

**SIFMA C&L ANNUAL SEMINAR, Orlando, Florida
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**TOPIC: Recent Changes and Developments in Prime Brokerage
and the Servicing of Hedge Fund Clients**

Moderator: Michael Huber, Managing Director & Associate General Counsel
Goldman Sachs & Co.

Panelists:

Steven Lofchie, Partner
Cadwalader, Wickersham & Taft LLP

Michael A. Macchiaroli, Associate Director, Division of Trading and
Markets
U.S. Securities and Exchange Commission

Tamela Merriweather, Senior Vice President and Assistant General
Counsel
Northern Trust

Robert O'Connor, Managing Director
Morgan Stanley

Bill Wollman, Executive Vice President, Member Supervision
FINRA

SIFMA Conference 2020 – Outline

I. Anti-Money Laundering (“AML”) and Clearing/Prime Brokerage Services - Oversight of Hedge Fund Trading Activities

1. Enforcement Actions

- a. **FINRA Enforcement Release - 2016051105201 - BNP Paribas Securities Corp., BNP Paribas Prime Brokerage, Inc. - 10/23/2019**

<https://www.findknowdo.com/us-federal/finra/enforcement-release/finra-enforcement-release-2016051105201-bnp-paribas-securities>

Summary:

From February 2013 to March 2017, BNP Paribas Securities Corp and BNP Paribas Prime Brokerage, Inc.— which provided clearing services for institutional clients, including institutional customers of introducing brokers—accepted the deposit of micro-cap securities and “penny stocks” having a material notional value. BNP also processed related wire transfers for customer accounts associated with such holdings. It also facilitated the removal of restrictive legends from certain of these securities.

FINRA brought an enforcement action alleging that until 2016, BNP’s AML Program did not conduct sufficient surveillance or review targeting transactions in penny stocks or securities trading outside of traditional exchange. Among other issues, FINRA asserted that BNP should have instituted a comprehensive AML program, and that BNP’s AML Program was understaffed and did not include procedures describing how BNP’s supervisors were to transfer information concerning red flags identified in AML surveillance to identify whether customer deposits and resales of securities complied with the registration requirements of Section 5 of the Securities Act of 1933.

- b. **FINRA Enforcement Release - 2015045550801 - Industrial and Commercial Bank of China Financial Services LLC - 05/16/2018**

<https://www.findknowdo.com/us-federal/finra/enforcement-release/finra-enforcement-release-2015045550801-industrial-and>

Summary:

FINRA alleges that from January 2013 through September 2015, Industrial and Commercial Bank of China Financial Services LLC (“ICBCFS”) had an AML program not reasonably designed to detect and cause the reporting of potentially suspicious transactions with respect to its clearance and settlement of equity transactions. According to FINRA, ICBCFS had inadequate surveillance reports designed to monitor potentially suspicious transactions or liquidations of penny stock shares, and it did not have in place AML procedures requiring its employees to document their review of reports. In addition, FINRA alleged that, ICBCFS did not provide sufficient guidance to

its employees on how to monitor its penny stock activity, generate reports, escalate matters of concern to senior management for further review, and document their review of new surveillance reports.

c. **FINRA Enforcement Release - 20120352981-01 - Electronic Transaction Clearing, Inc. - 02/24/2016**

<https://www.findknowdo.com/us-federal/finra/enforcement-release/finra-enforcement-release-20120352981-01-electronic-transaction>

Summary:

Electronic Transaction Clearing, Inc. (“ETC”), a clearing and self-clearing broker-dealer, settled with FINRA in 2016 regarding FINRA finding various trade surveillance and supervision violations. FINRA alleged that from the period December 2009 through June 2013, ETC failed to establish and implement AML policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act. In over 350 situations between May 2010 and September 2011, ETC gave foreign and domestic traders direct market access to securities on U.S. markets through front-end, third-party order management system (“OMS”) service bureaus, and such traders participated in potentially suspicious or manipulative activity. Such trading activity caused ETC to file a number of exception reports to monitor trading activity, and to restrict or prohibit such traders’ trading activity. However, such exception reports were used primarily for trade supervision, not for AML purposes, and ETC did not take any further steps to assess whether a Suspicious Activity Report (“SAR”) needed to be filed. FINRA also alleged that ETC’s monitoring of the account activity was also unreasonable because ETC did not consider the customer account when analyzing potentially suspicious activity, resulting in the accounts monitored by ETC being primarily reviewed at the trader level rather than the customer account level. ETC did not take any action to monitor whether traders entered potentially suspicious or manipulative trades paired with trades entered by other traders in the same professional trading firm’s account. ETC also did not monitor trading activity to detect recurring patterns or types of trading activity by various traders within a customer’s account. While ETC changed its policies in September 2011 regarding review of trading activity, which led to a trader being on a “Disabled/Restricted Trader List” and the filing of SARs, it did not update its written supervisory procedures to reflect its AML policy changes.

d. **FINRA Enforcement Release 20090162347-01 - Legent Clearing LLC (N/K/A COR Clearing LLC) - 12/16/2013**

<https://www.findknowdo.com/us-federal/finra/enforcement-release/finra-enforcement-release-20090162347-01-legent-clearing-llc-%28n>

Summary:

From January 2009 through early 2013, FINRA alleges that Legent Clearing LLC (“Legent”) did not have an AML program that was reasonably designed to monitor for, detect and report suspicious activity, especially in relation to its significant number of accounts conducting activity in microcap securities and third-party wire activity.

