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Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Via email to rule-comments@sec.gov

Re: File No. SR-FINRA-2021-008 – Proposed Rule Change Relating to Security-Based Swaps

Dear Ms. Countryman:

This letter is being submitted by the Financial Industry Regulatory Authority, Inc. (“FINRA”) in response to comments received by the Securities and Exchange Commission (“SEC” or “Commission”) regarding the above-referenced rule filing. The proposed rule change would amend FINRA Rules 0180, 4120, 4210, 4220, 4240 and 9610 to clarify the application of FINRA rules to security-based swaps (“SBS”) following the SEC’s completion of its rulemaking regarding SBS dealers (“SBSDs”) and major SBS participants (“MSBSPs”) (collectively, “SBS Entities”).

The Commission published the proposed rule change for public comment in the Federal Register on May 12, 2021.¹ The Commission received two comment letters directed to the rule filing.² Both commenters supported most aspects of the Proposal, but requested specific modifications and clarifications as described in further detail below.

¹ See Securities Exchange Act Release No. 91789 (May 7, 2021), 86 FR 26084 (May 12, 2021) (Notice of Filing of File No. SR-FINRA-2021-008) (“Proposal”). Any capitalized terms not otherwise defined herein shall have the meanings assigned to them in the Proposal.

² See Letter from Kyle L. Brandon, Managing Director, Head of Derivatives Policy, Securities Industry and Financial Markets Association, to Vanessa A. Countryman, Secretary, SEC, dated June 2, 2021 (“SIFMA”); and Letter from Matthew R. Cohen, Chief Executive Officer & Richard C. Chase, Chief Compliance Officer, Provable Markets LLC, to Jill M. Peterson, Assistant Secretary, SEC, dated June 7, 2021 (“Provable Markets”).

The following are FINRA's responses to these comments.

Support for the Proposal

SIFMA stated that, overall, it supports many aspects of the Proposal. SIFMA also specifically expressed support for a number of particular aspects of the Proposal, except for the issues discussed in greater detail below. Provable Markets described the Proposal as "rigorous and thoughtful" and expressed its belief that FINRA seeks to be consistent with the objectives of achieving a harmonious regulatory structure providing for consistent, even-handed treatment across regulated entities and that imposes regulatory obligations that are carefully calibrated to address the specific risks that these products and markets pose. Provable Markets further stated that FINRA seeks to craft measures that are consistent with the goals set out in Title VII and seeks to accomplish this while simultaneously taking into consideration the complexities of the SBS market and its many components. As such, Provable Markets stated that it is strongly supportive of the vast majority of the substantive proposals.

General Comments on the Proposal

Provable Markets said that varying regulatory requirements by FINRA, the SEC and the CFTC can benefit from further alignment and continuity where possible, noting that FINRA broker-dealers who engage in SBS activities are the entities primarily affected by the Proposal. Such firms will be relatively smaller participants, in comparison to SBS Entities, and smaller even than FINRA broker-dealers that establish separate affiliates for their SBS activities. As such, Provable Markets supported prior statements by SIFMA that market participants can greatly benefit from standardized rules and/or the ability to "opt-in" to the rules and regulations adopted by the SEC for SBS Entities, noting its belief that such an approach will reduce barriers to entry, provide broader and fairer public access, increase transparency, and improve pricing and liquidity. Provable Markets went on to state that the Proposal could potentially impose costs on FINRA broker-dealers that may have the unintended effect of discouraging, or even preventing, broker-dealers from entering the SBS market, and that the Proposal could also cause investors to forego the use of SBS entirely. In addition, Provable Markets stated that the Proposal may increase costs and barriers solely for new SBS market participants, specifically FINRA broker-dealers, especially as compared to established SBS Entities. Provable Market expressed its belief that recent changes to the CFTC's swap execution facility rules and the forthcoming SEC SBSEF rules will encourage new entrants into the SBS market, and therefore supported a regulatory framework that offers flexibility as well as a level playing field.

Given these concerns, Provable Markets said that FINRA should instead adopt a set of rules that mirror or harmonize SEC (and where applicable, CFTC) rules, rather than adopting a different set of rules that are "similar" or "comparable." Provable Markets noted that such comparable or similar approaches may impose real cost differentials and result in material competitive burdens, and further noted that even comparable or similar

SEC rules for SBS Entities may change in the future. Provable Markets therefore stated that, at a general level, FINRA should give consideration to incorporating by reference into the parallel FINRA rule the applicable SEC rules, and also supported previous comments by SIFMA that FINRA-regulated broker-dealers should be offered the choice to “opt-in” to relevant SEC SBS rules as an alternative to following the provisions of the proposed FINRA rule counterparty.

