

Morgan Stanley

July 20, 2021

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Substituted Compliance for Nonbank Security-Based Swap Dealers Subject to Regulation in the Federal Republic of Germany

Ladies and Gentlemen:

We anticipate that one of our subsidiaries in the Federal Republic of Germany (“**Germany**”) may register as a nonbank security-based swap dealer (“**SBSD**”) with the Securities and Exchange Commission (the “**Commission**”). We understand that the German Federal Financial Supervisory Authority has submitted an application for substituted compliance for capital requirements for nonbank SBSBs subject to regulation in Germany. We are submitting this letter to provide our recommendations related to certain technical matters that may be relevant for consideration in connection with a substituted compliance order for nonbank SBSBs subject to regulation in Germany.

1. Article 7 Arrangements

Article 7 of the European Union (“**EU**”) Capital Requirements Regulation permits EU financial institutions, including nonbank SBSBs, to apply for “derogation” from the application of capital requirements directly to the institution.¹ Such derogation is subject to explicit approval from the applicable supervisory authority and is also subject to a number of conditions, including the application of EU capital requirements, on a consolidated basis, to the institution’s EU parent company (an “**Article 7 Consolidated Group**”). A German nonbank SBSB may receive a derogation under Article 7 (an “**Article 7 Nonbank SBSB**”).

We understand that the Commission may, in connection with a future substituted compliance order, consider applying conditions on both Article 7 Consolidated Groups and Article 7 Nonbank SBSBs in order for an Article 7 Nonbank SBSB to receive substituted compliance for its capital requirements. We recommend that the Commission consider these substituted compliance conditions:

- An Article 7 Consolidated Group and an Article 7 Nonbank SBSB would each be required to maintain an amount of liquid assets, less total liabilities maturing within one year, in excess of \$100 million.

¹ Regulation (EU) No 575/2013.

- For purposes of this standard, “liquid assets” would be defined as including:
 - All assets or positions except those that would be classified as “assets not readily convertible into cash” in a manner similar to Exchange Act Rule 18a-1 standards;²
 - Derivatives receivables, even if otherwise classified as unsecured receivables under applicable accounting standards; and
 - Initial margin posted by an Article 7 SBSB in non-cleared derivatives where the Article 7 Nonbank SBSB has received an affiliate loan compliant with the three conditions in Commission guidance to avoid deductions.³
- In addition, an Article 7 Consolidated Group and an Article 7 Nonbank SBSB would each be required to maintain an amount of liquid assets, less total liabilities maturing within one year, less a prescribed risk-weighted asset adjustment (“**RWA Adjustment**”), in excess of \$20 million.
 - The RWA Adjustment would be equal to the credit and market risk-weighted assets of the entity, as calculated under applicable European capital standards, divided by 12.5.⁴

We note that our recommendation focuses on total liabilities maturing within one year, rather than total liabilities, as a total liabilities requirement may not result in a manageable standard. If, for example, an Article 7 Consolidated Group or an Article 7 Nonbank SBSB failed to meet one of the quantitative standards summarized above, it might potentially seek to receive an unsecured affiliate loan of greater than one year to resolve the deficit. However, while increasing the entity’s liquid assets, such a loan would result in an equally sized increase in liabilities, making it impossible to address shortfalls through infusions of long-dated unsecured affiliate loans.

Alternatively, if the Commission elects not to adopt a total liabilities maturing within one year standard, we recommend that the total liabilities measurement exclude any liabilities that qualify as regulatory capital under host country capital rules, including subordinated debt instruments that qualify as

² European regulatory capital and accounting standards do not include the same technical requirements as Exchange Act Rule 18a-1. Accordingly, Article 7 Nonbank SBSBs do not have existing regulatory capital and financial reporting processes designed to validate positions or exposures that would be classified “assets not readily convertible into cash.” While we believe that this recommendation, in its core design, would advance the Commission’s policy objectives and provide a feasible operational approach for Article 7 Nonbank SBSBs, we are submitting this recommendation based on an analysis of how applicable European accounting standard line items may be expected to correspond to Exchange Act Rule 18a-1 standards.

³ 84 Fed. Reg. 43872, 43887 (Aug. 22, 2019); *see also* Letter from Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, Commission, to Kris Dailey, Vice President, Risk Oversight and Regulation, FINRA (Aug. 19, 2016).

⁴ European capital standards also include, in some cases, operational risk-weighted assets, a credit valuation adjustment requirement, and large exposure-based charges. These standards are not directly analogous to Commission net capital requirements and, as such, may not be suitable for inclusion in the RWA Adjustment.

Tier 2 capital. Similar to Commission net capital standards that recognize subordinated debt instruments as capital, European capital standards recognize subordinated debt instruments as a form of capital, subject to quantitative limits. Failure to accommodate Tier 2 subordinated debt instruments in the substituted compliance standard would introduce conceptual and practical challenges for capital management at Article 7 Consolidated Groups and Article 7 Nonbank SBSs.