Legent relied in part on the introducing firms for surveillance of suspicious activity, even though Legent did not conduct a review of the introducing firms' AML programs. Legent's procedures required the creation and maintenance of a "tagged identifier list"—a list of names, identification numbers and addresses that were affiliated with individuals or entities that maintained high risk accounts at Legent in the past. This list would be checked against information obtained from a "demographic AML" system, consisting of customer identification information gathered by introducing firms and maintained by a third-party vendor. However, not all introducing firms provided customer identification information for Legent's demographic AML system. Customers of the introducing firms that did not populate the demographic AML system, in violation of the requirements of Legent's written procedures, could not be checked for prior Legent accounts with potential suspicious activities. Moreover, Legent did not have adequate parameters to detect suspicious activity (e.g., Legent identified accounts that had a current account value in excess of \$5,000 rather than those involving at least \$5,000, thus failing to identify as suspicious or report, where appropriate, those transactions that involved activity in excess of \$5,000 if the account value was below \$5,000).

Legent also had a SARs Program that facilitated the filing of SARs without initially completing a review to investigate suspicious activity or red flags potentially identified. Furthermore, Legent: (i) had limited staff and resources devoted to AML monitoring; (ii) did not update or review its internal reports that monitored for suspicious activities; (iii) did not report on AML red flags and issues to its AML officer; (iv) did not complete email reviews within its internal email search system as required in its AML program; (v) did not identify correspondent accounts for foreign financial institutions and conduct appropriate due diligence on these accounts; and (vi) did not have an AML officer with appropriate training or knowledge required to function as an AML officer.

II. Trading of Cannabis Stocks – Issues for Broker-Dealers

Generally, financial institutions face difficult, and somewhat unusual, decisions in determining how to provide services to the cannabis industry, including with regard to the application of anti-money laundering programs. While marijuana is legal in many of the states of the United States,¹ and in Canada,² it remains illegal under U.S. federal law.³ The federal government has also previously issued directives regarding the likelihood (or not) of marijuana-related prosecutions and enforcement, creating uncertainty as to what services financial institutions may reasonably provide that touch cannabis, directly, or indirectly or very indirectly.

Thus, questions remain for broker-dealers as to what services they can legally provide for their customers who are engaged in the marijuana industry. Some, but not all, of these questions are relevant to prime brokerage services in particular. Potential money laundering risk also arises where a financial institution receives or transfers funds from a U.S. MRB that it knows are derived from the sale of cannabis. Moreover, there may be risk in providing services to businesses that support U.S. MRBs, such as companies manufacturing fertilizer and packaging materials for MRBs, even though connections between the financial institution and the U.S. MRB are indirect. This is due to the fact that such supporting businesses may engage in transactions with funds that contain proceeds from U.S. marijuana sales, and the receipt or transfer of such funds by a financial institution may expose a financial institution to liability under U.S. anti-money laundering laws.

Questions that remain regarding traditional brokerage and prime brokerage services for customers engaged in the marijuana industry include:

- a. Whether a broker-dealer can actively raise money for a cannabis company;

¹ In the United States, as of February 2019, 46 states have legalized marijuana for medical and/or recreational use in some form. In states allowing for recreational use, a medical reason to grow, distribute, or dispense marijuana is generally not necessary. Additionally, where states have either a medical or an adult-use scheme, there are generally *detailed state regulations*, including licensing requirements, that a business must follow to be compliant with state law.

² Canada's legalization of recreational marijuana sales in 2018 seems to have established the country as a leading financial market for the industry, especially as most cannabis stocks are listed on Canadian exchanges. See Sun, M., *Marijuana Laws Create Compliance Quandry for U.S. Broker-Dealers*, WALL STREET JOURNAL (Nov. 4, 2019).

³ Under the Controlled Substances Act ("CSA"), cannabis remains a Schedule I controlled substance and is considered to have no legitimate medical use. See 21 U.S.C. § 801 *et seq.* The CSA makes the manufacture, distribution, and possession with intent to distribute marijuana a felony. The CSA also criminalizes conspiracy to manufacture, distribute or possess with intent to distribute marijuana.

The legal risks of providing services to marijuana-related businesses ("MRBs") are not limited to potential narcotics laws violations. The U.S. anti-money laundering laws make it a crime to conduct a financial transaction with the proceeds of "specified unlawful activity," provided that a defendant has the requisite knowledge and/or intent. See 18 U.S.C. §§ 1956 and 1957. It is also a crime to transport, transmit, or transfer funds internationally for the purpose of promoting a "specified unlawful activity" even if the funds are derived from a legitimate source. See 18 U.S.C. § 1956(a)(2). Federal, state, and foreign narcotics laws offenses constitute specified unlawful activity.

- b.** Whether a broker-dealer can transfer money to a cannabis company for an investor who wants to buy stock in that company;
- c.** Whether a broker-dealer can make a market in cannabis stocks;
- d.** Whether a broker-dealer can act as agent in executing a trade in cannabis stocks;
- e.** Whether a broker-dealer can clear trades in cannabis stocks when the trade is executed away;
- f.** Whether a broker-dealer can custody cannabis stocks; and
- g.** Whether a broker-dealer can pass on dividends and other financial distributions from cannabis stocks to an investor.