FINRA shares the view stated by Provable Markets that varying regulatory requirements should be aligned to the extent feasible and appropriate for the type of activity and market participant involved. However, FINRA does not believe that it would be appropriate to incorporate SEC rules by reference or allow members to “opt-in” to SEC rules as an alternative to FINRA rules. SBS are securities, and FINRA’s existing rule framework for securities applies to SBS as it does to any other securities activities of its members. As such, with the exception of the proposed margin requirements under proposed FINRA Rule 4240, where FINRA believes a separate, SBS-specific rule is appropriate to fill a regulatory gap and prevent regulatory arbitrage,³ the Proposal clarifies that SBS are treated as securities under FINRA rules—consistent with Congressional intent under Title VII⁴—and provides certain limited ongoing exceptions in circumstances where FINRA believe such exceptions are appropriate, for the reasons set forth in the Proposal.

Relevant to Provable Markets’ comments, FINRA has identified a limited set of FINRA rules, primarily related to business conduct, where the SEC has put in place similar rules under Title VII applicable to SBS Entities. To avoid unnecessary regulatory duplication, FINRA is therefore proposing to provide limited exceptions from the parallel FINRA rules, but only in circumstances where the SEC’s SBS Entity rules apply to the SBS activity. These limited exceptions do not relieve a member from complying with any other FINRA rules applicable to such SBS activity. FINRA does not believe it would be appropriate to permit members that are not SBS Entities to “opt-in” to the parallel SEC rules, or to incorporate SEC rules by reference for members that are not SBS Entities. FINRA believes that the exceptions in proposed Rules 0180(c) through (g) are appropriate only in the context of registered SBS Entities subject to the SEC’s full regulatory framework applicable to such registrants. FINRA notes that a member engaged in SBS activities below the *de minimis* threshold for SBS registration may elect to register as an SBS,⁵ thereby becoming subject to the SEC’s regulatory framework for SBS Entities and

³ See Proposal, *supra* note 1, at 26097.

⁴ See *id.* at 26086.

⁵ FINRA notes that voluntary registration is permitted under SEC rules. See 17 CFR 240.3a71-2(e) (“Notwithstanding paragraph (a) of this section, a person that chooses to register with the Commission as a security-based swap dealer shall be deemed to be a security-based swap dealer and, therefore, shall be subject to Section 15F of the Act (15 U.S.C. 70o-10) and the rules, regulations and interpretations issues thereunder.”)

able to avail itself of the exceptions for SBS Entities under proposed Rules 0180(c) through (g).

Customer Confirmations

SIFMA noted that the Commission has adopted an exemption from a broker-dealer's requirement to give or send to a customer the disclosures required by Rule 10b-10(a) under the Securities Exchange Act of 1934 ("Exchange Act") at or before completion of the transaction in connection with such broker-dealer or its associated persons arranging, negotiating or executing an SBS transaction on behalf of an affiliated SBSB, provided that the broker-dealer gives or sends the customer written notification containing such disclosures in accordance with the time and form requirements for an SBSB's trade acknowledgment under Exchange Act Rule 15Fi-2(b) and (c) and, as applicable, Exchange Act Rule 10b-10(c).⁶ SIFMA therefore requested clarification that, to the extent a member would be eligible for this exemption but not the proposed FINRA Rule 0180(c) exception from FINRA Rule 2232 (Customer Confirmations)'s customer confirmation requirements, it can satisfy FINRA Rule 2232 by giving or sending a written notification to its customer in accordance with the timing reflected by this exemption.

FINRA Rule 2232(a) requires that a member shall, at or before the completion of any transaction in a security effected for or with an account of a customer, give or send to such customer a confirmation in conformity with the requirements of Exchange Act Rule 10b-10. Since the Commission has provided an exemption permitting a broker-dealer to provide the disclosures required by Exchange Act Rule 10b-10(a) in accordance with the time and form requirements for an SBSB's trade acknowledgment, a member acting in conformity with the requirements of Exchange Act Rule 10b-10, including where the member is acting in accordance with an applicable SEC exemption, would satisfy the requirements of Rule 2232(a) (provided that the member complies with all other provisions of Rule 2232, as applicable).⁷

Customer Account Statements and Information

SIFMA supported the proposed exception under proposed FINRA Rule 0180(f) from FINRA Rules 2231 (Customer Account Statements) and 4512 (Customer Account Information) to the extent a member is acting in its capacity as a registered SBS Entity and a customer's account solely holds SBS and collateral posted as margin in connection with SBS, provided that the member complies with the portfolio reconciliation requirements of

⁶ See Securities Exchange Act Release No. 90308 (November 2, 2020), 85 FR 70667 (November 5, 2020).

