

Security-Based Swaps

FINRA Requests Comment on a Concept Proposal Regarding the Application of FINRA Rules to Security-Based Swaps

Comment Period Expires: November 16, 2020

Summary

FINRA requests comment on a concept proposal regarding the application of FINRA rules to security-based swaps (SBS) following the Securities and Exchange Commission's (SEC) completion of its rulemaking regarding SBS dealers and major SBS participants. Current FINRA Rule 0180, which will expire in September 2021, provides a temporary exception from the application of FINRA rules to SBS, with certain limited exceptions. FINRA is considering revising Rule 0180 to replace the general exception from FINRA rules for members engaging in SBS activities with limited, targeted exceptions from certain FINRA rules where FINRA believes application of the rules to SBS activity is infeasible or inappropriate, particularly where members' activities are subject to parallel SEC requirements. FINRA is also considering proposing certain modifications to its financial responsibility and operational rules to conform to the SEC's amended net capital rule and take into account members' SBS activities, as well as a new margin rule specifically applicable to SBS.

Questions regarding this *Notice* should be directed to:

- ▶ Kris Dailey, Vice President, Office of Financial Operational Risk Policy (OFORP), at (646) 315-8434 or kris.dailey@finra.org;
- ▶ David Aman, Senior Advisor, OFORP, at (212) 416-1544 or david.aman@finra.org;
- ▶ Adam Arkel, Associate General Counsel, Office of General Counsel (OGC), at (202) 728-6961 or adam.arkel@finra.org;
- ▶ Robert McNamee, Assistant General Counsel, OGC, at (202) 728-8012 or robert.mcnamee@finra.org; or
- ▶ Dror Kenett, Economist, Office of the Chief Economist, at (202) 728-8208 or dror.kenett@finra.org.

October 15, 2020

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Institutional
- ▶ Legal
- ▶ Margin
- ▶ Operations
- ▶ Risk
- ▶ Senior Management
- ▶ Systems
- ▶ Trading
- ▶ Training

Key Topics

- ▶ Security-Based Swaps

Referenced Rules

- ▶ FINRA Rules 0180, 2010, 2020, 2030, 2090, 2111, 2210, 2231, 2232, 3110, 3120, 3130, 3310, 4110, 4120, 4130, 4240, 4521, 4522, 4523 and 5210
- ▶ FINRA Rule 1000 Series
- ▶ FINRA Rule 4000 Series
- ▶ FINRA Rule 6000 Series
- ▶ FINRA Rule 7000 Series
- ▶ FINRA Rule 11000 Series
- ▶ Exchange Act Rules 3a71-3, 15c3-1, 15Fh-3, 15Fh-5, 15Fh-6, 15Fi-2, 15Fi-3, 17a-13 and 18a-3
- ▶ Exchange Act Sections 3(a)(10), 3(a)(68) and 15C

Action Requested

FINRA encourages all interested parties to comment on this concept proposal. Comments must be received by November 16, 2020.

Comments must be submitted through one of the following methods:

- ▶ Online using FINRA’s comment form for this *Notice*;
- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the concept proposal.

Important Notes: Comments received in response to *Regulatory Notices* will be made available to the public on the FINRA website. In general, comments will be posted as they are received.¹

Before becoming effective, a proposed rule change must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).²

Background and Discussion

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)³ established a new framework for the regulation of SBS.⁴ Among other things, the Dodd-Frank Act granted the SEC regulatory authority over SBS and directed the SEC to establish a process for the registration of SBS dealers and major SBS participants (collectively, SBS Entities). The SEC has set October 6, 2021, as the date by which SBS Entities generally will be required to register with the SEC (Registration Compliance Date).⁵ The SEC has broadly coordinated the compliance dates for many of its SBS rules to align with the Registration Compliance Date, including certain business conduct, capital and margin requirements for SBS Entities.