Additional regulatory questions regarding broker-dealers and prime brokerage services offered to customers engaged in the marijuana industry include:

- a.** Whether the location of the issuer matters (*e.g.*, a Canadian issuer);
- b.** Whether the location of the investor in the cannabis stocks matters (*e.g.*, an investor in Colorado);
- c.** Whether it matters in a trade if the broker-dealer is acting as principal, as agent, or only settling the trade;
- d.** Whether it matters if the trade was solicited;
- e.** Whether it matters if a derivatives trade involving cannabis stocks is physically-settled or cash-settled;
- f.** Whether a broker-dealer may engage in traditional margin lending and hedging involving cannabis stocks;
- g.** Whether a broker-dealer can act as custodian without concern if the cannabis company does not pay dividends and the broker-dealer is not involved in handling any of the cannabis company's funds; and
- h.** Under what circumstances does a broker-dealer need to file SARs pursuant to the BSA.

III. Regulation SHO – No-Action Relief Discussions

The Securities Industry and Financial Markets Association (“SIFMA”) has been in discussion with the staff of the Division of Trading and Markets (the “Staff”) of the Securities and Exchange Commission (“SEC”) regarding the possible issuance of no-action relief vis-à-vis the close-out requirements of Rule 204 of Regulation SHO under the Securities Exchange Act of 1934. SIFMA is discussing a request regarding whether the Staff would agree not to recommend to the Commission enforcement action under Rule 204 of Regulation SHO for subsequent trading activity on the applicable close-out date, if broker-dealers that are participants of a registered clearing agency (“Participants”) and broker-dealers that are allocated fail to deliver (“FTD”) positions under Rule 204(d) instead establish written policies and procedures that are reasonably designed to require the Participant or allocated broker-dealer, as applicable, to identify, conduct further inquiry, and take appropriate action with respect to any accounts that demonstrate a pattern of re-establishing FTDs for the purpose of evading Rule 204.

Rule 204(a) of Regulation SHO generally requires Participants to close out a FTD position at a registered clearing agency “by no later than the beginning of regular trading on the settlement day following the settlement date” (for long sales and bona-fide market making sales) (collectively referred to as the “Applicable Close-Out Date”).¹ Under Rule 204(d) of Regulation SHO, a Participant that has a close-out obligation may reasonably allocate its FTD position to a broker-dealer(s) for which it clears trades or from which it receives trades for settlement, based on such broker-dealer’s short position.² By allocating its FTD positions, the responsibilities of such allocating Participant under Rules 204(a) and (b) of Regulation SHO apply to the broker-dealer being allocated such FTD positions, and not to the allocating Participant.

Additionally, the SEC’s adopting release regarding Rule 204 established a “net flat or net long” (“NFNL”) requirement in which “a participant also must be able to demonstrate on its books and records that on the [Applicable Close-Out Date], it purchased or borrowed shares in the full quantity of its FTD positions and, therefore, that the participant has a net flat or net long position on its books and records on the [Applicable Close-Out Date].”³ SIFMA is discussing expressing the view that the NFNL requirement was established to prevent transactions on the Applicable Close-Out Date that are intended to offset the close-out purchase in order to re-establish or otherwise extend the FTD position and, thus, evade the requirements of Rule 204.

¹ 17 C.F.R. § 242.204(a).

² 17 C.F.R. § 242.204(d).

³ Securities Exchange Act Release No. 60388, 74 Fed. Reg. 38266, 38272 (July 31, 2009).

IV. Broker-Dealers and Custody

1. SEC and FINRA Joint Statement on Financial Intermediation and Custody of Digital Asset Securities

On July 8, 2019, the staffs of the SEC Division of Trading and Markets (the “Division”) and FINRA released a joint statement on financial intermediation and custody of digital asset securities.¹ The joint statement was released in response to inquiries by market participants concerning the application of federal securities laws and the FINRA rules to the custody of digital asset securities, especially in regard to issues such as the importance of: (i) the Customer Protection Rule (Securities Exchange Act Rule 15c3-3), (ii) noncustodial broker-dealer models for digital asset securities, and (iii) other broker-dealer considerations applicable to digital asset securities.

a. The Customer Protection Rule

The joint statement emphasizes that entities seeking to participate in the marketplace for digital asset securities must comply with the relevant securities laws. For entities that buy, sell, or transact otherwise in digital asset securities for customers as agent or principal, compliance with the securities laws may include registration with the SEC as a broker-dealer and membership in and compliance with the FINRA rules. These requirements include that a broker-dealer that is registered, or required to register, must hold or custody the securities in a good “control location.”

The joint statement noted that various unregistered entities that intend to engage in broker-dealer activities involving digital asset securities, and specifically custody of digital asset securities, are currently seeking to register with the SEC and have submitted New Membership Applications to FINRA. Moreover, a number of current broker-dealers are seeking to expand the scope of their business practices to include digital asset securities services and activities. However, the joint statement emphasized that the regulators continue to have concerns regarding broker-dealers’ custody of digital asset securities and the requirements of the Customer Protection Rule. Specifically, such issues involve: (i) the lack of insurance coverage for certain types of digital asset securities under the Securities Investor Protection Act (“SIPA”); (ii) transfer of clients’ digital asset securities to an “unknown or unintended address without meaningful recourse” to correct such errors; and (iii) the possibilities for cybertheft and fraud involving digital asset securities, including the loss of “private keys” that are required to transfer digital asset securities and evidence custody of a digital asset.²

SIPA concerns over digital asset securities, in particular, are notable due to the fact that SIPA protections apply to a “security” as defined in SIPA and cash deposited with the broker-dealer for the purpose of purchasing securities, but do not apply to other types of assets, including assets that are considered a “securities” for the purposes of the Securities Act of 1933, but that are not

¹ Division of Trading and Markets, U.S. Securities and Exchange Commission & Office of General Counsel, Financial Industry Regulatory Authority, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, <https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities> (July 8, 2019).