⁷ FINRA reminds members that they must be able to demonstrate how they have complied with applicable SEC and FINRA rules, including the member's eligibility for, and compliance with the conditions of, any relevant exemption.

Exchange Act Rule 15Fi-3 with respect to such account and that such portfolio reconciliations include collateral posted as margin in connection with SBS in the account. However, SIFMA requested two clarifications with respect to proposed FINRA Rule 0180(f). First, SIFMA stated that FINRA should clarify that a member may rely on the Rule 0180(f) exception in circumstances where the member's SBS account for the customer also includes non-securities positions, such as swaps. SIFMA noted that this clarification would address situations in which a member portfolio margins its SBS with non-securities positions such as uncleared swaps. Second, SIFMA requested that FINRA clarify that a member may rely on the Rule 0180(f) exception when, in addition to a customer's SBS account, the member carries a non-SBS securities account for the customer and there is no portfolio margining or other commingling between the accounts. FINRA notes that the Commission, jointly with the Commodity Futures Trading Commission, has published a request for comment on the portfolio margining of uncleared swaps and uncleared SBS.⁸ Given that portfolio margining remains pending on the SEC's rulemaking agenda, FINRA believes it would be premature to provide further guidance in this area at this time, but will consider addressing remaining questions through interpretive guidance when appropriate.

Provable Markets said that there is potential for confusion and disparate treatment as it pertains to FINRA Rules 2231 and 4512 relative to Exchange Act Rule 15Fi-3 (the SEC's portfolio reconciliation rule for SBS Entities). While noting that it respects FINRA's goal of attempting to reduce burdens for participants, Provable Markets states that with increased activity, this can be a burden on some SBS entities, while providing relief to others. Provable Markets believes that the differences between the FINRA rules and the SEC's portfolio reconciliation rule are stark and that, as a practical matter, the burden of providing account statements based on a pre-defined methodology does serve an important purpose for risk control. Further, Provable Markets states that the likelihood of an existing SBS Entity that solely holds SBS and related collateral and is an affiliate of larger organizations with sufficient infrastructure to comply with Rule 2232 is high. Therefore, Provable Markets supports eliminating the proposed exception given the presumed relatively low cost for an entity exempt under proposed Rule 0180(f), while adding additional layers of risk management to the market structure.

FINRA notes that the exception in proposed Rule 0180(f) applies only where a member is acting in its capacity as a registered SBS Entity and a customer's account solely holds SBS and collateral posted as margin in connection with SBS, provided that the member complies with the portfolio reconciliation requirements of Exchange Act Rule 15Fi-3 with respect to such account and that such portfolio reconciliations include collateral posted as margin in connection with SBS in the account (subject to the clarifications in response to SIFMA's comments above). While the SEC's portfolio

⁸ See Securities Exchange Act Release No. 90246 (October 22, 2020), 85 FR 70536 (November 5, 2020) (Portfolio Margining of Uncleared Swaps and Non-Cleared Security-Based Swaps; Request for Comment).

reconciliation rule differs in some respects from the customer account statement requirements under FINRA Rule 2231, FINRA continues to believe that they serve similar purposes such that requiring the delivery of customer account statements for SBS-only accounts subject to portfolio reconciliation would be unnecessary duplication. FINRA does not expect this exception to create confusion, as SBS customers of an SBS Entity would expect to engage in portfolio reconciliation for their SBS accounts in accordance with SEC rules, rather than for such SBS to appear on the customer account statement they may receive because the firm is also a FINRA member broker-dealer. Conversely, FINRA believes that a member that is not an SBS Entity and thus not subject to the SEC's portfolio reconciliation requirements—as well as other SEC rules related to risk mitigation, such as portfolio compression and trading relationship documentation—should include any SBS on a customer's account statements, regardless of whether such SBS are in a separate account from other securities, because SBS are securities.

Associated Person Registration and Continuing Education Requirements

SIFMA supported the proposed exception under proposed FINRA Rule 0180(g), which would provide that persons associated with a member whose functions are related solely and exclusively to SBS undertaken in such person's capacity as an associated person of a registered SBS Entity are not required to be registered with FINRA. However, SIFMA requested that FINRA clarify that an associated person relying on this exception may, in addition to his or her SBS activities, also engage in non-securities activities on behalf of the member, such as soliciting or accepting swaps in the capacity as an associated person of a swap dealer. SIFMA accordingly suggested that FINRA Rule 0180(g) should provide that the person's "securities-related functions" must be related solely and exclusively to SBS undertaken in such person's capacity as an associated person of a registered SBS Entity.

