

SECURITIES AND EXCHANGE COMMISSION

Release No. 34-91477; File No. S7-22-20

Reopening of Comment Period for Order Proposing Conditional Substituted Compliance in Connection with Certain Requirements Applicable to Non-U.S. Security-Based Swap Dealers and Major Security-Based Swap Participants Subject to Regulation in the French Republic

AGENCY: Securities and Exchange Commission.

ACTION: Reopening of comment period.

SUMMARY: The Securities and Exchange Commission (“Commission”) is reopening the comment period for its proposed conditional substituted compliance order, published in the Federal Register on December 29, 2020, in connection with certain requirements applicable to non-U.S. security-based swap dealers and major security-based swap participants subject to regulation in the French Republic (“Proposed Order”). The reopening of the comment period is intended to allow interested persons time to analyze and comment upon potential changes to the Proposed Order and additional questions related to the Proposed Order.

DATES: The comment period is re-opened until [INSERT DATE 25 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission’s Internet comment form (<https://www.sec.gov/rules/submitcomments.htm>);
- Send an email to rule-comments@sec.gov. Please include File Number S7-22-20; or
- Use the Federal Rulemaking portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments:

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

All submissions should refer to File Number S7-22-20. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. We will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/other.shtml>). Typically, comments are also 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 a.m. and 3 p.m. Due to pandemic conditions, however, access to the Commission's public reference room is not permitted at this time. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Carol M. McGee, Assistant Director Office of Derivatives Policy, Division of Trading and Markets, at (202) 551-5870, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Background

The French Autorité des Marchés Financiers ("AMF") and the Autorité de Contrôle Prudentiel et de Résolution ("ACPR"), the French financial authorities, have submitted a "substituted compliance" application requesting that the Commission determine, pursuant to the Securities Exchange Act of 1934 ("Exchange Act") rule 3a71-6, that security-based swap dealers and major security-based swap participants ("SBS Entities") subject to regulation in France

conditionally may satisfy requirements under the Exchange Act by complying with comparable French and European Union (“EU”) requirements.¹ In their application, the AMF and the ACPR (“French Authorities”) sought substituted compliance in connection with certain Exchange Act requirements related to risk control, capital and margin, internal supervision and compliance, counterparty protection, recordkeeping, reporting and notification. The application incorporated comparability analyses regarding applicable French and EU law, as well as information regarding French supervisory and enforcement frameworks.

On December 22, 2020, the Commission published a notice of the French Authorities’ completed application, accompanied by a Proposed Order to conditionally grant substituted compliance in connection with the application.² The Proposed Order incorporated a number of conditions to tailor the scope of substituted compliance consistent with the prerequisite that relevant French and EU requirements produce regulatory outcomes that are comparable to relevant requirements under the Exchange Act.

II. Reopening of Comment Period

As a result of comments received³ and upon further reflection, the Commission is reopening the comment period for the Proposed Order until [*insert date 25 days after publication*

¹ See Letter from Robert Ophèle, Chairman, AMF, and Denis Beau, Chairman, ACPR, to Vanessa Countryman, Secretary, Commission, dated Nov. 6, 2020 (“French Authorities’ Application”). The application is available on the Commission’s website at: <https://www.sec.gov/files/full-french-application.pdf>.

² Exchange Act Release No. 90766 (Dec. 22, 2020), 85 FR 85720 (Dec. 29, 2020) (“French Substituted Compliance Notice and Proposed Order”).

³ See Letter from Kyle Brandon, Managing Director, Head of Derivative Policy, SIFMA (Jan. 25, 2021) (“SIFMA Letter”), letter from Wim Mijs, Chief Executive Officer, European Banking Federation (Jan. 25, 2021) (“EBF Letter”) (generally supporting the SIFMA letter), and Letter from Etienne Barel, Deputy Chief Executive Officer, French Banking Federation (Jan. 25, 2021) (“FBF Letter”). Comments may be found on the Commission’s website at: <https://www.sec.gov/comments/s7-22-20/s72220.htm>.

in the Federal Register]. Commenters may submit, and the Commission will consider, comments on any aspect of the Proposed Order. In addition to the questions raised in the Proposed Order, the Commission specifically seeks comments on the issues below and potential changes to the Proposed Order (defined terms can be found in the Proposed Order). Commenters should also consider the approaches taken in connection with the application and proposed order for substituted compliance for the United Kingdom⁴ when answering these questions.

A. EMIR-related general conditions

Commenters raised concerns regarding the proposed conditions associated with substituted compliance for trade acknowledgement and verification requirements and trading relationship documentation requirements.⁵ They particularly requested that those parts of the final Order not incorporate proposed conditions requiring compliance with certain provisions under MiFID, arguing that those MiFID-related conditions in practice would prevent SBS Entities with branches in other EU countries from relying on substituted compliance for those requirements, and that compliance with proposed EMIR conditions would be sufficient to produce the requisite regulatory outcomes.⁶

⁴ See Notice of Substituted Compliance Application Submitted by the United Kingdom Financial Conduct Authority in Connection with Certain Requirements Applicable to Security-Based Swap Dealers and Major Security-Based Swap Participants Subject to Regulation in the United Kingdom; Proposed Order, Exchange Act Release No. 91476 (Apr. 5, 2021) (“Proposed UK Order”).

⁵ See SIFMA Letter at 3-6, FBF Letter at 2.

⁶ *Id.* Under the proposal, substituted compliance for trade acknowledgment and for trading relationship documentation in part would require that relevant SBS Entities (“Covered Entities” as defined in the proposed Order) comply with certain requirements under MiFID (“Markets in Financial Instruments Directive,” Directive 2014/65/EU) and the French implementation of MiFID, and also comply with certain requirements under EMIR (“European Market Infrastructure Regulation,” Regulation (EU) 648/2012). See paras. (a)(2) and (a)(5) to the proposed Order.

As discussed below, the Commission believes that based on the issues raised by those commenters, it may be appropriate for the portions of the final Order related to trade acknowledgment and verification and to trading relationship documentation not to include the MiFID-related conditions and instead to rely solely on EMIR conditions. Any such heightened reliance on EMIR, however, highlights the need for safeguards to ensure that there will be no opportunity for gaps that may prevent the EMIR provisions in practice from producing regulatory outcomes consistent with those of the Exchange Act rules.