The Dodd-Frank Act also amended the definition of “security” under the Exchange Act to expressly encompass SBS,⁶ thus treating SBS as securities under the Exchange Act and its underlying rules. This change was effective as of July 16, 2011, the effective date of

Title VII of the Dodd-Frank Act. However, in order to allow sufficient time to consider the potentially complex interpretive issues that may arise by treating SBS as securities for various purposes, the SEC issued a series of temporary exemptive orders beginning in July 2011.⁷ With certain limited exceptions, the SEC's temporary exemptive orders relating to the treatment of SBS as securities have now expired.⁸

The addition of SBS to the definition of "security" had similar implications for FINRA rules. In particular, under the amended definition any FINRA rule that applies to a security, securities business, a transaction involving a security or a securities position applies by its terms to SBS. Therefore, pending the final implementation of the SEC's rules and guidance related to SBS, FINRA adopted Rule 0180 in July 2011.⁹ Rule 0180 is currently set to expire on September 1, 2021, just over a month before the Registration Compliance Date.¹⁰

Rule 0180 broadly excepted SBS activities from most FINRA requirements. Specifically, Rule 0180(a) provides that FINRA rules shall not apply to members' activities and positions with respect to SBS, except for Rule 2010 (Standards of Commercial Honor and Principles of Trade), Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices), Rule 3310 (Anti-Money Laundering Compliance Program) and Rule 4240 (Margin Requirements for Credit Default Swaps).¹¹ Rule 0180(b) provides that certain rules apply to members' activities and positions with respect to SBS only to the extent they would have applied as of July 15, 2011 (*i.e.*, the day before the effective date of Title VII of the Dodd-Frank Act) and Rule 0180(c) provides that certain other rules apply as necessary to effectuate members' compliance with the rules applicable to SBS as noted above.

In light of the expiration of the SEC's temporary exemptive orders, the finalization of the SEC's SBS regulatory framework and the upcoming Registration Compliance Date, FINRA is seeking comment on a concept proposal relating to the application of FINRA rules to SBS when current Rule 0180 expires.¹²

Extension of Expiration Date

Rule 0180 was intended to provide temporary, targeted relief in order to help avoid undue market disruptions that could result from the change to the definition of "security" under the Exchange Act. FINRA believes that it would be preferable to align the expiration of Rule 0180 with the compliance date for the SEC's SBS rules. Therefore, FINRA expects to extend the expiration date of current Rule 0180 from September 1, 2021, until the Registration Compliance Date on October 6, 2021.

General Presumption of Applicability

FINRA is also proposing to amend Rule 0180, and modify its margin, financial responsibility and operational rules as described in further detail below, effective as of the Registration Compliance Date. Under this concept proposal, Rule 0180 would provide that FINRA rules

would generally apply to members' activities and positions with respect to SBS to the extent that a particular rule applies to a member's activities and positions with respect to securities, except as specified in amended Rule 0180 as described below. Thus, the current presumption that FINRA rules do not apply to SBS, with certain exceptions, would be flipped, and the presumption going forward would be that FINRA rules apply to SBS, with certain exceptions. FINRA preliminarily believes this general presumption of applicability is appropriate given Congress's intent to regulate SBS as securities under the Exchange Act and FINRA's regulatory responsibility to oversee the securities activities of its members.¹³

Exceptions From Presumption of Applicability

Under the proposed approach, certain rules could potentially be interpreted as applying to SBS activities by their terms even though they were intended for other types of securities and could create operational difficulties if so applied. For clarity, under the concept proposal the following rules would be specifically excepted from applying to members' activities and positions with respect to SBS:

- ▶ the Rule 6000 Series (Quotation, Order, and Transaction Reporting Facilities);
- ▶ the Rule 7000 Series (Clearing, Transaction and Order Data Requirements, and Facility Charges); and
- ▶ the Rule 11000 Series (Uniform Practice Code).

Exception for SBS Entities and Associated Persons

The SEC has finalized business conduct and related requirements that will apply to SBS Entities beginning on the Registration Compliance Date. Certain of these rules are similar to existing FINRA business conduct rules. In order to avoid unnecessary regulatory duplication, FINRA preliminarily believes it would be appropriate to permit an SBS Entity that is a FINRA member and an associated person of a member who is acting in his or her capacity as an associated person of an SBS Entity to comply with the parallel SEC requirements applicable to the SBS Entity in lieu of the similar FINRA rules. Thus, under the concept proposal FINRA is proposing to except certain of these FINRA rules from applying to members' activities and positions with respect to SBS, but only to the extent that the associated person of the member involved in the SBS activity is acting in his or her capacity as an associated person of an SBS Entity. This exception would apply both where the member itself is registered as an SBS Entity and where the associated person of the member is "dual-hatted" as an associated person of an affiliated SBS Entity.