² *Id.*

considered “securities” under SIPA. The joint statement expresses the concern that digital asset securities that do not meet the more narrow definition of “security” under SIPA would likely not receive SIPA protection and that the holders of those digital asset securities would have only unsecured general creditor claims against a broker-dealer’s estate in the event of the failure of a carrying broker-dealer.

Additionally, issues with custody of digital asset securities arise involving the fact that a broker-dealer (or its third-party custodian) maintains the private key may not be sufficient evidence by itself that the broker-dealer has exclusive control of the digital asset security, as required by the Customer Protection Rule. The joint statement acknowledges that these issues may cause securities customers to suffer losses with corresponding liabilities for the broker-dealer and possibly its creditors. The joint statement acknowledged that the staffs of the Division and FINRA have received inquiries from broker-dealers proposing to utilize an issuer or transfer agent as the “control location” for the purposes of the possession or control requirements under the Customer Protection Rule. In these situations, the issuer or a transfer agent maintains a traditional single master security holder list regarding uncertificated securities, but also publishes the ownership record through the use of distributed ledger technology. However, the distributed ledger would not be the authoritative record of share ownership. The joint statement stated that “to the extent a broker-dealer contemplates an arrangement of this type, the Division [of Trading and Markets] will consider whether the issuer or the transfer agent can be considered a satisfactory control location pursuant to an application under paragraph (c)(7) of Rule 15c3-3.”³

b. Noncustodial Broker-Dealer Models for Digital Asset Securities

The joint statement offered some new guidance on noncustodial business models for digital asset securities, which generally do not raise the same degree of concern. The joint statement outlined a number of examples of the noncustodial business activities that have been described to the staffs including: (i) broker-dealers sending trade-matching details to the buyer and issuer of a digital asset security, and the issuer settling the transaction bilaterally between the buyer and issuer; (ii) broker-dealers facilitating “over-the-counter” secondary market trades in digital asset securities without assuming custody of or exercising control over the digital asset securities; and (iii) broker-dealers introducing buyers to sellers of digital asset securities through a trading platform that facilitates and settles the trade bilaterally between the buyer and seller.

c. Other Considerations for Broker-Dealer Custody of Digital Asset Securities

The staffs of the Division and of FINRA also emphasized in the joint statement various other broker-dealer financial responsibility rules, as well as broker-dealer recordkeeping and reporting rules. Additionally, the joint statement noted that custody of digital asset securities implicates a broker-dealer’s obligations to make and keep current a securities record reflecting each security carried by the broker-dealer for its customers and document any differences between the count of customer securities in the broker-dealer’s possession or control and the result of the count with the broker-dealer’s existing books and records. The joint statement observed that distributed ledger

³ *Id.*

technology may make it challenging to keep accurate books and records of digital assets, creating challenges for broker-dealers' independent auditors.

2. SEC No-Action Relief Regarding Concentrated Debits

The Staff of the SEC issued, on January 8, 2020, significant guidance through a “no-action” letter in response to a request letter sent by the Securities Industry and Financial Markets Association (“SIFMA”) regarding “concentrated debits” under SEA Rule 15c3-3, Exhibit A, Note E(5).⁴ The no-action relief is industry guidance applying to all carrying firms, or U.S. prime brokers, and is effective immediately.

Rule 15c3-3 promulgated under Section 15(c) of the Securities Exchange Act of 1934 (the “SEA”) requires that broker-dealers acting as carrying firms, such as U.S. prime brokers, must safeguard their customers' securities and funds or cash held by such firms on behalf of, or for the account of, their customers.⁵ The SEA's “customer reserve formula” established by SEA Rule 15c3-3, Exhibit A, requires U.S. prime brokers and other carrying firms to conduct periodic computations (daily, weekly or monthly, depending on the firm) of “credits” (e.g., balances subject to immediate cash payment upon customer demand) and “debits” (e.g., margin financing and indebtedness loaned to the brokerage customer with regard to the purchase of long securities positions by such customer).⁶ The customer protection rule also restricts broker-dealers to using only credit balances in the customer reserve formula calculation in Exhibit A in order to finance debit balances. Alternatively, broker-dealers may be required to deposit net credit balances into a special reserve account of the carrying broker for the customer. Thus, a prime broker or other carrying firm has the ability to utilize a customer's free credit balances to fund the customer's debits, items 1 and 10 in the customer reserve formula, respectively.

Note E(5) of SEA Rule 15c3-3, adopted in October 1985,⁷ limits the amount of debit balance that a broker-dealer can recognize in item 10 of the customer reserve formula with regard to a variety of account types. Such account types include: (i) a single customer's account other than an omnibus account, (ii) accounts under “common control,” (iii) guaranteed accounts, and (iv) other “related accounts.”⁸ The chief purpose of Note E(5) is to protect customers' “free credit balances,” or cash balances available for immediate withdrawal upon demand by the customer, against fraudulent

⁴ No-Action Letter, Division of Trading and Markets, Securities and Exchange Commission, *Treatment of Certain Investment Companies and Investment Funds under Note E(5) to Rule 15c3-3a* (Jan. 8, 2020), <https://www.sec.gov/divisions/marketreg/mr-noaction/2020/sifma-010820-15c3.pdf>.

