserve must be maintained at all times based on the results of the liquidity stress test. This is interpreted to apply even during stress events 	<ul style="list-style-type: none"> ■ The standard requires that, absent a situation of financial stress, the value of the ratio be no lower than 100% ■ During a period of financial stress, however, banks may use their stock of HQLA, thereby falling below a 100% LCR ■ Supervisor must be notified on any business day that its LCR is less than 100% ■ If the LCR is below 100% for three consecutive business days, a remediation plan is to be submitted to the supervisor ■ Supervisors will subsequently assess the situation to monitor and respond appropriately to the unique circumstances that are giving rise to the LCR shortfall 	<ul style="list-style-type: none"> ■ 	<ul style="list-style-type: none"> ■ The regulator acknowledges that in periods of stress a firm's liquid assets buffer may be eroded. Those periods of stress may be both market-wide and idiosyncratic in nature
Consolidated vs. Entity	<ul style="list-style-type: none"> ■ Rules and measurements applied at entity level 	<ul style="list-style-type: none"> ■ Rules and measurements applied at consolidated level 	<ul style="list-style-type: none"> ■ 	<ul style="list-style-type: none"> ■ Rules and measurements applied at entity level
Implementation schedule	<ul style="list-style-type: none"> ■ Implementation timeframe not indicated 	<ul style="list-style-type: none"> ■ Phase-in approach starting from Jan 1, 2015 with minimum requirement of 80% and rise in equal annual steps to reach 100% on Jan 1, 2017 	<ul style="list-style-type: none"> ■ 	<ul style="list-style-type: none"> ■ Reporting implemented. ILG requirements currently at 50% glide-path.

¹ Banking and Investment Firm Prudential Sourcebook

Intraday Liquidity Usage

- ❑ **Firms can meet intraday liquidity requirements with excess cash, unencumbered liquid collateral and intra-day committed lines of credit provided by 3rd party banks or affiliates**
- ❑ Intraday needs arise from the timing mismatch of daily operational procedures. BAU scenarios call for efficient management of cash and unencumbered liquid securities to meet every day settlement requirements AND ensure excess liquidity targets are met daily.
- ❑ Net Free Equity (NFE) is a term used to describe the measurement of intraday liquidity. Clearing Banks extend credit to Dealers based upon cash & unencumbered liquid collateral (NFE) held in a Dealer's account minus an established margin requirement. The NFE position allows for payments to be settled along with other cash debits listed below.
- ❑ Current limits on intra-day credit: Daily DTC Debit Cap set individually per dealer by DTC based on dealer debit history with DTC; Triparty Task Force proposed maximum 10% Clearing Bank intraday credit exposure based on Dealer's notional triparty book (final implementation by Q4'14).
- ❑ **Primary drivers for intraday usage are:**
 - 1) Collateral substitution: DTC collateral, allocated to triparty trades, which has been sold requires cash or unencumbered Fed eligible securities to be pledged prior to release of the sold security. *(Note: All substituted securities must be eligible under the triparty schedule)*
 - 2) Purchase DTC wire securities: Intraday liquidity is required or Dealers would hit their DTC debit cap and stop all settlement activities.
 - 3) Syndicate deal settlement: Payment to the Trustee is required prior to release of new securities for delivery to purchasing clients.
 - 4) Various BAU cash wire requirements, including margin calls and money market funds customer redemptions

Broker-Dealer Indicative Business-as-Usual Intra-day Liquidity Flows

Start of Day Liquidity Sources	Primary Intraday Funding Requirements	Target End of Day Position
<ul style="list-style-type: none"> ▪ Broker-Dealer on hand liquidity: cash and unencumbered securities ▪ Borrowing capacity from Parent and affiliates ▪ Intraday liquidity from affiliate banks ▪ Intraday liquidity from Clearing Banks* and other 3rd parties 	<ul style="list-style-type: none"> ▪ Collateral substitution ▪ Purchase DTC wire securities ▪ Syndicate deal settlement ▪ Various BAU cash wire requirements 	<ul style="list-style-type: none"> ▪ Broker-dealer on hand liquidity in excess of requirements ▪ Potential change in borrowing levels from Parent and affiliates depending on liquidity needs – “swing” funding source ▪ All intraday borrowing from affiliate banks fully repaid ▪ All intraday borrowing from 3rd parties fully repaid. Committed overnight lines of credit via Parent serve as final source