This exception would not apply where the associated person involved in the SBS activity is not acting in his or her capacity as an associated person of an SBS Entity. The exception would therefore not apply to SBS activity engaged in by a member that is not a registered SBS Entity because it is operating below the applicable SBS Entity registration thresholds, nor to a member engaged in other types of SBS activity, including brokerage activity.¹⁴

The chart below lists the FINRA business conduct rules that FINRA is proposing to except as described above, together with the parallel SEC SBS requirements:

FINRA Rule	SEC Rule
Rule 2030 (Engaging in Distribution and Solicitation Activities with Government Entities)	Exchange Act Rule 15Fh-6
Rule 2090 (Know Your Customer)	Exchange Act Rules 15Fh-3(a) and (e)
Rule 2111 (Suitability)	Exchange Act Rules 15Fh-3(f) and 15Fh-5
Rule 2232 (Customer Confirmations)	Exchange Act Rule 15Fi-2
Rule 3110 (Supervision), Rule 3120 (Supervisory Control System) and Rule 3130 (Annual Certification of Compliance and Supervisory Processes)	Exchange Act Rule 15Fh-3(h)

FINRA believes that its Communications with the Public rule, Rule 2210, warrants special consideration under the concept proposal. FINRA believes that the content standards in Rule 2210(d) are appropriate to apply to members' SBS activities, but that associated persons of SBS Entities should be excepted from these content standards and instead comply with Exchange Act Rules 15Fh-3(b), (c), (d) and (g), as described above. However, the remainder of Rule 2210 would be unnecessary and operationally difficult to apply to SBS, and FINRA is therefore proposing to except from the remainder of Rule 2210's requirements all members' activities and positions with respect to SBS.¹⁵

Financial Responsibility and Operational Requirements

In June 2019, the SEC adopted final capital, margin and segregation requirements for SBS Entities, along with amendments to the capital and segregation requirements for broker-dealers, with a compliance date aligned with the Registration Compliance Date.¹⁶ In doing so, the SEC amended the net capital rule for broker-dealers, Exchange Act Rule 15c3-1, in two key respects:

- ▶ First, the SEC adopted new minimum net capital requirements for broker-dealers that are also registered as SBS dealers, but that do not operate pursuant to the alternative net capital (ANC) requirements of the rule. These entities will need to comply with a new minimum dollar net capital requirement and a new component for determining their minimum capital requirement that is based on a percentage of initial margin computed for SBS (in addition to other minimum requirements applicable to the

broker-dealer). These changes do not apply to broker-dealers that operate pursuant to the ANC requirements of the rule (ANC Firms). These new minimum net capital requirements also will not impact non-ANC Firms that are not also registered SBS dealers, regardless of whether such firms engage in SBS activities below the SBS dealer registration threshold.

- ▶ Second, the SEC changed the minimum net capital requirements for ANC Firms, regardless of whether they transact in SBS.¹⁷ For these broker-dealers, the SEC increased the minimum dollar net capital requirement and added a new component for determining their minimum capital requirement that is based on a percentage of initial margin computed for SBS (in addition to other minimum requirements applicable to the broker-dealer), added a minimum tentative net capital requirement and amended the early warning notification requirement for tentative net capital.

FINRA's Regulatory Notification and Business Curtailment rule, Rule 4120, is based on the minimum capital requirements of each member. It allows FINRA to restrict a member's business if its capital falls below certain thresholds described in the rule. Under the concept proposal, FINRA is proposing to amend Rule 4120 to conform the rule to the increased minimum capital requirements for SBS dealers and ANC Firms described above.¹⁸ Since the SEC chose not to apply increased minimum requirements to non-ANC Firms that engage in SBS activities without registration as an SBS dealer, FINRA believes that it is not necessary at this time to impose additional minimum requirements for those members. However, FINRA notes that, as a general matter, Rule 4120 would apply to all entities that engage in SBS transactions (and any related transactions) because net capital is a holistic calculation based on a firm's liquid net worth, which includes all of a firm's activities.

In addition to conforming Rule 4120 to the SEC's amended net capital rule, FINRA notes that "tiering" was built into some of its rules in the Rule 4000 Series (Financial and Operational Rules) so that firms that introduce their customer accounts and do not have exposure to the settlement system are provided relief from the higher standards required of firms that carry or clear transactions and accounts (Carrying Firms). For example, Rule 4110 gives FINRA the authority to prescribe greater net capital and net worth requirements for Carrying Firms. SBS are complex transactions that will require detailed recordkeeping, margining, legal agreements, collateral management, reconciliation and risk management. Therefore, under the concept proposal, FINRA is proposing to treat firms that enter into SBS on a principal basis the same as Carrying Firms for purposes of rules in the Rule 4000 Series where tiering has been employed (to the extent such firms are not already Carrying Firms).

