

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-91783; File No. SR-FINRA-2021-008)

May 5, 2021

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend FINRA Rules 0180 (Application of Rules to Security-Based Swaps), 4120 (Regulatory Notice and Business Curtailment), 4210 (Margin Requirements), 4220 (Daily Record of Required Margin), 4240 (Margin Requirements for Credit Default Swaps), 4240 (Security-Based Swap Margin Requirements), and 9610 (Procedures for Exemptions - Application)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on April 26, 2021, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).³ Title VII of the Dodd-Frank Act, entitled the “Wall Street Transparency and Accountability Act of 2010,”⁴ established a

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁴ See Dodd-Frank Act Section 701.

comprehensive new regulatory framework for over-the-counter (“OTC”) derivatives known in the industry as “swaps,” which were generally unregulated in the United States prior to passage of the Dodd-Frank Act. Among other things, Title VII of the Dodd-Frank Act was intended to implement in the United States the mandate agreed by the G20 in September 2009 for its members to improve the OTC derivatives markets by improving transparency, mitigating systemic risk and protecting against market abuse.⁵

Generally, Title VII of the Dodd-Frank Act divided regulatory jurisdiction over swap products between the Commodity Futures Trading Commission (“CFTC”) and the SEC, with the CFTC regulating “swaps” and the SEC regulating SBS.⁶ The Dodd-Frank Act directed the SEC to promulgate rulemakings implementing the new regulatory framework for SBS, including rules requiring SBS Entities to register with the SEC; business conduct and supervision requirements, risk mitigation techniques and other rules specifically applicable to SBS Entities; recordkeeping and financial reporting rules for SBS Entities; capital, margin and segregation requirements for SBS Entities; rules requiring regulatory reporting and public dissemination of SBS information; and processes to require SBS to become subject to mandatory clearing and execution on a

⁵ See G20 Leaders’ Statement from The Pittsburgh Summit (Sept. 24–25, 2009), https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

⁶ The terms “swap” and “security-based swap” are defined in Sections 721 and 761 of the Dodd-Frank Act. The Commission and the CFTC have jointly promulgated rules further defining these terms. See Securities Exchange Act Release No. 67453 (July 18, 2012), 77 FR 48208 (August 13, 2012) (Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping) (“Product Definitions”). Very generally, SBS are swaps referencing a single security or loan, or a narrow-based security index. Certain products sharing characteristics of both swaps and SBS are regulated as “mixed swaps” subject to both CFTC and SEC jurisdiction.

registered or exempt execution facility or exchange.⁷ The Commission has now finalized a majority of its rulemakings pursuant to Title VII of the Dodd-Frank Act (the “Title VII rulemakings”).⁸ The Commission has also established the compliance date for registration of SBS Entities, which will be October 6, 2021 (the “Registration Compliance Date”), and has broadly coordinated the compliance date for a number of other Title VII rulemakings with the

⁷ See Dodd-Frank Act Section 763.

⁸ See Securities Exchange Act Release No. 74244 (February 11, 2015), 80 FR 14564 (March 19, 2015) (Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information) (“Regulation SBSR Release”); Securities Exchange Act Release No. 75611 (August 5, 2015), 80 FR 48964 (August 14, 2015) (Final Rule: Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants) (“Registration Process Release”); Securities Exchange Act Release No. 77617 (April 14, 2016), 81 FR 29960 (May 13, 2016) (Final Rule: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants) (“Business Conduct Standards Release”); Securities Exchange Act Release No. 78011 (June 8, 2016), 81 FR 39808 (June 17, 2016) (Final Rule: Trade Acknowledgment and Verification of Security-Based Swap Transactions) (“Trade Acknowledgment and Verification Release”); Securities Exchange Act Release No. 86175 (June 21, 2019), 84 FR 43872 (August 22, 2019) (Final Rule: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers) (“Capital, Margin, and Segregation Release”); Securities Exchange Act Release No. 87005 (September 19, 2019), 84 FR 68550 (December 16, 2019) (Final Rule: Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers) (“Recordkeeping Release”); Securities Exchange Act Release No. 87780 (December 18, 2019), 85 FR 6270 (February 4, 2020) (Final Rules; Guidance: Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements) (“Cross-Border Release”); Securities Exchange Act Release No. 87782 (December 18, 2019), 85 FR 6359 (February 4, 2020) (Final Rule: Risk Mitigation Techniques for Uncleared Security-Based Swaps) (“Risk Mitigation Release”). The SEC has also proposed, but not yet finalized, rules governing SBS execution facilities (“SBSEFs”) and rules regarding fraud in the SBS market. See Securities Exchange Act Release No. 63236 (November 3, 2010), 75 FR 68560 (November 8, 2010) (Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps; Proposed Rule); Securities Exchange Act Release No. 63825 (February 2, 2011), 76 FR 10948 (February 28, 2011) (Registration and Regulation of Security-Based Swap Execution Facilities; Proposed Rule; Proposed Interpretation).

Registration Compliance Date.⁹ Accordingly, beginning on October 6, 2021, registered SBS Entities will become subject to the Title VII rulemakings, and the deadline for the initial wave of SBS Entity registrations is November 1, 2021.¹⁰

Title VII of the Dodd-Frank Act also amended the definition of “security” under the Act to expressly encompass SBS.¹¹ Therefore, in addition to the comprehensive new SBS-specific regulatory framework discussed above, SBS are now also defined as securities under the Act and the rules thereunder. This amendment to the Act was effective as of July 16, 2011, the effective date of Title VII of the Dodd-Frank Act. However, to allow sufficient time to consider the potentially complex interpretive issues that may arise by defining SBS as securities, the SEC

⁹ See Cross-Border Release supra note 8, at 6345. The Commission stated that the Registration Compliance Date for SBS Entities will be 18 months after the effective date of the rules adopted pursuant to the Cross-Border Release, which was April 6, 2020. See Cross-Border Release at 6270. Generally, the other Title VII rulemakings will apply to SBS Entities upon registration with the SEC. The first compliance date for SBS reporting under Regulation SBSR will be the first Monday that is the later of (1) six months after the date on which the first SBS data repository (“SBSDR”) that can accept reports in a given asset class registers with the SEC and (2) one month after the Registration Compliance Date. See Cross-Border Release at 6346. No SBSDRs are currently registered with the SEC.

¹⁰ The Registration Compliance Date is October 6, 2021. The SEC has also clarified that the transitional period before a person that is deemed to be an SBSR must register with the SEC runs until two months after the end of the month in which the person is no longer able to satisfy the de minimis exception from the SBSR definition. Therefore, entities exceeding the de minimis threshold on the first counting date of August 6, 2021 or later in August 2021 must register no later than November 1, 2021. See SEC, Key Dates for Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, <https://www.sec.gov/page/key-dates-registration-security-based-swap-dealers-and-major-security-based-swap-participants> (“SEC Transitional Period Guidance”).

¹¹ See Dodd-Frank Act Section 761(a)(2) (inserting “security-based swap” in the definition of “security” in Section 3(a)(10) of the Act); see also 15 U.S.C. 78c(a)(10).

issued a series of temporary exemptive orders beginning in July 2011.¹² With limited exceptions, the SEC’s temporary exemptive orders relating to the regulation of SBS as securities have now expired or will expire on the Registration Compliance Date.¹³

The addition of SBS to the definition of “security” under the Act had similar implications for FINRA rules. In particular, under the amended definition, any FINRA rule that applies to FINRA members’ activities involving a security, securities business, a transaction involving a security or a securities position applies by its terms to those activities involving SBS. Therefore, consistent with the SEC’s actions in this area, on July 8, 2011, FINRA filed for immediate effectiveness FINRA Rule 0180, which, with certain exceptions noted below, temporarily limits

¹² See, e.g., Securities Exchange Act Release No. 64795 (July 1, 2011), 76 FR 39927 (July 7, 2011) (Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With the Pending Revision of the Definition of “Security” To Encompass Security-Based Swaps, and Request for Comment) (“2011 Exemptive Order”); Securities Exchange Act Release No. 71485 (February 5, 2014), 79 FR 7731 (February 10, 2014) (Order Extending Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With the Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment).

¹³ See Securities Exchange Act Release No. 84991 (January 25, 2019), 84 FR 863 (January 31, 2019) (Order Granting a Limited Exemption from the Exchange Act Definition of “Penny Stock” for Security-Based Swap Transactions between Eligible Contract Participants; Granting a Limited Exemption from the Exchange Act Definition of “Municipal Securities” for Security-Based Swaps; and Extending Certain Temporary Exemptions under the Exchange Act in Connection with the Revision of the Definition of “Security” to Encompass Security-Based Swaps) (“2019 Exemptive Order”); Securities Exchange Act Release No. 90308 (November 2, 2020), 85 FR 70667 (November 5, 2020) (Order Granting Exemptions from Sections 8 and 15(a)(1) of the Securities Exchange Act of 1934 and Rules 3b-13(b)(2), 8c-1, 10b-10, 15a-1(c), 15a-1(d) and 15c2-1 Thereunder in Connection with the Revision of the Definition of “Security” to Encompass Security-Based Swaps and Determining the Expiration Date for a Temporary Exemption from Section 29(b) of the Securities Exchange Act of 1934 in Connection with Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants). Generally, the SEC has extended the expiration date for the temporary exemptions directly related to pending SBS rulemakings until the compliance date for the related SBS rulemakings. Temporary exemptions not directly linked to SBS rulemakings have either expired or, in certain limited circumstances, been extended or made permanent.

the application of FINRA rules with respect to SBS, thereby avoiding undue market disruptions resulting from the change to the definition of “security” under the Act.¹⁴ Pending the SEC’s final implementation of the Title VII rulemakings, FINRA has extended the expiration date of FINRA Rule 0180 a number of times, mostly recently in January 2020.¹⁵ FINRA Rule 0180 is currently set to expire on September 1, 2021.

FINRA Rule 0180 broadly excepts SBS activities from most FINRA requirements. Specifically, FINRA Rule 0180(a) provides that FINRA rules shall not apply to members’ activities and positions with respect to SBS, except for FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade), FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices), FINRA Rule 3310 (Anti-Money Laundering Compliance Program) and FINRA Rule 4240 (Margin Requirements for Credit Default Swaps).¹⁶ In addition, FINRA Rule 0180(b) provides that the following rules apply to members’ activities and positions with respect to SBS only to the extent they would have applied as of July 15, 2011 (i.e., the day before the effective date of Title VII of the Dodd-Frank Act): (i) NASD Rule 3110 and all successor FINRA Rules to such NASD Rule, (ii) the FINRA Rule 4500 Series and (iii) the

¹⁴ See Securities Exchange Act Release No. 64884 (July 14, 2011), 76 FR 42755 (July 19, 2011) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2011-033).

¹⁵ See Securities Exchange Act Release No. 88023 (January 23, 2020), 85 FR 5261 (January 29, 2020) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2020-001).

¹⁶ FINRA Rule 4240 establishes an interim pilot program with respect to margin requirements for any transactions in credit default swaps (“CDS”) held in an account at a FINRA member. Like FINRA Rule 0180, the interim pilot program under FINRA Rule 4240 will automatically expire on September 1, 2021. See FINRA Rule 4240(a); see also Securities Exchange Act Release No. 89036 (June 10, 2020), 85 FR 36458 (June 16, 2020) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2020-016).

FINRA Rule 4100 Series.¹⁷ Finally, FINRA Rule 0180(c) provides that certain other rules apply as necessary to effectuate members' compliance with the rules applicable to SBS as noted above, including, for example, supervision requirements and rules relating to FINRA investigations and sanctions.

In light of the expiration of the SEC's temporary exemptive orders, the finalization of the SEC's regulatory framework for SBS, and the upcoming Registration Compliance Date, FINRA believes it is appropriate and in the public interest for current FINRA Rule 0180 to expire and for FINRA to clarify the treatment of SBS under FINRA rules going forward.¹⁸ Accordingly, FINRA is proposing to amend FINRA Rules 0180, 4120, 4210, 4220, 4240 and 9610 to take into account members' SBS activities once SBS Entities begin registering with the SEC on October 6, 2021. These proposed amendments generally fall into three categories. First, the proposed rule change would adopt a new FINRA Rule 0180, to replace expiring current FINRA Rule 0180, that would generally apply FINRA rules to members' activities and positions with respect to SBS, while providing limited exceptions for SBS in circumstances where FINRA believes such exceptions are appropriate. Second, the proposed rule change would amend FINRA's financial responsibility and operational rules to conform to the SEC's amendments to its capital, margin and segregation requirements for SBSs and broker-dealers, and to otherwise take into account members' SBS activities. Finally, the proposed rule change would adopt a new margin rule specifically applicable to SBS, which would replace the expiring interim pilot program

¹⁷ These FINRA rules relate to books and records requirements and financial responsibility standards.

¹⁸ FINRA intends to extend the expiration dates of existing FINRA Rules 0180 and 4240 to October 6, 2021 to align with the Registration Compliance Date and implementation of the proposed rule change.

establishing margin requirements for CDS. Each aspect of the proposed rule change is discussed in greater detail below.

General Presumption of Applicability

As described above, FINRA Rule 0180 currently provides a broad, temporary exception from the application of FINRA requirements to SBS by providing that FINRA rules shall not apply to members' activities and positions with respect to SBS, with limited exceptions. Under the proposed rule change, current FINRA Rule 0180 would be replaced by a new FINRA Rule 0180 on October 6, 2021, which would effectively flip the existing presumption that FINRA rules do not apply to SBS, with certain exceptions, and instead provide that, going forward, FINRA rules do apply to SBS, with certain exceptions.¹⁹ Specifically, proposed FINRA Rule 0180(a) would provide that, except as otherwise provided in FINRA Rule 0180, FINRA rules shall apply to members' activities and positions with respect to SBS.²⁰ As discussed in greater detail below, proposed FINRA Rules 0180(b) through (g) would specify the exceptions from this general presumption of applicability that FINRA believes it should provide to members engaged in SBS activity. Proposed FINRA Rule 0180(i) also would provide FINRA with exemptive authority to consider exemptive relief from the application of specific FINRA rules to SBS on a case-by-case basis.

¹⁹ Supplementary Material .01 to FINRA Rule 0180 provides that for purposes of FINRA Rule 0180, "security-based swap" has the same meaning as defined in Section 3(a)(68) of the Act and the rules and guidance of the SEC or its staff. FINRA is not proposing to modify the definition of "security-based swap" in Supplementary Material .01.

²⁰ FINRA notes that since the definition of "security" now includes SBS, once current FINRA Rule 0180 expires all FINRA rules applicable to securities will apply by their terms to SBS, regardless of whether a FINRA rule specifically states that FINRA rules apply to SBS. However, FINRA believes that including an affirmative statement regarding the application of FINRA rules to SBS in proposed FINRA Rule 0180(a) will promote legal certainty and provide greater clarity for its members.

As discussed above, Title VII of the Dodd-Frank Act amended the definition of “security” under the Act to specifically encompass SBS.²¹ As the Commission has noted, in “making this change, Congress intended for [SBS] to be treated as securities under the Exchange Act and the underlying rules and regulations.”²² FINRA is a registered national securities association under Section 15A of the Act, which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.²³ FINRA adopted existing Rule 0180 to avoid undue market disruption while the SEC completed its Title VII rulemaking, but this broad exception was always intended to be temporary. Now that the SEC has largely finalized its regulatory framework for SBS and set the Registration Compliance Date for SBS Entities, FINRA believes it would be consistent with Congress’s intent and FINRA’s regulatory responsibility to generally apply FINRA rules to members’ activities and positions with respect to SBS, subject to specified exceptions.

Under proposed Rule 0180(a), FINRA rules would generally apply to SBS in the same manner that such rules apply to securities generally.²⁴ FINRA notes that while the proposed rule

²¹ See supra note 11.

²² See 2011 Exemptive Order, supra note 12, at 39929.

²³ 15 U.S.C. 78o-3(b)(6).

²⁴ As for any other activity or product, members are responsible for determining the regulatory characterization of SBS and the applicability of specific rules to such products.

change would therefore regulate SBS activities similarly to any other securities activities of its members, it expects that the practical impact of the proposed rule change will be limited. As an initial matter, in developing the proposed rule change, FINRA solicited input from its members regarding their anticipated SBS activities, including through direct conversations with a number of members that currently engage or have affiliates that engage in SBS activity, an invitation for submission of views and information on SBS activities on the FINRA website,²⁵ and issuance of Regulatory Notice 20-36 soliciting comment on a concept proposal relating to SBS.²⁶ Based on feedback received, FINRA understands that only a small number of its members will register as SBSs or otherwise directly engage in SBS activities. In addition, FINRA notes that many of its rules relate to specific activities or lines of business that are unlikely to be relevant to SBS given the unique and limited characteristics of SBS. For example, FINRA’s rules relating to securities offerings and underwriting are unlikely to implicate SBS.²⁷ Moreover, at present SBS generally may only be entered into with persons who qualify as “eligible contract participants” (“ECPs”),²⁸

²⁵ See FINRA, Views and Information on Activity Related to Security-Based Swaps, <https://www.finra.org/rules-guidance/requests-for-comments/security-based-swaps>.

²⁶ See FINRA Regulatory Notice 20-36 (October 2020).

²⁷ FINRA notes that certain rules in the FINRA Rule 5200 Series (Quotation and Trading Obligations and Practices) and 5300 Series (Handling of Customer Orders) apply by their terms to “securities” generally, and therefore would apply to SBS under the proposed rule change. FINRA believes such rules are likely to have limited impact on SBS at present because SBS are generally bilateral OTC derivatives transactions negotiated and entered into between two counterparties. However, these trading and quoting rules may become more relevant to SBS in the future, particularly if trading or execution of SBS on exchanges or SBSEFs becomes prevalent. FINRA will monitor developments in the SBS market and evaluate the appropriateness of applying these rules to SBS transactions if quoting and trading activity develops.

²⁸ “Eligible contract participant” is defined under the Act to have the same meaning as under the Commodity Exchange Act (“CEA”). See 15 U.S.C. 78c(a)(65). Under the CEA, ECPs are defined to include certain regulated entities, such as broker-dealers, futures commission merchants (“FCMs”), financial institutions and insurance companies,

such that FINRA rules specific to activities involving retail customers are unlikely to apply to SBS at this time.

FINRA notes that current FINRA Rule 0180(a) provides: “The Rules shall not apply to members’ activities and positions with respect to security-based swaps, except for” certain rules noted above. Article I of the FINRA By-Laws defines the “Rules” as used in FINRA Rule 0180(a) to mean “the numbered rules set forth in the [FINRA manual] beginning with the Rule 0100 Series, as adopted by the Board pursuant to these By-Laws, as hereafter amended or

as well as government entities and certain qualifying individuals and entities meeting net worth or total assets thresholds. See 7 U.S.C. 1a(18). Generally, an individual qualifying as an ECP must have amounts invested on a discretionary basis in excess of \$10,000,000, or \$5,000,000 if hedging. See 7 U.S.C. 1a(18)(A)(xi). The Dodd-Frank Act amended the Securities Act of 1933 (“Securities Act”) and the Act to require that SBS transactions involving a person that is not an ECP must be registered under the Securities Act and effected on a national securities exchange. See Product Definitions, supra note 6, at 48246 n.429. FINRA understands that no SBS are currently registered or available for execution on an exchange, and therefore all SBS at present must be entered into with ECPs.

FINRA’s retail customer-focused rules generally apply to accounts of customers that do not meet the definition of an “institutional account” under FINRA Rule 4512(c). In addition to certain types of regulated entities, an “institutional account” under FINRA Rule 4512(c) includes any person with total assets of at least \$50 million. See FINRA Rule 4512(c)(3). Certain FINRA rules also exclude other specified types of entities or persons from the coverage of retail customer-focused provisions. See, e.g., FINRA Rule 2210(a)(4) (defining “institutional investor” for purposes of the communications with the public requirements as an institutional account under FINRA Rule 4512(c) or certain other specified entities, plans or persons). Given the differences between the ECP definition and the definition of “institutional account” (or other variations used to define non-retail customers in the FINRA rulebook), it is possible that FINRA members may engage in SBS with customers that qualify as ECPs but that do not qualify as “institutional accounts,” and therefore would be covered by FINRA retail customer-focused rules. For example, an individual may have more than \$10 million invested on a discretionary basis, but not total assets of at least \$50 million. Given the nature of the SBS market, FINRA believes that this scenario is likely to occur infrequently, but believes it would be appropriate to apply FINRA rules applicable to activities involving retail customers in such situations. FINRA notes that its retail customer-focused rules would also apply to SBS if non-ECP markets develop.

supplemented.” Current FINRA Rule 0180 does not provide an exception from other parts of the FINRA manual, including the FINRA By-Laws and related governance documents, the Capital Acquisition Broker (CAB) rulebook, the Funding Portal rulebook or the Temporary Dual FINRA-NYSE Member Rules Series. Therefore, to the extent any of FINRA’s governance documents or other rule sets apply to securities activities, they already apply to SBS by their terms. However, FINRA believes that these other parts of the FINRA manual likely have little direct relevance to SBS activities, since they relate primarily to governance or, as is the case for the CAB and Funding Portal rulebooks, are likely generally inapplicable due to the restricted nature of activities covered. FINRA also notes that Schedule A to the FINRA By-laws lists various fees that FINRA may assess, including two types of transaction fees. First, Section 1 of Schedule A provides for assessment of Member Regulatory Fees, including the Trading Activity Fee or “TAF.” The TAF applies only to sales of “covered securities” as defined in paragraph (b) of Section 1 of Schedule A. FINRA does not currently consider SBS to be “covered securities” as currently defined in paragraph (b), and therefore has not assessed the TAF with respect to SBS transactions entered into by its members. Second, Section 3 of Schedule A provides that each member shall be assessed a Regulatory Transaction Fee, which shall be determined periodically in accordance with Section 31 of the Act.²⁹ The SEC has addressed whether SBS are subject to Section 31 fees, stating that SBS are not currently subject to Section 31 fees and will not become subject to Section 31 fees until such time as the SEC implements real-time public reporting of SBS transactions.³⁰ FINRA will monitor developments with respect to the applicability of

²⁹ See 15 U.S.C. 78ee.