- Funding requirements for cash and unencumbered collateral start at the beginning of the day
- Cash and collateral returns occur throughout the day, with majority of net cash receipts in afternoon
- Broker-dealer operations manage cash and collateral requirements as needed to minimize intraday funding

Broker-Dealer Indicative Intra-day Liquidity Flows Under Stress Scenarios

Start of Day Liquidity Sources	Primary Intraday Funding Requirements	Target End of Day Position
<ul style="list-style-type: none"> ▪ Broker-Dealer on hand liquidity may be lower as funding for modeled stresses occurs ▪ Borrowing capacity from Parent and affiliates, although capacity may be reduced if incremental funding was required ▪ Intraday liquidity from affiliate banks, although capacity may be reduced ▪ Clearing Banks continue to provide committed intraday credit*, although other intraday liquidity from 3rd parties may be reduced. 	<ul style="list-style-type: none"> ▪ Collateral substitution: Expect reduced requirements as trading volumes decline ▪ Purchase DTC wire securities: Expect reduced requirements as firms limit new inventory purchases and focus on selling down inventory. ▪ Syndicate deal settlement: Expect reduced requirements with declining volume of new deals ▪ Various BAU cash wire requirements: Potentially higher margin call activity and exchange requirements for clients 	<ul style="list-style-type: none"> ▪ Broker-dealer on hand liquidity in excess of requirements. Same as in BAU and expect lower requirements as contingent flows are realized and funded. ▪ Potential change in borrowing levels from Parent and affiliates depending on liquidity needs. Same as in BAU. ▪ All intraday borrowing from affiliate banks fully repaid. Same as in BAU. ▪ All intraday borrowing from 3rd parties fully repaid. Committed overnight lines of credit via Parent serve as final source. Same as in BAU.

Liquidity Generation Actions

- Broker-dealers should be allowed flexibility to take action in anticipation of or during a liquidity event. These actions could vary based on the severity of the specific event and include both short-term and medium-term actions.
- The primary source of liquidity for most financial institutions will consist of a pool of High Quality Liquid Assets (or “HQLA”) within the broker-dealer or at the parent company for purposes of meeting entity-level B-D/SBSD liquidity requirements
- A firm’s Treasury function should implement policies and procedures that
 - Identify the amount and composition of HQLA on a daily basis
 - Include any other relevant details such as legal entity, location, currency or custodial account
 - Ensure that the HQLA pool has proper diversification
 - Ensure any HQLA held in foreign jurisdictions is appropriate for the financial institutions outflows in that jurisdiction
- The policies should also establish procedures for the use or deployment of HQLA assets. The procedures should establish under what conditions the assets will be deployed; escalation processes to firm management (e.g. CEO, CFO, Global Treasurer or Board of Directors); timing of communication with external contacts (e.g. regulators and/or ratings agencies).
- Finally a summary of other potential liquidity actions are listed on the following slide

Liquidity Generation Actions (cont'd)

- Asset-related actions (short-term)
 - Finance or sell liquid assets, specifically High Quality Liquid Assets held by the Treasury function with the sole intent of use as a source of liquidity during a stress event
 - Reduce or unwind discretionary activities (e.g., reverse repo transactions, excess stock borrow, etc.)
 - Reduce any excess collateral maintained with trading counterparts or clearing organizations
- Liability-related actions (short-term)
 - Reduce reliance on short-term funds
 - Maximize unsecured funding to the extent possible
 - Drawdown of existing committed facilities, whether from parent company or external relationships
 - If unsecured funding is not available, increase secured funding (repo and securities lending of unencumbered assets) to the extent possible with external counterparties including central bank institutions
- Other asset-related actions (medium- to long-term)
 - Sell non-strategic and/or illiquid assets
 - Exit businesses that not core to franchise

APPENDIX

Proposed Edits to Draft Rule 18a-1

[Corresponding edits would apply to Draft Rule 15c3-1(f)]

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Rule 18a-1

(f) Liquidity requirements.