For reference, below is a list of rules in the Rule 4000 Series where tiering has been employed for Carrying Firms, and where FINRA is therefore proposing to treat firms that enter into SBS similarly:

FINRA Rule	Description of the Tier for Carrying Firms
4110 (Capital Compliance)	Requirement to keep greater net capital, seek permission for withdrawals and seek approval for add-backs to net capital.
4120 (Regulatory Notification and Business Curtailment)	Restrictions on expanding, or requirements to reduce business, if sufficient capital levels are not maintained.
4521 (Notifications, Questionnaires and Reports)	Allows FINRA to collect additional data and requires reporting of a drop in Tentative Net Capital.
4522 (Periodic Security Counts, Verification and Comparison)	Requires more frequent counts than would be required under Exchange Act Rule 17a-13.
4523 (Assignment of Responsibility for General Ledger Accounts And Identification of Suspense Accounts)	Requires a record of primary and supervisory named individuals over general ledger bookkeeping accounts.

Other than these adjustments to conform to amended capital requirements or to address rule tiering, FINRA is not proposing any other changes to the Rule 4000 Series, except for the Rule 4200 Series (Margin) as described below. The Rule 4000 Series would otherwise apply to members' SBS activity under the general presumption of applicability described above.

Margin Requirements

FINRA believes margin is an important means of protecting member firms against counterparty credit risk, and having uniform minimum margin requirements for members is an important way to create a level playing field for its members. FINRA cannot simply defer to the SEC's SBS margin rule (Exchange Act Rule 18a-3) because that rule applies only to members registered as SBS Entities. FINRA also cannot simply remove the exception from Rule 4210 (Margin Requirements) currently provided by Rule 0180 because it is unclear how Rule 4210 would apply to SBS and some types of SBS (*e.g.*, credit default swaps or CDS¹⁹) are not easily accommodated by Rule 4210. To eliminate this unclarity, protect members against counterparty credit risk, maintain the level playing field and prevent regulatory arbitrage, FINRA under the concept proposal is proposing to except SBS from Rule 4210 and adopt a new margin rule specifically applicable to SBS. The new SBS margin rule would have the following characteristics:

- ▶ The new margin rule would not apply to:
 - ▶ any member registered as an SBS dealer (which would be subject to SEC margin requirements under Exchange Act Rule 18a-3); or
 - ▶ any SBS in a portfolio margin account if that SBS is of a type whose risk is appropriately addressed by an approved theoretical pricing model (*e.g.*, TIMS) and covered by portfolio risk management procedures filed by the member with FINRA.
- ▶ The new margin rule would defer to registered clearing agencies to set the margin requirements for cleared SBS and require members to maintain the margin required by the clearing agency through which the SBS is cleared.
- ▶ The new margin rule generally would require members, on a daily basis, to collect from, or deliver to, each counterparty margin (variation margin) equal to any current exposure on uncleared SBS with such counterparty.
- ▶ The new margin rule would generally require members, on a daily basis, to compute an initial margin amount on uncleared "plain vanilla" SBS with each counterparty as follows:
 - ▶ for any uncleared "Basic CDS,"²⁰ initial margin would be computed based on the term and spread of the CDS, using the chart and offsets set out in Exchange Act Rule 15c3-1(c)(2)(vi)(P);²¹ and
 - ▶ for any uncleared SBS (other than a CDS) that is the economic equivalent of a margin account containing a portfolio of long or short positions in securities or options (a Basic SBS), initial margin would be computed by applying Rule 4210 to that equivalent margin account.²² Initial margin could be computed on a combination of multiple uncleared Basic SBS, or on a combination of uncleared Basic SBS and securities or options positions held together with the uncleared Basic SBS if the firm has an enforceable netting or collateral agreement with a counterparty covering those Basic SBS and securities or options positions.

- ▶ The new margin rule would require any member that intends to engage in a type of uncleared SBS other than Basic CDS or Basic SBS to obtain prior approval from FINRA of an appropriate initial margin requirement for that type of uncleared SBS. After approving a firm's initial margin requirement for a particular type of SBS, FINRA may publish a *Regulatory Notice*, or similar communication, approving the general use of that initial margin requirement for that type of SBS.
- ▶ The new margin rule generally would require members to obtain variation margin and the computed initial margin amount from each counterparty as promptly as possible and no later than the close of business on the business day after the day on which a deficiency occurs, unless FINRA has specifically granted the member additional time, except that:
 - ▶ members would not be required by the new margin rule to collect variation margin or initial margin from registered clearing agencies;
 - ▶ members would be permitted to take capital charges in lieu of collecting variation margin or initial margin from certain multilateral organizations;²³ and
 - ▶ members would be permitted to take capital charges in lieu of collecting initial margin (but not variation margin) from sovereign entities²⁴ and financial market intermediaries.²⁵
- ▶ The new margin rule would permit only cash and marginable securities to be deposited as margin for uncleared SBS. Any securities deposited as margin for uncleared SBS would themselves be margined in accordance with Rule 4210.
- ▶ The new margin rule would require members engaged in SBS to have comprehensive written credit risk management procedures appropriate for the business and include guidelines for those procedures.²⁶