³⁰ Specifically, the SEC has stated:

A sale of a security is subject to Section 31 fees only if (1) the sale occurs on a national securities exchange, or (2) the sale is transacted by or through a member

Section 31 fees to SBS and apply its Regulatory Transaction Fee coextensively with Section 31 fees. Therefore, FINRA expects that its Regulatory Transaction Fee will apply to SBS if real-time reporting for SBS comes into effect without the SEC providing an exemption for SBS from Section 31 fees. However, if the SEC grants an exemption from Section 31 for SBS, the Regulatory Transaction Fee would likewise not apply to SBS.

FINRA believes that applying the general presumption of applicability of FINRA rules to SBS under proposed FINRA Rule 0180(a) as described above is appropriate and in the public interest. In formulating the proposed rule change, however, FINRA reviewed its rulebook to evaluate whether it would be appropriate to provide exceptions for SBS from particular FINRA rules or rule series and, if so, under what circumstances such exceptions should apply. Based on this review and feedback from its members and others, FINRA is proposing to provide three categories of exceptions: (1) general exceptions based on impracticability or operational burdens;

of a national securities association otherwise than on a national securities exchange and the security is registered on a national securities exchange or subject to prompt last-sale reporting pursuant to the rules of the Commission or a registered national securities association. Although security-based swaps are securities, they do not meet any of the conditions noted above. Thus, security-based swaps are currently not subject to Section 31 fees and would not become subject to Section 31 fees due to the expiration of the Unlinked Temporary Exemptions or the full implementation of Regulation SBSR as it currently exists.

The Dodd-Frank Act created a new Section 13(m) of the Exchange Act that requires “real-time public reporting” of security-based swap transactions. Once real-time public reporting is fully-implemented, security-based swaps will be subject to prompt last-sale reporting pursuant to the rules of the Commission, which will subject them to Section 31 fees. Thus, when the Commission proposes to implement prompt last-sale reporting for security-based swap transactions, it may also revisit the appropriateness of exempting security-based swaps from Section 31 fees at such time.

See 2019 Exemptive Order, supra note 13, at 866 (citations omitted).

(2) limited exceptions for SBS Entities and associated persons of SBS Entities; and (3) limited exceptions in connection with the conditions to the SEC's cross-border SBS counting exception. In addition, FINRA is proposing to provide exemptive authority to exempt a person from the application of specific FINRA rules to the person's SBS activities in circumstances not already covered by the proposed rule change. Each of these aspects of the proposed rule change is discussed in greater detail below.

General Exceptions From Presumption of Applicability

Proposed FINRA Rule 0180(b) would provide that the following FINRA rules shall not apply to members' activities and positions with respect to SBS: (1) the FINRA Rule 6000 Series; (2) the FINRA Rule 7000 Series; and (3) the FINRA Rule 11000 Series. While some of these rules could potentially be interpreted as applying to SBS activities by their terms, FINRA believes that these rules were intended for other types of securities and could create operational difficulties if so applied. Therefore, FINRA believes the proposed rule change would provide legal certainty and clarity for its members by specifically excepting these rules from applying to members' activities and positions with respect to SBS.

The FINRA Rule 6000 Series (Quotation, Order, and Transaction Reporting Facilities) and 7000 Series (Clearing, Transaction and Order Data Requirements, and Facility Charges) include various rules relating to trading, quoting, clearing and reporting for different types of securities. These rule series includes rules relating to quoting and trading in NMS stocks, quoting and trading in OTC Equity Securities, the Alternative Display Facility (the ADF, a facility for display of quotations in, and reporting OTC transactions in, NMS stocks), the Trade Reporting Facilities (the TRFs, facilities for reporting OTC transactions in NMS stocks), the OTC Reporting Facility (the ORF, a facility for reporting transactions in OTC Equity Securities),

the OTC Bulletin Board Service (the OTCBB, an interdealer quotation system for OTC Equity Securities), the Trade Reporting and Compliance Engine (TRACE, a facility for reporting transactions in eligible debt securities), the Order Audit Trail system (OATS, a system to capture order information in NMS stocks and OTC Equity Securities), compliance with the Consolidated Audit Trail (CAT), and fees and charges associated with various FINRA facilities. Many of these rules would clearly not apply to SBS by their terms. For example, SBS are not NMS stocks, nor are SBS subject to the CAT. However, FINRA understands that the characterization of SBS may be unclear in some circumstances, which could raise the possibility that certain of these rules could be interpreted as applying to SBS. FINRA does not intend for the FINRA Rule 6000 or 7000 Series to apply to SBS, as these rules were specifically designed for other types of securities and would be operationally burdensome if applied to SBS. In addition, reporting to FINRA's various trade reporting facilities would be unnecessarily duplicative with the SEC's Title VII rulemakings related to regulatory reporting and public dissemination of SBS information.³¹ Therefore, the proposed rule change would provide clarity in this area by specifically providing exceptions for SBS from the FINRA Rule 6000 and 7000 Series.³²

In addition, the FINRA Rule 11000 Series sets forth the Uniform Practice Code ("UPC"). The UPC is a series of rules, interpretations and explanations designed to make uniform, where

³¹ See Regulation SBSR Release, supra note 8.

³² FINRA notes that the FINRA Rule 6400 Series (Quoting and Trading in OTC Equity Securities) includes certain rules governing quoting and trading practices for OTC Equity Securities. FINRA believes these rules are not relevant to SBS at present because SBS are generally OTC derivatives transactions negotiated and entered into between two counterparties. However, these type of trading and quoting rules may become more relevant to SBS in the future, particularly if market centers begin quoting or trading SBS. FINRA will monitor developments in the SBS market and evaluate the appropriateness of applying these or similar rules to SBS transactions at such time.

practicable, custom, practice, usage, and trading technique in the investment banking and securities business, particularly with regards to operational and settlement issues. These can include such matters as trade terms, deliveries, payments, dividends, rights, interest, reclamations, exchange of confirmations, stamp taxes, claims, assignments, powers of substitution, computation of interest and basis prices, due-bills, transfer fees, “when, as and if issued” trading, “when, as and if distributed” trading, marking to the market, and close-out procedures. The UPC was created so that the transaction of day-to-day business by members may be simplified and facilitated, that business disputes and misunderstandings, which arise from uncertainty and lack of uniformity in such matters, may be eliminated, and that the mechanisms of a free and open market may be improved and impediments thereto removed. For example, FINRA Rules 11310 through 11365 address matters relating to the delivery of securities, FINRA Rules 11510 through 11581 address certificated security matters, FINRA Rules 11610 through 11650 address the delivery of bonds and other evidence of indebtedness and FINRA Rules 11810 through 11894 address close-out procedures.

By its terms, the UPC applies to all OTC secondary market transactions in securities between members, with enumerated exceptions.³³ Therefore, the UPC could be interpreted as applying to SBS transactions in some circumstances. However, FINRA notes that the UPC is limited to transactions between members. It would therefore apply only in the very limited circumstances involving SBS transacted between FINRA members. As discussed above, FINRA

³³ See FINRA Rule 11100(a). Under FINRA Rule 11100(a)(1), transactions in securities between members which are compared, cleared or settled through the facilities of a registered clearing agency are not subject to the UPC, except to the extent that the rules of the clearing agency provide that rules of other organizations shall apply. Paragraphs (a)(2) through (a)(5) of FINRA Rule 11100 also provide exceptions for specific types of securities, including exempted securities, municipal securities, redeemable securities issued by investment companies and Direct Participation Program Securities.

understands that only a small number of its members will register as SBSs or otherwise directly engage in SBS activities. The UPC would therefore only potentially be invoked for a small portion of the SBS market, which FINRA believes has the potential to create confusion and uncertainty. In addition, while FINRA recognizes the importance of operational and settlement risks in SBS transactions, FINRA believes these risks are more appropriately addressed through other means, including through the contractual provisions utilized by SBS counterparties under industry-standard SBS documentation and, where applicable, the SEC's risk mitigation requirements.³⁴ By contrast, the UPC was designed to facilitate and make uniform the operational aspects of cash securities transactions. These operational provisions were not designed for, and are not well-suited to, the particular characteristics of SBS transactions involving bilateral contractual negotiations between counterparties. FINRA therefore believes it is appropriate to except the FINRA Rule 11000 Series from applying to members' activities and positions with respect to SBS.

Exceptions for SBS Entities and Associated Persons

As discussed above, the SEC has now completed the majority of its Title VII rulemakings, including business conduct standards, trade acknowledgement and verification requirements, risk mitigation techniques and recordkeeping rules for SBS Entities.³⁵ These rules

³⁴ For example, the SEC's SBS trading relationship documentation rules require SBS Entities to have in place trading relationship documentation including all terms governing the trading relationship between the SBS Entity and its counterparty, including, without limitation, terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution. See 17 CFR 240.15Fi-5(b)(1).

³⁵ See Business Conduct Standards Release; Trade Acknowledgment and Verification Release; Risk Mitigation Release; Recordkeeping Release, supra note 8.

will apply to SBS Entities once they register with the SEC on or after the Registration Compliance Date. As described below, certain of these new SBS-specific rules are similar to existing FINRA rules that apply to members' securities activities generally. FINRA believes that applying both the SEC's rules for SBS Entities and FINRA's parallel rules for its members to the same SBS activity would result in unnecessary regulatory duplication. Therefore, to promote regulatory clarity and avoid unnecessary regulatory duplication, the proposed rule change would provide exceptions from specific FINRA rules in circumstances where the SEC's SBS Entity rules will apply to the SBS activity. As described in further detail below, proposed FINRA Rules 0180(c), (d), (f) and (g) would specify the FINRA rules subject to these exceptions and the conditions to such exceptions.

Proposed FINRA Rules 0180(c) and (d) would provide that certain specified FINRA rules shall not apply to members' activities and positions with respect to SBS, to the extent that the member is acting in its capacity as an SBS Entity or the associated person of the member is acting in his or her capacity as an associated person of an SBS Entity, as applicable, and that such activities or positions relate to the business of the SBS Entity within the meaning of the Exchange Act Rule 15Fh-3(h)(1).³⁶ As described below, each rule listed in proposed FINRA Rules 0180(c) and (d) is similar to a particular SEC rule or set of rules applicable to SBS Entities (or specifically applicable to SBSs, but not MSBSPs, in the case of proposed FINRA Rule 0180(d)). FINRA believes it is appropriate to provide exceptions from these specific FINRA rules, but only to the extent that the SEC's parallel SBS Entity rules will apply to the SBS

³⁶ See 17 CFR 240.15Fh-3(h)(1). These exceptions are split between paragraphs (c) and (d) of proposed FINRA Rule 0180 to account for certain SEC rules that apply only to SBSs, but not MSBSPs. Specifically, the exceptions in proposed FINRA Rule 0180(c) would apply for all Swap Entities, while the exceptions in proposed FINRA Rule 0180(d) would apply only for SBSs.

activity.³⁷ The exceptions are therefore limited to circumstances where the member engaged in the SBS activity is acting in its capacity as an SBS Entity, or where the associated person engaged in the SBS activity is acting in his or her capacity as an associated person of an SBS Entity.³⁸ To ensure that the exceptions apply only where the SBS activity is covered by the

³⁷ Conversely, the proposed exceptions would not apply in circumstances where the SEC's SBS Entity rules do not apply. For example, the exceptions in proposed FINRA Rules 0180(c) and (d) would not apply to a member engaged in SBS brokerage activity. FINRA notes that the SEC has contemplated that a registered broker-dealer engaged in SBS brokerage activity would be subject to applicable self-regulatory organization rules. See, e.g., Cross-Border Release at 6284, Business Conduct Standards Release at 29966-68, *supra* note 8. The exceptions would also not apply to a member entering into SBS below the *de minimis* threshold for SBS registration or engaging in other SBS activity not requiring SBS Entity registration (e.g., SBS hedging activity). In these circumstances, the FINRA rules would apply to the SBS activity.

³⁸ FINRA's business conduct rules apply both to the FINRA member and persons associated with the member. Similarly, the SEC's SBS Entity rules apply to activity undertaken by an SBS Entity or its associated persons. Therefore, proposed Rule 0180(c) applies to the SBS activities engaged in by a member that is also registered as an SBS Entity as well as SBS activities engaged in by an associated person of a member where the associated person is acting in their capacity as an associated person of an SBS Entity, since the SBS Entity rules would apply in those circumstances. The exceptions would therefore apply to an associated person of a member that is also registered as an SBS Entity where the associated person is acting in his or her capacity as an associated person of the SBS Entity.

FINRA understands that certain firms engaged in SBS activity may employ a "dual-hatted" personnel structure. In this structure, an affiliate of the member is registered as an SBS Entity, but the member itself is not dually-registered as an SBS Entity. However, certain personnel of the member may be "dual-hatted" such that they act as associated persons of the member with respect to general securities activities but as associated persons of the affiliated SBS Entity with respect to the SBS Entity's SBS activities. FINRA intends for the exceptions in proposed FINRA Rule 0180(c) to apply to SBS activities undertaken by an associated person of a member acting in his or her capacity as an associated person of an affiliated SBS Entity under the dual-hatted structure described above. FINRA is providing this guidance to promote legal certainty and provide clarity to its members regarding the application of the particular rules covered by the proposed exceptions in FINRA Rule 0180(c). The proposed rule change does not address whether or to what extent other FINRA rules not covered by proposed FINRA Rule 0180(c) might apply to a dual-hatted associated person when he or she is acting in his or her capacity as an associated person of an affiliated SBS Entity.

SEC's rules and subject to the oversight and supervision of an SBS Entity (which itself is subject to oversight by the Commission and, if a FINRA member, FINRA), proposed FINRA Rules 0180(c) and (d) include a further condition that the SBS activities or positions relate to the business of the SBS Entity within the meaning of the SEC's SBS Entity supervision rule.³⁹

Under proposed FINRA Rules 0180(c) and (d), these proposed exceptions would be available for eight FINRA rules, subject to the conditions described above. Specifically, proposed FINRA Rule 0180(c) would provide exceptions for the following FINRA rules:

- FINRA Rule 2210(d) (Communications with the Public – Content Standards) requires members to adhere to content standards with respect to all of their communications, whether correspondence, retail communications or institutional communications. Among other things, FINRA Rule 2210(d) requires that member communications be based on principles of fair dealing and good faith, be fair and balanced, and not omit any material

FINRA also notes that whether a particular individual is acting as an associated person of the member or of an SBS Entity (whether the same entity as the member or an affiliated entity) is a facts and circumstances determination and is not dependent on the particular method in which such arrangements are documented. However, FINRA reminds members that they must be able to demonstrate how a particular individual is designated and for what purposes, as well as the specific capacity in which an individual is acting with respect to any particular transaction or activity.

³⁹ The SEC's SBS supervision rule states: "A security-based swap dealer or major security-based swap participant shall establish and maintain a system to supervise, and shall diligently supervise, its business and the activities of its associated persons. Such a system shall be reasonably designed to prevent violations of the provisions of applicable federal securities laws and the rules and regulations thereunder relating to its business as a security-based swap dealer or major security-based swap participant, respectively." 17 CFR 240.15Fh-3(h)(1). Therefore, to qualify for the exceptions in proposed FINRA Rules 0180(c) and (d), the particular SBS activity must be within the scope of the business of the SBS Entity that is subject to the SBS Entity's supervisory system. If an SBS Entity were to engage in other SBS activity that it did not consider within the scope of its business as an SBS Entity, and therefore not subject to the SEC's rules applicable to SBS Entities, the exceptions would not be available and the applicable FINRA rules would apply to that activity.

facts or make false or exaggerated claims. The SEC's business conduct rules for SBS Entities include Exchange Act Rule 15Fh-3(g), which generally requires SBS Entities to communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith.⁴⁰ The SEC's business conduct rules also include requirements for SBS Entities to make certain disclosures to their SBS counterparties, including disclosures of material risks and characteristics of the SBS and material incentives or conflicts of interest (Exchange Act Rule 15Fh-3(b)), daily mark disclosures (Exchange Act Rule 15Fh-3(c)) and disclosures regarding clearing rights (Exchange Act Rule 15Fh-3(d)).⁴¹

- FINRA Rule 2232 (Customer Confirmations) generally requires members to provide customers with written confirmations in conformity with Exchange Act Rule 10b-10,⁴² along with specified additional disclosures for certain types of securities. Exchange Act Rule 15Fi-2 requires SBS Entities to provide trade acknowledgements and to establish, maintain and enforce written policies and procedures reasonably designed to obtain prompt verification of the terms of such trade acknowledgments.⁴³ FINRA also notes that the SEC's trade acknowledgement and verification rule provides that an SBS Entity that is also a broker or dealer, is purchasing from or selling to any counterparty, and that

⁴⁰ See 17 CFR 240.15Fh-3(g); Business Conduct Standards Release, supra note 8, at 30000-02.

⁴¹ See 17 CFR 240.15Fh-3(b), (c) and (d); Business Conduct Standards Release, supra note 8, at 29980-93.

⁴² See 17 CFR 240.10b-10.

⁴³ See 17 CFR 240.15Fi-2; see generally Trade Acknowledgment and Verification Release, supra note 8.

complies with the relevant requirements of the trade acknowledgement and verification rule, is exempt from the requirements of Exchange Act Rule 10b-10 with respect to the SBS transaction.⁴⁴

- FINRA Rules 3110 (Supervision), 3120 (Supervisory Control System) and 3130 (Annual Certification of Compliance and Supervisory Processes) require, among other things, each member to establish and maintain a supervisory system; establish, maintain and enforce written supervisory procedures; designate principals to establish, maintain and enforce a system of supervisory control policies and procedures; designate a chief compliance officer; and submit annual certifications to FINRA related to the member's compliance policies and written supervisory procedures. The SEC's business conduct rules for SBS Entities include Exchange Act Rules 15Fh-3(h) and 15Fk-1.⁴⁵ Exchange Act Rule 15h-3(h) requires, among other things, an SBS Entity to establish and maintain a system to supervise, and to diligently supervise, its business and the activities of its associated persons; designation of at least one person with authority to carry out supervisory responsibilities; and establishment, maintenance and enforcement of written policies and procedures addressing supervision of the SBS Entity's SBS business. Exchange Act Rule 15Fk-1 requires each SBS Entity to designate a chief compliance officer and submit annual compliance reports to the SEC.

Proposed FINRA Rule 0180(d) would provide exceptions for the following FINRA Rules:

⁴⁴ See 17 CFR 240.15Fi-2(g); Trade Acknowledgement and Verification Release, supra note 8, at 39824-25.

⁴⁵ See 17 CFR 240.15Fh-3(h) and 15Fk-1; Business Conduct Standards Release, supra note 8, at 30002-07 and 30050-61.

- FINRA Rule 2030 (Engaging in Distribution and Solicitation Activities with Government Entities) is FINRA’s “pay-to-play” rule, which imposes restrictions on member firms engaging in distribution or solicitation activities with government entities. Exchange Act Rule 15Fh-6 imposes pay-to-play restrictions on SBSs (but not MSBSPs), including similar restrictions on an SBS engaging in SBS transactions with a municipal entity within two years after specified types of political contributions have been made to officials of the municipal entity.⁴⁶
- FINRA Rule 2090 (Know Your Customer) generally requires that each member use reasonable diligence to know and retain essential facts concerning every customer and the authority of each person acting on behalf of such customer. The SEC’s business conduct rules for SBS Entities include Exchange Act Rules 15Fh-3(a) and (e).⁴⁷ Exchange Act Rule 15Fh-3(a) generally requires SBS Entities to verify the status of their SBS counterparties, including verification that the counterparty is an ECP and whether the counterparty is a “special entity.”⁴⁸ Exchange Act Rule 15Fh-3(e) requires each SBS (but not MSBSP) to establish, maintain and enforce written policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each counterparty whose identity is known to the SBS that are necessary for conducting business with such counterparty.