A member is responsible for monitoring the activities of each of its associated persons to determine whether such person is required to be registered with FINRA and, if required, to ensure that each associated person is registered in the appropriate category or categories.⁹ The exception in proposed FINRA Rule 0180(g) applies solely to the circumstances set forth in Rule 0180(g), and does not otherwise affect members' responsibilities regarding the registration of their associated persons. Thus a member relying on the proposed exception with respect to one or more of its associated persons would still need to monitor the activities of all of its associated persons, including any associated persons relying on the exception, to determine whether any of the person's

⁹ Specifically, FINRA Rule 1210 (Registration Requirements) states: "Each person engaged in the investment banking or securities business of a member shall be registered with FINRA as a representative or principal in each category of registration appropriate to his or her functions and responsibilities as specified in Rule 1220, unless exempt from registration pursuant to Rule 1230. Such person shall not be qualified to function in any registered capacity other than that for which the person is registered, unless otherwise stated in the rules."

activities require registration under FINRA rules. Accordingly, FINRA does not believe that any change to the text of proposed FINRA Rule 0180(g) is necessary or appropriate.¹⁰

Provable Markets questioned whether there are likely to be many, or perhaps even any persons associated with a FINRA broker-dealer who are likely to trade SBS exclusively without also engaging in transactions in the underlying equity securities. To the extent there are, Provable Markets questioned the appropriateness of excluding such persons from the requirements to be familiar with the regulatory scheme for the underlying securities, noting its belief that the overall requirements for such persons are reasonable and not overly burdensome. Provable Markets further stated it believes that having an understanding of the underlying equity securities and their regulatory framework is important and should be applicable to anyone engaging in SBS activity. Provable Markets noted in particular that such persons could avoid regulations, such as FINRA's suitability rule under FINRA Rule 2111 (Suitability), to which registrants trading other products are generally subject. With respect to Rule 2111 specifically, Provable Markets stated that SBSDs are afforded different treatment under the Proposal, creating another disparity for a non-SBS Entity participating in SBS to manage competing regulations, potentially imposing greater burdens on compliance for both non-registered and "dual-hatted" personnel. Provable Markets noted as an additional example the application of FINRA Rule 4530 (Reporting Requirements), stating that if complaints were made against an SBS-only associated person of a broker-dealer, it would be unclear how the rule would be applied. In summary, Provable Markets supported the registration of any and all persons who are functioning in the SBS market, and stated that "either the same substantive regulations should be adopted for all SBS market participants/or an 'opt-in' option be provided for SBS Entities to allow for harmonization of FINRA, SEC and CFTC related rules for SBS activities to ensure all participants operate under identical standards."

With respect to Provable Markets' comments on the exception from associated person registration under proposed Rule 0180(g), FINRA notes that the exception would apply only in the limited circumstances where an associated person's functions are related solely and exclusively to SBS in such person's capacity as an associated person of a registered SBS Entity. As discussed above in response to SIFMA's comments, a member relying on the proposed exception would need to monitor the activities of all of its associated persons, including any associated persons relying on the exception, to determine whether any of the person's activities require registration under FINRA rules. To the extent that an associated person engages in any other activities that would require registration, such as activities involving securities underlying SBS, the member must ensure that the person is registered in the appropriate category or categories. Further, as

¹⁰ As noted in the Proposal, the exception in proposed FINRA Rule 0180(g) is structured similarly to existing exceptions from registration for persons associated with a member whose functions are related solely and exclusively to certain other product types, as found in FINRA Rule 1230 (Associated Persons Exempt from Registration). See Proposal, *supra* note 1, at 26092 n.57.

noted in the Proposal, FINRA understands that the number of associated persons that would be eligible for the exception is limited. FINRA continues to believe that the proposed exception is appropriate to avoid unnecessary regulatory burdens with respect to such limited set of individuals, given that such individuals would not be engaged in any other activities that would require registration.