Accordingly, upon further consideration, the Commission believes that it may be useful for the final Order to incorporate two additional general conditions to promote certainty that EMIR will apply and help preclude gaps between the regulatory outcomes associated with Exchange Act requirements and those associated with the relevant EMIR provisions.⁷

Potential counterparty-related EMIR condition. First, it may be useful for the final Order to incorporate a new general condition to address the fact that the “financial counterparty” and “non-financial counterparty” definitions that trigger the application of the relevant EMIR provisions in part are predicated on the Covered Entity and its counterparty being either subject to certain authorizations consistent with its activities or a legal entity established in the EU.⁸ To help ensure that the relevant EMIR requirements would produce the requisite regulatory outcomes

⁷ Addition of two new EMIR-related general conditions potentially would necessitate renumbering of certain of the extant proposed general conditions, and the addition of technical clarifying language to the captions for certain of the other proposed general conditions (e.g., recaptioning proposed general conditions (a)(1) through (a)(3) to the Proposed Order so they specifically refer to MiFID, and recaptioning of proposed general condition (a)(4) so it specifically refers to CRD/CRR).

⁸ See EMIR art. 2(8) (defining “financial counterparty” by reference to certain investment firms, insurers and other types of institutions authorized pursuant to various EU directives), 2(9) (defining “non-financial counterparty” as an “undertaking” established in the EU that is not a financial counterparty).

regardless of a counterparty's status under those definitions, the Commission is considering adding a general condition to provide that, for each part of the final Order that requires compliance with EMIR-related requirements, if the Covered Entity's relevant security-based swap counterparty does not fall within the relevant "financial counterparty" or "non-financial counterparty" definitions, the Covered Entity must comply with the applicable condition as if the counterparty were a "financial counterparty" or "non-financial counterparty" consistent with the counterparty's business.⁹

Potential product-related conditions. It may also be useful for the final Order to account for the facts that the relevant trade acknowledgement and verification and trading relationship documentation rules under the Exchange Act do not apply to security-based swaps cleared by a clearing agency registered with the Commission (or exempt from registration), while the analogous EMIR provisions exclude instruments that are cleared by a central counterparty that has been authorized or recognized to clear derivatives contracts in the EU. As a result,

⁹ In other words, the Covered Entity would be subject to the relevant requirements under EMIR even if the counterparty is not authorized pursuant to EU law as anticipated by the EMIR art. 2(8) "financial counterparty" definition, or if the counterparty is not an "undertaking" (such as by virtue of being a natural person), or is not established in the EU (by virtue of being a U.S. person or otherwise being established in some non-EU jurisdiction), as anticipated by the EMIR art. 2(9) "non-financial counterparty" definition. This approach appears to be consistent with European guidance. See European Securities and Markets Authority, "Questions and Answers: Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)" (https://www.esma.europa.eu/sites/default/files/library/esma70-1861941480-52_qa_on_emir_implementation.pdf) answer 5(a) (stating that compliance with the EMIR confirmation requirement necessitates that the counterparties must reach a legally binding agreement to all terms of the OTC derivative contract, and that the EMIR RTS "implies" that both parties must comply and agree in advance to a specific process to do so); answer 12(b) (stating that where an EU counterparty transacts with a third country entity, the EU counterparty generally must ensure that the EMIR requirements for portfolio reconciliation, dispute resolution, timely confirmation and portfolio compression are met for the relevant portfolio and/or transactions even though the third country entity would not itself be subject to EMIR; this is subject to special processes when the European Commission has declared the third country requirements to be comparable to EU requirements).

instruments that have been cleared at an EU-authorized or EU-recognized central counterparty neither would be excluded from the application of those Exchange Act rules nor would be subject to the EMIR requirements that otherwise would underpin substituted compliance – making direct compliance problematic but compliance with the conditions of a positive substituted compliance order unworkable. To bridge that gap and help ensure that substituted compliance is not precluded in connection with instruments that have been cleared in the EU, the Commission is considering adding a new general condition that, for each part of the final Order that requires compliance with EMIR-related conditions: (i) the relevant security-based swap must either be an “OTC derivative” or “OTC derivative contract” for purposes of EMIR¹⁰ that has not been cleared and otherwise is subject to the provisions of the relevant requirements under EMIR, or (ii) the relevant security-based swap has been cleared by a central counterparty that has been authorized or recognized to clear derivatives contracts in the EU.¹¹

Commenters are invited to address whether additional general conditions of this nature are appropriate to help ensure that EMIR-related conditions to the final Order will apply in an appropriate scope, particularly in connection with trade acknowledgment and verification requirements and trading relationship documentation requirements. Would general conditions of the type discussed above be appropriate to help foreclose substituted compliance when there are

¹⁰ See EMIR art. 2(7) (defining those terms by reference to “a derivative contract the execution of which” does not take place on a regulated market or certain third-party market as defined in the 2004 iteration of MiFID).

¹¹ Prong (i) to this potential new condition would require uncleared instruments to fall within the ambit of the EMIR requirements at issue. The alternative prong (ii) would be satisfied when cleared instruments fall outside the ambit of those EMIR requirements by virtue of being cleared in the EU, akin to the Exchange Act rules’ exclusion for security-based swaps cleared by clearing agencies registered with the Commission.

gaps inconsistent with the comparability of regulatory outcomes? Would different approaches be more effective at achieving that goal? If so, please describe.