⁴⁶ See 17 CFR 240.15Fh-6; Business Conduct Standards Release, supra note 8, at 30045-50.

⁴⁷ See 17 CFR 240.15Fh-3(a) and (e); Business Conduct Standards Release, supra note 8, at 29978-80 and 29993-94.

⁴⁸ “Special entity” is defined in Exchange Act Rule 15Fh-2(d) and includes certain government entities, employee benefit plans and endowments. See 17 CFR 240.15Fh-2(d).

- FINRA Rule 2111 (Suitability) is FINRA’s suitability rule, which generally requires a member or associated person to have a reasonable basis that a recommended transaction or investment strategy is suitable for the customer.⁴⁹ The SEC’s business conduct rules for SBS Entities include Exchange Act Rules 15Fh-3(f) and 15Fh-5.⁵⁰ Exchange Act Rule 15Fh-3(f) imposes similar suitability obligations on SBSDs (but not MSBSPs) with respect to recommendations of SBS or trading strategies.⁵¹ In addition, Exchange Act

⁴⁹ Specifically, FINRA Rule 2111 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability. The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. A member’s or associated person’s reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer’s investment profile, with the ability to fulfill this obligation for an institutional account if (i) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities, and (ii) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member’s or associated person’s recommendations. Quantitative suitability requires a member or associated person to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer’s investment profile. See Supplementary Material .05 to FINRA Rule 2111.

⁵⁰ See 17 CFR 240.Fh-3(f) and Fh-5; Business Conduct Standards Release, supra note 8, at 29994-30000 and 30007-45.

⁵¹ Specifically, Exchange Act Rule 15Fh-3(f)(1)(i) provides that an SBSD that recommends an SBS or trading strategy involving an SBS to a counterparty (other than an SBS Entity, swap dealer or major swap participant) must undertake reasonable diligence to understand the potential risks and rewards associated with the recommended SBS or trading strategy involving an SBS. FINRA notes that, as proposed, Exchange Act Rule 15Fh-3(f)(1)(i) would have required an SBSD to have a reasonable basis to believe, based on reasonable diligence, that the recommended SBS or trading strategy is suitable for at least some counterparties (similar to FINRA Rule 2111’s reasonable-basis obligation). See Business Conduct Standards Release, supra note 8 at 29994. When adopting its final business conduct rules, the SEC modified Exchange Act Rule 15Fh-3(f)(1)(i) to

Rule 15Fh-5 applies special, enhanced requirements when SBS Entities act as counterparties to special entities.

Proposed FINRA Rule 0180(f) would provide that FINRA Rules 2231 (Customer Account Statements) and 4512 (Customer Account Information) shall not apply to members' activities and positions with respect to SBS, to the extent that the member is acting in its capacity as an SBS Entity and the customer's account solely holds SBS and collateral posted as margin in

“rephrase the suitability obligation...to make it consistent with the CFTC’s parallel suitability requirement in Commodity Exchange Act Rule 23.434(a)(1), which explicitly requires [SBSDs] to understand the risk-reward tradeoff of their recommendations.” In doing so, the SEC noted that the SEC’s “proposed formulation and the CFTC’s formulation would have achieved the same purpose.” See id. at 29996. The SEC also noted that the “new formulation is also consistent with FINRA’s approach to this aspect of suitability [i.e., the reasonable-basis obligation as described in Supplementary Material .05(a) to FINRA Rule 2111].” See id. at 29996 n.493. As with the reasonable-basis obligation in FINRA Rule 2111, SBSDs “are always required to meet their suitability obligation in [Exchange Act] Rule 15Fh-3(f)(1)(i), regardless of whether they avail themselves of the institutional suitability alternative to meet their customer-specific obligations.” See id. at 29997.

In addition, Exchange Act Rule 15Fh-3(f)(1)(ii) requires the SBSD to have a reasonable basis to believe that a recommended SBS or trading strategy involving an SBS is suitable for the counterparty (similar to FINRA Rule 2111’s customer-specific obligation). Also similar to the institutional account alternative in FINRA Rule 2111, an SBSD may fulfill its obligations under Exchange Act Rule 15Fh-3(f)(1)(ii) with respect to an institutional counterparty if it complies with specified conditions, including reasonably determining that the counterparty or its agent is capable of independently evaluating investment risks with regard to the relevant SBS or trading strategy involving an SBS and that the counterparty or its agent affirmatively represents in writing that it is exercising independent judgment in evaluating the recommendations of the SBSD with regard to the relevant SBS or trading strategy involving an SBS. See Exchange Act Rules 15Fh-3(f)(2) and (3).

FINRA acknowledges that the SEC’s suitability rule differs in some respects from FINRA’s suitability requirements under FINRA Rule 2111. For example, Exchange Act Rule 15F-3(f) does not explicitly include a quantitative suitability obligation. However, FINRA believes that, while not identical, Exchange Act Rule 15Fh-3(f) serves similar purposes to FINRA Rule 2111, such that requiring members that are SBSDs to also comply with FINRA Rule 2111 in circumstances where Exchange Act Rule 15Fh-3(f) applies would be unnecessarily duplicative.

connection with such SBS, provided that the member complies with the portfolio reconciliation requirements of Exchange Act Rule 15Fi-3 with respect to such account and that such portfolio reconciliations include collateral posted as margin in connection with SBS in the account.

FINRA Rule 2231 generally requires each member to provide, on at least a quarterly basis, an account statement to each customer containing a description of any securities positions, money balances or account activity during the period since the last customer account statement. FINRA Rule 4512 generally requires each member to maintain specified information for each customer account, including specified identifying information about the customer.

FINRA believes that the customer account statements required under FINRA Rule 2231 generally should reflect a holistic view of a member's relationship with its customer, including SBS transactions, positions and related collateral, if applicable. Therefore, to the extent that a customer's account includes SBS along with other securities positions or activity, or related money balances, then FINRA believes that the account statement under FINRA Rule 2231 should include SBS. However, FINRA understands that members that are also registered SBS Entities may have customer accounts that hold solely SBS and related collateral, and do not hold any other securities positions or have any other securities activity. While SBS Entities are not subject to a customer account statement requirement with respect to SBS, the SEC's risk mitigation requirements for SBS Entities include Exchange Act Rule 15Fi-3, which requires SBS Entities to engage in portfolio reconciliation with their counterparties.⁵² Exchange Act Rule

⁵² See 17 CFR 240.15Fi-3; Risk Mitigation Release, supra note 8, at 6362-70. For purposes of Exchange Act Rule 15Fi-3, "portfolio reconciliation" is defined as any process by which counterparties to one or more SBS (1) exchange the material terms of all SBS in the SBS portfolio between the counterparties, (2) exchange each counterparty's valuation of each SBS in the SBS portfolio between the counterparties as of the close of business on the immediately preceding day and (3) resolve any discrepancy in valuations or material terms. See 17 CFR 240.15Fi-1(l).

15Fi-3(a) generally requires SBS Entities to engage in portfolio reconciliation for all SBS with their SBS Entity counterparties, with the frequency of such portfolio reconciliations ranging from once each business day (for SBS portfolios that include 500 or more SBS), to once each week (for SBS portfolios that include more than 50 but fewer than 500 SBS on any business day during the week), to once each calendar quarter (for SBS portfolios that include no more than 50 SBS at any time during the calendar quarter).⁵³ Exchange Act Rule 15Fi-3(b) requires each SBS Entity to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation for all SBS with non-SBS Entity counterparties, with the frequency of such portfolio reconciliations ranging from once each calendar quarter (for SBS portfolios that include more than 100 SBS at any time during the calendar quarter) to once annually (for SBS portfolios that include no more than 100 SBS at any time during the calendar year).⁵⁴

FINRA acknowledges that the SEC's SBS portfolio reconciliation rule differs in some respects from the customer account statement requirements under FINRA Rule 2231. For example, the frequency of portfolio reconciliations varies as described above, while customer account statements must be delivered at least quarterly. In addition, as described above, an SBS entity must have policies and procedures in place to ensure that it engages in portfolio reconciliation with non-SBS Entity counterparties, while a member must provide a customer account statement to each customer unless a specific exception under FINRA Rule 2231(b) applies. However, FINRA believes that, while not identical, Exchange Act Rule 15Fi-3 serves similar purposes to FINRA Rule 2231, such that requiring members that are SBS Entities to also

⁵³ See 17 CFR 240.15Fi-3(a).

⁵⁴ See 17 CFR 240.15Fi-3(b).

provide customer account statements for accounts holding solely SBS and related collateral would be unnecessarily duplicative. Accordingly, to promote regulatory clarity and avoid unnecessary duplication, proposed FINRA Rule 0180(f) would provide an exception from FINRA Rule 2231 in the limited circumstances where the member is acting in its capacity as an SBS Entity and the account solely holds SBS and collateral posted as margin in connection with such SBS. FINRA notes that collateral in a customer's account would be included in account statements provided under FINRA Rule 2231. The proposed rule change therefore includes as a condition to the proposed exception that the member comply with Exchange Act Rule 15Fi-3 with respect to an account qualifying for the exception and include collateral in the portfolio reconciliation and dispute resolutions requirements as applied to such an account.

The SEC's risk mitigation requirements for SBS also include Exchange Act Rule 15Fi-5, which requires SBS Entities to have in place SBS trading relationship documentation with their SBS counterparties, including all terms governing the trading relationship between the SBS and its counterparty.⁵⁵ In addition, SBS Entities that are also registered broker-dealers are subject to the SEC's recordkeeping requirements under Exchange Act Rule 17a-3, which require, among other things, certain records to be kept for each SBS account.⁵⁶ These SEC rules generally require SBS Entities to obtain and keep records of certain information in connection with their

⁵⁵ See 17 CFR 240.15Fi-5; Risk Mitigation Release, supra note 8, at 6372-6377. SEC rules also require SBS Entities to maintain records of SBS trading relationship documentation. See 17 CFR 17a-4(e)(12)(ii).

⁵⁶ See 17 CFR 240.17a-3; see generally Recordkeeping Release, supra note 8. FINRA notes in particular Exchange Act Rule 17a-3(a)(9)(iv), which requires an SBS Entity to keep a record, for each SBS account, of the unique identification code of the counterparty, the name and address of the counterparty, and a record of the authorization of each person the counterparty has granted authority to transact business in the SBS account. See 17 CFR 240.17a-3(a)(9)(iv).

SBS accounts, including SBS-specific identifying information. FINRA believes that, while not identical to FINRA Rule 4512, these SEC rules serve similar purposes, and that also applying FINRA Rule 4512 to SBS-only accounts would be duplicative. Accordingly, in order to promote regulatory clarity and avoid unnecessary duplication, FINRA believes it is appropriate to provide an exception from FINRA Rule 4512 in the limited circumstances where the member is acting in its capacity as an SBS Entity and the account solely holds SBS and collateral posted as margin in connection with such SBS. Both exceptions under proposed FINRA Rule 0180(f) would not apply to accounts holding SBS together with other securities or to members that are not also registered SBS Entities.

Finally, proposed FINRA Rule 0180(g) would provide that persons associated with a member whose functions are related solely and exclusively to SBS undertaken in such person's capacity as an associated person of an SBS Entity are not required to be registered with FINRA.⁵⁷ Generally, FINRA Rule 1210 requires that each person engaged in the investment banking or securities business of a member must be registered with FINRA as a representative or principal in each category of registration appropriate to his or her functions and responsibilities as specified in FINRA Rule 1220. Individuals seeking to become registered with FINRA generally must pass an appropriate qualification examination, and registered individuals are subject to continuing education ("CE") requirements under FINRA Rule 1240. These registration, licensing and CE requirements would generally apply to associated persons of a member engaged in SBS activities due to the change to the definition of "security" to encompass

⁵⁷ This exception is structured similarly to existing exceptions from registration for persons associated with a member whose functions are related solely and exclusively to certain other product types (such as municipal securities, commodities or security futures), as found in FINRA Rule 1230.

SBS. Accordingly, FINRA believes that associated persons of a member who are engaged in SBS activities generally should be registered—and subject to accompanying licensing and CE requirements—as appropriate based on the scope of their activities (e.g., Series 7 for general SBS activities, Series 24 for SBS principals, etc.). However, FINRA understands that members that are also registered SBS Entities may in some limited circumstances have an associated person whose securities-related activities relate solely and exclusively to transactions conducted in the individual's capacity as an associated person of the SBS Entity. Such individuals engage solely in SBS activities on behalf of the SBS Entity (and potentially non-securities activities, such as swaps), but do not engage in any other securities activities that would require registration under FINRA Rule 1210.

FINRA's current registration, licensing and CE requirements are not specifically tailored to SBS. To reduce unnecessary regulatory burdens, FINRA therefore believes it is appropriate for the proposed rule change to provide an exception at the current time from these requirements in the limited circumstances where an associated person of a member is engaged solely and exclusively in SBS activities in his or her capacity as an associated person of an SBS Entity. Under this proposed exception, such persons would not be required to register with FINRA, and therefore would not be required to pass any qualification examinations or become subject to CE requirements under FINRA Rule 1240. This proposed exception is based on FINRA's analysis of its existing registration and related requirements, and its understanding that the number of such associated persons is limited. FINRA will monitor developments with respect to the SBS activities of its members and will continue to consider whether it would be appropriate to tailor the registration and related requirements to SBS, for example through targeted SBS-related registration categories or the addition of SBS-specific content to qualification examinations or

CE content. FINRA will consider whether it would be appropriate to rescind the exception under proposed FINRA Rule 0180(g) in such circumstances. The exception under proposed FINRA Rule 0180(g) would not apply to associated persons of a member engaged in any other securities activities or to associated persons of members that are not also registered SBS Entities.⁵⁸ FINRA also notes that, although individuals qualifying for the proposed exception would not be required to register with FINRA (and therefore a member firm would not be required to file a Form U4 on behalf of such individuals), they would remain associated persons of the member subject to all FINRA and SEC rules applicable to such associated persons, including fingerprinting requirements under Exchange Act Rule 17f-2.⁵⁹

Exceptions in Connection with the SEC's Cross-Border Exception

In connection with finalizing the Title VII rulemakings, the SEC also adopted a number of rules and provided guidance to address the cross-border application of various SBS requirements. One of these rules, Exchange Act Rule 3a71-3(d), provides a conditional exception to the provisions of Exchange Act Rule 3a71-3 that otherwise would require non-U.S. persons to count—against the thresholds associated with the de minimis exception to the SBS definition—SBS dealing transactions with non-U.S. counterparties when U.S. personnel

⁵⁸ FINRA notes that associated persons of SBS Entities are not independently subject to registration, licensing or CE requirements. However, an SBS Entity is prohibited from permitting an associated person that is subject to a statutory disqualification to effect or be involved in effecting SBS on behalf of the SBS Entity. See 15 U.S.C. 78o-10(b)(6). The SEC's SBS Entity registration rules also require an SBS Entity to certify that it neither knows, nor in the exercise of reasonable care should have known, of any such statutory disqualification. Such certifications must be supported by questionnaires or employment applications serving as the basis for background checks. See 17 CFR 240.15Fb6-2; Registration Process Release, supra note 8, at 48973-79.

⁵⁹ See 17 CFR 240.17F-2.

arrange, negotiate or execute those transactions.⁶⁰ To qualify for this exception, all such arranging, negotiating or executing activity must be conducted by U.S. personnel in their capacity as persons associated with a registered broker-dealer or a registered SBSB that is a majority-owned affiliate of the non-U.S. person relying on the exception (the “U.S. Registered Affiliate”).⁶¹ Further, to qualify for the exception, the U.S. Registered Affiliate must comply with specified SBS Entity rules with respect to such SBS transactions as if the counterparties to the non-U.S. person relying on the exception also were counterparties to the U.S. Registered Affiliate and as if the U.S. Registered Affiliate were registered as an SBSB, if not so registered.⁶² The specified SBS Entity rules under this exception are Exchange Act Rule 15Fh-3(b) (disclosures of material risks and characteristics and material incentives or conflicts of interest), Exchange Act Rule 15Fh-3(f)(1) (recommendations and suitability), Exchange Act Rule 15Fh-3(g) (fair and balanced communications) and Exchange Act Rule 15Fi-2 (acknowledgement and verification of SBS transactions).⁶³

Where a member is acting as the U.S. Registered Affiliate for a foreign affiliate pursuant to the exception in Exchange Act Rule 3a71-3(d), the member would be required to comply with the SEC’s SBS Entity rules noted above. The consequence of the member not complying with these rules is that the member’s foreign affiliate would be required to count such SBS toward its de minimis SBSB registration threshold. In these circumstances, FINRA believes it is appropriate to provide exceptions from the parallel FINRA rules to provide clarity and avoid

⁶⁰ See 17 CFR 240.3a71-3(d); Cross-Border Release, supra note 8, at 6276-92.

⁶¹ See 17 CFR 240.3a71-3(d)(1)(i).

⁶² See 17 CFR 240.3a71-3(d)(1)(ii)(A).

⁶³ See 17 CFR 240.3a71-3(d)(1)(ii)(B).

unnecessary regulatory duplication, but only where the member is in fact complying with the specified SEC rules. Specifically, proposed FINRA Rule 0180(e) would provide that the following rules shall not apply to members' activities and positions with respect to SBS, to the extent that the member or the associated person of the member, as applicable, is arranging, negotiating or executing SBS on behalf of a non-U.S. affiliate pursuant to, and in compliance with the conditions of, the exception from counting certain SBS under Exchange Act Rule 3a71-3(d)(1): (1) FINRA Rule 2111 (Suitability); (2) FINRA Rule 2210(d) (Communications with the Public – Content Standards); and (3) FINRA Rule 2232 (Customer Confirmations).⁶⁴ As noted above, the availability of the exceptions under proposed FINRA Rule 0180(e) would be conditioned on the member's compliance with the rules specified in Exchange Act Rule 3a71-3(d)(1)(ii)(B) as if the member were the counterparty to the SBS transactions.⁶⁵

Exemptive Authority

As discussed above, in formulating the proposed rule change, FINRA consulted with its members and reviewed its rulebook to determine whether continuing exceptions from any of its rules are appropriate. FINRA recognizes, however, that the SBS market continues to evolve and that particular circumstances may arise in which applying specific FINRA rules not otherwise covered by the proposed exceptions to SBS activities may not be appropriate or feasible.

Therefore, proposed FINRA Rule 0180(i) would provide that, pursuant to the FINRA Rule 9600 Series, FINRA may, taking into consideration all relevant factors, exempt a person

⁶⁴ FINRA believes these proposed exceptions are appropriate for similar reasons as the proposed exceptions for SBS Entities in proposed FINRA Rules 0180(c) and (d). See supra notes 40 through 44 and 49 through 51 and accompanying text.

⁶⁵ A member acting as the U.S. Registered Affiliate under Exchange Act Rule 3a71-3(d) would remain subject to all other FINRA rules applicable to such SBS brokerage activity. See supra note 37.

unconditionally or on specified terms from the application of FINRA rules (other than an exemption from the general application of paragraph (a) of proposed FINRA Rule 0180) to the person's SBS activities or positions as it deems appropriate consistent with the protection of investors and the public interest. Under this proposed provision, FINRA would consider written applications for exemptive relief pursuant to FINRA Rule 9610 from the application of specific rules to a member's SBS activities or positions. Such applications would be required to address the need for exemptive relief from specific FINRA rules on a rule-by-rule basis, and FINRA would not provide exemptive relief from the application of FINRA rules generally to a member's SBS activities or positions. Therefore, proposed FINRA Rule 0180(i) would not provide for exemptive authority from the general application of FINRA rules to SBS under proposed FINRA Rule 0180(a). Pursuant to FINRA Rule 9620, FINRA would consider such an application and issue a written decision to the requesting member, which may be made publicly available.⁶⁶ A member would have the ability to appeal such a decision pursuant to FINRA Rule 9630. FINRA believes it is appropriate and in the public interest to provide this exemptive authority so that FINRA can account for specific situations that may arise with respect to SBS in the future on a case-by-case basis.

FINRA also is proposing a conforming change to FINRA Rule 9610 to add FINRA Rule 0180 to the list of rules pursuant to which FINRA has exemptive authority.

Financial Responsibility and Operational Requirements

⁶⁶ FINRA would consider any such application based on the specific circumstances described in the application and whether the requested exemptive relief would be consistent with the protection of investors and the public interest. FINRA expects that it would apply heightened scrutiny to applications for exemptive relief from members that are not also registered with the SEC as SBS Entities, and therefore not subject to the SEC's regulatory framework for SBS.