FINRA further notes that, under SEC rules, associated persons of SBS Entities, while subject to statutory disqualification prohibitions (and related background check requirements), are not independently subject to registration, licensing or continuing education (“CE”) requirements. FINRA believes that, at the current time,¹¹ there would be limited benefit to requiring FINRA registration for the limited group of individuals that are associated persons of an entity that is dual-registered as a broker-dealer FINRA member and engaged solely in SBS activities.¹² With respect to Provable Markets’ comments on the potential for such persons to avoid regulation, FINRA notes that a person relying on the proposed exception would be excepted from registration, but as an associated person of the member would remain subject to all FINRA rules applicable to associated persons with respect to their SBS activities, unless another specific exception applied. For example, an associated person excepted under proposed Rule 0180(g) would remain subject to suitability obligations under FINRA Rule 2111 when recommending SBS, unless the member satisfied the conditions of the exception in proposed FINRA Rule 0180(d) with respect to such activity. However, in such circumstances, the member and the associated person would be required to comply with the SEC’s parallel suitability and other business conduct obligations. As explained above, FINRA believes these exceptions are appropriate and is not proposing to incorporate SEC rules or permit an “opt-in” to SEC rules more

¹¹ As noted in the Proposal, FINRA will monitor developments with respect to the SBS activities of its members and will continue to consider whether it would be appropriate to tailor the registration and related requirements to SBS. FINRA will consider whether it would be appropriate to rescind the exception under proposed FINRA Rule 0180(g) in such circumstances. See Proposal, supra note 1, at 26092.

¹² For example, as Provable Markets notes, SBS may reference underlying equity securities and an understanding of those markets may therefore be useful. Generally, brokerage or dealing activity with respect to such equity securities must be engaged in through a FINRA member broker-dealer, and an associated person of a FINRA member engaged in such activities must be appropriately registered. By contrast, dealing in SBS referencing those same equity securities does not require dealer registration, and therefore may be engaged in by SBS Entities that may or may not also be registered FINRA members. As noted above, associated persons of SBS Entities are not independently subject to registration requirements. FINRA will monitor developments and continue to consider whether requiring registration for an associated person whose functions are related solely and exclusively to SBS in such person’s capacity as an associated person of a registered SBS Entity would be appropriate.

generally. FINRA also notes that the Proposal would not provide an exception from the application of FINRA Rule 4530 to SBS, and therefore a member and its associated persons would be subject to FINRA Rule 4530 and related guidance with respect to their SBS activities (regardless of whether a particular individual relies on the exception from registration under proposed Rule 0180(g)).

Margin Requirements

SIFMA noted that proposed FINRA Rule 4240 would differ in several material respects from Exchange Act Rule 18a-3.¹³ SIFMA stated that these differences would present material issues for members subject to proposed Rule 4240, especially in connection with certain inter-affiliate SBS designed to promote centralized, group-wide risk management, as well as SBS entered into with unaffiliated financial market intermediaries for hedging purposes. SIFMA provided several examples where SIFMA said the differences between Exchange Act Rule 18a-3 and proposed FINRA Rule 4240 would present material issues, including (1) when a foreign dealer affiliate of a U.S. broker-dealer hedges risks of SBS based on U.S. securities with their foreign customers via offsetting SBS with the U.S. broker-dealer, (2) when a broker-dealer forms an affiliated special purpose vehicle to issue a structured note that references a security, and (3) when a broker-dealer, in order to hedge the risk of its securities inventory, enters into one or more SBS with unaffiliated financial market intermediaries.

SIFMA said that permitting a broker-dealer instead to follow Exchange Act Rule 18a-3 would address these issues. However, SIFMA also stated that it appreciates FINRA's concerns regarding a smaller broker-dealer entering into uncleared SBS with margin requirements that differ from the requirements that would apply under FINRA Rule 4210 (Margin Requirements) to equivalent securities positions. To address this consideration, SIFMA proposed that, in order for a member to apply Exchange Act Rule 18a-3 in lieu of amended Rule 4240, the member must satisfy the higher capital requirements applicable to an SBS in Exchange Act Rule 15c3-1(a)(10) (or the even higher capital requirements applicable to an ANC firm in Exchange Act Rule 15c3-1(a)(7)). SIFMA further proposed that for such a member to use a model to calculate initial margin ("IM") requirements, the model would need to be approved by the SEC for use by an affiliate of the member that is registered as an SBS.

¹³ Specifically, SIFMA said that proposed FINRA Rule 4240 "would (a) not permit a member to use an approved model to calculate IM requirements, (b) require a member to collect IM from affiliates that are not financial market intermediaries or majority owners, (c) not permit a member to apply an IM threshold, (d) not permit a member to apply a minimum transfer amount, and (e) not permit an ANC firm to apply credit risk charges under [Exchange Act] Rule 15c3-1e(c) in lieu of collecting margin except for SBS with a majority owner or an affiliated registered or foreign SBS."