B. Risk control requirements

The proposal in part would condition substituted compliance for Exchange Act rule 15Fi-2 trade acknowledgment and verification requirements and rule 15Fi-5 trading relationship documentation requirements on firms complying with certain requirements under MiFID article 25 (including the French implementation of those MiFID requirements) and under EMIR. Commenters expressed the view that the EMIR-based requirements standing alone would be sufficient to produce regulatory outcomes that are comparable to those associated with the Exchange Act rules, and that the conditions should not incorporate references to MiFID provisions.¹²

The commenter concern regarding the application of MiFID arises from application of a proposed cross-border condition providing that if responsibility for ensuring compliance with any provision of MiFID (or EU or French implementing requirement) that is listed as a condition for substituted compliance is allocated to an authority in a member state of the EU in whose territory a Covered Entity provides a service, the AMF or ACPR must be the authority responsible for supervision and enforcement of that provision.¹³ In the commenter's view, this EU cross-border

¹² See SIFMA Letter at 2-6, FBF Letter at 2. Under the Proposed Order, substituted compliance in connection with trade acknowledgment and verification requirements in part would be conditioned on an entity's compliance with EMIR article 11(1)(a) and EMIR RTS article 12, which jointly set forth a bilateral confirmation requirement. Substituted compliance in connection with trading relationship requirements in part would be conditioned on compliance with EMIR Margin RTS article 2, which addresses risk management procedures related to the exchange of collateral, including procedures related to the terms of all necessary agreements to be entered into by counterparties (e.g., payment obligations, netting conditions, events of default, calculation methods, transfers of rights and obligations upon termination, and governing law).

¹³ See paragraph (a)(8) to the proposed Order ("EU cross-border condition"). In practice (pursuant to MiFID article 35), this allocation of oversight applies to requirements pursuant to MiFID article 25

condition means that conditioning substituted compliance on Covered Entities also having to comply with MiFID confirmation and documentation requirements in practice would undermine the availability of substituted compliance for Covered Entities that have branches in EU Member States for which the Commission has not entered into an applicable substituted compliance memorandum of understanding.¹⁴

In light of those commenters' concerns that substituted compliance for trade acknowledgment and verification and for trading relationship documentation as proposed would be curtailed as a result of the interplay between the MiFID provisions and the EU cross-border condition, the Commission is considering whether the EMIR requirements standing alone produce comparable results such that the Commission appropriately may remove those MiFID provisions as prerequisites to substituted compliance in connection with the trade acknowledgment and verification and trading relationship documentation requirements under the Exchange Act.¹⁵

(“assessment of suitability and appropriateness and reporting to clients”) as well as certain other MiFID provisions not relevant here.

¹⁴ See SIFMA Letter at 2-6. In the commenter's view, application of those MiFID article 25 conditions in connection with trade acknowledgment and verification requirements and trading relationship documentation requirements would “in practice lead to an untenable patchwork of substituted compliance.” See SIFMA letter at 3. The commenter further explained that SBS Entities “operating branches throughout the EU” would not be able to avail themselves of substituted compliance in connection with these requirements “unless authorities or regulated SBS Entities in every or nearly every one of the 27 EU Member States submit their own substituted compliance applications covering local branches of SBS Entities, and the Commission reviews and responds to those applications and enters into memoranda of understanding [] in each of these Member States.” The same problem does not arise in connection with requirements under EMIR, which would not allocate oversight of a French entity's compliance to authorities in other EU Member States.

¹⁵ For trade acknowledgment and verification, proposed paragraph (b)(2) in part particularly would require compliance with MiFID article 25(6) (requiring that investment firms provide certain reports to clients), and MiFID Org Reg articles 59-61 (addressing contents of reports with specificity). EMIR article 11(1)(a) and EMIR RTS article 12, in contrast, specify more general conformation requirements applicable to both counterparties to a transaction. For trading relationship documentation requirements, proposed paragraph (b)(5) in part particularly would require compliance with MiFID Org Reg article 25(5) (requiring investment firms to establish a

Under such an approach, substituted compliance in connection with Exchange Act rule 15Fi-2 trade acknowledgment and verification requirements would be conditioned solely on compliance with the confirmation provisions of EMIR article 11(1)(a) and EMIR RTS article 12.

Moreover, under such an approach, substituted compliance in connection with Exchange Act rule 15Fi-5 trading relationship documentation requirements in part would be conditioned on compliance with the collateral-related risk management procedure provisions of EMIR Margin RTS article 2 (as proposed). In addition, to further promote comparability with the rule 15Fi-5(b)(2) provisions requiring that trading relationship documentation incorporate trade acknowledgements and verification, substituted compliance under such an approach also may be conditioned on compliance with the confirmation provisions of EMIR article 11(1)(a) and EMIR RTS article 12.

Commenters are invited to address whether MiFID requirements should be removed from the conditions for substituted compliance in connection with trade acknowledgment and verification requirements and trading relationship documentation requirements. Would the proposed EMIR conditions (and the potential additional EMIR condition related to trading relationship documentation) be sufficient to produce regulatory outcomes that are comparable to those associated with the Exchange Act rules, particularly if the new general conditions addressed in part II.A above also are incorporated as part of the final Order? If so, please explain. If not, please explain.

record regarding the rights and obligations of parties and other terms of service), and MiFID Org Reg articles 24, 58, 73 and applicable parts of Annex I (addressing internal audit, client agreements and recordkeeping). EMIR Margin RTS article 2, in contrast, encompasses collateral-related risk management procedures that in part require counterparties to specify the terms of all necessary agreements to be entered into by counterparties.

C. Capital

The Proposed Order did not contain any proposed conditions for substituted compliance with respect to the capital requirements of Exchange Act section 15F(e) and Exchange Act rule 18a-1 and its appendices (collectively “Exchange Act rule 18a-1”).¹⁶ In the Proposed Order, the Commission, however, requested comment on whether there are any conditions that should be applied to substituted compliance for these capital requirements to promote comparable regulatory outcomes.¹⁷ The Commission also requested comment on whether it should consider conditions related to: (1) maintaining a minimum amount of liquid assets; (2) imposing a specific liquidity requirement; and (3) maintaining minimum equity capital at least equal to the minimum fixed-dollar capital requirements under Exchange Act rule 18a-1.¹⁸ In addition, the Commission requested comment on the types of firms in France that would be relying on substituted compliance for capital, and whether the balance sheets of these entities were primarily composed of liquid or illiquid assets.¹⁹

Commenters supported the proposed approach of making a positive substituted compliance determination with respect to Exchange Act rule 18a-1. Commenters, however, stated that imposing any conditions on applying substituted compliance to Exchange Act rule 18a-1 was neither necessary nor appropriate.²⁰ For example, one commenter expressed concern that requiring a Covered Entity to maintain a minimum amount of liquid assets would impose

¹⁶ See Proposed Order, 85 FR at 85726.