We believe that these conditions are consistent with the Commission's substituted compliance policy objectives.⁵ We are providing these recommendations for the Commission's consideration on an expedited basis, taking into account the short period of time remaining before SBS registration requirements take effect. In making these recommendations, we would emphasize that, in practice, we believe it would be appropriate to align the "liquid assets" standard in a future substituted compliance order with balance sheet line items prepared in accordance with applicable accounting standards (e.g., "trading financial assets" and "trade and other receivables" for International Financial Reporting Standards purposes would be included, as a category, in "liquid assets," noting that a full mapping of these categories against "assets not readily convertible into cash" has not been completed). We also believe that the Commission should accommodate a reasonable time to come into compliance with these conditions, as explained more fully in Section 3 of this letter.

2. U.S. Person Transactions

We understand that the Commission may, in connection with a future substituted compliance order, consider imposing limitations on an Article 7 Nonbank SBS's security-based swap ("SBS") transactions with U.S. persons.

We recommend that no limitations be placed on an Article 7 SBS's SBS transactions with U.S. persons. An Article 7 Nonbank SBS would be subject to extensive conditions for capital substituted compliance that, in our view, are effectively equivalent to anticipated capital substituted compliance conditions for other non-U.S. SBSs. In addition, there does not appear to be a compelling rationale to limit an Article 7 Nonbank SBS's SBS activities in this manner. While Article 7 Nonbank SBSs are not, in the normal course, expected to focus on SBS transactions with U.S. persons, any such activities would remain subject to European capital standards and the conditions imposed in the Commission's substituted compliance order.

We also emphasize that imposing U.S. person limitations would raise a number of significant potential frictions that appear to be unrelated to the Commission's policy objectives in the substituted compliance framework, which the Commission has stated "should accept differences between regulatory regimes when those differences nevertheless accomplish comparable regulatory outcomes."⁶ For example, a blanket prohibition on SBS transactions with U.S. persons would impede group-wide risk management

⁵ We understand that the Commission may be considering a range of technical issues in connection with the finalization of substituted compliance orders more broadly. Notwithstanding the distinct circumstances of Article 7 Nonbank SBSs, we would encourage the Commission, to the greatest extent practicable, to align technical standards and conditions for Article 7 Nonbank SBSs with those applicable to European Nonbank SBSs generally.

⁶ 78 Fed. Reg. 30,968, 30,975 (May 23, 2013).

activities with U.S. affiliates, notwithstanding the Commission’s recognition that “a financial group may book security-based swaps arising from its dealing business in separate affiliates” and that inter-affiliate transactions may be used to support risk management.⁷ Similarly, an Article 7 Nonbank SBSB may seek to hedge or manage risks through SBS transactions with non-affiliate U.S. persons, including SBSBs, clearing agencies, broker-dealers, swap dealers, banks or other financial intermediaries. Additionally, an Article 7 Nonbank SBSB may engage in normal course negotiations with U.S. persons acting as agents or order placers for non-U.S. person principals, posing complications for how a U.S. person limitation may apply in practice in non-U.S. client transactions. Finally, as noted above, while Article 7 Nonbank SBSBs may generally not be expected to face U.S. clients in SBS transactions, it is unclear why such a condition is necessary to advance the Commission’s policy objectives.

3. Timing Considerations

The Commission has not, as of the date of this letter, published an order proposing substituted compliance for German nonbank SBSBs’ capital requirements. Assuming that the Commission provides at least 25 days for comment on any such order, consistent with other proposed substituted compliance orders, the comment deadline will end after August 6, 2021, the date on which “counting” begins for purposes of SBS dealing activities that require SBSB registration with the Commission. In addition, to the extent that any final order includes conditions that require new reporting requirements or operational changes, Article 7 Nonbank SBSBs would only have a period of weeks to come into compliance before SBSB registration requirements take effect.

In recognition of these timing considerations, we recommend that the Commission consider, in any final German nonbank SBSB substituted compliance order, requiring an Article 7 SBSB to continue to operate in compliance with applicable European regulatory capital requirements, without the addition of new Commission conditions, until September 1, 2022.⁸ After that date, an Article 7 SBSB would be required to comply, in full, with any conditions in a final German nonbank SBSB substituted compliance order.

Considerations supporting this recommendation include:

- The absence of a proposed substituted compliance order as of the current date, which impedes orderly planning for substituted compliance as of the registration date;
- The existing application of European regulatory capital standards to Article 7 SBSBs indirectly through Article 7 Consolidated Groups, ensuring that Article 7 Nonbank SBSBs’ activities are subject to regulatory capital requirements;
- The temporary nature of this recommendation, which would provide less than one year of relief and align the compliance date of the Commission’s substituted

⁷ 81 Fed. Reg. 29,960, 30,104 (May 13, 2016).

⁸ While this letter focuses on a potential German nonbank substituted compliance order, we note that this timing recommendation may also be relevant for other Commission substituted compliance final orders adopted after August 6, 2021.

compliance order with the compliance date of Phase VI uncleared margin requirements otherwise applicable to Article 7 Nonbank SBSBs; and

- The potential need for corporate restructurings or similar actions in response to technical conditions imposed on Article 7 Consolidated Groups and Article 7 Nonbank SBSBs in any final substituted compliance order, which may be operationally difficult to comply with in the weeks remaining before registration.

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Please contact us if discussion of any points raised in this letter would be helpful.

Sincerely,



Andrew Nash
Managing Director