As discussed previously, FINRA acknowledges that proposed FINRA Rule 4240 would differ from Exchange Act Rule 18a-3 in some respects.¹⁴ While such differences may in some cases result in increased costs for members that are not registered SBSDs when entering into SBS with certain counterparties, FINRA continues to believe that the provisions of proposed Rule 4240 as set forth in the Proposal are important to protect the financial condition of its members, given that members subject to the rule would not be subject to the comprehensive regulatory framework applicable to SBSDs. Of course, a member can “opt-in” to Exchange Act Rule 18a-3 by registering as an SBSD. FINRA continues to believe that SBSD registration is an important precondition to margining pursuant to Exchange Act Rule 18a-3 because this registration assures that the entity is fully regulated as an SBSD, including the higher minimum capital requirements applicable to SBSDs. Therefore, FINRA does not believe it would be appropriate to incorporate SEC margin rules by reference or allow members to “opt-in” to the SEC margin rules as an alternative to FINRA rules. For the reasons set forth in the Proposal, FINRA believes the specific requirements of proposed Rule 4240 are appropriately calibrated to provide parity with both FINRA Rule 4210 and Exchange Act Rule 18a-3, where possible, but also to provide greater protection to the financial condition of members not subject to the SEC’s comprehensive requirements for registered SBSDs.

For those same reasons, FINRA declines to adopt a number of specific modifications proposed by SIFMA to align Rule 4240 more closely with Exchange Act Rule 18a-3 in lieu of allowing members to follow Exchange Act Rule 18a-3.¹⁵ SIFMA made a number of similar recommendations in its comments responding to the Concept Proposal.¹⁶ FINRA responded previously to these recommendations, which included several modifications from the margin rule described in the Concept Proposal intended to address SIFMA’s comments and enhance competitive parity, while still providing appropriate protection for the financial condition of non-SBSD members entering into Uncleared SBS.¹⁷ FINRA notes that, as a general matter, proposed Rule 4240 is not intended to level the playing field between SBSDs and non-SBSD members entering into SBS, such as *de minimis* dealers. Rather, the proposed rule is intended to adequately

¹⁴ See Proposal, supra note 1, at 26107.

¹⁵ Specifically, SIFMA proposed that FINRA (1) adopt an IM exception for all majority-owned affiliates; (2) permit an ANC firm to calculate credit risk charges in accordance with Exchange Act Rule 15c3-1e(c) for exposures to all counterparty types; (3) permit use of SEC-approved IM models for non-equity SBS; (4) adopt a \$50 million IM threshold, applicable on a group-wide basis; (5) adopt a \$500,000 minimum transfer amount; (6) align Rule 4240’s collateral haircuts with Exchange Act Rule 18a-3; and (7) extend the deadline for posting or collecting margin for counterparties in distant time zones.

¹⁶ See Proposal, supra note 1, at 26107-09.

¹⁷ See id.

protect members from counterparty credit risk and prevent regulatory arbitrage, in particular by removing incentives for members to restructure as SBS their traditional extensions of credit (e.g., margin lending) subject to FINRA Rule 4210.

With respect to SIFMA's request for FINRA to align Rule 4240's collateral haircuts with Exchange Act Rule 18a-3, FINRA does not believe permitting use of the haircuts applicable to SBS collateral under Exchange Act Rule 18a-3 would be appropriate. As noted above, the proposed rule is not intended to level the playing field between SBSDs and non-SBSD members entering into SBS, such as *de minimis* dealers, but rather to prevent regulatory arbitrage as between members extending credit through SBS and members extending credit through traditional means. With respect to SIFMA's request for FINRA to extend the deadline for posting or collecting margin for counterparties in distant time zones, FINRA notes that Exchange Act Rule 18a-3 requires that a member both take the applicable capital charge and take prompt steps to liquidate positions that do not meet the margin requirements generally within T+1, but extends that deadline to T+2 if the counterparty is located in another country and four time zones away.¹⁸ While proposed FINRA Rule 4240 would similarly require a capital charge if required margin is not collected on T+1, Rule 4240 would not require liquidation of the position until T+3. This timing follows the portfolio margin requirements under FINRA Rule 4210, and FINRA continues to believe it is appropriate to require a capital charge on T+1 because the location of the counterparty does not affect the counterparty credit risk to the member. However, FINRA believes that, generally, additional time should be provided before liquidation is required, and this additional time (T+3) should be sufficient to accommodate counterparties in distant time zones.

Provable Markets raised concerns regarding the disparate treatment for non-bank SBSDs with respect to uncleared SBS. Provable Markets noted that proposed FINRA Rule 4240 and Exchange Act Rule 18a-3 impose different margin and collateral requirements, depending on whether an entity is designated as an SBS or a FINRA broker-dealer. Provable Markets said it is concerned that this difference could hinder the ability of a FINRA broker-dealer to compete with SBSDs or other SBS market participants on a level playing field. In particular, Provable Markets stated that counterparties would potentially choose a higher cost option of facing an SBS rather than a similarly capitalized FINRA broker-dealer in order to avoid the need for the daily collection of IM and variation margin, which could lead to reduced firm participation impacting cost and liquidity overall.