Economic Impact Assessment

FINRA has analyzed the potential costs and benefits of the concept proposal, and the different parties that are expected to be affected. FINRA believes that member firms that register as SBS Entities, member firms seeking to broker SBS transactions, member firms engaging in SBS activities under the *de minimis* threshold for registration and member firms engaging in SBS activities in other capacities, as well as their customers, would be affected by the concept proposal.²⁷ The proposed rules are expected to reduce regulatory arbitrage and establish a regulatory framework for FINRA member firms that wish to engage in SBS activities that will maintain investor protections.

Economic Baseline

The concept proposal should be evaluated against a baseline where the SEC's new rules for SBS activities are in effect and current Rule 0180 has expired, along with the current margin and financial responsibility and operational rules that are relevant, as discussed above.

Under this baseline, all member firms contemplating offering SBS services to clients would be subject to FINRA's applicable rules around business conduct, financial responsibility and operational requirements, and margin.

As discussed above, some of these rules may be duplicative of SEC rules scheduled to be in effect, may impose unnecessary material obligations given the member firms' activities in the space, could result in operational difficulties or be insufficient to provide appropriate risk controls. Under this scenario, some member firms may choose not to provide SBS services, which may result in decrease of choice and increased costs to customers.

Anticipated Benefits

FINRA believes that the concept proposal would benefit member firms by ultimately reducing regulatory uncertainty, unnecessary regulatory duplication and the potential for arbitrage with the SEC's regulatory framework for SBS Entities. Furthermore, FINRA believes that the concept proposal would alleviate some of the potential competitive disadvantages for FINRA member firms that wish to engage in SBS activities or become SBS Entities.

A primary benefit of the approach presented above is that it permits firms to rely on relevant SEC rules governing general business conduct. In so doing, the concept proposal ensures there would be no unintended differences between the member firms' obligations under SEC and FINRA rules, and would impose no additional direct or indirect costs to firms that are SBS Entities engaging in SBS activities.

Firms would be expected to be able to use their existing governance and compliance systems and procedures, including in situations where member firms will have dual-hatted personnel or have an affiliate that is registered with the Commodity Futures Trading Commission (CFTC) as a swap dealer. Finally, member firms are expected to benefit from the proposed exemption for current rules that might otherwise apply. This will reduce operational and compliance costs of firms. Similarly, with respect to financial responsibility and operational requirements, the concept proposal would benefit member firms by aligning FINRA rules with SEC rules, thus reducing regulatory arbitrage.

With respect to the proposed margin rules, the concept proposal also seeks to rely on the SEC's rules and framework in order to provide consistent protections and regulatory requirements. First, member firms that register as SBS dealers would be exempted from the FINRA margin requirements, thus eliminating any regulatory burden that might arise from a different approach. Second, for other firms, the margin requirements for uncleared Basic CDS would conform with the standard SEC margin requirements, thus reducing risk of

regulatory arbitrage. Third, the proposal is expected to benefit member firms by providing additional mitigation of counterparty risks for SBS-related activities that fall outside of the SEC regulatory framework. Fourth, the margin requirements are expected to enhance member firms' ability to compete in these products.

Finally, FINRA believes that the anticipated benefits might accrue to counterparties, customers and the financial system as the proposed approach decreases the chance of unexpected firm failure and dampens shock transmission.

Anticipated Costs

FINRA believes that the concept proposal would result in some direct costs to member firms that choose to engage in SBS activities in various capacities. In particular, member firms would be required to develop a regulatory program for SBS activities and monitor for their compliance.

FINRA believes the proposal's exception for some FINRA rules that may be relevant to SBS activities benefits member firms. However, such exception could potentially also result in costs to member firms. Such costs could stem from potential regulatory or compliance uncertainty.