¹⁷ See Proposed Order, 85 FR at 85737.

¹⁸ Id.

¹⁹ Id.

²⁰ See SIFMA Letter at 11; EBF Letter at 4; FBF Letter at 4.

unnecessary burdens.²¹ This commenter believed that imposing additional liquidity conditions would be duplicative of, and (depending on their design) inconsistent with applicable EU and French capital requirements, since these Covered Entities are already subject to the liquidity coverage ratio (“LCR”), the net stable funding ratio (“NSFR”), and an internal liquidity adequacy assessment process (“liquidity assessment process”).²² This commenter also noted that Covered Entities are subject to bank-style resolution regimes, which the commenter believed makes their liquidity risks less significant than other SBS Entities.²³ This commenter also noted that certain Covered Entities will have access to short-term liquidity through relevant EU Member State central banks.²⁴ This commenter also expressed concern, that absent an additional comment period, any definitions contained in a final substituted compliance determination would be adopted without the benefit of public comment.²⁵ Finally, this commenter also stated that imposing a liquidity condition would be similar to the Commission imposing a net liquid assets test on Covered Entities, in contrast to EU policy makers applying a risk-based approach to capital. The commenter believed this would potentially change the ways these entities conduct business in a manner that may be inconsistent with their home country regulation.²⁶

The Commission continues to consider whether it would be appropriate to impose additional conditions with respect to applying substituted compliance to Exchange Act rule 18a-1. In this regard, the Commission is seeking further comment about the concerns raised by the

²¹ See SIFMA Letter at 11.

²² See SIFMA Letter at 12.

²³ See SIFMA Letter at 12.

²⁴ See SIFMA Letter at 12.

²⁵ Id.

²⁶ See SIFMA Letter at 12-13.

commenters and potential capital conditions. The reasons why the Commission continues to consider additional capital conditions are discussed below.

As a commenter noted, the capital standard of Exchange Act rule 18a-1 is the net liquid assets test. This is the same capital standard that applies to broker-dealers under Exchange Act rule 15c3-1. The net liquid assets test is designed to promote liquidity. In particular, Exchange Act rule 18a-1 allows an SBS Entity to engage in activities that are part of conducting a securities business (e.g., taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors).²⁷ For example, Exchange Act rule 18a-1 allows securities positions to count as allowable net capital, subject to standardized or internal model-based haircuts. The rule, however, does not permit most unsecured receivables to count as allowable net capital. This aspect of the rule severely limits the ability of SBS Entities to engage in activities, such as uncollateralized lending, that generate

²⁷ See, e.g., Exchange Act Release No. 8024 (Jan. 18, 1967), 32 FR 856 (Jan. 25, 1967) (“Rule 15c3-1 (17 CFR 240.15c3-1) was adopted to provide safeguards for public investors by setting standards of financial responsibility to be met by brokers and dealers. The basic concept of the rule is liquidity; its object being to require a broker-dealer to have at all times sufficient liquid assets to cover his current indebtedness.”) (footnotes omitted); Exchange Act Release No. 10209 (June 8, 1973), 38 FR 16774 (June 26, 1973) (Commission release of a letter from the Division of Market Regulation) (“The purpose of the net capital rule is to require a broker or dealer to have at all times sufficient liquid assets to cover its current indebtedness. The need for liquidity has long been recognized as vital to the public interest and for the protection of investors and is predicated on the belief that accounts are not opened and maintained with broker-dealers in anticipation of relying upon suit, judgment and execution to collect claims but rather on a reasonable demand one can liquidate his cash or securities positions.”); Exchange Act Release No. 15426 (Dec. 21, 1978), 44 FR 1754 (Jan. 8, 1979) (“The rule requires brokers or dealers to have sufficient cash or liquid assets to protect the cash or securities positions carried in their customers’ accounts. The thrust of the rule is to insure that a broker or dealer has sufficient liquid assets to cover current indebtedness.”); Exchange Act Release No. 26402 (Dec. 28, 1989), 54 FR 315 (Jan. 5, 1989) (“The rule’s design is that broker-dealers maintain liquid assets in sufficient amounts to enable them to satisfy promptly their liabilities. The rule accomplishes this by requiring broker-dealers to maintain liquid assets in excess of their liabilities to protect against potential market and credit risks.”) (footnote omitted).

unsecured receivables. The rule also does not permit fixed assets or other illiquid assets to count as allowable net capital, which creates disincentives for SBS Entities to own real estate and other fixed assets that cannot be readily converted into cash. For these reasons, Exchange Act rule 18a-1 incentivizes SBS Entities to confine their business activities and devote capital to security-based swap activities.

The net liquid assets test is imposed through the mechanics of how an SBS Entity is required to compute net capital pursuant to Exchange Act rule 18a-1. The first step is to compute the SBS Entity's net worth under generally accepted accounting principles. Next, the SBS Entity must make certain adjustments to its net worth to calculate net capital, such as deducting illiquid assets and taking other capital charges and adding qualifying subordinated loans.²⁸ The amount remaining after these deductions is defined as "tentative net capital." Exchange Act rule 18a-1 prescribes a minimum tentative net capital requirement of \$100 million for SBS Entities approved to use models to calculate net capital. The final step in computing net capital is to take prescribed percentage deductions (standardized haircuts) or model-based deductions from the mark-to-market value of the SBS Entity's proprietary positions (e.g., securities, money market instruments, and commodities) that are included in its tentative net capital. The amount remaining is the firm's net capital, which must exceed the greater of \$20 million or a ratio amount. An SBS Entity that is meeting its minimum net capital requirement will be in the position where each dollar of unsubordinated liabilities is matched by more than a dollar of highly liquid assets.

²⁸ See 17 CFR 240.15c3-1(c)(2).