In June 2019, the Commission adopted final capital, margin and segregation requirements for SBS Entities, along with amendments to the existing capital and segregation requirements for broker-dealers, in the Capital, Margin, and Segregation Release. As with many of its other Title VII rulemakings, the SEC aligned the compliance date for the amendments under the Capital, Margin, and Segregation Release with the Registration Compliance Date.⁶⁷ Among other things, the Capital, Margin, and Segregation Release amended the existing net capital rule for broker-dealers, Exchange Act Rule 15c3-1,⁶⁸ in two key respects relevant to FINRA’s rules:

- First, the SEC adopted new minimum net capital requirements for broker-dealers that are also registered as SBSs, but that do not operate pursuant to the alternative net capital (“ANC”) requirements of Exchange Act Rule 15c3-1 (“Non-ANC Firms”).⁶⁹ Non-ANC Firms that are also registered as SBSs will need to comply with a new minimum dollar net capital requirement and a new component for determining their minimum capital requirement that is based on a percentage of initial margin computed for SBS (in addition to other minimum requirements applicable to the broker-dealer).⁷⁰ These changes do not apply to broker-dealers that operate pursuant to the ANC requirements of the rule (“ANC

⁶⁷ See Capital, Margin, and Segregation Release, supra note 8, at 43954.

⁶⁸ 17 CFR 240.15c3-1.

⁶⁹ Generally, a broker-dealer may apply to the SEC for authorization to use the alternative method for computing net capital contained in Appendix E to Exchange Act Rule 15c3-1. See 17 CFR 240.15c3-1(a)(7). Such broker-dealers are known as “ANC broker-dealers.” There are currently five approved ANC broker-dealers. See SEC, Broker-Dealers Using the Alternative Net Capital Computation under Appendix E to Rule 15c3-1, <https://www.sec.gov/tm/broker-dealers-alternative-net-capital-computation>. Other broker-dealers are known as non-ANC broker-dealers and must compute net capital pursuant to the provisions of Exchange Act Rule 15c3-1.

⁷⁰ See 17 CFR. 240.15c3-1(a)(10).

Firms”). These new minimum net capital requirements also will not impact Non-ANC Firms that are not also registered as SBSs, regardless of whether such Non-ANC Firms engage in SBS activities.⁷¹

- Second, the SEC changed the minimum net capital requirements for ANC Firms, regardless of whether they transact in SBS. For ANC Firms, the SEC increased the minimum dollar net capital requirement, added a new component for determining the minimum capital requirement that is based on a percentage of initial margin computed for SBS (in addition to other minimum requirements applicable to the broker-dealer), increased the minimum tentative net capital requirement and amended the early warning notification requirement for tentative net capital.⁷²

FINRA Rule 4120 (Regulatory Notification and Business Curtailment) sets forth certain early warning notification and business curtailment requirements if a member’s capital falls below certain thresholds. Specifically, FINRA Rule 4120(a) requires each carrying or clearing member to notify FINRA if its net capital falls below certain specified levels.⁷³ FINRA Rule

⁷¹ For example, the new minimum net capital requirements do not apply to a Non-ANC Firm engaged in SBS dealing activity below the de minimis threshold for SBS registration, or to a Non-ANC Firm engaged in SBS brokerage activity or entering into non-dealing SBS transactions (e.g., hedging). FINRA notes that the SEC also adopted new minimum capital requirements for MSBSPs, including that such entities must at all times have and maintain a tangible net worth. See Capital, Margin, and Segregation Release, supra note 8, at 43906-07. FINRA does not believe any changes to FINRA rules are necessary with respect to the new MSBSP capital requirements.

⁷² See 17 CFR 240.15c3-1(a)(7). The compliance date for the amended minimum net capital requirements for all ANC Firms is the Registration Compliance Date, i.e., October 6, 2021.

⁷³ As discussed below, FINRA is also proposing to apply all requirements in the FINRA Rule 4000 Series applicable to carrying or clearing firms to members that act as principal counterparty to an SBS, clear or carry an SBS, guarantee an SBS or otherwise have financial exposure to an SBS.

4120(b) allows FINRA to restrict a member from expanding its business in certain circumstances and FINRA Rule 4120(c) allows FINRA to require a member to reduce its business if its net capital falls below certain specified levels (generally lower than those required for notification under FINRA Rule 4120(a)). These requirements are based on the minimum capital requirements applicable to a member broker-dealer under Exchange Act Rule 15c3-1. FINRA believes it is necessary to amend FINRA Rule 4120 to conform the rule to the new and increased minimum capital requirements for Non-ANC Firms that are also registered as SBSDs and for ANC Firms, as described above.⁷⁴

FINRA Rule 4120(a) requires each carrying or clearing firm to promptly, but in any event within 24 hours, notify FINRA in writing if its net capital falls below any of the percentages specified in subparagraphs (A) through (F) of FINRA Rule 4120(a)(1). The proposed rule change would modify subparagraph (D), which applies to ANC Firms, and also add new subparagraph (E), applicable to Non-ANC Firm members that are also registered SBSDs.⁷⁵

Existing Exchange Act Rule 15c3-1(a)(7)(i) requires an ANC Firm to maintain minimum tentative net capital of not less than \$1 billion and minimum net capital of not less than \$500

⁷⁴ As noted above, the SEC did not amend Exchange Act Rule 15c3-1 to apply increased minimum capital requirements to Non-ANC Firms that engage in SBS activities but that are not registered SBSDs. FINRA is therefore not proposing to amend FINRA Rule 4120 to impose any additional minimum thresholds on such members. However, FINRA notes that, as a general matter, FINRA Rule 4120 would apply to all members that engage in SBS transactions (and any related transactions) because net capital is a holistic calculation based on a firm's liquid net worth, which includes all of a firm's activities.

⁷⁵ The proposed rule change would also make non-substantive and conforming changes to other subparagraphs of FINRA Rule 4120(a) to reflect the insertion of new subparagraph (E), update cross-references to SEC rules that have been amended and reflect FINRA rulebook format conventions.

million. In addition, existing Exchange Act Rule 15c3-1(a)(7)(ii) requires an ANC Firm to provide an “early warning” notice to the SEC when its tentative net capital falls below \$5 billion (or a lower threshold if the SEC has granted an ANC Firm’s application to use such lower threshold). Subparagraph (D) of FINRA Rule 4120(a) is based on these net capital requirements, requiring notification to FINRA if the member is an ANC Firm and (i) its tentative net capital under Exchange Act Rule 15c3-1(c)(15) is less than 50 percent of the early warning notification amount required by Exchange Act Rule 15c3-1(a)(7)(ii) or (ii) its net capital is less than \$1.25 billion. In other words, notification to FINRA is required if an ANC Firm’s tentative net capital falls below \$2.5 billion (or a lower amount, if the ANC Firm has been permitted to use a lower early warning notice threshold), which is half of the SEC’s early warning notification amount, or its net capital falls below \$1.25 billion, which is 2.5 times the SEC’s net capital requirement for ANC Firms.

In the Capital, Margin, and Segregation Release, the SEC amended the net capital requirements for ANC Firms in three ways. First, the SEC raised the tentative net capital requirement for ANC Firms from \$1 billion to \$5 billion. Second, the SEC raised the minimum net capital requirement for ANC Firms from \$500 million to the greater of \$1 billion or the sum of the applicable ratio requirement under Exchange Act Rule 15c3-1(a)(1)⁷⁶ and two percent of the risk margin amount.⁷⁷ Third, the SEC raised the tentative net capital early warning

⁷⁶ See 17 CFR 240.15c3-1(a)(7)(i)(A). Under Exchange Act Rule 15c3-1(a)(1)(i), a broker-dealer generally may not permit its aggregate indebtedness to exceed 1500 percent of its net capital. A broker-dealer may elect not to be subject to the aggregate indebtedness standard if it complies with an alternative method of computing net capital. See 17 CFR 240.15c3-1(a)(1)(ii).

⁷⁷ The “risk margin amount” means the total initial margin for SBS. See 17 CFR 15c3-1(c)(17). Exchange Act Rule 15c3-1(a)(7)(i)(A) provides that initially the requirement will be two percent of the risk margin amount. However, the SEC may issue an order raising the requirement to four percent on or after the third anniversary of the amended

notification threshold from \$5 billion to \$6 billion. In light of these increased capital requirements under the SEC's net capital rule, FINRA believes it is appropriate to also modify the thresholds for required notification to FINRA for ANC Firms under FINRA Rule 4120(a)(1)(D). Specifically, under the proposed rule change, an ANC Firm would be required to notify FINRA if, in addition to the conditions currently prescribed under FINRA Rule 4120(a)(1)(A), (E) and (F):

- its tentative net capital is less than 150 percent of the minimum tentative net capital amount required by Exchange Act Rule 15c3-1(a)(7)(i)(A) (i.e., \$5 billion, such that the notification amount would be \$7.5 billion),
- the member is subject to the aggregate indebtedness requirement of Exchange Act Rule 15c3-1(a)(1)(i), and its net capital is less than the sum of 1/10th of its aggregate indebtedness and 150 percent of the required percentage of the risk margin amount,⁷⁸ or
- the member elects to use the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii), and its net capital is less than the sum of the level

rule's compliance date and to eight percent on or after the fifth anniversary of the amended rule's compliance date. See 17 CFR 15c3-1(a)(7)(i)(A)(2) and (3) and 15c3-1(a)(7)(i)(B).

⁷⁸ See supra note 77.

specified in Exchange Act Rule 17a-11(b)(2)⁷⁹ and 150 percent of the required percentage of the risk margin amount.⁸⁰

FINRA believes these modified thresholds are appropriately calibrated to provide FINRA with sufficient early warning that an ANC Firm's capital levels may be deteriorating. By revising the early warning levels as proposed, the proposed rule change aligns the historical thresholds in FINRA Rule 4120(a) for early warning notification for ANC Firms with the revised capital requirements applicable to such firms under the SEC's amended rules. Additionally, ANC Firms historically maintain capital far in excess of the proposed amounts, so FINRA does not expect these levels to be problematic for firms to maintain.

In the Capital, Margin, and Segregation Release, the SEC also added a new minimum net capital requirement for Non-ANC Firms that are also registered as SBSBs.⁸¹ Specifically, a Non-ANC Firm that is registered as an SBSB must maintain minimum net capital of not less than the greater of \$20 million or the sum of the ratio requirements under Exchange Act Rule 15c3-1(a)(1)⁸² and two percent of the risk margin amount.⁸³ Accordingly, FINRA believes it is necessary to add corresponding new thresholds for required notification to FINRA for Non-ANC

⁷⁹ See 17 CFR 240.17a-11(b)(2). Exchange Act Rule 17a-11 requires broker-dealers to promptly notify the SEC after the occurrence of certain events. Exchange Act Rule 17a-11(b)(2) requires such notification for broker-dealers using the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii) when net capital is less than five percent of aggregate debit items under the Exchange Act Rule 15c3-3 reserve formula.

⁸⁰ See supra note 77.

⁸¹ See 17 CFR 15c3-1(a)(10).

⁸² See supra note 76.

⁸³ See supra note 77.

Firms that are also registered SBSBs under new FINRA Rule 4120(a)(1)(E). Specifically, under the proposed rule change, a Non-ANC Firm that is also a registered SBSB would be required to notify FINRA if, in addition to the conditions currently prescribed under FINRA Rule 4120(a)(1)(A), (E) and (F):

- the member is subject to the aggregate indebtedness requirement of Exchange Act Rule 15c3-1(a)(1)(i), and its net capital is less than the sum of 1/10th of its aggregate indebtedness and 150 percent of the required percentage of the risk margin amount,⁸⁴ or
- the member elects to use the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii), and its net capital is less than the sum of the level specified in Exchange Act Rule 17a-11(b)(2)⁸⁵ and 150 percent of the required percentage of the risk margin amount.⁸⁶

FINRA believes it is appropriate to include specific thresholds for early notification to FINRA based on the new minimum net capital requirements for Non-ANC Firms that are registered SBSBs. FINRA also believes that the thresholds described above are appropriately calibrated to provide FINRA with sufficient early warning that such a firm's capital levels may be deteriorating. By defining the early warning levels as proposed, the proposed rule change aligns the historical thresholds in FINRA Rule 4120(a) for early warning notification with the new capital requirements applicable to Non-ANC Firms that are registered SBSBs under the SEC's amended rules.

⁸⁴ See supra note 77.

⁸⁵ See supra note 79.

⁸⁶ See supra note 77.

FINRA Rule 4120(b) allows FINRA to require a member that carries customer accounts or clears transactions to not expand its business during any period in which any of the conditions described in paragraph (a)(1) of FINRA Rule 4120 continue to exist for more than 15 consecutive business days, provided that such condition(s) has been known to FINRA or the member for at least five consecutive business days. Since the proposed rule change would modify the conditions specified in FINRA Rule 4120(a)(1) as described above, the triggers for the application of restrictions under FINRA Rule 4120(b) would be similarly affected. However, FINRA does not believe that any conforming changes are needed at this time to the restrictions on business expansion requirements under FINRA Rule 4120(b). FINRA notes that FINRA Rule 4120(b)(3)(A)-(G) includes a non-exclusive list of activities that may constitute an “expansion of business” for these purposes, and FINRA Rule 4120(b)(3)(H) provides that the term “expansion of business” may include such other activities as FINRA deems appropriate under the circumstances, in the public interest or for the protection of investors. FINRA believes that a member firm’s SBS activities would be within the scope of “other activities” contemplated by FINRA Rule 4120(b)(3)(H).

FINRA Rule 4120(c) allows FINRA to require a member to reduce its business if its net capital falls below any of the percentages specified in subparagraphs (A) through (F) of FINRA Rule 4120(c)(1). Similar to the proposed modifications to FINRA Rule 4120(a) described above, the proposed rule change would modify subparagraph (D) of FINRA Rule 4120(c)(1), which applies to ANC Firms, and also add new subparagraph (E), applicable to Non-ANC Firm members that are also registered SBSBs.⁸⁷

⁸⁷ The proposed rule change would also make non-substantive and conforming changes to other subparagraphs of FINRA Rule 4120(c)(1) to reflect the insertion of new subparagraph (E), update cross-references to SEC rules that have been amended and

Current subparagraph (D) of FINRA Rule 4120(c)(1) permits business curtailment if the member is an ANC Firm and (i) its tentative net capital under Exchange Act Rule 15c3-1(c)(15) is less than 40 percent of the early warning notification amount required by Exchange Act Rule 15c3-1(a)(7)(ii) or (ii) its net capital is less than \$1 billion. These thresholds are based on the current broker-dealer net capital rule. As described above, the SEC amended the net capital requirements for broker-dealers in the Capital, Margin, and Segregation Release. Accordingly, under the proposed rule change, a member that is an ANC Firm would be subject to the business curtailment provisions of FINRA Rule 4120(c)(1) if, in addition to the conditions currently prescribed under FINRA Rule 4120(c)(1)(A), (E) and (F):

- its tentative net capital is less than the amount specified under Exchange Act Rule 15c3-1(a)(7)(ii) (i.e., the early warning amount, \$6 billion),
- the member is subject to the aggregate indebtedness requirement of Exchange Act Rule 15c3-1(a)(1)(i), and its net capital is less than the sum of 1/12th of its aggregate indebtedness and 125 percent of the required percentage of the risk margin amount,⁸⁸ or
- the member elects to use the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii), and its net capital is less than the sum of one percentage point below the level specified in Exchange Act Rule 17a-11(b)(2)⁸⁹ and 125 percent of the required percentage of the risk margin amount.⁹⁰

reflect FINRA rulebook format conventions. Similar non-substantive changes would be made to paragraph (b)(1) and Supplementary Material .01 to FINRA Rule 4120 to reflect FINRA rulebook format conventions.

⁸⁸ See supra note 77.

⁸⁹ See supra note 79.

⁹⁰ See supra note 77.

FINRA believes these modified thresholds are appropriately calibrated to provide FINRA with the ability to require ANC Firms to reduce their business when their capital levels have deteriorated to a level that may jeopardize their ability to continue to comply with their capital requirements.

As described above, in the Capital, Margin, and Segregation Release, the SEC also added a new minimum net capital requirement for Non-ANC Firms that are also registered as SBSBs. Accordingly, the proposed rule change would add corresponding new thresholds for business curtailment for Non-ANC Firms that are also registered SBSBs under new FINRA Rule 4120(c)(1)(E). Specifically, under the proposed rule change, a Non-ANC Firm that is also a registered SBSB would be subject to the business curtailment provisions of FINRA Rule 4120(c)(1) if, in addition to the conditions currently prescribed under FINRA Rule 4120(c)(1)(A), (E) and (F):

- the member is subject to the aggregate indebtedness requirement of Exchange Act Rule 15c3-1(a)(1)(i), and its net capital is less than the sum of 1/12th of its aggregate indebtedness and 125 percent of the required percentage of the risk margin amount,⁹¹ or
- the member elects to use the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii), and its net capital is less than the sum of one percentage point below the level specified in Exchange Act Rule 17a-11(b)(2)⁹² and 125 percent of the required percentage of the risk margin amount.⁹³

⁹¹ See supra note 77.

⁹² See supra note 79.

⁹³ See supra note 77.

FINRA believes it is appropriate to include specific thresholds for business curtailment based on the new minimum net capital requirements for Non-ANC Firms that are registered SBSBs. FINRA also believes that the thresholds described above are appropriately calibrated to provide FINRA with the ability to require such firms to reduce their business when their capital levels have deteriorated to a level that may jeopardize their ability to continue to comply with their capital requirements.

Lastly, FINRA notes that FINRA Rule 4120(c)(3)(A)-(J) includes a non-exclusive list of activities that may constitute a “business reduction” for these purposes, and FINRA Rule 4120(c)(3)(K) provides that the term “business reduction” may include such other activities as FINRA deems appropriate under the circumstances, in the public interest or for the protection of investors. FINRA believes that a member firm’s SBS activities would be within the scope of “other activities” contemplated by FINRA Rule 4120(c)(3)(K).

In addition to these conforming changes to FINRA Rule 4120, the proposed rule change would apply FINRA’s financial and operational rules more broadly to firms that enter into, or otherwise have exposure to, SBS. Specifically, certain rules in the FINRA Rule 4000 Series (Financial and Operational Rules) include provisions that impose higher standards, or provide FINRA the authority to impose additional requirements, on firms that carry or clear transactions or accounts (generally referred to as “carrying or clearing firms”). This “tiering” structure was built into certain rules so that firms that only introduce their customer accounts and do not have exposure to the settlement system are provided relief from the higher standards required of firms that carry or clear transactions and accounts. Below is a list of rules in the FINRA Rule 4000 Series where tiering has been employed for carrying or clearing firms and a brief description of the tiered requirements for such firms:

- FINRA Rule 4110 (Capital Compliance) includes requirements for carrying or clearing firms to keep greater net capital, seek permission for withdrawals of capital and seek approval for certain add-backs to net capital.
- FINRA Rule 4120 (Regulatory Notification and Business Curtailment) includes restrictions on expanding, or requirements to reduce business, if sufficient capital levels are not maintained.
- FINRA Rule 4521 (Notifications, Questionnaires and Reports) allows FINRA to collect additional data and require reporting of a material decline in tentative net capital.
- FINRA Rule 4522 (Periodic Security Counts, Verification and Comparison) requires more frequent security counts, verifications and comparisons than would be required under Exchange Act Rule 17a-14. Rule 4523 (Assignment of Responsibility for General Ledger Accounts and Identification of Suspense Accounts) requires a record of primary and supervisory named individuals over general ledger bookkeeping accounts.

The intent of the tiering employed in these rules in the FINRA Rule 4000 Series is to impose higher capital, recordkeeping and operational standards on firms that carry or clear transactions and accounts, and therefore may have financial exposure to customers, other broker-dealers, central counterparties or others. FINRA believes that similar considerations apply for members with exposure to SBS. SBS are complex transactions that will, by their nature, require detailed recordkeeping, margining, legal agreements, collateral management, reconciliation and risk management. FINRA therefore believes it is appropriate to also employ tiering in the FINRA Rule 4000 Series for members that enter into SBS on a principal basis or otherwise have financial exposure to SBS. Specifically, under the proposed rule change, proposed FINRA Rule 0180(h) would provide that, for purposes of the FINRA Rule 4000 Series, all requirements that

apply to a member that clears or carries customer accounts shall also apply to any member that acts as a principal counterparty to an SBS, clears or carries an SBS, guarantees an SBS or otherwise has financial exposure to an SBS.⁹⁴ FINRA believes that applying these higher standards when a member enters into SBS or otherwise has exposure to SBS is appropriate and consistent with the protection of investors and the public interest.