⁵ SEA Rule 15c3-3.

⁶ For context, generally, brokerage customers that maintain margin accounts at a U.S. prime broker, or other carrying firm, are subject to established margin limits under Regulation T of the Board of Governors of the Federal Reserve and FINRA Rule 4210. Separate limitations on the maximum amount of the customer's margin indebtedness are applicable to a customer with large margin indebtedness or loans from the customer's carrying firm.

⁷ Securities Exchange Act Release No. 34-22499 (October 3, 1985).

⁸ The customer reserve formula in SEA 15c3-3, Appendix A, also applies to proprietary accounts of U.S. broker-dealers and foreign broker-dealers, as well as foreign banks acting as broker-dealers (otherwise known as “PAB” accounts).

debits and credit risk related to margin debits of large customers. Thus, Note E(5) requires that a broker-dealer reduce debit balances in margin accounts other than omnibus accounts by the amount by which any single customer's debit balance exceeds 25% (to the extent that such amount is greater than \$50,000) of the broker-dealer's tentative net capital. Note E(5) further requires that related accounts—*e.g.*, accounts under common control—be deemed to be a single customer's account for the purposes of Note E(5).

The request letter to the SEC expressed the view that the SEC did not contemplate a particular investment fund structure when it adopted Note E(5) in 1985: a fund structure where different investment funds, public or private, with different beneficial ownership, have in common a manager or have affiliated managers under common control. As such, it is not clear when item 10 debit balances should be aggregated for the purposes of Note E(5) regarding investment funds that have in common a manager or have affiliated managers under common control. In the absence of the no-action letter's relief, U.S. prime brokers and other carrying firms may have chosen to aggregate item 10 debit balances of investment funds that have in common a manager or have affiliated managers under common control, resulting in the debit balance ceiling imposed by Note E(5) being applied to the "concentrated debits" of a single investment fund family or "concentrated" investment fund customer. By applying Note E(5) to such "concentrated debits," carrying firms and U.S. prime brokers may be limiting the amount of margin financing such broker-dealers would extend to any one of the funds of such "concentrated" investment fund customers separately from loan limits under applicable margin regulations.

To clarify the scope of the application of Note E(5), SIFMA's request letter asked that in regard to the meaning of "common control" under Note E(5) the SEC exclude publicly-offered registered investment companies ("RICs") under the U.S. Investment Company Act of 1940 (the "1940 Act") whose shares/interests issued are registered under the U.S. Securities Act of 1933, even if such RICs have the same investment manager or have affiliated managers. The request letter also asked that the SEC exclude from the "common control" analysis under Note E(5) of SEA Rule 15c3-3: (i) certain private investment funds, *i.e.*, hedge funds not registered under the 1940 Act due to the 1940 Act's Section 3(c)(1) and Section 3(c)(7) exclusions from the definition of "investment company" ("Private Investment Fund"); and (ii) certain privately-offered RICs with shares/interests that are not registered under the U.S. Securities Act of 1933 ("Privately-offered RIC").

The SEC no-action letter provided clarity on the issue of the application of Note E(5) stating that it will not recommend enforcement action to the SEC if a broker-dealer, for the purposes of the Note E(5) requirements, does not treat the account(s) of publicly-offered RICs as being under common control with the account(s) of one or more investment companies or investment funds notwithstanding the fact that the entities share a common investment manager or have affiliated investment managers. Furthermore, the no-action letter indicates that the SEC Staff will not recommend enforcement action to the SEC if a broker-dealer, regarding Note E(5), does not treat the account(s) of a Private Investment Fund or a Privately-offered RIC as being under common control with the account(s) of one or more investment companies or investment funds notwithstanding that the entities share a common investment manager or have affiliated investment managers if any of the following conditions is met:

- a. The aggregate amount of debit balances in the account(s) of the Private Investment Fund or Privately-offered RIC does not exceed a “de minimis” balance (set at 2.5% of the broker-dealer’s tentative net capital); or
- b. The Private Investment Fund or Privately-offered RIC is not “narrowly held”⁹; or
- c. If narrowly held, the Private Investment Fund or Privately-offered RIC does not have ownership in common¹⁰ with any other Private Investment Fund or Privately-offered RIC that shares a common investment manager or has affiliated investment managers.¹¹

⁹ For the purposes of the SEC’s no-action letter, a Private Investment Fund or a Privately-offered RIC will not be deemed to be “narrowly held” if the broker-dealer has determined within the last 12 months that the fund or company has at least ten investors and no single investor has more than a 10% ownership interest in the Private Investment Fund or the Privately-offered RIC.

¹⁰ For purposes of the SEC’s no-action letter, ownership in common will be deemed to occur whenever a Private Investment Fund or Private Investment Company shares at least one investor in common with another Private Investment Fund or Private Investment Company.

¹¹ The SEC’s no-action position addresses only the question of “common control,” and does not address other types of “related accounts,” such as accounts subject to “cross guarantees,” as those terms are used in Note E(5) to item 10. Moreover, the no-action position does not address the circumstance in which a single account, even an account of a publicly-offered RIC or of a Private Investment Fund or Privately-offered RIC that is not narrowly held, exceeds the tentative net capital limit described in Note E(5) to item 10. In that circumstance, Note E(5) to item 10 requires the broker-dealer to reduce the debit balance in the single margin account by the amount by which it exceeds 25% of the broker-dealer’s tentative net capital.