As discussed previously, while proposed FINRA Rule 4240 would diverge from Exchange Act Rule 18a-3 in some respects, FINRA continues to believe that proposed FINRA Rule 4240 strikes the appropriate balance in protecting members from counterparty credit risk and preventing regulatory arbitrage between different methods of extending credit. FINRA does not believe that the potential for increased market liquidity if more

¹⁸ In this context, "T+1" and similar terms refer to the number of business days after the date on which the person was required to compute the margin requirement.

members functioned as *de minimis* dealers justifies replacing the specific margin requirements set forth in proposed Rule 4240. Moreover, as discussed above a member seeking to establish parity with other SBSDs with respect to margin requirements may elect to register as an SBSD and become subject to the SEC's comprehensive SBSD regulatory framework. The intent of proposed Rule 4240 is not to level the playing field between SBSDs and members engaged in *de minimis* SBS dealing, but rather to prevent regulatory arbitrage as between members extending credit through SBS and members extending credit in the traditional fashion.

Provable Markets further sought clarification regarding Non-Basic SBS, and more specifically uncleared total return swap structures. Provable Markets stated that the SBS market is dynamic and that market developments, such as its proposed alternative trading system platform, may make commonplace transactions that today are limited. Provable Markets said that a key blocker to growth of this activity is potential ambiguity around timing and the open-ended nature of the approval process for margin requirements for Non-Basic SBS. Provable Markets stated that SBSDs would be placed at a significant advantage under the proposed framework, and supported a more clearly defined process for non-SBSDs to evaluate new products within existing or potentially expanded lines of business.

Under proposed FINRA Rule 4240(b)(2)(C), a member may apply to FINRA for the approval of an Initial Margin Requirement for a type of SBS other than Basic CDS and Basic SBS. The proposed rule sets forth the requirements for any such application, and provides that no member shall become a party to an SBS other than a Basic CDS or Basic SBS unless FINRA has approved an Initial Margin Requirement for such member's use with respect to that type of SBS. As discussed in the Proposal, FINRA believes that other types of SBS—including credit default swaps (“CDS”) and equity total return swaps with complex features—may not be easily accommodated under the frameworks applicable to Basic CDS and Basic SBS, and that the specific risks of such SBS may not be readily apparent or quantifiable to FINRA without additional information.¹⁹ Further, SBS can be complex financial instruments that pose substantial risks to the financial condition of members, and margin serves as an important means of protecting member firms, and thereby their customers and investors, from such risks. FINRA believes that the application process under proposed FINRA Rule 4240(b)(2)(C) permits appropriate flexibility so that FINRA and its member firms may analyze all relevant risks that may be associated with a new type of SBS product. FINRA also notes that proposed Rule 4240 defers to registered clearing agencies with respect to the margin requirements for Cleared SBS. Therefore, *de minimis* dealers may enter into Cleared SBS without seeking approval under Rule 4240(b)(2)(C); the application process would only be required before entering into new types of Uncleared SBS.

¹⁹ See Proposal, *supra* note 1, at 26100.

Compliance Dates

In the Proposal, FINRA noted its intent to extend the existing exceptions in FINRA Rule 0180, as well as the interim CDS margin program under FINRA Rule 4240, to October 6, 2021, which is the SEC's Registration Compliance Date for SBS Entities.²⁰ Accordingly, FINRA also proposed that the effective date of the Proposal would be October 6, 2021, to align with the Registration Compliance Date.²¹ Per SEC staff guidance, the earliest date by which an SBS Entity will be required to register will be November 1, 2021, approximately three and a half weeks after the Registration Compliance Date.²² As explained in the Proposal, FINRA proposed that the effective date of the Proposal would be October 6, 2021 to align with the implementation of the SEC's Title VII rulemakings and avoid unnecessary confusion.²³ FINRA further noted its understanding that existing, temporary exemptions from some SEC rules expire on the Registration Compliance Date, and as such SBSDs are likely to register on that date to align with the expiration of those exemptions.