Margin Requirements

As discussed above, in June 2019 the Commission adopted its final Capital, Margin, and Segregation Release, with a compliance date aligned with the Registration Compliance Date.⁹⁵ Among other things, the Capital, Margin, and Segregation Release adopted new Exchange Act Rule 18a-3, which prescribes margin requirements for nonbank SBSs with respect to uncleared SBS.⁹⁶ Generally, Exchange Act Rule 18a-3 requires a nonbank SBS to calculate, for each account of an SBS counterparty as of the close of business of each day: (i) the amount of current exposure in the account (i.e., variation margin) and (ii) the initial margin amount for the

⁹⁴ Although this proposed tiering provision relates to the financial responsibility and operational rules, FINRA believes it should be included as a paragraph in proposed FINRA Rule 0180 so that all provisions relating to the treatment of SBS under FINRA rules are found in a single, consolidated rule.

⁹⁵ See Capital, Margin, and Segregation Release, supra note 8, at 43954.

⁹⁶ See 17 CFR 240.18a-3. Exchange Act Rule 18a-3 also prescribes margin requirements for nonbank MSBSPs with respect to uncleared SBS. As discussed above, Exchange Act Rule 18a-3 generally requires SBSs to collect or deliver variation margin, and also to collect initial margin, with respect to its SBS counterparties. However, Exchange Act Rule 18a-3 requires that a nonbank MSBSP only collect and deliver variation margin, without prescribing any initial margin requirement. See Capital, Margin, and Segregation Release, supra note 8, at 43877. As discussed below, FINRA believes it is appropriate to apply variation margin and initial margin requirements to all of its members that transact in uncleared SBS. Therefore, proposed FINRA Rule 4240 would provide an exception for members that are registered as SBSs (and therefore subject to the variation and initial margin requirements of Exchange Act Rule 18a-3), but not for members that are registered as MSBSPs.

account.⁹⁷ Under Exchange Act Rule 18a-3, variation margin must be calculated by marking the position to market, while initial margin must generally be calculated using standardized haircuts, which are prescribed in Exchange Act Rule 15c3-1 for nonbank SBSs that are registered broker-dealers.⁹⁸ Nonbank SBSs may apply to the SEC for authorization to use models to calculate initial margin instead of the standardized haircuts (including the option to use the more risk sensitive methodology in Exchange Act Rule 15c3-1a), but nonbank SBSs that are registered broker-dealers must use standardized haircuts to calculate initial margin for uncleared equity SBS.⁹⁹ Based on these calculations, Exchange Act Rule 18a-3 generally requires a nonbank SBS to collect and deliver variation margin, and to collect (but not deliver) initial margin.¹⁰⁰ Exchange Act Rule 18a-3 also provides certain exceptions from the margin requirements, establishes thresholds and minimum transfer amounts, specifies collateral requirements (including collateral haircuts), establishes risk monitoring requirements and includes other miscellaneous provisions, such as definitions. All nonbank SBSs, including nonbank SBSs that are FINRA members, will become subject to the margin requirements set forth in Exchange Act Rule 18a-3 beginning on the Registration Compliance Date.

The FINRA Rule 4200 Series sets forth margin requirements applicable to FINRA members. In particular, FINRA Rule 4210 describes the margin requirements that determine the amount of equity or “margin” customers are expected to maintain in their securities accounts,

⁹⁷ See 17 CFR 240.18a-3(c)(1)(i); Capital, Margin, and Segregation Release, supra note 8, at 43876.

⁹⁸ See 17 CFR 240.18a-3(d).

⁹⁹ See supra note 99; Capital, Margin, and Segregation Release, supra note 8, at 43876.

¹⁰⁰ See 17 CFR 240.18a-3(c)(1)(ii).

including margin requirements for equity and fixed income securities as well as options, warrants and security futures. Current FINRA Rule 4240 separately establishes an interim pilot program with respect to margin requirements for any transactions in CDS held in an account at a member (the “Interim Pilot Program”). Under current FINRA Rule 0180, FINRA Rule 4210 does not apply to members’ activities and positions with respect to SBS, but current FINRA Rule 4240 does apply to activities and positions within its scope. Therefore, to the extent that a FINRA member enters into SBS that are CDS, the margin requirements under the Interim Pilot Program apply to such SBS.¹⁰¹ However, the Interim Pilot Program is a temporary rule, and SBS that are not CDS are not currently subject to any margin requirements under FINRA rules.

The Interim Pilot Program was originally proposed by FINRA and approved by the Commission in 2009 specifically to address concerns arising from systemic risk posed by CDS.¹⁰² Pending the SEC’s final implementation of the Title VII rulemakings, FINRA has extended the expiration date of the Interim Pilot Program a number of times, mostly recently in June 2020.¹⁰³ The Interim Pilot Program under current FINRA Rule 4240 is currently set to expire on September 1, 2021, the same date that current FINRA Rule 0180 is set to expire.¹⁰⁴

In light of the finalization of the SEC’s margin requirements for nonbank SBSs under Exchange Act Rule 18a-3 and the upcoming Registration Compliance Date, FINRA believes it is

¹⁰¹ For purposes of current FINRA Rule 4240, the term “credit default swap” includes any product that is commonly known to the trade as a “credit default swap” and is an SBS as defined pursuant to Section 3(a)(68) of the Act or the rules and guidance of the SEC and its staff. See FINRA Rule 4240(a).

¹⁰² See Securities Exchange Act Release No. 59955 (May 22, 2009), 74 FR 25586 (May 28, 2009) (Order Approving File No. SR-FINRA-2009-012).

¹⁰³ See supra note 16.

¹⁰⁴ See supra note 18.

appropriate and in the public interest for the Interim Pilot Program to expire and for FINRA to adopt a new margin rule specifically applicable to SBS.¹⁰⁵ Accordingly, under the proposed rule change, current FINRA Rule 4240 would be replaced by a new FINRA Rule 4240 on October 6, 2021 that would prescribe margin requirements for SBS. Consistent with Exchange Act Rule 18a-3—and unlike the Interim Pilot Program—proposed new Rule 4240 would apply margin requirements to all SBS, not just CDS. However, proposed new FINRA Rule 4240 would not apply to any member that is registered as an SBS, as such members will be subject to the margin requirements of Exchange Act Rule 18a-3 as summarized above. Additionally, and consistent with the SEC’s approach under the Act and Exchange Act Rule 18a-3, proposed FINRA Rule 4240 would defer to registered clearing agencies to set the margin requirements for cleared SBS, and as such would only specify new variation margin and initial margin requirements for uncleared SBS. Therefore, the specific new margin requirements prescribed under proposed FINRA Rule 4240 would only apply to uncleared SBS transacted by FINRA members that are not registered SBSs. FINRA believes that, by applying margin requirements in these circumstances, the proposed rule change would fill an important regulatory gap, protect FINRA members against counterparty credit risk, maintain a level playing field for members and prevent regulatory arbitrage. As described in further detail below, the margin requirements under proposed FINRA Rule 4240 would be structurally aligned with the margin requirements that will apply to nonbank SBSs under Exchange Act Rule 18a-3, with certain modifications

¹⁰⁵ FINRA notes that, under the proposed rule change, proposed FINRA Rule 0180 would no longer provide an exception from current FINRA Rule 4210 applying to members’ activities and positions with respect to SBS. Absent additional changes, therefore, the general margin requirements under FINRA Rule 4210 would apply to SBS. However, as described above, FINRA believes specifically listing SBS within the exceptions listed in FINRA Rule 4210, and adopting a separate, new FINRA Rule 4240 applicable to SBS, would promote legal certainty and provide clarity to its members.

that FINRA believes are necessary given that such members will not be subject to the SEC's comprehensive regulatory framework for SBSs. Thus, subject to certain exceptions described in the proposed rule, proposed FINRA Rule 4240 would require members that are not SBSs to collect and deliver variation margin on a daily basis to cover the member's current exposure to or from each uncleared SBS counterparty, and also to collect (but not deliver) initial margin from each SBS counterparty.

Proposed FINRA Rule 4240 is divided into a header followed by paragraphs (a) through (d). The header would specify the scope of the margin requirements under proposed FINRA Rule 4240. Paragraph (a) would describe the margin requirements for cleared SBS. Paragraph (b) would describe the margin requirements for uncleared SBS. Specifically, paragraph (b)(1) would set forth how variation margin must be calculated, paragraph (b)(2) would set forth how initial margin must be calculated, paragraph (b)(3) would prescribe the collection and delivery requirements for variation and initial margin, paragraph (b)(4) would specify the manner and time of collection or delivery of variation and initial margin, and paragraph (b)(5) would list certain exceptions from the margin requirements. Paragraph (c) would require members to employ specified risk monitoring procedures and guidelines for uncleared SBS. Finally, paragraph (d) would define certain terms used in proposed FINRA Rule 4240. Each of these aspects of the proposed rule change is described in further detail below.

Proposed FINRA Rule 4240 would be entitled "Security-Based Swap Margin Requirements."¹⁰⁶ The header text to the rule would state that each member that is a party to an

¹⁰⁶ In addition to the new provisions under proposed FINRA Rule 4240 discussed above, the implementation of new margin requirements for SBS under proposed FINRA Rule 4240 will also require a conforming change to FINRA Rule 4220 (Daily Record of Required Margin). FINRA Rule 4220 requires each member carrying securities margin accounts for customers to make a record each day of every case in which initial or additional margin must be obtained in a customer's account. To ensure that similar records are

SBS with a customer, broker or dealer, or other Counterparty,¹⁰⁷ or who has guaranteed or otherwise become responsible for any other person's SBS obligations, shall comply with the requirements of proposed FINRA Rule 4240, except that a member that is registered as an SBS shall instead comply with Exchange Act Rule 18a-3. This provision of the proposed rule is intended to clarify that the margin requirements under proposed FINRA Rule 4240 apply in all circumstances where a member is a party to a SBS, regardless of the type of counterparty, and also where a member has financial exposure to an SBS, whether through a guarantee or other arrangements under which the member is responsible for another person's SBS obligations.

FINRA believes that this provision is necessary to ensure that the proposed margin requirements

maintained for SBS margin required under proposed new FINRA Rule 4240, the proposed rule change would update FINRA Rule 4220 to also require such records for each member subject to proposed FINRA Rule 4240.

In addition, the proposed rule change would add new Supplementary Material .06 to FINRA Rule 4210 to clarify that a Regulation T good faith account, other than a non-securities account, is a margin account for purposes of FINRA Rule 4210. This provision is intended merely to codify FINRA's existing interpretation regarding the scope of FINRA Rule 4210. The proposed rule change would also include a parallel provision in new Supplementary Material .01 to proposed new Rule 4240.

Finally, the proposed rule change would make two other conforming changes to FINRA Rule 4210, including to add proposed new FINRA Rule 4240(e)(9) and to make a technical adjustment to FINRA Rule 4240(g)(2)(H). These proposed changes are discussed below.

¹⁰⁷ "Counterparty" would be defined under proposed FINRA Rule 4240(d)(5) to mean a person with whom a member has entered into an Uncleared SBS. An "SBS" would be defined in proposed FINRA Rule 4240(d)(16) by reference to the definition of "security-based swap" under Section 3(a)(68) of the Act and "Uncleared" would be defined in proposed FINRA Rule 4240(d)(18) as an SBS that is not Cleared. Under proposed FINRA Rule 4240(d)(3), an SBS would be considered Cleared if it is cleared through a Clearing Agency by or on behalf of the member, and Clearing Agency would be defined under proposed FINRA Rule 4240(4) as a clearing agency registered pursuant to Section 17A of the Act or exempted by the SEC from such registration by a rule or order pursuant to Section 17A of the Act.

adequately protect member firms against counterparty credit risk, regardless of the specific manner through which the member has become exposed to such risk. Additionally, as discussed above, this provision clarifies that members that are registered SBSDs are not subject to the proposed margin requirements because they are instead required to comply with Exchange Act Rule 18a-3. FINRA believes it should defer to the SEC's margin framework for registered SBSDs rather than impose additional or different requirements on such entities.

Proposed FINRA Rule 4240(a), entitled "Cleared SBS Margin Requirements," would state that, except as provided in paragraph (b)(5) (i.e., specified exceptions from proposed FINRA Rule 4240, discussed below), the margin to be maintained on any Cleared SBS is the margin on such Cleared SBS required by the Clearing Agency through which such SBS is Cleared. As discussed above, this provision clarifies that proposed FINRA Rule 4240 defers to registered clearing agencies to set the margin requirements for cleared SBS. FINRA believes that it is appropriate to defer to clearing agencies to establish margin requirements for cleared SBS in light of the SEC's comprehensive regulation of clearing agencies, including their required margin levels, under the Act.

Proposed FINRA Rule 4240(b), entitled "Uncleared SBS Margin Requirements," would set forth the substantive margin requirements applicable to members that are not SBSDs when such members transact in Uncleared SBS. Paragraph (b)(1), entitled "Current Exposure Calculation," would require that, as of the close of business of each business day, the member calculate with respect to each Uncleared SBS Account¹⁰⁸ the Counterparty's Current Exposure to

¹⁰⁸ Under proposed FINRA Rule 4240(d)(19), an "Uncleared SBS Account" would be defined to mean an account with respect to a Counterparty consisting of all Uncleared SBS between the member and the Counterparty, together with long or short positions for Variation Margin in the form of securities collected or delivered, respectively, credit or debit balances for Variation Margin in the form of cash collected or delivered, respectively, and long positions or credit balances for Initial Margin collected in the form

the member (if positive) or the member's Current Exposure to the Counterparty (if negative). Current Exposure would be calculated as an amount equal to the net Value¹⁰⁹ of all Uncleared SBS in the Uncleared SBS Account plus the Value of all Variation Margin collected from the Counterparty minus the Value of all Variation margin delivered to the Counterparty.¹¹⁰ This provision would define a member's Current Exposure for purposes of collecting or delivering Variation Margin under proposed FINRA Rule 4240(b)(3), discussed below, by taking into account the net Value of SBS in the Counterparty's account together with any Variation Margin that has already been collected or delivered. FINRA believes this calculation is consistent with the variation margin requirements under Exchange Act Rule 18a-3.

of securities or cash, respectively. The definitions of "Variation Margin" and "Initial Margin" are discussed below.

¹⁰⁹ "Value" would be defined in proposed FINRA Rule 4240(d)(20). Under this definition, the Value of one or more SBS would be the mid-market replacement cost for such SBS. The Value of a security position would be the current market value of such margin securities, as defined in FINRA Rule 4210(a)(2) and determined in accordance with FINRA Rule 4210(f)(1) (i.e., the provisions of FINRA's general margin rule used to determine the current market value of margin securities). Alternatively, a member could elect to determine the Value of margin securities collected as Variation Margin or Initial Margin by applying a haircut to the current market value of such securities equal to the margin requirement that would be applicable to them under FINRA Rule 4210 if they were held in the Counterparty's margin account (in which case, however, such margin securities would not be required to be themselves margined under proposed FINRA Rule 4240(b)(2)(A)(iii)). The Value of cash in U.S. dollars would be the amount of such cash, while the Value of freely convertible foreign currency would be the amount of U.S. dollars into which the currency could be converted, provided the currency is marked-to-market daily.

¹¹⁰ Under proposed FINRA Rule 4240(d)(21), "Variation Margin" would be defined to mean the cash or margin securities collected from, or delivered to, a Counterparty in accordance with proposed FINRA Rule 4240(b)(3)(A), as discussed below. Under proposed FINRA Rule 4240(b)(2)(A)(iii), all securities deposited as Variation Margin for Uncleared SBS would themselves be margined in accordance with FINRA Rule 4210, unless the member has chosen to haircut them for purposes of determining their Value. See supra note 110.

Proposed FINRA Rule 4240(b)(2), entitled “Initial Margin Computation,” would require that, as of the close of business on each business day, the member compute the Initial Margin Requirement for each Uncleared SBS Account equal to the sum of the Initial Margin Requirements on the Uncleared SBS and securities positions in that Uncleared SBS Account. The remainder of proposed FINRA Rule 4240(b)(2) describes how a member must calculate the Initial Margin Requirement, which is then used for purposes of collecting Initial Margin under proposed FINRA Rule 4240(b)(3), discussed below.¹¹¹ Under the proposed rule change, the Initial Margin Requirement would depend on the type of uncleared SBS involved, with different requirements depending on whether the uncleared SBS is (i) a “plain vanilla” CDS; (ii) a “plain vanilla” SBS other than an CDS (i.e., an SBS that is the economic equivalent of a margin account containing a portfolio of long or short positions in securities or options, such as a “plain vanilla” equity total return swap (“TRS”)); or (iii) any other type of SBS (e.g., a complex CDS or equity TRS that would not be considered “plain vanilla” under the proposed rule, including for example a CDS swaption, or a dividend swap). FINRA believes that differentiation as to initial margin requirements among these different types of SBS is appropriate and necessary given the unique characteristics and risks posed by different SBS products.

¹¹¹ Under proposed FINRA Rule 4240(d)(9), the term “Initial Margin” would be defined to mean all cash or marginable securities, excluding Variation Margin, received by the member for a Counterparty’s Uncleared SBS Account or transferred to the Counterparty’s Uncleared SBS Account from another account at the member, including margin collected from a Counterparty in accordance with proposed FINRA Rule 4240(b)(3)(B), as discussed below, that in each case have not been returned to the Counterparty or applied to an obligation of the Counterparty. Under proposed FINRA Rule 4240(b)(2)(A)(iii), all securities deposited as Initial Margin for Uncleared SBS would themselves be margined in accordance with FINRA Rule 4210, unless the member has chosen to haircut them for purposes of determining their Value. See supra note 110.

Proposed paragraphs (b)(2)(A)(i) and (ii) would define the Initial Margin Requirements for uncleared plain vanilla CDS (referred to as “Basic CDS”)¹¹² and other uncleared “plain vanilla” SBS (referred to as “Basic SBS”),¹¹³ respectively. First, the Initial Margin Requirement for an Uncleared Basic CDS would generally be computed based on the term and spread of the Uncleared Basic CDS, using the chart and offsets set out in Exchange Act Rule 15c3-1(c)(2)(vi)(P).¹¹⁴ The proposed rule would therefore follow Exchange Act Rule 18a-3(d)(1)(i) by determining the Initial Margin Requirement for Uncleared Basic CDS using the haircuts applicable to such SBS under the SEC’s net capital rule. FINRA believes that determining initial margin for CDS in this manner would promote regulatory consistency and reduce potential arbitrage. Additionally, the haircuts prescribed in Exchange Act Rule 15c3-1(c)(2)(vi)(P) are

¹¹² Under proposed FINRA Rule 4240(d)(1), a “Basic CDS” would be defined to mean a Basic Single Name Credit Default Swap or a Basic Narrow-Based Index Credit Default Swap. A Basic Single-Name Credit Default Swap would mean an SBS in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments issued, guaranteed or otherwise entered into by a third party (*i.e.*, the “Reference Entity”) upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). The term “Basic Single-Name Credit Default Swap” would also include a swap that, upon the occurrence of one or more specified credit events with respect to the Reference Entity, is physically settled by payment of a specified fixed amount by one party against delivery by the other party of eligible obligations of the Reference Entity. A Basic Narrow-Based Index Credit Default Swap would be defined to mean an SBS consisting of multiple component Basic Single-Name Credit Default Swaps.

¹¹³ Under proposed FINRA Rule 4240(d)(2), a “Basic SBS” would be defined to mean an SBS, other than a CDS, under which each party is contractually obligated to provide the other the economic equivalent of a margin account containing a portfolio of long or short positions in securities or options (*i.e.*, an “Equivalent Margin Account”).

¹¹⁴ See 17 CFR 240.15c3-1(c)(2)(vi)(P). This provision of the SEC’s broker-dealer net capital rule defines the haircuts applicable to uncleared SBS.

substantially similar to existing FINRA Rule 4240 margin requirements, so in effect the proposed requirements have already been used during the Interim Pilot Program. Second, the Initial Margin Requirement for a Basic SBS would generally be computed by applying FINRA Rule 4210 to the Equivalent Margin Account. Since an Uncleared Basic SBS would be the economic equivalent of a margin account that would otherwise be governed by the margin provisions of FINRA Rule 4210, FINRA believes it is appropriate to treat such SBS similarly.