With respect to financial responsibility and operational requirements, FINRA expects the proposal would result in member firms that engage in SBS transactions being treated the same as Carrying Firms with regard to tiering under FINRA's financial and operational rules. However, FINRA believes that the majority of member firms that will be engaged in such transactions already qualify as Carrying Firms under these rules. Thus, it is expected that any incurred compliance costs resulting from this requirement would be minimal. For member firms not registering as SBS entities, the proposal to align FINRA's Regulatory Notification and Business Curtailment rule requirements with the amended SEC net capital rule may result in accrued costs.

The proposed margin requirements may impose some costs on member firms that engage in SBS without registering as SBS dealers. The proposal would require members engaged in SBS to have comprehensive written credit risk management procedures appropriate for the business and to ensure compliance with them. In other circumstances, the proposal would permit firms to take a capital charge in lieu of margin. FINRA understands that, in some circumstances, this option may reduce the costs that a margin requirement may impose. To better understand these trade-offs, FINRA seeks comment below on the efficacy of this approach.

FINRA recognizes that the proposed rules should be considered relative to alternative regulatory regimes available to member firms and their affiliates. Member firms will consider whether the costs and benefits of providing SBS services is most efficient under these proposed rules, alternative domestic rules, such as those of the CFTC, or through a foreign entity. FINRA specifically seeks comments below on how these proposed rules might affect competition among financial service providers and how that competition may limit investor choice, or impose high risks or costs on investors.

Request for Comment

FINRA requests comment on all aspects of this concept proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. In addition to general comments, FINRA specifically requests comments on the following questions:

Extension of Expiration Date

1. FINRA expects to extend the expiration date of current, temporary Rule 0180 until the Registration Compliance Date. Do commenters agree with this aspect of the concept proposal? Why or why not? If not, should Rule 0180 expire on September 1, 2021, as currently scheduled, or on a different date?

General Presumption of Applicability

2. FINRA is considering allowing the current exception from the application of FINRA rules to SBS to expire, such that FINRA rules applicable to securities would generally apply by their terms to SBS. Do commenters agree with this approach? Why or why not?

Exceptions from Presumption of Applicability

3. FINRA preliminarily believes that the Rule 6000 Series, Rule 7000 Series and Rule 11000 Series would be operationally impractical to apply to SBS, and therefore would propose to provide a permanent exception for these rules. Do commenters agree that these rules would be impractical to apply to SBS? Should any rules in these series be applied to SBS and, if so, which ones and why?
4. Are there any other rules or rule series that would present operational or other challenges if applied to SBS, such that a permanent exception may be appropriate? If so, please provide specific, detailed information regarding such challenges and explain why the general treatment of SBS as securities should not apply for such rules.

Exceptions for SBS Entities and Associated Persons

5. FINRA would propose to except specified rules from applying to SBS in circumstances where the associated person of the member involved in the SBS activity is acting in his or her capacity as an associated person of an SBS Entity, and therefore is subject to parallel SEC requirements. Do commenters agree with this approach? Why or why not?
6. Are there other circumstances where an exception may be appropriate in light of the SEC's rules relating to SBS activities? Please be specific.

Financial Responsibility and Operational Requirements

7. FINRA is considering amending Rule 4120 to conform the rule to the new capital requirements for SBS dealers and the increased capital requirements for ANC Firms. Do commenters agree with this approach? Why or why not?
8. FINRA is considering treating firms that enter into SBS on a principal basis the same as Carrying Firms for purposes of the Rule 4000 Series where tiering has been employed. Do commenters agree with this approach? Why or why not?

Margin Requirements

9. FINRA is considering adopting a new margin rule specifically applicable to SBS. Do commenters agree with this approach? Why or why not? Do commenters agree with the initial and variation margin requirements for Basic CDS and Basic SBS? Why or why not? Are there other exceptions to the proposed margin requirements for SBS that FINRA should consider adopting? Please be specific.

Economic Impacts

10. What is the extent of SBS activities and related business models conducted by member firms? To what extent would such activities or business models change as result of the concept proposal?
11. Are there any additional or alternative material economic impacts, including costs and benefits, to investors and member firms that are associated specifically with the concept proposal? If so:
 - a. What are these economic impacts and what are their primary sources?
 - b. To what extent would these economic impacts differ by business attributes, such as size of firm or differences in business models?
 - c. What would be the magnitude of these impacts, including costs and benefits?
12. Are there any expected economic impacts associated with the concept proposal not discussed in this *Notice*? What are they and what are the estimates of those impacts?