In comparison, Covered Entities in France are subject to capital requirements applicable to prudentially regulated entities based on the international capital standard for banks (the “Basel capital standard”).²⁹ The Basel capital standard counts as capital assets that Exchange Act rule 18a-1 would exclude (e.g., loans and most other types of uncollateralized receivables, furniture and fixtures, real estate). The Basel capital standard accommodates the business of banking: making loans (including extending unsecured credit) and taking deposits. While the Covered Entities that will apply substituted compliance with respect to Exchange Act rule 18a-1 will not be banks, the Basel capital standard allows them to count illiquid assets such as real estate and fixtures as capital. It also allows them to treat unsecured receivables related to activities beyond dealing in security-based swaps as capital notwithstanding the illiquidity of these assets.

Further, one critical example of the difference between the requirements of Exchange Act rule 18a-1 and the Basel capital standard relates to the treatment of initial margin with respect to security-based swaps and swaps. Under French margin requirements, Covered Entities will be required to post initial margin to counterparties unless an exception applies.³⁰ Under Exchange Act rule 18a-1, an SBS Entity cannot count as capital the amount of initial margin posted to a counterparty unless it enters into a special loan agreement with an affiliate.³¹ The special loan agreement requires the affiliate to fund the initial margin amount and the agreement must be structured so that the affiliate – rather than the SBS Entity – bears the risk that the counterparty may default on the obligation to return the initial margin. The reason for this restrictive approach to initial margin posted away is that it “would not be available [to the SBS Entity] for other

²⁹ See BCBS, The Basel Framework, available at: https://www.bis.org/basel_framework/.

³⁰ Exchange Act rule 18a-3 does not require SBS Entities to post initial margin (though it does not prohibit the practice).

³¹ See 84 FR at 43887-88.

purposes, and, therefore, the firm's liquidity would be reduced.”³² Under the Basel capital standard, a Covered Entity can count initial margin posted away as capital without the need to enter into a special loan arrangement with an affiliate. Consequently, because of the ability to include illiquid assets and margin posted away as capital, Covered Entities subject to the Basel capital standard may have less balance sheet liquidity than SBS Entities subject to Exchange Act rule 18a-1.

To address this potential liquidity difference, the Commission is seeking comment on whether substituted compliance with respect to Exchange Act rule 18a-1 should be subject to the conditions that a Covered Entity: (1) maintains an amount of assets that are allowable under Exchange Act rule 18a-1, after applying applicable haircuts under the Basel capital standard, that equals or exceeds the Covered Entity's current liabilities coming due in the next 365 days; (2) makes a quarterly record listing: (a) the assets maintained pursuant to the first condition, their value, and the amount of their applicable haircuts; and (b) the aggregate amount of the liabilities coming due in the next 365 days; (3) maintains at least \$100 million of equity capital composed of highly liquid assets, as defined in the Basel capital standard; and (4) includes its most recent statement of financial condition (*i.e.*, balance sheet) filed with its local supervisor whether audited or unaudited with its written notice to the Commission of its intent to rely on substituted compliance. This potential approach to substituted compliance is illustrated in the Proposed UK Order.³³

The purpose of the potential conditions would be to address the concern that, while the Basel capital standard may contain requirements designed to address liquidity such as the LCR

³² See *id.* at 43887.

³³ See para. (c)(1)(ii) of the Proposed UK Order.

and NSFR, the Basel capital standard does not impose a net liquid assets test that requires a Covered Entity to maintain more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities. The Commission requests comment on how the liquidity provisions in the Basel capital standard (the LCR, NSFR, and liquidity assessment process) impact the liquidity of Covered Entities that would apply substituted compliance with respect to Exchange Act rule 18a-1 (i.e., nonbanks). Do these requirements in practice result in Covered Entities maintaining more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities? If so, explain why. If not, explain why not.

A commenter stated that certain non-bank entities in the European Union have access to short-term liquidity through relevant Central Banks.³⁴ The Commission requests comment on whether Covered Entities that are not banks have access to short-term liquidity through Central Bank facilities in France or Europe that are available to banks. Please identify and describe each facility that is available to nonbank Covered Entities, including any limitations on their ability to access the facility.

The Commission also requests comment on how the potential additional capital conditions compare to any existing capital requirements under the Basel capital standards. For example, are there differences in the frequency or nature of calculations under the Basel capital standards?

The Commission continues to request comment on and seek information about the assets, liabilities, and capital of the Covered Entities that would apply substituted compliance with respect to Exchange Act rule 18a-1. What are the primary business lines engaged in by these entities and what types of assets and liabilities do they typically carry on their balance sheets? Are the balance sheets of these entities primarily composed of liquid or illiquid assets? The

³⁴ See SIFMA Letter at 12.

Commission would use this information to analyze the liquidity of these entities in the context of considering the potential additional capital conditions. For example, do the Covered Entities that would apply substituted compliance with respect to Exchange rule 18a-1 engage primarily in a securities business? If so, are their balance sheets similar to those of U.S. broker-dealers that deal in securities in terms of holding highly liquid assets? If their balance sheets are similar to U.S. broker-dealers, are the additional capital conditions discussed above necessary? Alternatively, would the additional capital conditions serve to ensure that these firms do not engage in non-securities business activities that could impair their liquidity? Should the Commission consider the relevance of a Covered Entity's business model in determining whether to impose any potential capital conditions? For example, should the Commission take into account the fact that a Covered Entity does not engage in unsecured lending and other activities more typical of banks?

The first potential additional capital condition would require a Covered Entity to maintain an amount of assets that are allowable under Exchange Act rule 18a-1, after applying applicable haircuts under the Basel capital standard³⁵ that equals or exceeds the Covered Entity's current liabilities coming due in the next 365 days. The objective of this condition is to require a Covered Entity to maintain sufficient liquidity to meet near-term liabilities through a simple computation, as compared to the net capital computation required by Exchange Act rule 18a-1. Generally, current liabilities are understood to mean those liabilities coming due within one year as distinct from long-term liabilities that mature in more than a year. The potential 365-day period is designed to align with that distinction between short-term and long-term liabilities to facilitate compliance with the condition. Because the condition does not address long-term liabilities, it

³⁵ See standard supervisory haircuts under the Basel capital standards. BCBS, The Basel Framework, available at: https://www.bis.org/basel_framework/.

would not necessarily leave the Covered Entity in position where each dollar of unsubordinated liabilities is matched by more than a dollar of highly liquid assets (as is the case with the net liquid assets test of Exchange Act rule 18a-1). However, it would provide a pool of highly liquid assets that can be used by the Covered Entity to avoid a near-term liquidity strain that could imperil its ability to remain a going concern.³⁶ The condition's use of the Basel capital standard haircuts (as opposed to Exchange Act rule 18a-1 haircuts) is designed to tailor the condition to the Basel capital standard consistent with substituted compliance.