V. Margin

1. Derivatives Margin – SEC Margin Rules

a. Margin Requirements for Nonbank Security Based Swap Dealers

i. **General Requirements**

On June 21, 2019, the SEC adopted margin requirements for security-based swaps (“SBS”) entered into by security-based swap dealers. These rules will become relevant once entities are required to register as security-based swap dealers (“SBSDs”).¹

A. **Daily Calculation and Transfers.**

SEA Rule 18a-3 will require those firms that are not subject to the capital and margin rules of the prudential regulators (“Nonbank SBSDs”) to calculate with respect to each account of a counterparty as of the close of business each day: (1) the amount of current exposure in the account (*i.e.*, variation margin or “VM”) and (2) the initial margin (“IM”) amount for the account. VM will be calculated by marking the position to market. IM will be calculated by applying standardized haircuts or a margin model. In limited circumstances where there is extreme volatility or a firm is holding concentrated positions, the SBSD will also be required to calculate intra-day margin requirements.

A Nonbank SBSD will be required to post VM to its counterparties, although it remains the case that it will not be required to post IM. Posting and collection is generally required to be done on a T+1 basis, with a limited exception for when a counterparty is in a far-off time zone (discussed further below). SBSDs are permitted to apply a \$500,000 minimum transfer amount to any transfer requirement. An SBSD is also permitted to apply a \$50 million group-to-group threshold for IM requirements, with an SBSD only required to collect two months after a counterparty’s IM requirement first exceeds the threshold.

B. **Model Approval and Oversight.**

A Nonbank SBSD may apply to the SEC for authorization to use a model (including an industry standard model) to calculate IM and it is to be expected that most SBSDs will seek model approval, as without the use of models, the business is not likely sustainable. The models are subject to quantitative and qualitative requirements and the firms’ use of, and governance over, the models is subject to ongoing oversight. The general requirements of the models are substantially similar to those under the margin rules adopted by the Prudential Regulators (the “PR Margin Rules”),² including a 99% confidence interval over a 10-day period.

Broker-dealer SBSDs must use the standardized haircuts for determining margin on SBS referencing equity securities and indexes. This requirement is designed to maintain parity with the

¹ Securities Exchange Act Release No. 34-86175, 84 Fed. Reg. 43872 (June 21, 2019).

² See generally *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74840 (Nov. 30, 2015).

margin rules for cash market equity positions (*e.g.*, exchange-traded equity securities and listed options). Broker-dealer SBSBs can use a margin model for other types of SBS (*e.g.*, CDS). Nonbank SBSBs may use a model to calculate IM for all types of SBS; with respect to SBS referencing equity securities or indexes, the model can be used only if the account holds no other type of equity securities.

C. Collateral Requirements.

The SEC rules permit collateral in the form of cash, securities, money market instruments, major foreign currencies, the settlement currency of the SBS or gold, *so long as* such collateral: (i) has a “ready market” and is (ii) “readily transferable.” The rules specifically exclude collateral issued by the SBSB, its counterparty or a “party related to” either such entity. Haircuts on collateral are those specified in the relevant capital rule for the SBSB, *except* that an SBSB can apply the haircuts specified under the CFTC margin requirements so long as the SBSB applies those deductions consistently with respect to a particular counterparty (*i.e.*, the SEC does not want firms “cherry-picking” the lesser haircuts as between the SEC and the CFTC).

D. Counterparty Scope.

The margin collection requirements apply to all counterparties of a broker-dealer or SBSB, except no margin (VM or IM) need be collected from: (i) commercial end users that may rely on an exception from mandatory clearing; and (ii) certain specified supra-national entities. In addition, a number of entities can benefit from an exception from posting IM (though not VM), including: (i) the SBSB's affiliates; (ii) certain sovereigns; and (iii) other financial market intermediaries (including banks, CFTC-registered FCMs, other SEC-registered SBSBs and broker-dealers).

IM collection requirements rules apply broadly to an SBSB's customers otherwise, regardless of the level of transactions that counterparty engages in. However, the SEC permits a \$50 million threshold, on a group-to-group basis. The threshold effectively softens the effect of the SEC policy decision not to apply the “material swaps exposure” trigger for IM requirements used in the PR Margin Rules. The threshold, combined with the fact that SBSBs are not required to collect IM from other financial market intermediaries, means that Nonbank SBSBs could have a very small number of counterparties that actually are subject to IM collection requirements.

E. Risk Management Procedures

An SBSB subject to the SEC rules is required to establish procedures to monitor the risks of SBS accounts. Review is required at “reasonable periodic intervals” and an SBSB must determine whether information and data to apply the procedures are accessible “on a timely basis” and if the systems established are appropriate to analyze risk. The rule specifies 8 particular required elements of the risk management program, including: (i) review of account documentation, (ii) determination of credit limits or limits on credit exposure, (iii) conducting of stress tests, (iv) management and monitoring of credit exposure, and (v) maintaining sufficient account equity to “protect against the largest individual potential future exposure” of an uncleared SBS in the account, as measured by computing the largest maximum possible loss that could result. Among other things, the risk management requirements make clear that, although the IM requirements of

the margin rules will apply to a relatively small subset of counterparties, the SEC expects SBSBs to establish “house” margin requirements that will apply to all counterparties.

ii. Comparison with the PR Margin Rules

The SEC rules are, in many ways, more similar to the PR Margin Rules than one might have expected. The below section highlights the most significant distinctions that remain between the PR Margin Rules and the SEC rules.