In addition, proposed FINRA Rule 4240(b)(2)(A) would permit the Initial Margin Requirements for both Uncleared Basic CDS and Uncleared Basic SBS to be computed based on a combination of multiple SBS and securities or options positions, as applicable and subject to certain conditions. Specifically, proposed FINRA Rule 4240(b)(2)(A)(i) would provide that, if the member has a netting or collateral agreement that is legally enforceable against the Counterparty and covers any combination of Uncleared Basic CDS or securities specified in clause (iii), (iv) or (v) of Exchange Act Rule 15c3-1(c)(2)(vi)(P)(1) (i.e., specified offsetting debt securities), the member may compute the Initial Margin Requirement on such combination of positions equal to the “haircut” on that combination under Exchange Act Rule 15c3-1(c)(2)(vi)(P)(1). Proposed FINRA Rule 4240(b)(2)(A)(ii) would similarly provide that, if the member has a netting or collateral agreement that is legally enforceable against the Counterparty and covers any combination of Uncleared Basic SBS, securities or options positions, the member may compute the Initial Margin Requirement on the combination of such positions equal to the margin that FINRA Rule 4210 would require to be maintained on the combination of Equivalent Margin Accounts for such Uncleared Basic SBS and securities or options positions. Proposed FINRA Rule 4240(b)(2)(B) would impose conditions on computing the Initial Margin Requirement using these combination methods, including that (i) securities positions must be in

the Counterparty's Uncleared SBS Account or margin account at the member; (ii) securities may not be included if the member has chosen to haircut them for purposes of determining their Value;¹¹⁵ (iii) options positions must be in the Counterparty's margin account at the member; (iv) no SBS, security or option positions may be included in more than one combination; and (v) no combinations may include securities or options positions for which reduced margin requirements are computed under FINRA Rule 4210(e)(1) (i.e., reduced margin requirements for offsetting long and short positions) or 4210(f)(2)(F)(ii) through (f)(2)(I) (i.e., various reduced margin requirements for certain options, including covered options and offsetting options positions). FINRA believes these conditions would ensure that the Initial Margin Requirement calculated using the combination method is based on securities and options positions that the member actually has in its possession and does not reflect reductions in value that would inappropriately lower the margin requirement. In addition, proposed FINRA Rule 4240(b)(2)(B) would provide that if the Initial Margin Requirement is computed on a combination as described above, the Initial Margin Requirement on the Uncleared SBS included in the combination shall be reduced (but not below zero) by the aggregate maintenance margin requirements under FINRA Rule 4210 applicable to such margin account positions. FINRA believes that this provision would appropriately take into account margin already collected under FINRA Rule 4210 with respect to such positions.¹¹⁶

¹¹⁵ See supra note 110.

¹¹⁶ In connection with this proposed provision of FINRA Rule 4240(b)(2)(B), the proposed rule change would also add a new paragraph (e)(9) to FINRA Rule 4210, entitled "Security-Based Swaps; SBS Offsets." Specifically, where the Initial Margin Requirement on the combination of SBS and a securities or options position in the margin account would be less than the FINRA Rule 4210 maintenance requirement on the margin account positions, proposed FINRA Rule 4210(e)(9) would reduce the FINRA

The proposed rule change would not specify Initial Margin Requirements for other Uncleared SBS that do not qualify as Basic CDS or Basic SBS. Instead, proposed FINRA Rule 4240(b)(2)(A)(iv) would provide that the Initial Margin Requirement for any Uncleared SBS other than a Basic CDS or Basic SBS would be determined in a manner approved by FINRA pursuant to proposed FINRA Rule 4240(b)(2)(C), which would permit a member to apply to FINRA for the approval of an Initial Margin Requirement for any other type of SBS. Under the proposed rule change, any such application would be required to:

- define the specific type of SBS covered by the application;
- describe the purpose(s) that the member and its Counterparties would have for entering that type of SBS;
- identify all variables that influence the value of that type of SBS;
- explain all risks of that type of SBS;
- propose a specific Initial Margin Requirement (not a margin model) for that type of SBS;
- explain how the proposed specific Initial Margin Requirement would adequately protect a member and its capital against each of those risks;
- attach copies of the member's SBS risk management procedures and describe the application of those procedures to that type of SBS; and

Rule 4210 maintenance requirement on the margin account positions to equal the computed Initial Margin Requirement.

In addition, proposed FINRA Rule 4210(e)(9) would clarify that, except for SBS carried by a member in a portfolio margin account subject to the requirements of FINRA Rule 4210(g), as discussed below, margin requirements on SBS and positions in Uncleared SBS Accounts are determined by proposed FINRA Rule 4240, rather than FINRA Rule 4210. FINRA believes that including this express statement regarding the applicability of each of its margin rules to SBS would enhance clarity and reduce legal uncertainty for its members.

- provide the results of backtesting of the proposed specific Initial Margin Requirement over periods of significant volatility in the variables influencing the value of that type of SBS.

Proposed FINRA Rule 4240(b)(2)(C) would further provide that, if FINRA approves any such application, the approval may be unconditional or conditional, including in the form of a time-limited pilot program; may approve the use of the specific Initial Margin Requirement only by the applicant; or may take the form of a Regulatory Notice or other communication approving the use of the specific margin requirements by members generally. Under proposed FINRA Rule 4240(b)(2)(C), no member would be permitted to become a party to an SBS other than a Basic CDS or Basic SBS unless FINRA has approved an Initial Margin Requirement for such member's use with respect to that type of SBS. As described above, the Initial Margin Requirements for Basic CDS are based on the SEC's treatment of such SBS under its net capital rule, while the Initial Margin Requirements for Basic SBS are based on the margin that would be required for a margin account that would be the economic equivalent of such SBS. However, other types of SBS—including CDS and equity TRS with complex features—may not be easily accommodated under these frameworks, and the specific risks that accompany such SBS may not be readily apparent or quantifiable to FINRA without additional information. Moreover, as noted above SBS can be complex financial instruments that pose substantial risks to members and margin serves as an important means of protecting member firms, and thereby their customers and investors, from such risks. FINRA therefore believes that members that are not SBSDs (and therefore not subject to the SEC's comprehensive regulatory framework for registrants under Title VII of Dodd-Frank) should not be permitted to enter into other types of SBS unless and until FINRA has evaluated the risks of such SBS and approved margin

requirements that adequately address such risks. If FINRA determines that a proposed margin requirement does not adequately address the risks for a particular type of SBS, FINRA would not approve the application under proposed FINRA Rule 4240(b)(2)(C), and members would not be permitted to enter into such SBS. To FINRA's knowledge, this SBS activity by members that do not plan to register as SBSs is relatively limited.

Proposed FINRA Rule 4240(b)(3), entitled "Collection or Delivery of Variation and Initial Margin," would set forth a member's obligation to collect or deliver margin as calculated pursuant to proposed FINRA Rule 4240(b)(1) and (2), described above. Paragraph (b)(3)(A) would require each member to deliver or return to each Counterparty cash or margin securities with a Value equal to the Counterparty's Current Exposure (if any) to the member, or collect or retrieve from the Counterparty cash or margin securities with a Value equal to the member's Current Exposure (if any) to the Counterparty. Paragraph (b)(3)(B) would require each member to collect from each Counterparty cash or margin securities with a Value at least equal to any Initial Margin Deficit.¹¹⁷ Therefore, consistent with Exchange Act Rule 18a-3, proposed FINRA Rule 4240(b)(3) would require members that are not SBSs to collect and deliver Variation Margin, and also to collect (but not deliver) Initial Margin, in amounts determined pursuant to the provisions of FINRA Rule 4240(b)(1) and (2) described above, for their transactions in Uncleared SBS.¹¹⁸

¹¹⁷ Under proposed FINRA Rule 4240(d)(10), the term "Initial Margin Deficit" would be defined as the amount, if any, by which (A) the sum of the Value of the Initial Margin in an Uncleared SBS Account and the Counterparty's Rule 4210 Excess is less than (B) the Initial Margin Requirement for the Uncleared SBS Account. A person's "Rule 4210 Excess" would be defined in proposed FINRA Rule 4240(d)(15) to mean the amount, if any, by which the equity (as defined in FINRA Rule 4210(a)(5)) in the Counterparty's margin account at the member exceeds the amount required by FINRA Rule 4210.

¹¹⁸ To account for situations where a member is not the actual party to an SBS, but nonetheless has financial exposure for Uncleared SBS (e.g., through a guarantee),

Proposed FINRA Rule 4240(b)(4), entitled “Manner and Time of Collection or Delivery of Variation and Initial Margin; Prohibited Returns and Withdrawals,” would set forth additional detailed requirements and clarifications regarding the manner and time of collection or delivery of variation and initial margin, as calculated pursuant to proposed FINRA Rules 4240(b)(1) and (2) and collected or delivered in accordance with proposed FINRA Rule 4240(b)(3), as described above. Specifically, proposed FINRA Rule 4240(b)(4) would provide for the following:

- Under proposed FINRA Rule 4240(b)(4)(A), margin would be deemed collected or returned to the member when it is received in the Counterparty’s Uncleared SBS Account at the member (or transferred to such account from another account at the member).
- Under proposed FINRA Rule 4240(b)(4)(B), margin would be deemed collected or returned to the Counterparty when it is transferred from the Counterparty’s Uncleared SBS Account at the member in accordance with the Counterparty’s instructions or agreement with the member, which could potentially include transfer to another account of the Counterparty carried by the member.
- Under proposed FINRA Rule 4240(b)(4)(C), margin would be required to be collected or delivered pursuant to proposed FINRA Rule 4240(b)(3) as promptly as possible, but in any case no later than the close of business on the business day after the date on which the Current Exposure or Initial Margin Requirement was required to be computed in accordance with proposed FINRA Rule 4240(b)(1) or (2) (i.e., margin would generally be required to be delivered or collected on a T+1 basis). Further, unless FINRA has

proposed FINRA Rule 4240(b)(3)(C) would also require a member to collect both Variation Margin and Initial Margin from the party that has obligations under the Uncleared SBS for which the member has responsibility, to the extent that such collection would be required if the member were a party to the Uncleared SBS, unless the member can establish that such margin has been delivered to the other party.

specifically granted the member additional time, a member that has not collected margin as required by the close of business on the third business day (i.e., by T+3) would be required to take prompt steps to liquidate positions in the Counterparty's Uncleared SBS Account to eliminate the margin deficiency.

- Proposed FINRA Rule 4240(b)(4)(D) would require a member to net the delivery or return of Variation Margin against the collection of Initial Margin, if applicable, and would further permit a member to net the return of Initial Margin against the collection or retrieval of Variation Margin, if applicable.
- Proposed FINRA Rule 4240(b)(4)(E) would prohibit a member from returning Initial Margin to a Counterparty, or permitting a Counterparty to make a withdrawal from the Counterparty's margin account, if doing so would create or increase an Initial Margin Deficit.

FINRA believes it is appropriate and consistent with the protection of member firms and investors to require margin for uncleared SBS to be delivered or collected, as applicable, on a T+1 basis, and to further require that uncleared SBS positions be liquidated if margin is not collected within a T+3 timeframe. FINRA also believes the other clarifications described above are necessary to ensure that members and their uncleared SBS counterparties have a clear and consistent understanding of when and how margin must be delivered or collected under the proposed rule change.

Proposed FINRA Rule 4240(b)(5), entitled "Exceptions," would provide eight specific exceptions from a member's general obligation to collect or deliver margin, as applicable, under proposed FINRA Rule 4240(b)(3), described above. FINRA believes the proposed exceptions would further align the requirements of proposed FINRA Rule 4240 with the margin

requirements applicable to SBSs under Exchange Act Rule 18a-3 and provide members with additional flexibility in managing their risk exposures, while still ensuring that the risks to members with respect to their uncleared SBS exposures are adequately addressed. The proposed exceptions under FINRA Rule 4240(b)(5) would include the following:

- Clearing Agencies. A member would not be required to deliver Variation Margin to, or collect Initial Margin or Variation Margin from, any Clearing Agency, and would also not be required to deduct otherwise required Variation Margin or Initial Margin in the computation of its net capital under Exchange Act Rule 15c3-1 or, if applicable, FINRA Rule 4110(a). FINRA believes this exception is consistent with its determination to defer to Clearing Agency margin requirements with respect to Cleared SBS.
- Legacy SBS. A member would be permitted to omit all (but not less than all) Legacy SBS with a Counterparty from the Counterparty's Uncleared SBS Account when computing Current Exposure and the Initial Margin Requirement, provided that the member collects and delivers margin on Legacy SBS to the extent of its contractual rights and obligations to do so.¹¹⁹ However, a member would be required to take a capital deduction under Exchange Act Rule 15c3-1 or, if applicable, FINRA Rule 4110(a), to reflect the amount of any margin that it would have otherwise been required to collect if

¹¹⁹ Under proposed FINRA Rule 4240(d)(12), a "Legacy SBS" would be defined as an Uncleared SBS entered into before October 6, 2021. Proposed FINRA Rule 4240(b)(2)(A)(iv) would also clarify that for any Legacy SBS for which proposed Rule 4240 does not specify an Initial Margin Requirement (*i.e.*, an SBS other than a Basic CDS, Basic SBS or other SBS for which FINRA has approved specific margin requirements), the Initial Margin Requirement must be calculated using the applicable method specified in Exchange Act Rule 15c3-1(c)(2)(vi)(P). The Initial Margin Requirement for Legacy SBS calculated under this provision would be used for purposes of determining the appropriate corresponding capital charge, as well as to determine the Initial Margin Requirement for a Legacy SBS to the extent that a member elects not to utilize the Legacy SBS exception under proposed FINRA Rule 4240(b)(5).

the Legacy SBS had been included in the Counterparty's Uncleared SBS Account. FINRA believes it is appropriate to provide a general exception for legacy SBS, as members would not be in a position to require their counterparties to legacy SBS to exchange margin under existing SBS agreements as would otherwise be required under proposed FINRA Rule 4240. However, in such cases FINRA believe it is appropriate to require a member to take a corresponding capital charge to account for the member's ongoing risk exposure under such SBS.

- Multilateral Organizations. A member would not be required to deliver Variation Margin to, or collect Initial Margin or Variation Margin from, any Multilateral Organization.¹²⁰ However, a member would be required to take a capital deduction to reflect the amount of any margin that it would otherwise have been required to collect from such a Multilateral Organization. FINRA believes it is appropriate to follow Exchange Act Rule 18a-3 by providing an exception for Multilateral Organizations and requiring the risk posed by such SBS to be accounted for in a member's capital computations.
- Financial Market Intermediaries. A member would not be required to collect Initial Margin from a Counterparty that is a Financial Market Intermediary (but would still be

¹²⁰ Under proposed FINRA Rule 4240(d)(13), a "Multilateral Organization" would be defined to mean the Bank for International Settlements, the European Stability Mechanism, the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, or any other multilateral development bank that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member.

required to collect or deliver Variation Margin, as applicable).¹²¹ In such case, a member would be required to take a capital deduction to reflect the amount of any Initial Margin that it would have otherwise been required to collect from such Financial Market Intermediary. A Counterparty that is a Financial Market Intermediary generally would be subject to a comprehensive regulatory framework, including capital requirements. FINRA therefore believes it is appropriate to account for the reduced counterparty credit risk posed by such Counterparties by permitting a member to take a capital charge in lieu of requiring such Counterparties to post Initial Margin. However, FINRA continues to believe that Variation Margin should be exchanged with such Counterparties to account for ongoing the market risk posed by such uncleared SBS.

- Sovereign Counterparties. A member would generally be required to deliver Variation Margin to, and collect Initial Margin or Variation Margin from, a Sovereign Counterparty.¹²² However, under proposed FINRA Rule 4240(b)(5)(E), if the member has determined pursuant to policies and procedures or credit risk models established pursuant to Exchange Act Rule 15c3-1(c)(2)(vi)(l) that the Sovereign Counterparty has only a minimal amount of credit risk, the member would not be required to collect Initial Margin from such Sovereign Counterparty (but would still be required to collect or deliver Variation Margin, as applicable). In such case, a member would be required to take a capital deduction to reflect the amount of any Initial Margin that it would have

¹²¹ Under proposed FINRA Rule 4240(d)(8), a “Financial Market Intermediary” would be defined to mean an SBS, swap dealer, broker or dealer, FCM, bank, foreign bank, or foreign broker or dealer.

¹²² Under proposed FINRA Rule 4240(d)(17), a “Sovereign Counterparty” would be defined as a Counterparty that is a central government (including the U.S. government) or an agency, department, ministry or central bank of a central government.

otherwise been required to collect from such Sovereign Counterparty. As for Financial Market Intermediaries, FINRA believes it is appropriate to account for the reduced counterparty credit risk posted by highly creditworthy Sovereign Counterparties by permitting a member to take a capital charge in lieu of requiring such Counterparties to post Initial Margin. However, FINRA continues to believe that Variation Margin should be exchanged with such Counterparties to account for ongoing the market risk posed by such uncleared SBS.

- Majority Owners; ANC Firms Transacting with Majority Owners or Registered or Foreign SBS Dealers Under Common Ownership. FINRA understands that members may enter into uncleared SBS with affiliated entities for a variety of reasons, including for risk management purposes. FINRA does not believe a broad exception from the proposed margin requirements for uncleared SBS with all affiliates would adequately account for the risks posed to its members by uncleared SBS in such circumstances. However, FINRA does believe that two specific, more limited exceptions for SBS entered into with certain affiliates would be appropriate. First, under proposed FINRA Rule 4240(b)(5)(F), a member would not be required to collect Initial Margin from a Counterparty that is a direct or indirect owner of a majority of the equity and voting interests in the member (a “Majority Owner”) (but would still be required to collect or deliver Variation Margin, as applicable). In such case, a member would be required to take a capital deduction to reflect the amount of any Initial Margin that it would have otherwise been required to collect from such Majority Owner. Second, under proposed FINRA Rule 4240(b)(5)(G), a member that is an ANC Firm would not be required to collect Initial Margin from a Counterparty that is a Majority Owner or a Registered or

Foreign SBS Dealer under common ownership (but would still be required to collect or deliver Variation Margin, as applicable).¹²³ In such case, an ANC Firm member would be required to take a deduction for credit risk on such transactions computed in accordance with Exchange Act Rule 15c3-1e(c).¹²⁴ FINRA believes that the proposed exception from the Initial Margin Requirements for uncleared SBS with Majority Owners, provided that the member takes a capital charge in lieu of collecting Initial Margin, would adequately protect members in such circumstances due to the lower risk presented by Majority Owners, which typically must satisfy capital and other requirements applicable to bank holding companies and similar entities. FINRA also believes that the proposed exception for ANC Firms with respect to SBS with Majority Owners and Registered or Foreign SBS Dealer affiliates, provided that the member takes a corresponding credit risk charge, would adequately protect such members while reducing potential competitive disparity as between ANC Firms that are registered SBSDs (and therefore subject to Exchange Act Rule 18a-3) and ANC Firms that are not

¹²³ Under proposed FINRA Rule 4240(d)(14), a “Registered or Foreign SBS Dealer” would be defined to mean (i) any person registered with the SEC as an SBSD or (ii) any foreign person if the SEC has made a substituted compliance determination under Exchange Act Rule 3a71-6(a)(1) that compliance by a SBSD or class thereof with specified requirements of a foreign regulatory system that are applicable to such foreign person may satisfy the capital requirements of Section 15F(e) of the Act and Exchange Act Rule 18a-1 that would otherwise apply to such SBSD or class thereof. Therefore, the definition would cover registered SBSDs and entities that are subject to equivalent SBSD capital requirements in a foreign jurisdiction.

¹²⁴ FINRA notes that an ANC Firm transacting with a Counterparty that is its Majority Owner would also benefit from the general exception for collecting Initial Margin from Majority Owners, described above. However, under this additional exception, an ANC Firm would be permitted to take only a deduction for the credit risk on its transactions with Majority Owner counterparties as calculated in accordance with Exchange Act Rule 15c3-1e, rather than the full amount of the Initial Margin Requirement that would otherwise have applied.

registered SBSDs (and therefore would be subject to proposed FINRA Rule 4240 with respect to their uncleared SBS).

- Portfolio Margin. Proposed FINRA Rule 4240(b)(5)(H) would provide that proposed FINRA Rule 4240 would not apply to any unlisted derivative, as defined in FINRA Rule 4120(g)(2)(H), carried by the member in a portfolio margin account subject to the requirements of FINRA Rule 4210(g) if such unlisted derivative is of a type addressed in the comprehensive written risk analysis methodology filed by the member with FINRA in accordance with FINRA Rule 4210(g)(1).¹²⁵ In addition, proposed FINRA Rule 4240 would not apply to any SBS carried in a commodity account or other account under the jurisdiction of the CFTC in accordance with an SEC rule, order or no-action letter permitting SBS and swaps to be carried and portfolio margined together in such an account. Portfolio margining provides members with the flexibility to manage their risk exposures based on a broader view of their overall relationship with a particular Counterparty. FINRA believes it is appropriate to provide an exception from proposed FINRA Rule 4240 for any SBS in a portfolio margin account if the SBS is of a type whose risk is appropriately addressed by an approved theoretical pricing model (e.g., TIMS) and covered by portfolio risk management procedures filed by the member with FINRA, as well as for SBS permitted by the SEC to be portfolio margined in a commodity account. In these circumstances, the risks presented by such SBS would already be subject to a comprehensive risk management framework, and therefore

¹²⁵ FINRA is also proposing a technical adjustment to the definition of “unlisted derivative” under FINRA Rule 4210(g)(2)(H) to clarify that, to qualify under the definition, the option, forward contract or SBS must be able to be valued by a theoretical pricing model that is approved by the SEC for valuing that type of options, forward contract or SBS.