13. Are there any expected potential competitive effects associated with the concept proposal, whether across member firms or between member firms and non-member firms?
 - a. What are the potential competitive impacts associated with the concept proposal between firms acting as SBS Entities and other firms seeking to provide these services to clients?
 - b. Would firms choose to provide SBS services to their clients under the proposed framework? Why or why not?
14. Do these proposed rules create additional benefits or protections for investors seeking to gain exposure to SBS? Is the proposal likely to impose any significant costs or burdens on investors seeking exposure to SBS?

Endnotes

1. Parties should submit in their comments only personally identifiable information, such as phone numbers and addresses, that they wish to make available publicly. FINRA, however, reserves the right to redact, remove or decline to post comments that are inappropriate for publication, such as vulgar, abusive or potentially fraudulent comment letters. FINRA also reserves the right to redact or edit personally identifiable information from comment submissions.
2. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the Federal Register. Certain limited types of proposed rule changes take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
3. Pub. L. No. 111-203, 124 Stat. 1376 (2010).
4. For purposes of Rule 0180 and this *Notice*, “security-based swap” has the same meaning as defined in SEA Section 3(a)(68) and the rules and guidance of the SEC or its staff. See Supplementary Material .01 to Rule 0180. FINRA is not proposing to modify the definition of “security-based swap” in Supplementary Material .01.
5. See Securities Exchange Act Release No. 87780 (Dec. 18, 2019), 85 FR 6270 (Feb. 4, 2020) (Cross-Border Application of Certain Security-Based Swap Requirements) (establishing the Registration Compliance Date at 18 months after the effective date of the cross-border amendments) (SEC Cross-Border Release). For more information regarding the key dates for registration of SBS Entities, see the [SEC’s information page](#).
6. See Dodd-Frank Act Section 761(a)(2) (inserting “security-based swap” in the definition of “security” in SEA Section 3(a)(10)).
7. See, e.g., Securities Exchange Act Release No. 64795 (July 1, 2011), 76 FR 39927 (July 7, 2011) (Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With the Pending Revision of the Definition of “Security” To Encompass Security-Based Swaps, and Request for Comment); Securities Exchange Act Release No. 71485 (February 5, 2014), 79 FR 7731 (February 10, 2014) (Order Extending Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With the Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment).
8. See Securities Exchange Act Release No. 84991 (January 25, 2019) (Order Granting a Limited Exemption from the Exchange Act Definition of “Penny Stock” for Security-Based Swap Transactions between Eligible Contract Participants; Granting a Limited Exemption from the Exchange Act Definition of “Municipal Securities” for Security-Based Swaps; and Extending Certain Temporary Exemptions under the Exchange Act in Connection with the Revision of the Definition of “Security” to Encompass Security-Based Swaps).
9. See Securities Exchange Act Release No. 64884 (July 14, 2011), 76 FR 42755 (July 19, 2011) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change; File No. SR-FINRA-2011-033). Rule 0180 was adopted with an expiration date of January 17, 2012, which was subsequently extended a number of times.
10. See Securities Exchange Act Release No. 88023 (Jan. 23, 2020), 85 FR 5261 (Jan. 29, 2020) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change; File No. SR-FINRA-2020-001).

11. Rule 4240 itself establishes an interim pilot program with respect to margin requirements for any transactions in credit default swaps held in an account at a member. Like Rule 0180, the interim pilot program under Rule 4240 will automatically expire on September 1, 2021. *See* Rule 4240(a).
12. FINRA is issuing this concept proposal following outreach to the industry regarding the expiration of Rule 0180 and the application of FINRA rules to SBS following such expiration. Since the SEC finalized the Registration Compliance Date, FINRA has met with a number of member firms directly to discuss their anticipated SBS activities. FINRA also published a [request for comment](#) on its website requesting views and information on activity related to SBS.
13. For example, under the general presumption of applicability after the current Rule 0180 expires, FINRA's rules under the Rule 1000 Series (Member Application and Associated Person Registration) would apply to SBS activities.
14. The SEC has contemplated that a registered broker-dealer engaged in SBS brokerage activity would be subject to applicable self-regulatory organization rules. *See* SEC Cross-Border Release at 6284. FINRA notes that, under the SEC's approach to the cross-border application of its SBS rules, a non-U.S. person is not required to count SBS toward its SBS dealer registration threshold if all arranging, negotiating or executing activity for such SBS is conducted by U.S. personnel in their capacity as associated persons of an affiliated registered broker or SBS dealer. *See* SEA Rule 3a71-3(d). In order to qualify for this exemption, the registered entity must comply with specified SBS dealer requirements as if the counterparties to the non-U.S. person were counterparties to the registered entity and as if the registered entity were registered as an SBS dealer. Therefore, a U.S. broker-dealer is required to comply with the SEC business conduct rules specified in SEA Rule 3a71-3(d)(ii) if relying on this exception, including rules relating to disclosures, communications, trade acknowledgement and verification and suitability. Although no SBS Entity would be involved in these circumstances, FINRA is considering whether it should also provide an exception for members acting in compliance with this exemption from the parallel FINRA rules.
15. FINRA notes that, in addition to the business conduct rules discussed above, Rule 2231 (Customer Account Statements) sets forth certain account statement requirements for each customer whose account had a security position, money balance or account activity with the FINRA member. FINRA believes that the account statements required under Rule 2231 should reflect a holistic view of a member's relationship with its customer, including SBS transactions and positions, if applicable. FINRA is aware that the SEC's business conduct rules include requirements for SBS Entities to engage in periodic portfolio reconciliation with their SBS counterparties. *See* SEA Rule 15Fi-3. While FINRA members that are SBS Entities would also be subject to the SEC's portfolio reconciliation requirements, given the importance of customer account statements and the different purposes of the rules, under the concept proposal FINRA is considering not proposing an exception from Rule 2231 for members that are SBS Entities.
16. *See* Securities Exchange Act Release No. 86175 (June 21, 2019), 84 FR 43872 (Aug. 22, 2019) (Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers).
17. *See* SEA Rule 15c3-1(a)(7).