The second potential additional capital condition would require that a Covered Entity make a quarterly record listing: (1) the assets maintained pursuant to the first potential additional capital condition, their value, and the amount of their applicable haircuts; and (2) the aggregate amount of the liabilities coming due in the next 365 days. The requirement to create this record would enable the Commission or Commission staff to monitor compliance with the potential condition and facilitate examination of the Covered Entity with regard to substituted compliance. The quarterly interval between making this record (as opposed to a daily, weekly, or monthly interval) is designed to facilitate exams while minimizing the burden of the condition. Should the Commission require a shorter interval such as daily, weekly, or monthly or a longer one such as semi-annually or annually? Please explain.

In considering these two potential conditions, the Commission recognizes that the LCR requires Covered Entities to maintain an amount of high quality liquid assets equal to or greater

³⁶ See Exchange Act Release No. 86175 (Jun. 21, 2019), 84 FR 43872, 43881 (Aug. 22, 2019) (“The Commission believes that the broker-dealer capital standard is the most appropriate alternative for nonbank SBSs, given the nature of their business activities and the Commission’s experience administering the standard with respect to broker-dealers. The objective of the broker-dealer capital standard is to protect customers and counterparties and to mitigate the consequences of a firm’s failure by promoting the ability of these entities to absorb financial shocks and, if necessary, to self-liquidate in an orderly manner.”).

than their projected total net cash outflows over a prospective 30 calendar-day period. As discussed above, the first potential additional condition requires sufficient liquidity to address liabilities coming due over the next 365 days. The longer period in the condition is designed to cover a greater amount of liabilities in order to further enhance the Covered Entity's liquidity to achieve an outcome more in line with the liquidity that results from the net liquid assets test of Exchange Act rule 18a-1. The Commission requests comment on how these conditions would compare to the LCR.

The Commission requests comment and supporting data on the potential first two capital conditions. Is the term "current liabilities" understood by market participants? If not, please explain why and suggest alternative language. Is 365 days an appropriate number of days to use in connection with covering "current liabilities"? If not, please explain why and suggest an alternative number of days. For example, would a period of 60, 90, 120, 150, 180, 210, 240, 270, 300, 330, 420, 510 days or some other period of days be more appropriate in terms of enhancing the liquidity of Covered Entities applying substituted compliance to Exchange Act rule 18a-1? If so, explain why. If the Commission determines to use a number of days that is less than 365, should the Commission use a term other than "current liabilities" such as "short-term liabilities"? If so, explain why. The Commission requests comment on whether the haircuts under the Basel capital standard are the appropriate haircuts to apply under the proposed capital condition. If so, please explain why. Are they comparable to the haircuts under Exchange Act rule 18a-1? Would it impose a significant burden on Covered Entities to apply the haircuts under Exchange Act rule 18a-1 rather than under the Basel capital standard? If so, please explain why. Please identify any regulatory or operational issues in connection with these proposed capital conditions, including with maintaining a quarterly record.

The third potential additional capital condition is that the Covered Entity maintain at least \$100 million of equity capital composed of highly liquid assets as defined in the Basel capital standard. This potential condition is based on the \$100 million tentative net capital requirement of Exchange Act rule 18a-1 for SBS Entities authorized to use models. The condition would be designed to ensure that Covered Entities applying substituted compliance with respect to Exchange Act rule 18a-1 have a minimum level of capital to absorb financial losses. Further, the LCR defines “highly liquid assets” and the use of that definition is designed to tailor the condition to the Basel capital standard consistent with the substituted compliance.

The Commission requests comment and supporting data on the third potential additional capital condition. How would this potential minimum capital amount compare with the amounts of equity capital currently maintained by Covered Entities that would apply substituted compliance to Exchange Act rule 18a-1? Should the condition require a different amount of equity capital? For example, should the amount be \$50, \$75, \$125, or \$150 million or some other amount? If so, explain why. Are the terms “highly liquid assets” and “equity capital” understood by market participants? If not, please explain why and suggest alternative terms.

The fourth potential additional capital condition is that the Covered Entity include its most recently filed statement of financial condition whether audited or unaudited with its initial notice to the Commission of its intent to rely on substituted compliance. This one-time obligation would provide the Commission with information about the assets, liabilities, and capital of Covered Entities applying substituted compliance with respect to Exchange Act rule 18a-1. The Commission would use the statement of financial condition and the periodic audited and unaudited reports Covered Entities will file with the Commission to monitor the appropriateness of the capital condition if it is included in the final Order. The Commission expects that most

Covered Entities will file their initial notice of intent to apply substituted compliance with respect to Exchange Act rule 18a-1 at or around the time they file their registration applications with the Commission. Therefore, receipt of the statement of financial condition at that time would allow the Commission to begin this monitoring process before Covered Entities begin filing audited and unaudited reports with the Commission pursuant to Exchange Act rule 18a-7.

The Commission requests comment on the fourth potential additional capital condition. Are there other means for the Commission to efficiently obtain this information? If so, explain how. Is the information presented in these reports prepared in accordance with the GAAP that the firm uses to prepare publicly available or available to be issued general purpose financial statements in its home jurisdiction?