FINRA does not believe it necessary to apply the proposed new margin requirements to such SBS.

Proposed FINRA Rule 4240(c), entitled “Risk Monitoring Procedures and Guidelines,” would require members to monitor the risk of any Uncleared SBS Accounts and maintain a comprehensive risk analysis methodology for assessing the potential risk to the member’s capital over a specified range of possible market movements over a specified time period. For purposes of this requirement, members would be required to employ the following risk monitoring procedures and guidelines:

- obtaining and reviewing the required documentation and financial information necessary for assessing the amount of credit to be extended to SBS Counterparties;
- determining and documenting the legal enforceability of netting or collateral agreements, including enforceability in the event a Counterparty becomes subject to bankruptcy or other insolvency proceedings;
- assessing the determination, review and approval of credit limits to each Counterparty, and across all Counterparties;
- monitoring credit risk exposure to the member from SBS, including the type, scope and frequency of reporting to senior management;
- the use of stress testing of accounts containing SBS contracts in order to monitor market risk exposure from individual accounts and in the aggregate;
- managing the impact of credit extended related to SBS contracts on the member's overall risk exposure;

- determining the need to collect additional margin from a particular customer or broker or dealer, including whether that determination was based upon the creditworthiness of the customer or broker or dealer and/or the risk of the specific contracts;
- determining the need for higher margin requirements than required by proposed FINRA Rule 4240 and formulating the member's own margin requirements, including procedures for identifying unusually volatile positions, concentrated positions (with a particular Counterparty and across all Counterparties and customers), or positions that cannot be liquidated promptly;
- monitoring the credit exposure resulting from concentrated positions with a single Counterparty and across all Counterparties, and during periods of extreme volatility;
- identifying any Uncleared SBS Accounts with intraday risk exposures that are not reflected in their end of day positions (e.g., Uncleared SBS Accounts that frequently establish positions and then trade out of, or hedge, those positions by the end of the day) and collecting appropriate margin to address those intraday risk exposures;
- identifying any Uncleared SBS Account that, in light of current market conditions, could not be promptly liquidated for an amount corresponding to the Current Exposure computed with respect to such account and determining the need for higher margin requirements on such accounts or the positions therein;
- maintaining sufficient Initial Margin in the accounts of each Counterparty to protect against the largest individual potential future exposure of an Uncleared SBS in such Counterparty's Uncleared SBS Account, as measured by computing the largest maximum possible loss that could result from the exposure; and

- increasing the frequency of calculations of Current Exposure and Initial Margin Requirements during periods of extreme volatility and for accounts with concentrated positions.

Proposed FINRA Rule 4240(c) would further require a member to review, in accordance with the member's written procedures, at reasonable periodic intervals, the member's SBS activities for consistency with these risk monitoring procedures and guidelines, and to determine whether the data necessary to apply the risk monitoring procedures and guidelines is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data.

The risk monitoring procedures and guidelines under proposed FINRA Rule 4240(c) are similar to the risk monitoring and procedure requirements applicable to nonbank SBSs with respect to their uncleared SBS transactions under Exchange Act Rule 18a-3.¹²⁶ These requirements are also based in part on aspects of FINRA Rule 4210, including procedures related to the need for additional margin under FINRA Rule 4210(d) and the portfolio margin risk monitoring requirements under FINRA Rule 4210(g)(1). SBS are complex financial instruments that may expose a member to significant risks, including, for example, market risk, counterparty credit risk, operational risk and legal risk. FINRA accordingly believes it is appropriate and necessary, and consistent with the protection of investors, for members with exposure to uncleared SBS to maintain a comprehensive risk monitoring program, including the specific elements described above, to address such risks.

¹²⁶ See 17 CFR 240.18a-3(e); Capital, Margin, and Segregation Release, supra note 8, at 43930.

As noted in Item 2 of this filing, if the Commission approves the proposed rule change, the effective date of the proposed rule change will be October 6, 2021.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹²⁷ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that, by affirmatively addressing the treatment of SBS under FINRA rules, the proposed rule change will serve to promote regulatory clarity and consistency. FINRA also believes that this aspect of the proposed rule change is consistent with Congress's intent to define SBS as securities under the Act and its underlying regulations, and that such treatment will enhance investor protection. FINRA further believes that, by providing limited exceptions from the application of FINRA rules to SBS, the proposed rule change will promote legal certainty, provide clarity regarding the application of its rules and avoid unnecessary regulatory duplication.

The proposed rule change will also promote regulatory consistency by conforming FINRA's capital-related requirements to the SEC's amended net capital rule. FINRA also believes that, by applying higher financial responsibility and operational standards to members with financial exposure to SBS, the proposed rule change will serve to protect investors and the public interest.

Finally, the proposed rule change will also protect investors and the public interest by establishing a new margin rule for SBS applicable to members that are not registered SBSDs.

¹²⁷ 15 U.S.C. 78o-3(b)(6).

FINRA believes that the proposed rule change will thereby fill an important regulatory gap, protect members against counterparty credit risk, maintain a level playing field for members and prevent regulatory arbitrage.

II. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rule change, its potential economic impacts (including anticipated costs, benefits, and distributional and competitive effects, relative to the current baseline) and the alternatives considered in assessing how best to meet FINRA's regulatory objective.

A. Regulatory Need

As detailed above, the SEC has adopted final rules under Title VII of the Dodd-Frank Act implementing the new regulatory framework for SBS, including rules requiring SBS Entities to register with the SEC, business conduct and supervision requirements, risk mitigation techniques, and margin, capital and segregation requirements for SBS Entities, among many other detailed requirements. For SBS Entities, the compliance date for the SEC's key SBS requirements will be October 6, 2021, and the deadline for the first wave of SBS Entities to register is November 1, 2021. FINRA currently has in place a temporary, broad exception from the application of its rules to its members' SBS activities and positions, which will expire on September 1, 2021. In light of the upcoming Registration Compliance Date, FINRA is

proposing to amend its rules as detailed above to clarify the application of its rules to SBS and take into account member's SBS activities once SBS Entities begin registering with the SEC.

B. Economic Baseline

The economic baseline for the proposed rule change is based on the relevant existing regulatory framework, existing firm practices and information collected through outreach efforts. FINRA believes that the proposed rule change should be evaluated against a baseline where the SEC's new rules for SBS have come into effect and FINRA's existing exceptions have expired—i.e., if current FINRA Rule 0180 were to expire as scheduled on September 1, 2021 and new FINRA Rule 0180 not adopted as proposed—as well as applying FINRA's existing margin and financial operational rules and requirements to SBS without the proposed changes described above. Under this baseline, all member firms contemplating offering SBS services to clients would be subject to FINRA's applicable rules with regard to business conduct requirements, financial responsibility and operational requirements, and margin. As discussed above, these rules as applied to SBS Entities, may in some cases be duplicative of SEC rules, and thus may impose unnecessary material obligations given the firms' activities in the space, could result in operational difficulties or be insufficient to provide appropriate risk controls. Under this scenario, some member firms may choose to limit or not provide SBS services, which may result in decreased choice and increased costs to customers.

Through outreach efforts and discussions with individual member firms, FINRA has learned about current member firm SBS activities and their preparations for the Registration Compliance Date. The majority of member firms that participated in the outreach efforts indicated that they intend to register a bank affiliate, foreign affiliate or stand-alone dealer affiliate as the SBS. Some of the firms indicated some involvement in SBS activities on the

part of their FINRA-registered associated persons, but typically in the person's capacity as an associated person of the affiliated SBS. Firms further indicated that their SBS activities will be focused on their existing trading programs related to CDS, equity index and single-name TRS, and asset-backed security swaps. FINRA also solicited input from member firms that may conduct an SBS business below the SEC's registration thresholds. Generally, FINRA has found that the number of member firms that are planning to register as an SBS, or engage in SBS activities below the SEC's registration thresholds, is small and concentrated in larger firms. FINRA also discussed with firms their practices with respect to margin practices for SBS transactions. Most firms reported they would be using the standard initial margin model ("SIMM") for margin purposes,¹²⁸ and rely on existing margin collection and governance systems and infrastructure.

FINRA has also engaged with other relevant regulators, including the SEC, the CFTC and the National Futures Association ("NFA"). Through these efforts, FINRA has gained further insight into the application of the SEC's SBS rules to its member firms, as well as the similarities and differences between the SEC and CFTC regulatory frameworks. Furthermore, FINRA gathered further information about the approach taken by the NFA for regulating the activities of FCMs and other registrants engaged in swap activities. For example, FINRA notes that an FCM generally does not need to comply with NFA rules specific to swaps (e.g., margin) unless it is

¹²⁸ The SIMM is a methodology proposed by ISDA to help market participants calculate initial margin on non-cleared derivatives under the framework developed by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions. See ISDA, Standard Initial Margin Model for Non-Cleared Derivatives (December 2013), <https://www.isda.org/a/cgDDE/simm-for-non-cleared-20131210.pdf>.

also a registered swap dealer. Finally, FINRA discussed the implications of member firms engaging in SBS activities under Exchange Act Rule 15a-6.¹²⁹

In parallel to the outreach efforts conducted through engagement with individual member firms, as discussed above, FINRA posted on its public website an open-ended request for feedback on how FINRA rules should be applied to SBS and invited interested parties to submit views and information via a dedicated email box.¹³⁰ The responses received largely echoed FINRA's discussion with member firms. In addition, FINRA issued Regulatory Notice 20-36 to solicit further comment on the proposal, including any potential economic impacts.¹³¹ As discussed in Item 5 of this filing, FINRA received one comment letter in response to Regulatory Notice 20-36.

C. Economic Impacts

FINRA has analyzed the potential costs and benefits of the proposed rule change, and the different parties that are expected to be affected. FINRA has identified member firms that engage in SBS activities and their customers as the parties that would primarily be affected by the proposed rule change. In particular, these include member firms that will register as SBSs, firms seeking to broker SBS transactions, firms engaging in SBS activities under the de minimis threshold for SBS registration, and firms engaging in SBS activities in other capacities (e.g., risk management). As discussed above, based on existing information, FINRA understands that the number of such member firms is small and concentrated among larger member firms. The

¹²⁹ Exchange Act Rule 15a-6 provides conditional exemptions from registration under the Exchange Act that permit non-US broker-dealers to engage in certain activities in the US or with US persons without having to register with the SEC.

¹³⁰ See supra note 25.

¹³¹ See supra note 26.

proposed rule change is expected to reduce regulatory arbitrage and establish a regulatory framework for FINRA member firms that wish to engage in SBS activities, without diminishing investor protections.

1. Anticipated Benefits

FINRA believes that the proposed rule change would benefit member firms by reducing regulatory uncertainty, unnecessary regulatory duplication and the potential for arbitrage with the SEC's regulatory framework for SBSs that are not FINRA member firms. Furthermore, FINRA believes that the proposed rule change would alleviate some of the potential competitive disadvantages for FINRA member firms that wish to engage in SBS activities without registering as SBSs. FINRA believes this goal is achievable through the increased regulatory clarity resulting from the proposed rule change. Finally, FINRA believes that the combination of these accrued benefits could incentivize member firms to engage in SBS activities. This could lead to an increase in consumer choice, and potentially increase member firms' ability to compete in SBS products.

A primary benefit of the proposed rule change is that it permits firms that are registered with the SEC to rely on relevant SEC rules governing business conduct requirements with respect to their SBS activities. In so doing, the proposed rule change ensures that there would be no unintended differences between the firms' obligations under SEC and FINRA rules and would impose no additional direct or indirect costs to firms that are registered SBSs engaging in SBS activities. The proposed rule change is also expected to reduce potential regulatory arbitrage across the relevant regulatory frameworks of FINRA, the SEC and the CFTC. Increased consistency across regulatory frameworks would benefit member firms seeking to

engage in SBS activities through multiple affiliates and those firms engaging in an SBS business without registering with the SEC.

Member firms would be expected to be able to use their existing governance and compliance systems and procedures, including in situations where member firms will have dual-hatted personnel or have an affiliate that is registered with the CFTC as a swaps dealer. Finally, member firms are expected to benefit from the proposed exception for current rules that otherwise might otherwise apply but are not feasible or appropriate in the context of SBS activities. This will reduce operational and compliance costs for firms without diminishing investor protections. Similarly, with respect to financial responsibility and operational requirements, the proposed rule change would benefit member firms by aligning FINRA rules with SEC rules, thus reducing the costs and risks of regulatory arbitrage.

With respect to margin requirements, the proposed rule change also seeks to rely on the SEC's rules and framework to provide consistent protections and regulatory requirements. First, member firms that register as SBSs would be exempted from the FINRA margin requirements, thus eliminating any regulatory burden that might arise from a different approach. Second, for other firms, the margin requirements for uncleared Basic CDS would conform with the standard SEC margin requirements, thus reducing risk of regulatory arbitrage. Third, the proposal is expected to benefit member firms by providing additional mitigation of counterparty risks for SBS-related activities that fall outside of the SEC regulatory framework. Fourth, the margin requirements are expected to enhance member firms' ability to compete in these products. Fifth, replacing the current FINRA Rule 4240, which by its terms is a temporary rule, with an ongoing rule would reduce regulatory uncertainty and benefit firms with respect to compliance systems and associated costs. Finally, FINRA believes that the anticipated benefits of the proposed

margin requirements might accrue to counterparties, customers and the financial system as a whole, as it decreases the chance of unexpected firm failure and dampens shock transmission.

2. Anticipated Costs

FINRA believes that the proposed rule change would result in some direct costs to member firms that choose to engage in SBS activities in various capacities. In particular, member firms would be required to develop a regulatory compliance program for SBS activities and monitor for their compliance.

FINRA believes that the proposed rule change's exceptions from applying some of its rules to SBS activities benefits member firms. However, such exceptions could potentially further result in costs to member firms. These can be either near-term costs, stemming from FINRA's decision to provide exceptions for certain rules but not others, or long-term costs, if trading in SBS evolves in ways that would require a reconsideration of the exceptions.

Some costs are also expected to stem from the proposal to treat member firms with financial exposure to SBS the same as carrying or clearing firms for purposes of FINRA's financial and operational rules. However, FINRA believes that the majority of member firms that will be engaged in SBS activities already qualify as carrying or clearing firms under these rules. Thus, it is expected that any incurred compliance costs resulting from this proposed requirement would be minimal. Further, for member firms not registering as SBSs, the proposal to align FINRA's regulatory notification and business curtailment rule requirements to the SEC's amended net capital rule may result in increased associated costs.

The proposed margin requirements may impose some costs on member firms seeking to engage in SBS activities without registering as SBSs. The new margin requirements would require such member firms engaged in SBS activities to have comprehensive written credit risk

management procedures appropriate for the business and to ensure compliance with them. Moreover, additional costs would arise from allowing firms to take a capital charge in lieu of margin, where permitted. These costs are associated with managing capital accounts, related compliance costs, and any opportunity costs that might arise from committing capital. FINRA notes that firms would be permitted to take this approach and thus would only be anticipated to do so in instances where the costs are lower than the alternative margin requirements.

FINRA recognizes that the proposal should be considered relative to alternative regulatory regimes available to member firms and their affiliates. Firms will consider whether the costs and benefits of providing SBS services are most efficient under these proposed rules, alternative domestic rules, such as those of the CFTC, or through a foreign entity. FINRA has considered the potential impacts of the proposal on competition among financial service providers and how that competition may limit investor choice or impose higher, or additional, risks or costs to investors. FINRA sought information and comments on this specific issue in Regulatory Notice 20-36. FINRA believes that given the current set of SBS activities, and member firms identified as engaged in such activities, the extent of such potential competitive impacts and outcomes is unclear. Moreover, FINRA believes that such competitive impacts would depend on a firm's interest in, and the scope of, its SBS activities.

D. Alternatives Considered

FINRA has considered various alternatives to the proposed rule change. For example, FINRA considered an option to allow current FINRA Rule 0180 to expire without replacing it with a new rule. This would result in no exceptions from the applications of the FINRA rules to member firms engaging in SBS activities. A different alternative that considered would be to delete the expiration date from current FINRA Rule 0180 and rely solely on the SEC's SBS

regulatory framework going forward. FINRA considered similar alternatives with respect to the proposed margin requirements and amendments to its financial responsibility and operational rules. FINRA believes that the proposed rule change strikes an appropriate balance among establishing a regulatory framework for SBS activities, regulatory burdens and investor protection considerations.

III. Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

A concept proposal summarizing the proposed rule change was published for comment in Regulatory Notice 20-36 (October 2020).¹³² One comment was received in response to the Regulatory Notice.¹³³ A copy of the Regulatory Notice is attached as Exhibit 2a. A copy of the comment letter received in response to the Regulatory Notice is attached as Exhibit 2b. The comment letter is summarized below.

SIFMA expressed overall support for many aspects of the Concept Proposal, but suggested further tailoring to seek greater clarity regarding the application of FINRA rules to SBS, ensure that standalone broker-dealers are not placed at a disadvantage to broker-dealers that are also registered as SBSs, and better harmonize certain FINRA rules with the SEC’s SBS Entity rules.¹³⁴ In the Concept Proposal, FINRA noted that it was considering extending its existing exceptions under current FINRA Rule 0180 until the Registration Compliance Date on

¹³² See Regulatory Notice 20-36 (October 2020) (“Concept Proposal”).

¹³³ See Letter from Kyle L Brandon, Managing Director, Head of Derivatives Policy, Securities Industry and Financial Markets Association (“SIFMA”), to Jennifer Pioro Mitchell, Office of the Corporate Secretary, FINRA, dated November 16, 2020 (“SIFMA Letter”).

¹³⁴ See SIFMA Letter at 1.

October 6, 2021.¹³⁵ SIFMA noted that, per the SEC Transitional Period Guidance, most, if not all, SBSs will wait to register until November 1, 2021, and therefore SIFMA recommended that FINRA instead extend the expiration date of current FINRA Rule 0180 until November 1, 2021.¹³⁶ After consideration, FINRA believes that the Registration Compliance Date is the most appropriate date to implement the proposed rule change in order to align with the implementation of the SEC's Title VII rulemakings and avoid unnecessary confusion. FINRA also understands that existing, temporary exemptions from some SEC rules expire on the Registration Compliance Date, and that SBSs are likely to register on that date to align with the expiration of those exemptions. Therefore, as discussed above, FINRA intends to extend the expiration date of current FINRA Rule 0180, as well as the interim CDS margin pilot program under current FINRA Rule 4240, to the Registration Compliance Date on October 6, 2021.¹³⁷

In the Concept Proposal, FINRA stated that it was considering providing general exceptions from the presumption of applicability of FINRA rules to SBS for certain rules that were intended for other types of securities and could create operational difficulties if applied to SBS.¹³⁸ SIFMA supported FINRA's proposal to except these rules from the general presumption of applicability, including the FINRA Rule 6000 Series (Quotation, Order, and Transaction Reporting Facilities), the FINRA Rule 7000 Series (Clearing, Transaction and Order Data Requirements, and Facility Charges) and the FINRA Rule 11000 Series (Uniform Practice Code). SIFMA stated that providing exceptions for these rules will promote clarity, considering

¹³⁵ See Concept Proposal at 3.

¹³⁶ See SIFMA Letter at 1-2; see also supra note 10.

¹³⁷ See supra note 18.

¹³⁸ See Concept Proposal at 4.

that these rules are not designed to apply to SBS and arguable overlap with some of the SEC's rules such as Regulation SBSR.¹³⁹ The proposed rule change would provide such exceptions under proposed FINRA Rule 0180(b).

In the Concept Proposal, FINRA stated that it was considering providing exceptions from the presumption of applicability of FINRA rules to SBS for certain business conduct rules that are similar to the SEC's new SBS Entity rules. Specifically, FINRA stated its preliminary belief that it would be appropriate to permit an SBS Entity that is a FINRA member and an associated person of an SBS Entity who is acting in his or her capacity as an associated person of an SBS Entity to comply with the parallel SEC requirements in lieu of the similar FINRA Rules.¹⁴⁰ FINRA noted the following rules in particular: (1) FINRA Rule 2030 (Engaging in Distribution and Solicitation Activities with Government Entities); (2) FINRA Rule 2090 (Know Your Customer); (3) FINRA Rule 2111 (Suitability); (4) FINRA Rule 2210(d) (Communications with the Public – Content Standards); (5) FINRA Rule 2232 (Customer Confirmations); and (6) FINRA Rules 3110 (Supervision), 3120 (Supervisory Control System) and 3130 (Annual Certification of Compliance and Supervisory Processes). SIFMA expressed general support for this aspect of the Concept Proposal, noting FINRA's observation that these rules would

¹³⁹ See SIFMA Letter at 2. SIFMA also noted that the Concept Proposal also stated FINRA's preliminary intention to provide a general exception from FINRA Rule 2210, other than the content standards in paragraph (d). See *id.* at 2 n.3. After further consideration, FINRA does not believe a general exception from the remainder of FINRA Rule 2210 is appropriate, and therefore the proposed rule change does not provide this exception under proposed FINRA Rule 0180(b). The remainder of FINRA Rule 2210 includes specified principal approval, review, filing and recordkeeping requirements applicable to certain types of communications, as well as limitations on the use of FINRA's name and standards applicable to public appearances. FINRA believes these requirements should apply to communications relating to SBS to the extent the rule otherwise applies to the communication.