- Scope of Customers.
 - Unlike the PR Margin Rules there is no general carve-out in the SEC rules for counterparties that are not “financial end users.” This distinction is most relevant for VM purposes. Very few counterparties will be out of scope for VM requirements.
 - The SEC did adopt an exception for “commercial end users” (as it was required to do under the statute).³ However, this exception requires an entity to satisfy the terms for an exception from mandatory clearing – including that the transaction is for “hedging” purposes and that the entity (generally) is not a “financial entity.” The exception is likely to be of very limited use in the SBS markets, given that the majority of hedging in SBS will be done by financial entities.
 - In addition, the SEC adopted explicit carve-outs from margin requirements for transactions with specified supranational entities (IM *and* VM) and sovereigns (IM only).
- No Third-Party Custodian Requirement. Unlike the PR Margin Rules, the SEC did not impose a requirement that IM be posted to an independent third-party custodian. However, the rules do permit this method and specifically contemplate the situations in which an SBSB: (1) posts collateral to an independent third-party custodian for the benefit of a counterparty (in which case the SBSB is *not* required to take a capital charge, so long as certain conditions are met) or (2) allows a counterparty to post collateral to an independent third-party custodian for the benefit of the SBSB (in which case certain exceptions to the segregation rules may apply, so long as conditions are met).
- No SBSB IM Posting. While VM requirements are two-way, as with the PR Margin Rules, the SEC did not impose a requirement on an SBSB to *post* IM to a customer, although it is not prohibited from doing so. This distinction significantly reduces the cost of SBS transactions for SBSBs subject to the SEC rules rather than the PR Margin Rule.

³ SEA § 15F(e)(4) (as added by Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015).

- No IM Requirements with Other Regulated Intermediaries. The SEC imposes no IM requirement on transactions between an SBSB and any of (i) SBSBs, (ii) swap dealers, (iii) broker-dealers, (iv) FCMs, (v) banks, (vi) foreign banks and (vii) foreign broker-dealers. This exception will significantly reduce the cost of entering into SBS for entities subject to the SEC rules rather than the PR Margin Rules. A question that will come up is how this exception will be handled for relationships between an SEC-regulated SBSB and a derivatives dealer subject to the CFTC or PR Margin Rules (or similar non-U.S. rules). Those rules generally impose IM collection requirements. In certain cases, an SEC-regulated SBSB could be in a situation where the other party requires it to post IM but the SEC-regulated SBSB is not required to collect IM.
- No Inter-Affiliate IM. The SEC imposed no inter-affiliate IM requirements. This is consistent with the CFTC margin requirements for swaps, but differs from the PR Margin Rules.⁴ It is also consistent with a recent push by industry groups for regulators to eliminate inter-affiliate margin posting requirements. This is a fairly significant decision by the SEC, which generally has viewed inter-affiliate transactions as requiring more oversight than independent third-party transactions.
- Transfer Timing. The SEC took a slightly different approach to transfer timing than the PR Margin Rules. Under those rules, transfer is generally required on a T+1 basis, with limited exception provided through the definition of “business day” which recognizes that time zones may make same-day transfer impracticable. The SEC also generally requires T+1 margin transfer, but has an exception if a customer is in another country and more than four time zones away. In that case, margin is required on a T+2 basis.
- Thresholds. The SEC rules permit a \$50 million IM threshold that applies on a group-to-group basis (*i.e.*, all SBSB affiliates and all of the counterparty's affiliates), consistent with the PR Margin Rules. In a wrinkle – and perhaps responding to recent guidance from BCBS-IOSCO and industry requests – the SEC provided a two-month period before IM requirements apply after a counterparty (group) *first* hits the threshold.
- Legacy Transactions. The SEC rules are similar to the PR Margin Rules with respect to SBS entered into before the compliance date for the SEC margin rules. Such transactions are not subject to margin requirements so long as they are in a separate *account* from those SBS subject to the rules. This differs from the “netting set” concept used in the PR Margin Rules, but presumably the SEC intends that it would apply similarly. It does, however, put the control for “legacy” status entirely with the SBSB – “account” is essentially a dealer determination, whereas netting set tends to speak more to how the transactions are documented.

iii. Comparison with Broker-Dealer Margin Rules

⁴ Although prudential regulators have proposed amendments to remove the inter-affiliate IM requirements in their rules. See [84 Fed. Reg. 71833](#) (Dec. 30, 2019).

While the SEC took certain steps to create margin parity between cash-market securities transactions and SBS, it is nonetheless possible, to some extent, for customers to obtain greater leveraged exposure to equity securities via SBS rather than via borrowing on margin. The standardized schedule for SBS IM requirements is substantially similar to the requirements under Regulation T and FINRA Rule 4210. In addition, SBSDs and broker-dealers engaging in non-SBS securities transactions are required to apply those margin requirements rather than models. However, it is almost certainly the case that those firms eligible to use models to calculate margin (alternative net capital Broker-Dealers and non-bank/broker-dealer SBSDs) will determine margin requirements to be less under models than under the standardized schedule. A lower margin requirement would typically apply for an SBS using models financing an equity position via SBS than a broker-dealer financing the same equity position via SBS or a margin loan.