The Commission requests comment on the potential benefits and costs of the potential capital conditions? Would the conditions promote comparable regulatory outcomes between the capital requirements applied to Covered Entities in France and capital requirements under Exchange Act rule 18a-1? If so, explain why. If not, explain why not. The Commission is mindful that compliance with these capital conditions would require Covered Entities applying substituted compliance to Exchange Act rule 18a-1 to supplement their existing capital calculations and practices, as well as to incur additional time and cost burdens to implement the potential conditions and integrate them into existing business operations.³⁷ The Commission requests comment and supporting data on these potential time and cost burdens, including quantitative information about the amount of the burdens. The Commission also requests

³⁷ Additional time and costs burdens may include employee costs and time to program software and computer systems to add an additional capital calculation into an existing system and firm processes and procedures, as well as ongoing time and expenses to monitor the calculations on an ongoing basis. Further, additional time and expense may be incurred with respect to any additional controls implemented to ensure compliance with the potential additional capital conditions.

comment on any potential operational or regulatory issues or burdens associated with adhering to the potential additional capital conditions.

The Commission requests comment on the potential impacts the capital conditions would have on competition. For example, how would they impact competition between Covered Entities applying substituted compliance with respect to Exchange Act rule 18a-1 and SBS Entities that will comply with Exchange Act rule 18a-1? Would the conditions eliminate or mitigate potential competitive advantages that Covered Entities adhering to the Basel capital standard might have over SBS Entities adhering to the more stringent net liquid assets test standard of Exchange Act rule 18a-1? Alternatively, would the conditions create competitive disadvantages for Covered Entities applying substituted compliance with respect to Exchange Act rule 18a-1 as compared to SBS Entities complying with Exchange Act rule 18a-1? Please describe and explain.

The Commission also requests comment on how the potential additional capital conditions compare to any existing capital requirements under the Basel capital standards (e.g., LCR, NSFR). For example, are there differences in the frequency or nature of calculations under the Basel capital standards?

Please identify and describe any potential impacts on the way Covered Entities currently conduct their business with respect to implementing the potential additional capital conditions.

The Commission further requests comment on whether the Commission should consider other potential conditions with respect to applying substituted compliance to Exchange Act rule 18a-1. Should the Commission consider imposing a potential capital condition that is more consistent with Exchange Act rule 18a-1? Please explain why or why not. Should the Commission consider a capital condition that includes higher requirements for a Covered Entity

that holds a significant amount of illiquid assets? For example, if 20%, 30%, 40%, 50%, or some other percent of the Covered Entity's assets would not be allowable under Exchange Act rule 18a-1, should the firm be required to hold an amount of allowable assets to cover liabilities coming due over a longer period of time than a firm that does not exceed the percent threshold? If so, explain why and identify the appropriate percent threshold. Should the Commission consider including a condition prescribing a percent threshold of non-allowable assets under Exchange Act rule 18a-1 held by the Covered Entity over which substituted compliance with respect to capital would not be permitted? If so, explain why and identify the appropriate percent threshold.

The Commission requests comment on whether the Commission should consider imposing other potential capital conditions (or no conditions) if a Covered Entity's business with U.S. persons falls below a certain notional threshold, such as \$8 billion, \$20 billion, \$50 billion, or some other threshold. Please explain which threshold may be appropriate or suggest an alternative.

D. Recordkeeping, Reporting, Notification, and Securities Count

The Commission received comment asking it to eliminate conditions requiring a Covered Entity to be subject to and comply with EU or French requirements that either do not apply to the Covered Entity on an entity-wide basis or are not supervised by the Covered Entity's home regulator.³⁸ The same commenter suggested as a possible solution that SBS Entities be permitted to elect to comply directly with U.S. law instead of EU or French requirements with respect to distinct requirements of the recordkeeping and reporting rules.

Would it be appropriate to structure the Commission's substituted compliance determinations in the Order with respect to the recordkeeping and reporting rules to provide

³⁸ SIFMA Letter at 2-4.

Covered Entities with greater flexibility to select which distinct requirements within the broader recordkeeping, reporting, notification, and securities count rules for which they want to apply substituted compliance? This approach of making substituted compliance determinations with respect to certain distinct requirements within the recordkeeping and reporting rules is illustrated in the proposed UK Order.³⁹

As applied to Exchange Act rules 18a-5 and 18a-6, this approach of providing greater flexibility would result in substituted compliance determinations with respect to the different categories of records these rules require SBS Entities to make, keep current, and/or preserve. Each requirement with respect to a specific category of records (e.g., paragraph (a)(2) of Exchange Act rule 18a-5 addressing ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts) would be viewed in isolation as a distinct recordkeeping rule. This approach is illustrated in the Proposed UK Order.⁴⁰ Would permitting Covered Entities to take a more granular approach to the requirements within these recordkeeping rules be appropriate for the final French Order? For example, would this approach make it more difficult for the Commission to get a comprehensive understanding of the Covered Entity's security-based swap activities and financial condition? Explain why or why not. Would it be overly complex for the Covered Entity to administer a firm-wide recordkeeping system under this approach? Explain why or why not. Would this approach address commenters' concerns with respect to the proposed French Order? If so, explain why. If not, explain why not.

The EU cross-border condition was intended to address concerns that are relevant not only to certain requirements under MiFID and MAR as noted in the Proposed Order, but also to certain

³⁹ See paras. (f)(1) through (3) of the Proposed UK Order.

⁴⁰ See paras. (f)(1) and (2) of the Proposed UK Order.

requirements under MiFIR (and other EU and French requirements adopted pursuant to MiFIR). Just as is true for certain requirements under MiFID and MAR, EU law allocates the responsibility for supervising and enforcing certain MiFIR requirements to authorities of the Member State where a Covered Entity provides certain services. If the Commission adopts the granular approach to recordkeeping, reporting, notification and securities count requirements suggested above, should it expand the EU cross-border condition described above in Section B to apply to the relevant requirements under MiFIR? Explain why or why not.

Commenters suggested that the Commission distinguish between EU and French laws that are conditions to substituted compliance for non-prudentially regulated SBS Entities versus prudentially regulated SBS Entities.⁴¹ Would this request be addressed if the Commission granted substituted compliance on a more granular level as described above and illustrated in the Proposed UK Order? If so, explain why. If not, explain why not.