¹⁴⁰ See Concept Proposal at 4-5.

unnecessarily duplicate certain of the SEC's SBS Entity rules if they applied to SBS Entities or their associated persons.¹⁴¹ However, SIFMA made four recommendations for FINRA to make certain clarifications and expand the proposed exceptions. The proposed rule change would provide these exceptions in proposed FINRA Rules 0180(c) and (d), with certain modifications as noted below.¹⁴²

First, in the Concept Proposal, FINRA stated that the proposed exceptions would apply both where the member itself is registered as an SBS Entity and where the associated person of the member is "dual-hatted" as an associated person of an affiliated SBS Entity.¹⁴³ SIFMA requested that FINRA clarify the treatment of dual-hatted personnel under these proposed exceptions in two respects. First, SIFMA requested that FINRA confirm that, by adopting these exceptions and applying such exceptions to dual-hatted individuals, FINRA is not addressing whether or to what extent the rules not covered by these exceptions might apply to dual-hatted personnel when acting in their capacity as associated persons of an affiliated entity. Second, SIFMA requested that FINRA confirm that regardless of how the dual-hatting arrangement is documented, if in substance the relevant individual is designated as an associated person of an SBS Entity and is in fact acting in that capacity, then such individual would benefit from

¹⁴¹ See SIFMA Letter at 2.

¹⁴² In addition to the modifications described above in response to SIFMA's feedback, the proposed rule change also splits these exceptions into two paragraphs of proposed FINRA Rule 0180 to account for SEC rules that apply to only SBSs rather than all SBS Entities. See supra note 36.

¹⁴³ See Concept Proposal at 4.

FINRA's proposed exceptions.¹⁴⁴ FINRA has addressed both aspects of SIFMA's request relating to dual-hatted personnel above.¹⁴⁵

Second, in the Concept Proposal, FINRA noted the SEC's cross-border counting exception under Exchange Act Rule 3a71-3(d) and stated that it was considering also providing an exception for members acting in compliance with that exception from the FINRA rules that are parallel to the SEC's SBS Entity rules that are conditions of the exception.¹⁴⁶ SIFMA expressed support for this additional exception and requested that FINRA expand its exceptions for FINRA Rules 2111 (Suitability), 2210(d) (Communications with the Public – Content Standards) and 2232 (Customer Confirmations) to cover a FINRA member when it is acting as the registered entity for a foreign affiliate pursuant to Exchange Act Rule 3a71-3(d).¹⁴⁷ As discussed above, the proposed rule change would include these exceptions in proposed FINRA Rule 0180(e).

Third, SIFMA requested that FINRA also adopt exceptions from associated person registration and CE requirements in FINRA Rules 1210, 1220 and 1240 for a person associated with a broker-dealer dually registered as an SBS Entity whose securities-related activities relate solely and exclusively to transactions in SBS conducted in his or her capacity as an associated person of an SBS Entity.¹⁴⁸ SIFMA noted that FINRA's existing registration, proficiency testing and CE requirements are not tailored to SBS and it would therefore seem to provide little, if any,

¹⁴⁴ See SIFMA Letter at 3.

¹⁴⁵ See supra note 38.

¹⁴⁶ See Concept Proposal at 16 n.14.

¹⁴⁷ See SIFMA Letter at 3-4.

¹⁴⁸ See SIFMA Letter at 4.

benefit to apply those requirements to such associated persons. In this regard, SIFMA noted that similar considerations led the NFA initially to exclude swaps associated persons from its proficiency testing requirements until tests tailored to swaps could be developed. SIFMA also stated that associated persons of standalone SBSDs are not subject to registration or CE requirements and, since SBSDs generally are not required to register as broker-dealers or become FINRA members, it would be inappropriate to subject associated persons of SBSDs to differing requirements solely depending on whether the SBSD happened, for other reasons, to be a FINRA member.¹⁴⁹ FINRA believes that an exception along the lines requested by SIFMA is appropriate, at least until such time as FINRA may develop registration, licensing and CE requirements tailored to SBS. As discussed above, the proposed rule change therefore includes proposed FINRA Rule 0180(g), which would provide that persons associated with a member whose functions are related solely and exclusively to SBS undertaken in such person's capacity as an associated person of an SBS Entity are not required to be registered with FINRA.

Finally, SIFMA requested that FINRA provide exceptions for a member dually registered as an SBS Entity from FINRA Rules 2231 (Customer Account Statements) and 4512 (Customer Account Information), in each case, for an account solely holding SBS and related collateral.¹⁵⁰ In the Concept Proposal, FINRA explained its preliminary belief that the account statements required under FINRA Rule 2231 should reflect a holistic view of a member's relationship with its customer, including SBS transactions and positions, if applicable. FINRA further stated that while FINRA members that are SBS Entities would also be subject to the SEC's portfolio reconciliation requirements, given the importance of customer account statements and the

¹⁴⁹ See SIFMA Letter at 4.

¹⁵⁰ See SIFMA Letter at 5.

different purposes of the rules, under the Concept Proposal FINRA was considering not proposing an exception from FINRA Rule 2231 for members that are SBS Entities.¹⁵¹ SIFMA acknowledged this rationale generally, but stated its belief that if an account only holds SBS and related collateral, the SEC's portfolio reconciliation requirement should be sufficient because it will provide the counterparty with information on a periodic basis regarding the parties' SBS portfolio and address the resolution of disputes, including collateral-related disputes.¹⁵² SIFMA also noted that the SEC's amended recordkeeping rules, specifically Exchange Act Rule 17a-3(a)(9)(iv), cover much of the information required by FINRA Rule 4512, and that such rules are specifically tailored to SBS while FINRA Rule 4512 requires information that is unlikely to be relevant to SBS.¹⁵³ FINRA believes that limited exceptions along the lines requested by SIFMA are appropriate where an account solely holds SBS and related collateral for a counterparty to a member that is acting in its capacity as an SBS Entity. Accordingly, as discussed above, the proposed rule change includes proposed FINRA Rule 0180(f), which would provide that FINRA Rules 2231 and 4512 shall not apply to members' activities and positions with respect to SBS, to the extent that the member is acting in its capacity as an SBS Entity and the customer's account solely holds SBS and collateral posted as margin in connection with such SBS.

¹⁵¹ See Concept Proposal at 16 n.15.

¹⁵² See SIFMA Letter at 5. SIFMA also stated that although the SEC's portfolio reconciliation rule does not expressly cover collateral-related disputes, the NFA has interpreted the parallel CFTC rule to cover such disputes, and the SEC indicated that an SBS Entity that is following NFA's processes in relation to disputes would also be compliant with Exchange Act Rule 15Fi-3. See id. at 5 n.4. As discussed above, the proposed rule change would include as a condition to proposed FINRA Rule 0180(f) that portfolio reconciliations and related dispute resolution requirements as applied to a customer's account qualifying for the proposed exception must include SBS-related collateral.

¹⁵³ See SIFMA Letter at 5.

In the Concept Proposal, FINRA requested comment on a proposed framework for a new SBS-specific margin rule, which would replace the Interim Pilot Program under existing FINRA Rule 4240 and apply to all SBS in lieu of FINRA's general margin requirements under FINRA Rule 4210.¹⁵⁴ SIFMA expressed support for the steps noted by FINRA in the Concept Proposal with respect to harmonizing the new SBS-specific margin rule with the SEC's margin rule for SBSs, including by including exceptions from Initial Margin Requirements for Sovereign Entities and Financial Market Intermediaries, as well as the Variation Margin and Initial Margin Requirements for Multilateral Organizations.¹⁵⁵ However, SIFMA noted that the proposed margin rule as described in the Concept Proposal would still diverge from Exchange Act Rule 18a-3 in several significant respects. SIFMA expressed concern that these differences would impose significant limitations on the ability of members that are not SBSs to transact in SBS, including for risk management purposes. SIFMA therefore suggested that FINRA allow a member subject to the proposed new rule to opt into compliance with Exchange Act Rule 18a-3 if the member (a) is affiliated with a registered SBS subject to Exchange Act Rule 18a-3 and (b) uses initial margin models, if any, that the SEC has approved for use by that affiliate.¹⁵⁶ FINRA acknowledges that proposed new FINRA Rule 4240 would diverge from Exchange Act Rule 18a-3 in some respects, which FINRA believes are important to protect its members given that members subject to the rule would not be subject to the comprehensive regulatory framework applicable to SBSs. For example, registered SBSs are subject to higher minimum capital requirements, and the SEC's margin requirements under Exchange Act Rule 18a-3 were

¹⁵⁴ See Concept Proposal at 8-9.

¹⁵⁵ See SIFMA Letter at 6.

¹⁵⁶ See SIFMA Letter at 7.

designed to apply to entities subject to those higher capital requirements. FINRA notes in this regard that firms engaged in a level of SBS dealing below the de minimis threshold requiring SBS registration may nonetheless elect to register as SBSs, and thereby become subject to the SEC's comprehensive regulatory framework for such entities, including the margin requirements under Exchange Act Rule 18a-3 tailored to such entities. FINRA does not believe it would be appropriate to permit members to opt-in to only one aspect of the SEC's financial responsibility rules for SBSs instead of complying with proposed FINRA Rule 4240, which, as described below, would in some respects provide a higher level of protection for non-SBS members engaged in uncleared SBS than SBSs because such members are not comprehensively regulated with respect to their SBS activities.

Alternatively, SIFMA requested that, if FINRA does not adopt its suggested opt-in approach, FINRA harmonize the new margin rule with Exchange Act Rule 18a-3 in certain respects.¹⁵⁷ First, SIFMA noted that the proposed new margin rule as described in the Concept Proposal would not include the same exceptions as Exchange Act Rule 18a-3, including an Initial Margin collection exception for affiliates and an exception from both Initial Margin and Variation Margin for legacy accounts. As described above, FINRA believes an exception from including Legacy SBS in a Counterparty's Uncleared SBS Account for purposes of the margin requirements under proposed FINRA Rule 4240 is appropriate to the extent the member does not have a contractual right or obligation to collect or deliver such margin, and is therefore including such an exception under the proposed rule change, provided that members take a corresponding capital charge to account for the risk of Legacy SBS (consistent with the SEC's approach to legacy accounts under Exchange Act Rule 18a-3). Also as described above, while FINRA does

¹⁵⁷ See SIFMA Letter at 7.

not believe a broad exception from the Initial Margin Requirements for SBS with all affiliates would be consistent with investor protection, the proposed rule change includes more limited exceptions (i) for all members, from collection of Initial Margin for SBS with Majority Owners, subject to a corresponding capital charge; and (ii) for ANC Firms, from collection of Initial Margin for SBS with Majority Owners and Registered or Foreign SBS Dealers, subject to taking a corresponding credit risk charge (as discussed in further detail below). FINRA believes these proposed exceptions, together with the proposed exception for SBS with Financial Market Intermediaries, should account for the vast majority of uncleared SBS entered into by non-SBSDs with affiliates and thus reduce the competitive disparity noted by SIFMA, while still sufficiently addressing the potential risks raised by SBS with other affiliated entities.

Second, SIFMA noted that an SBSB generally may use an approved model to calculate initial margin requirements and stated that, if standalone broker-dealers are not able to use similar models, the rule may result in competitive disparities between standalone broker-dealers and broker-dealers dually-registered as SBSBs. SIFMA therefore requested that FINRA modify the proposed margin rule to provide that, if the SEC has approved an affiliate of a standalone broker-dealer to use an initial margin model, such as the ISDA “Standard Initial Margin Model,” then such broker-dealer should be able to use the same model to the same extent as a broker-dealer dually-registered as an SBSB would be able to under the SEC’s margin rules.¹⁵⁸ SIFMA further requested that the use of such a model should not be limited to products that are Basic CDS or Basic SBS.¹⁵⁹ FINRA believes similar considerations apply with respect to the use of SEC-approved Initial Margin models as for permitting a non-SBSB member to opt-in to

¹⁵⁸ See SIFMA Letter at 8.

¹⁵⁹ See SIFMA Letter at 8 n.6.

Exchange Act Rule 18a-3. Proposed FINRA Rule 4240 would apply only to members that are not registered SBSBs, and therefore such members would not be subject to the comprehensive regulatory framework applicable to SBSBs, including higher capital requirements. Similarly, FINRA does not believe it would be appropriate to permit a non-SBSB member to opt-in to using models that the SEC has approved for an affiliate that is itself registered as an SBSB.

Third, SIFMA requested that, when ANC Firms transact pursuant to an exception from the proposed new margin rule, they should be permitted to use credit risk charges set forth in Exchange Act Rule 15c3-1e in lieu of capital charges computed using the Initial Margin methodology required under the proposed new margin rule.¹⁶⁰ SIFMA stated that this approach should not pose undue risks to ANC Firms given the significantly higher minimum net capital and tentative net capital requirements applicable to such firms, and cited the SEC's decision to allow ANC Firms to apply Exchange Act Rule 15c3-1e's credit risk charges to all derivatives transactions not subject to margin collection requirements.¹⁶¹ FINRA acknowledges that not permitting all ANC Firms subject to the rule to use credit risk charges in lieu of capital charges could create certain competitive disparities as between ANC Firms that are registered SBSBs (and therefore are subject to Exchange Act Rule 18a-3) and ANC Firms that are not registered SBSBs (and therefore would be subject to the Initial Margin requirements under proposed FINRA Rule 4240). However, FINRA notes that the credit risk charges calculated under Exchange Act Rule 15c3-1e represent a fraction of the Initial Margin Requirement that would otherwise be required to be collected under proposed FINRA Rule 4240 (or to be taken as a

¹⁶⁰ See SIFMA Letter at 8.

¹⁶¹ See SIFMA Letter at 8-9.

capital deduction in certain circumstances as described above).¹⁶² Therefore, as described above, FINRA believes it is appropriate to provide a limited exception permitting ANC Firms to use credit risk charges when they transact with registered SBSB affiliates or affiliates that are subject to comparable capital requirements in a foreign jurisdiction. FINRA believes this proposed exception should substantially address the potential competitive disparity highlighted by SIFMA, while providing the heightened protection provided by collecting the full Initial Margin Requirement, or taking the associated full capital charge in certain circumstances, for SBS with other Counterparties.

Fourth, SIFMA requested that FINRA include an Initial Margin threshold consistent with Exchange Act Rule 18a-3's \$50 million threshold.¹⁶³ SIFMA noted that, because Exchange Act Rule 18a-3 includes such a threshold while FINRA's proposed new margin rule would not, members subject to the proposed margin rule would face a significant competitive disadvantage relative to SBSBs. SIFMA suggested that, if FINRA permitted a member to take a capital charge in lieu of collecting Initial Margin up to the threshold, similar to that permitted by the SEC for SBSBs, then FINRA could ensure protection against credit risks without creating an unlevel playing field or increasing market concentration. Fifth, SIFMA requested that FINRA adopt a \$500,000 minimum transfer amount to minimize operational burdens and competitive disadvantages that would otherwise be imposed on broker-dealers, including when facing SBSBs, in which case broker-dealers would be required to collect or post Variation Margin when

¹⁶² Specifically, these charges are the product of (x) 8%, (y) the counterparty risk weighting (20% for internal AAA/AA rating, 50% for internal investment grade rating or 150% for internal non-investment grade rating), and (z) a potential exposure computed using a VaR model (or if not modeled, by applying the capital rule haircut to the underlying). See 17 CFR 15c3-1e.

¹⁶³ See SIFMA Letter at 9.

its SBSB counterparty would not.¹⁶⁴ FINRA acknowledges that these aspects of the proposed rule change differ from the SEC's margin rule for SBSBs under Exchange Act Rule 18a-3. However, FINRA does not believe the application of a large threshold or minimum transfer amount would be appropriate for uncleared SBS entered into by non-SBSB members that would be subject to proposed FINRA Rule 4240, as such members will not be subject to the comprehensive regulatory framework applicable to SBSBs, including higher minimum capital requirements. FINRA also notes that, from an operational perspective, member broker-dealers should already have operational processes in place for the collection of margin without any threshold or minimum transfer amount. Further, FINRA believes that adopting a threshold or minimum transfer amount under proposed FINRA Rule 4240 would incentivize restructuring of margin accounts as Basic SBS given that FINRA Rule 4210 does not provide for any threshold or minimum transfer amount. To prevent regulatory arbitrage, FINRA is therefore not proposing to include any threshold or minimum transfer amount under proposed FINRA Rule 4240.

Fifth, SIFMA noted that the definition of Basic CDS as described in the Concept Proposal would not seem to cover an option on a CDS, *i.e.*, CDS swaptions. SIFMA requested that FINRA change the definition of Basic CDS to include swaptions, so that swaptions are treated the same as the underlying CDS, to avoid a situation that would make it difficult for FINRA members to employ CDS swaption hedging techniques.¹⁶⁵ SIFMA noted that such a change would also eliminate the added costs market participants would otherwise incur in requesting approval from FINRA of the appropriate Initial Margin Requirement for swaptions. FINRA notes that there is some uncertainty regarding the appropriateness of applying the

¹⁶⁴ See SIFMA Letter at 9.

¹⁶⁵ See SIFMA Letter at 9-10.

generally applicable haircut grid for CDS under Exchange Act Rule 15c3-1(c)(2)(vi)(P)(1) to CDS swaptions. As such, FINRA believes it would be beneficial for SIFMA or other market participants to submit an application for approval of an Initial Margin Requirement for CDS swaptions under proposed FINRA Rule 4240(2)(C), as described above. FINRA notes that it would consider such a request expeditiously provided that such an application included all relevant supporting information. SIFMA also expressed concern that the Basic CDS definition could be read to require physical settlement of CDS. Given the prevalence of auction settlement in the CDS market, SIFMA requested that the definition of Basic Single-Name Credit Default Swap (a component of Basic CDS) specifically contemplate auction settlement as well.¹⁶⁶ FINRA notes that it intends for the definition of Basic CDS, as described in greater detail above, to cover both physical and auction settlement.

Finally, SIFMA made several comments regarding paragraph (g) (the portfolio margin section) of FINRA Rule 4210:¹⁶⁷

- SIFMA requested that FINRA conform FINRA Rule 4210's definitions of "related instrument" and "underlying instrument" to the definitions in Appendix A to Exchange Act Rule 15c3-1, which now include swaps and SBS. FINRA will consider these suggestions, but does not believe these changes are necessary as a part of this rulemaking.
- SIFMA further requested that FINRA clarify FINRA Rule 4210 to permit house margin and stress test requirements for portfolio margin accounts to recognize risk offsets across all types of swaps, SBS and other positions permitted in the

¹⁶⁶ See SIFMA Letter at 10.

¹⁶⁷ See SIFMA Letter at 6.

account. FINRA notes that this request relates to “house margin,” which generally refers to margin requirements that a member’s portfolio margin risk management procedures may impose in addition to, or parallel to, the requirements under the applicable portfolio margin model. FINRA believes that the practice of recognizing risk offsets across all types of swaps, SBS and other positions permitted in the account for purposes of calculating house margin and related stress test requirements is permissible under current FINRA Rule 4210, and FINRA does not intend to alter such permissibility under the proposed rule change.

- SIFMA also requested that FINRA clarify that SBS may be held in a portfolio margin account even if the underlier for the SBS would not be eligible for portfolio margining, given that Exchange Act Rule 18a-3 imposes no limitation on the types of SBS that can be margined using the methodology set forth in Appendix A to Exchange Act Rule 15c3-1. FINRA notes that, under the proposed rule change, the eligibility of specific SBS for portfolio margining would depend on whether such SBS can be valued by a theoretical pricing model approved by the SEC for valuing that type of SBS. As such, an SBS would be permitted to be held in a portfolio margin account if it satisfies this condition, regardless of whether the underlier for the SBS would itself be eligible for portfolio margining.

IV. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days of such date (i) as the Commission may designate if it finds

such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2021-008 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2021-008. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those

that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2021-008 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁶⁸

J. Matthew DeLesDernier
Assistant Secretary

¹⁶⁸ 17 CFR 200.30-3(a)(12).