November 19, 2018

Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

File No. S7-08-12

RE: Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers

To Whom It May Concern,

The Americans for Financial Reform Education Fund ("**AFR**") appreciates the opportunity to comment on the Securities and Exchange Commission's ("**SEC**" or "**Commission**") Request for Additional Comment (the "**2018 Request**") on the Proposed Rule on the Capital, Margin and Segregation Requirements for Security-Based Swap (**"SBS")** Dealers and Capital Requirements for Broker-Dealers (the **"2012 Proposal**").[1]

In 2013 AFR wrote a comment letter on the initial 2012 Proposal.[2] Unfortunately, our criticisms at that time remain relevant to this 2018 Request, and elements of the 2018 Request appear to indicate that the Commission is contemplating further weakening the proposal.

Our original comment criticized the 2012 Proposal as being insufficiently responsive to both the experience of the financial crisis and the efforts of banking regulators to design an improved framework for capital and margin that incorporated lessons from the crisis. In particular, we criticized the Commission's willingness to permit so-called ANC broker-dealers to set their own net capital requirements through internal models based on value-at-risk (VAR) calculations. This decision is reminiscent of the same type of self-regulatory methods, using the same type of models, which failed so spectacularly prior to the 2008 crisis.

Unlike the banking regulators, the 2012 Proposal did not appear to restrict the extent to which broker-dealers could use internal models to reduce their capital requirements by flooring the risk output of internal models at levels set by external models, or by requiring stressed VAR calculations of capital. Since the time of the original 2012 Proposal, international banking regulators have moved further to address the flaws in market risk modeling practices, introducing

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[1] Americans for Financial Reform Educated Fund represents a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://realbankreform.org/about/our-coalition/ .

[2] See AFR Letter on Capital, Margin, and Segregation Requirements for Security Based Swap Dealers and Capital Requirements for Broker-Dealers, February 22, 2013. Available at https://www.sec.gov/comments/s7-08-12/s70812-35.pdf

a new Expected Shortfall methodology to replace VAR and making other changes in internal modeling practices.[3] None of these changes are reflected on or discussed in this 2018 Request.

In light of the various efforts by the Banking Regulators, we urged and continue to urge the Commission to place more limitations the ability of ANC broker-dealers to set crucial capital and risk requirements based solely on their own internal VAR models. The Commission should take additional actions to ensure that loss absorbency at large broker-dealers properly reflects tail risk, by ensuring that model outputs reflect stress scenarios and potential extreme outcomes and by limiting capital reduction available based solely on internal models.

Another post-crisis shift from the banking regulators in response to the failure of regulatory risk models was the imposition of leverage ratio capital requirements that vary with the amount of bank assets but are (for the most part) insensitive to model-based forecasts of risk. Such leverage requirements are one of the most crucial safeguards against future failures of risk modeling.[4] We urge the Commission to adopt such a leverage ratio backstop for broker-dealers as well.

The case for stronger capital regulation of SEC-regulated broker-dealers has only grown greater over the past five years. The divergence between the SEC regulation of non-bank broker-dealers and the regulation of bank broker-dealers is apparently already leading to some migration of risk toward non-bank broker dealers.[5] While risk migration can be appropriate in cases where such migration is toward less systemically risky entities, we are still concerned about the clear possibility of regulatory arbitrage. This is especially true since the difference in regulatory treatment does not appear to be based on any assessment of the systemic risk of different entities but simply on a failure to fully update SEC broker-dealer standards since the crisis. The 2008 crisis certainly gave clear evidence in the case of AIG that a SBS dealer or major SBS participant can create risks to the broader financial system.

Not only does the 2018 Request fail to demonstrate interest in correcting the weaknesses of the original proposal, several questions in the re-opened proposal indicate that the Commission is considering adopting the weakest version of the original proposal in the crucial area of inter-dealer margin. Question 8 of the 2018 Request asks for further comment on whether the Commission should entirely exclude transactions between SBS dealers from initial margin requirements (referenced as "Option A" in the question).

As we stated in our original comment on the 2012 Proposal, we believe that this exclusion could permit a dangerous buildup of un-margined risk in the heart of the financial system, the network of derivatives dealers. The argument cited in the 2018 Request for adopting Option A, namely

[3] Bank of International Settlements, "Standards: Minimum Capital Requirements for Market Risk", January, 2016. Available at https://www.bis.org/bcbs/publ/d352.pdf

[4] For evidence on the significance of the leverage ratio, see the discussion and references in AFR Education Fund, "Letter on Regulatory Capital Rules, Enhanced Supplementary Leverage Ratio Standards", June 25, 2018. Available at http://ourfinancialsecurity.org/wp-content/uploads/2018/06/AFR-Education-Fund-Leverage-Ratio-Comment-Letter.pdf

[5] Allahraka, Menaj, Jill Cetina and Benjamin Munyan, "Do Higher Capital Standards Always Reduce Bank Risk?", Office of Financial Research Working Paper, November 10, 2016. Available at https://www.financialresearch.gov/working-papers/files/OFRwp-2016-11_Higher-Capital-Standards.pdf

that initial margin requirements are pro-cyclical, is deeply flawed. Dealer counterparties would be extremely likely to increase their margin demands in periods of market stress regardless of whether they were required to do so.[6] Exempting dealers from initial margin in normal times would only ensure that margin demands would swing even more sharply as markets came under stress, from a baseline level of no margin at all to whatever margin level dealers felt was necessary to avoid losses. Bank regulators have explicitly required the exchange of margin between bank swap dealers, and the Commission should do so as well.

In addition, Question 9 of the 2018 Request appears to contemplate an expanded permission for the use of portfolio margining and co-mingling of margin for SBS and other swaps, based on the netted risks of the entire portfolio. As pointed out by Commissioner Stein in her statement on the proposal, this would heighten uncertainties concerning the accessibility of margin in bankruptcy, leading to greater risks for counterparties and potentially increased run risk.[7] In addition, portfolio margining only increases the dependence of key risk requirements on calculations based on current market prices and correlations, which may shift rapidly in periods of stress. We urge the Commission to restrict the use of portfolio margining to ensure greater security for market participants.

Other areas of the 2018 Request also call for weakening the 2012 Proposal. For example, the discussion of capital on CFR 53008-53010 suggests that several safeguards on capital for cleared derivatives at SBS dealers be weakened, specifically by eliminating standardized minimum charges for exposure to cleared SBS in cases where the margin collected by a clearing agency is less than certain standardized haircuts or deductions. This removes a regulatory floor on the effective extent to which clearing agencies could reduce margin requirements for cleared swaps. This change is dangerous given that competing clearing agencies may have an incentive to charge lower margin requirements to gain business. However, no reason is given for why the Commission's trust in clearing agencies has increased since 2012, either by describing enhanced Commission oversight of clearing agencies or by giving data that substantiates reliable clearing agency risk management. Absent such information the removal of these protective floors is unjustified.

Thank you for the opportunity to comment on this Proposal. If you have questions, contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely

AFR Education Fund

[6] See discussion in Duffie, Darrell, How Big Banks Fail and What to do About It, Princeton University Press, November 7, 2010.

[7] Stein, Kara, "Statement on Commission Action on Capital, Margin, and Segregation Requirements for Security-Based Swaps", October 11, 2018. https://www.sec.gov/news/public-statement/statement-stein-101118