Certain of the Commission's recordkeeping, reporting, and notification requirements are fully or partially linked to substantive Exchange Act requirements for which a positive substituted compliance determination is preliminarily not being made under the proposed Order. In these cases, should the Commission not make a positive substituted compliance determination for the fully linked requirement in the recordkeeping or reporting rules or to the portion of the requirement that is linked to substantive Exchange Act requirements? In particular, should the Commission not make a positive substituted compliance determination for recordkeeping, reporting, or notification requirements linked to the following Exchange Act rules for which a positive substituted compliance determination is preliminarily not being made: (1) Exchange Act rule 10b-10; (2) Exchange Act rule 15Fh-4; (3) Exchange Act rule 15Fh-5; (4) Exchange Act rule

⁴¹ See SIFMA Letter at 8; FBF Letter at 2.

15Fh-6; (5) Exchange Act rule 18a-2; (6) Exchange Act rule 18a-4; and (7) Regulation SBSR?

This approach is illustrated in the Proposed UK Order.⁴² Is this approach appropriate for the final French Order? If not, explain why.

Certain of the requirements in the Commission's recordkeeping, reporting, and notification rules are linked to substantive Exchange Act requirements where a positive substituted compliance determination is being made under the proposed Order. In these cases, should a positive substituted compliance determination for the linked requirement in the recordkeeping, reporting, or notification rule be conditioned on the Covered Entity applying substituted compliance to the linked substantive Exchange Act requirement? If not, explain why. Should this be the case regardless of whether the requirement is fully or partially linked to the substantive Exchange Act requirement? If not, explain why. In particular, should substituted compliance for recordkeeping, reporting, and notification requirements linked to the following Exchange Act rules be conditioned on the SBS Entity applying substituted compliance to the linked substantive Exchange Act rule: (1) Exchange Act rule 15Fh-3; (2) Exchange Act rule 15Fi-2; (3) Exchange Act rule 15Fi-3; (4) Exchange Act rule 15Fi-4; (5) Exchange Act rule 15Fi-5; (6) Exchange Act rule 15Fk-1; (7) Exchange Act rule 18a-1; (8) Exchange Act rule 18a-3; (8) Exchange Act rule 18a-5; and (9) Exchange Act rule 18a-7? This approach is illustrated in the Proposed UK Order.⁴³ Is this approach appropriate for the final French Order? If not, explain why.

While certain recordkeeping and reporting requirements are not expressly linked to Exchange Act rule 18a-1, they would be important to the Commission's ability to monitor or

⁴² See paras. (f)(1) through (4) of the Proposed UK Order.

⁴³ See paras. (f)(1) through (4) of the Proposed UK Order.

examine for compliance with the capital requirements under this rule. The records also will assist the firm in monitoring its net capital position and, therefore, in complying with Exchange rule 18a-1 and its appendices. Should a positive substituted compliance determination with respect to these recordkeeping and reporting requirements be subject to the condition that the Covered Entity applies substituted compliance with respect to Exchange Act rule 18a-1 and its appendices? If not, explain why. This approach is illustrated in the Proposed UK Order.⁴⁴ Is this approach appropriate for the final French Order? If not, explain why.

French credit institutions and finance companies are generally required to close their financial year on December 31.⁴⁵ Moreover, the French substituted compliance application does not identify French laws that are comparable to Exchange Act rule 18a-7(i) (notice of change of fiscal year end). Consequently, is there a basis and a need for the Commission to make a positive substituted compliance determination with respect to the requirements in Exchange Act rule 18a-7(i)? If so, explain why? Should the Commission condition a positive substituted compliance determination with respect to Exchange Act rule 18a-7(i) on the Covered Entity simultaneously transmitting to the Commission a copy of any comparable notice required to be sent by applicable French law, and including with the transmission the contact information of an individual who can provide further information about the matter that is the subject of the notice. If so, explain why. If not, explain why not.

E. Covered Entity Definition

As discussed in the Proposed Order, Exchange Act rule 3a71-6 provides that the Commission's assessment of the comparability of the requirements of the foreign financial

⁴⁴ See paras. (f)(1) through (5) of the Proposed UK Order.

⁴⁵ See French Monetary and Financial Code article R. 511-6.

regulatory system must account for the effectiveness of foreign authority's supervisory and enforcement frameworks.⁴⁶ This prerequisite accounts for the understanding that substituted compliance determinations should reflect the reality of the foreign regulatory framework, in that rules that appear high-quality on paper nonetheless should not form the basis for substituted compliance if – in practice – market participants are permitted to fall short of their regulatory obligations.

The French Authorities' Application provided information about the AMF's and ACPR's supervisory framework. With respect to the AMF's supervision, the information related to Tier 1 firms. The Commission is therefore considering revising the definition of Covered Entity to be limited to credit institutions and investment firms that are supervised by the AMF under the Tier 1 framework through the single supervisory mechanism.

Commenters are invited to address whether the change in the definition of Covered Entity is appropriate. Would the change result in the exclusion of any entities likely to register as SBS Entities in France from reliance on the substituted compliance order?

F. Internal Supervision and Compliance

Finally, the Commission is considering revising paragraph (d)(3) to the proposal, which sets forth conditions to substituted compliance in connection with internal supervision and compliance. Under the potential revision, substituted compliance for internal supervision and compliance would encompass two additional sets of prerequisites (in addition to the other provisions identified in proposed paragraph (d)(3)): CRR articles 286-88 and 293, which address counterparty credit risk and risk management generally; and EMIR Margin RTS article 2, which

⁴⁶ See French Substituted Compliance Notice and Proposed Order, 85 FR at 85721 (citing Exchange Act rule 3a71-6(a)(2)(i)).

addresses collateral-related risk management procedures. Those provisions, which also are incorporated within the proposed prerequisites to substituted compliance for internal risk management (proposed paragraph (b)(1)), promote analogous compliance goals as the other requirements identified within proposed paragraph (d)(3).⁴⁷ Commenters are invited to address the appropriateness of this potential revision, particularly with regard to the goal of promoting regulatory outcomes that are comparable to those associated with the internal supervision and compliance requirements under the Exchange Act.

All comments received to date on the Proposed Order will be considered and need not be resubmitted.

By the Commission.

Dated: April 5, 2021

Vanessa A. Countryman,
Secretary.

⁴⁷ The Proposed UK Order similarly encompasses those provisions as part of the proposed prerequisites to substituted compliance for internal supervision and compliance requirements.