Note, in this regard, that Broker-Dealers applying standardized capital haircuts cannot use models. Also non-bank/broker-dealer SBSDs would not be permitted to make margin loans, as that would generally require broker-dealer registration and is not a permitted activity for an SEC-registered OTC derivatives dealer or “BD Lite.”

b. Cross-Margining

In the [adopting release](#) for the SBS margin requirements, the SEC indicated that permitting portfolio margin with CFTC products would need to be coordinated with the CFTC. The chairman of the SEC and the chairman of the CFTC also issued a [joint statement](#) in June 2019 indicating that they would work together to pursue avenues for portfolio margining of swaps and SBS.

SIFMA has continued to have conversations with SEC and CFTC staff about ways to implement cross-product portfolio margining.

2. FINRA Rule 4210 and Regulation T

a. Covered Agency Transactions

FINRA once again [extended](#) the implementation date of the margin collection requirements associated with the “Covered Agency Transaction” provisions of Rule 4210 that were first adopted in December 2016.⁵

In the extension, FINRA noted that it is “considering, in consultation with industry participants and other regulators, potential amendments to the requirements of [the CAT margin rules].” Under the amendment, the CAT margin requirements will not go into effect until March 25, 2020.

In discussions, FINRA staff members have indicated that FINRA is contemplating, among other things: (i) removing the requirement that broker-dealers collect maintenance (or initial) margin on CATs; and (ii) adopting a (limited) ability for broker-dealers to take capital charges in lieu of collecting margin on CATs.

⁵ See FINRA Regulatory Notice 19-05, *FINRA Extends Effective Date of Margin Requirements for Covered Agency Transactions* (Feb. 12, 2019).

b. **FINRA Enforcement Release 2016049875801 - ABN AMRO Clearing Chicago LLC - 10/03/2019**

<https://www.findknowdo.com/us-federal/finra/enforcement-release/finra-enforcement-release-2016049875801-abn-amro-clearing>

Summary:

FINRA alleged that from April 2007 until July 2015, ABN AMRO Clearing Chicago LLC (“AACC”)—a firm that provides clearing services for institutional customers such as broker-dealers and proprietary trading customers—violated FINRA Rule 4210(g) and 2010 by understating the portfolio margin requirements for 22 accounts at various times over the relevant period. FINRA alleged that AACC incorrectly counted certain “over-the-counter” equity securities as marginable securities when such securities are not margin eligible. As a result, AACC applied a 15 percent margin requirement to equities that were margin ineligible, instead of applying the appropriate 100 percent amount. The margin ineligible securities were traded over-the-counter and not on a domestic exchange, consisting chiefly of American Depositary Receipts on foreign equities. The incorrect treatment and categorization of over-the-counter traded equities was a result of the incorrect definition of “margin eligible securities” used by the firm.

Although AACC corrected the issue, FINRA alleged that the aggregate understatements in the firm’s portfolio margin accounts on the sampled dates ranged from approximately \$1.27 million to more than \$101 million. Notably, these portfolio margin account understatements did not result in either the firm having a net capital deficiency, or having insufficient margin on deposit in the form of securities and other assets in excess of the recalculated requirement.

c. **FINRA Enforcement Release 2014041808101 - Merrill Lynch, Pierce, Fenner & Smith Inc. - 12/19/2017**

<https://www.findknowdo.com/us-federal/finra/enforcement-release/finra-enforcement-release-2014041808101-merrill-lynch-pierce>

Summary:

FINRA alleged that Merrill Lynch, Pierce, Fenner & Smith Inc. (“Merrill”), from at least April 2013 through mid-2015, failed to identify and evaluate, for margin and net capital purposes, certain trades with extended settlement dates (“ES Trades”) across its various product lines and business units. ES Trades have a longer time between trade and settlement than the standard post-trade settlement period applicable (*i.e.*, one to three business days).

d. **FINRA Enforcement Release No. 2013035677101 - KeyBanc Capital Markets Inc. - 08/26/2016**

<https://www.findknowdo.com/us-federal/finra/enforcement-release/finra-enforcement-release-2013035677101-keybanc-capital-markets>

Summary:

KeyBanc Capital Markets Inc. (“KeyBanc”), a broker-dealer engaged in providing corporate and investment banking and capital markets services for institutional customers only, is alleged to have violated FINRA Rule 4210, among other relevant securities laws and regulations. Between October 2011 and March 2012, KeyBanc failed to accurately compute the margin charges applicable to TBA transactions. In addition to applying incorrect haircut deductions in connection with certain underwritings by KeyBanc, as of January 2012 the firm also had no procedures, controls or process to enforce TBA credit limits established by KeyBanc and review breaches or those limits, or to correctly calculate mark-to-market TBA transactions on a gross basis by counterparty for FOCUS reporting purposes. In connection with incorrect margin charges on TBA transactions in violation of FINRA Rule 4210, KeyBanc also did not have a system in place to correctly calculate net capital charges for TBA transactions.

e. **FINRA Enforcement Release No. 2011030759101 - Nomura Securities International, Inc. - 01/26/2015**

<https://www.findknowdo.com/us-federal/finra/enforcement-release/finra-enforcement-release-2011030759101-nomura-securities>

Summary:

FINRA alleged that Nomura Securities International, Inc. failed to either liquidate customer positions or request and receive an extension in at least one instance in which customers purchased securities but did not timely provide the funds to cover the cost of the purchase. Additionally, FINRA alleged that Nomura also failed to establish, maintain, and enforce written supervisory procedures reasonably designed to ensure compliance with the requirements to timely and accurately process credit extension requests pursuant to Regulation T.