(1) Liquidity stress test. A security-based swap dealer that computes net capital under paragraph (a)(2) of this Rule 18a-1 must perform a liquidity stress test at least monthly, the results of which must be provided within ten business days to senior management that has responsibility to oversee risk management at the security-based swap dealer. The assumptions underlying the liquidity stress test must be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the security-based swap dealer and at least annually by senior management of the security-based swap dealer. The liquidity stress test must include, at a minimum, the following assumed conditions lasting for 30 consecutive days:

(A) A stress event includes a decline in creditworthiness of the broker or dealer severe enough to trigger contractual credit-related commitment provisions of counterparty agreements;

(B) The loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding from third parties or non-affiliates, including intercompany advances and unfunded committed lines of credit;

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- (C) The potential for a material net loss of secured funding for less liquid assets;
- (D) The loss of the ability to procure repurchase agreement financing for less liquid assets;
- (E) The illiquidity of collateral required by and on deposit at clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets;
- (F) A material increase in collateral required to be maintained at registered clearing agencies of which it is a member; and
- (G) The potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the security-based swap dealer, including those related to customer businesses of the security-based swap dealer.

(2) Stress test of consolidated entity. The security-based swap dealer must justify and document any differences in the assumptions used in the liquidity stress test of the security-based swap dealer from those used in the liquidity stress test of the consolidated entity of which the security-based swap dealer is a part.

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(3) Liquidity reserves. ~~The~~ Subject to the provisions of paragraph (f)(4) of this Rule 18a-1, the security-based swap dealer must maintain at ~~all times~~ the end of each business day liquidity reserves based on the results of the liquidity stress test. The liquidity reserves used to satisfy the liquidity stress test must be:

(A) (i) Cash, obligations of the United States, or obligations fully guaranteed as to principal and interest by the United States; and

~~(B)(i)~~ (ii) Unencumbered and free of any liens at all times; or

(B) Any assets that qualify as “high-quality liquid assets” in 12 C.F.R. § .20.

Securities in the liquidity reserve can be used to meet delivery requirements as long as cash or other acceptable securities of equal or greater value are moved into the liquidity pool contemporaneously.

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(4) Consolidated liquidity compliance program. A security-based swap dealer that is a consolidated subsidiary of a bank holding company that has submitted a resolution plan to the Board of Governors of the Federal Reserve System (the “Board”) and the Federal Deposit Insurance Corporation (the “Corporation”) during the most recent completed annual cycle, pursuant to 12 C.F.R. § 243, may apply to the Commission for approval to adopt a consolidated liquidity compliance program in lieu of maintaining the liquidity reserves that would otherwise be required by paragraph (f)(3) of this Rule 18a-1. A security-based swap dealer that has received approval from the Commission, in writing, to adopt a consolidated liquidity compliance program may maintain all or a portion of its liquidity reserves with its top-tier bank holding company [or an affiliate], as determined by the security-based swap dealer. A consolidated liquidity compliance program must ensure that the bank holding company, on a consolidated basis, complies with applicable liquidity requirements imposed by the Board and must require the bank holding company to monitor the liquidity needs of, and provide liquidity support to, the security-based swap dealer subsidiary, as necessary.

When evaluating requests under this paragraph (f)(4), the Commission shall consider:

- (A) The extent to which the resolution plan anticipates the security-based swap dealer receiving liquidity support in the event of material financial distress at the bank holding company; and
- (B) Whether the Board or the Corporation has objected to any relevant provision of the bank holding company’s resolution plan for the most recent completed annual cycle and, if so, whether the bank holding company has resolved any such objections.

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(5) Contingency funding plan. (A) The security-based swap dealer must have a written contingency funding plan that addresses the security-based swap dealer's policies and the roles and responsibilities of relevant personnel for meeting the liquidity needs of the security-based swap dealer and communications with the public and other market participants during a liquidity stress event.

(B) A security-based swap dealer that has received approval from the Commission to adopt a consolidated liquidity compliance program under paragraph (f)(4) may rely on the contingency funding plan adopted by its top-tier bank holding company rather than adopt a separate contingency funding plan under this paragraph (f)(5).