



May 3, 2021

Vanessa A. Countryman  
Secretary, Securities and Exchange Commission  
100 F St NE  
Washington, DC 20549-1090

Re: 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 (File No. S7-22-20); 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 (File No. S7-04-21)

Secretary Countryman:

The Americans for Financial Reform Education Fund (AFREF) appreciates the opportunity to comment on the above referenced Orders by the Securities and Exchange Commission (the "SEC" or the "Commission") concerning substituted compliance under the Exchange Act for French and UK based security-based swap dealers and participants ("SBS Entities")

We support the Commission's proposal to require foreign security-based swap dealers and participants ("Covered Entities") to abide by capital and initial margin requirements that reflect Exchange Act rule 18a-1 standards appropriate for broker-dealers, as opposed to Basel capital requirements for banks that permit illiquid assets to count toward capital minimums. We also support the related disclosure requirements for quarterly record keeping and balance sheet disclosures.

The Commission should require that SBS entities who want to operate in the U.S. comply with the Net Liquid Assets test under the Exchange Act Rule 18a-1 rather than the Basel capital standards applicable under UK and EU regulations. Under Rule 18a-1, SBS entities must hold at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities.

The Exchange Act appropriately limits uncollateralized lending, fixed assets, and other illiquid assets such as real estate which have been proven repeatedly to be unreliable forms of capital but are currently counted as such by French and EU regulators.

The recent debacle with family office Archegos- which lost tens of billions of dollars in a matter of days, has vividly demonstrated that the entire initial margin posted by an SBS

entity and even more can very quickly disappear.<sup>1</sup> As the Commission rightly notes, the initial margin that is posted is not available for other purposes and therefore, under the Basel standard, could swiftly result in less balance sheet liquidity than the standards under the Exchange Act's Rule 18a-1.

Real estate is also notoriously illiquid and many funds that focus specifically on the space often suspend redemptions during volatile markets. For example, real estate funds managed by Heitman America Real Estate Trust and ASB Real Estate Investments among many others had to suspend all dividend distributions and redemptions in May 2020.<sup>2</sup>

These instances make it clear that capital rules which treat those illiquid assets as capital cannot be relied upon and therefore should not be permitted under substituted compliance. We support the recommendations that the Commission require an additional minimum amount of capital that qualifies as liquid under Exchange Act Rule 18a-1 in an amount that provide enough capital for the Covered Entity to safely meet its liabilities coming due over the next 365 days, as well as imposing a \$100 million minimum standard for equity capital composed of highly liquid assets.

The Commission is also correct to seek greater disclosures and reporting related to the Covered Entities' other lines of business given the risks present in those other divisions, which the Commission has little ability to assess, and that could suddenly impact its capital position.

In a particularly colorful example, Dallas-based hedge fund Highland Capital Management, which filed for bankruptcy in October 2019, had been accused of using money owed to investors to instead purchase a South American condom manufacturer. The CEO of the hedge fund was also forced to pledge his gun collection to meet margin calls and make delinquent tax payments.<sup>3</sup> Or in the instance of investment bank Jefferies, its parent company Leucadia National had owned alongside it, mining companies, meat processors, and an assortment of real estate.<sup>4</sup>

Finally, we urge that Covered Entities be subject to monthly instead of quarterly reporting of their financial condition. We also caution that such reporting is still subject to gaming, as evidenced by the current process of "window dressing" that goes on around quarter end.

In this dodge, funds are lent out, increasing the overall leverage of the bank's balance sheet; then, right before quarter end, some trades are unwound to give the appearance of lower

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<sup>1</sup> Detrixhe, John. Quartz. How many hedge funds are a margin call away from Archegos-style implosion? Mar 31, 2021. <https://qz.com/1991073/how-many-funds-are-a-margin-call-away-from-failing-like-archegos/>

<sup>2</sup> Peterson, Jon. IPE Real Assets. US open-ended property funds 'gating' distributions and redemptions, say investors. May 19, 2020. <https://realassets.ipe.com/news/us-open-ended-property-funds-gating-distributions-and-redemptions-say-investors/10045717.article>

<sup>3</sup> Korosec, Tom and Porzecanski, Katia. Bloomberg News. Fired Highland Capital Manager Says He Opposed Self-Dealing. Sep 15, 2016. <https://www.bloombergquint.com/onweb/fired-highland-capital-manager-says-he-objected-to-self-dealing>

<sup>4</sup> Reuters. Leucadia to shed most non-financial assets, rename as Jefferies. Apr 9, 2018. <https://www.reuters.com/article/us-leucadia-natl-restructuring/leucadia-to-shed-most-non-financial-assets-rename-as-jefferies-idUSKBN1HG1N3>

leverage on their financial statements.<sup>5</sup> European institutions are already notorious for engaging in this tactic<sup>6</sup>

While European banks are subject to existing liquidity tests such as the Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR), and other internal liquidity adequacy assessments, we urge the Commission to be mindful of the different tactics that Covered Entities could use to window dress in their reporting.

The two Orders also ask 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.” While a de minimis requirement may be appropriate for some very small broker-dealers, we do not believe that the notional thresholds of \$8 billion to \$50 billion cited in the Orders would be appropriate. These levels are much too large. A broker-dealer holding billions or tens of billions of dollars in assets connected to business with U.S. persons should not qualify for a de minimis exemption.

In sum, we urge the Commission to require that foreign Covered Entities wishing to qualify for substituted compliance hold minimum amounts of liquid capital compliant with Exchange Act rule 18a standards, disclose all business lines that could negatively affect their securities businesses, and provide monthly reporting of their balance sheets to regulators. These requirements should apply to all broker dealers of a reasonable size, to include those with billions of dollars of assets.

We appreciate your consideration of this important matter. For further discussion, please contact Andrew Park at [andrew@ourfinancialsecurity.org](mailto:andrew@ourfinancialsecurity.org)

Sincerely,

Americans for Financial Reform Education Fund

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<sup>5</sup> Jacobs, Sam. Business Insider Australia. Global banks may be adopting a ‘window dressing’ technique used by Lehman Brothers before it went bankrupt. Jun 25, 2018. <https://www.businessinsider.com/banks-are-using-a-trick-that-was-popular-before-the-financial-crisis-2018-6>

<sup>6</sup> Smith, Robert Mackenzie. Risk. L’exception francaise: why French banks dominate US repo trading. Sep 1, 2016. <https://www.risk.net/derivatives/2469133/lexception-francaise-why-french-banks-dominate-us-repo-trading>