SIFMA said that it is the misalignment of the SEC's exemptions, as well as, under the Proposal, existing FINRA Rules 0180 and 4240, with the Registration Compliance Date that is the source of confusion. SIFMA believes that the SEC's exemptions, as well as existing FINRA Rules 0180 and 4240, should instead align with the November 1, 2021 date when SBS Entities are expected to register. SIFMA stated that this misalignment will encourage firms to register early, eliminating the "critical period of time" of three and a half weeks for implementing the SBS D rule set. SIFMA went on to note that this misalignment would have a disproportionate impact on prospective SBS Ds that are broker-dealers, while prospective SBS Ds that are not broker-dealers would not be subject to FINRA rules nor would they be subject to some of the key SEC rules (such as Exchange Act Rule 10b-10) for which these exemptions are scheduled to expire on the Registration Compliance Date. SIFMA therefore requested that FINRA extend the expiration dates of

²⁰ See Proposal, supra note 1, at 26086 n.18.

²¹ See id. at 26103.

²² See id. at 26085 n.10. Specifically, a person must begin counting SBS transactions toward the SBS D *de minimis* threshold on August 6, 2021, and then is not deemed to be an SBS D until two months after the end of the month in which the person crosses the *de minimis* threshold. Therefore, if a person crosses the threshold on August 6, 2021 or later in August 2021, it would be required to register on November 1, 2021. However, October 6, 2021 remains the Registration Compliance Date.

²³ See Proposal, supra note 1, at 26106.

existing FINRA rules 0180 and 4240 until the earlier of (a) the date on which a FINRA member firm registers with the SEC as an SBS Entity or (b) November 1, 2021.²⁴

In addition, SIFMA noted that the SEC provided SBSs with over 18 months to implement Exchange Act Rule 18a-3, stating that the proposed three-month transition period for the new SBS-specific margin requirements under proposed FINRA Rule 4240 will not be sufficient. SIFMA therefore recommended that FINRA extend the compliance date for these new margin requirements by six months, until April 6, 2022. SIFMA also requested that, as a conforming change, FINRA modify the proposed definition of Legacy SBS to mean an uncleared SBS entered into before April 6, 2022.

After consideration of SIFMA's comments, as well as further feedback from member firms, FINRA believes it is appropriate to extend the effective date of the Proposal to provide member firms with sufficient time to prepare for compliance with the new requirements applicable to SBS. Accordingly, as discussed in Partial Amendment No. 1, FINRA is proposing to change the effective date of the Proposal as follows:

- The effective date of the proposed amendments to FINRA Rules 0180 (Application of Rules to Security-Based Swaps), 4120 (Regulatory Notification and Business Curtailment) and 9610 (Procedures for Exemptions – Application) would be changed from October 6, 2021 to February 6, 2022, which is four months after the Registration Compliance Date.
- The effective date of the proposed amendments to FINRA Rules 4210 (Margin Requirements), 4220 (Daily Record of Required Margin) and 4240 (Security-Based Swap Margin Requirements) would be changed from October 6, 2021 to April 6, 2022, which is six months after the Registration Compliance Date. As a conforming change, the proposed definition of Legacy Swap in proposed Rule 4240(d)(12) would also be amended to mean an Uncleared SBS entered into before April 6, 2022.

FINRA notes that existing FINRA Rule 0180, as well as the interim CDS margin program under FINRA Rule 4240, are currently set to expire on September 1, 2021.²⁵ In connection with these changes, and as discussed further in Partial Amendment No. 1, FINRA also intends to extend the expiration dates of (i) existing FINRA Rule 0180 until

²⁴ SIFMA also stated that it is discussing a similar clarification with SEC staff in relation to the expiration of temporary exemptions from certain SEC rules for SBS activities.

²⁵ See Proposal, *supra* note 1, at 26086.

February 6, 2022 and (ii) existing FINRA Rule 4240 until April 6, 2022, so as to align with the amended effective dates of the Proposal.²⁶

FINRA believes that the foregoing responds to the material issues raised by the commenters on the rule filing. If you have any questions, please contact me at (202) 728-8012 or robert.mcnamee@finra.org.

Sincerely,

/s/ Robert McNamee

Robert McNamee
Associate General Counsel
Office of General Counsel

²⁶ FINRA notes that, beginning on the Registration Compliance Date, members may register with the SEC as SBSBs, and thereby become subject to the margin requirements applicable to SBSBs under Exchange Act Rule 18a-3. As discussed in Partial Amendment No. 1, FINRA also intends to add a provision to existing Rule 4240 stating that the requirements of Rule 4240 do not apply to a member that is registered as an SBSB. This provision, along with the rest of existing Rule 4240, would expire on April 6, 2022, the amended effective date of the new SBS-specific margin requirements under amended Rule 4240. FINRA believes this temporary clarification is appropriate to avoid unnecessary regulatory duplication or potential conflict between Exchange Act Rule 18a-3 and the temporary CDS margin program under existing Rule 4240.