18. FINRA would similarly amend Rule 4130 in the same manner and for the same reasons. Rule 4130 applies to entities registered pursuant to SEA Section 15C, commonly known as government securities dealers.
19. Recognizing this, Rule 4240 (Margin Requirements for Credit Default Swaps) established an interim pilot program with respect to margin requirements for CDS in any account at a member. This interim pilot program is scheduled to expire automatically on September 1, 2021. See Note 11 *supra*. As described above, rather than proposing to make this pilot program permanent, FINRA is proposing to apply to Basic CDS (as defined in Note 20 *infra*) the very similar requirements of SEA Rule 15c3-1(c)(2)(vi)(P).
20. For this purpose, the new margin rule would use the following definitions:
- “Basic CDS” means a Basic Single-Name CDS or a Basic Narrow-Based Index CDS.
- “Basic Narrow-Based Index CDS” means an SBS transaction consisting of component Basic Single-Name CDS.
- “Basic Single-Name CDS” means an SBS in which one party (the “credit protection buyer,” or the party “long” the CDS protection) pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party (the “credit protection seller,” or the party “short” the CDS protection) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments issued, guaranteed or otherwise entered into by a third party (the “Reference Entity”) upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). A Basic Single-Name CDS may be physically settled by payment of a specified fixed amount by one party against delivery of specified obligations by the other party.
21. The chart and offsets in SEA Rule 15c3-1(c)(2)(vi)(P) are very similar to the chart and offsets under the Rule 4240 interim pilot program. SEA Rule 18a-3(d)(1) requires broker-dealers that are registered as SBS dealers and use the “standardized approach” to apply SEA Rule 15c3-1(c)(2)(vi)(P) to calculate the initial margin amount for CDS, so requiring members that are not registered SBS dealers to use the same method prevents regulatory arbitrage by preventing these members from offering counterparties more lenient margin terms than such SBS dealers could offer.
22. Applying the requirements of Rule 4210 to such Basic SBS prevents regulatory arbitrage by preventing members from offering to restructure margin accounts as SBS on more favorable margin terms.
23. Consistent with SEA Rule 18a-3(c)(1)(iii)(E), this exception would apply to SBS with a counterparty that is the Bank for International Settlements or the European Stability Mechanism, or is the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank or any other multilateral development bank that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member.

24. Consistent with SEA Rule 18a-3(c)(1)(iii)(F), this exception would apply to any counterparty that is a central government (including the U.S. government) or an agency, department, ministry or central bank of a central government if the member has determined that the counterparty has only a minimal amount of credit risk pursuant to policies and procedures or credit risk models established pursuant to SEA Rule 15c3-1.
25. Consistent with SEA Rule 18a-3(c)(1)(iii)(B), this exception would apply to any counterparty that is an SBS dealer, swap dealer, broker or dealer, futures commission merchant, bank, foreign bank, or foreign broker or dealer.
26. *Cf.* FINRA Rule 4210(g)(1), FINRA Rule 4240(d), and SEA Rule 18a-3(e).
27. Firms may be involved in SBS activities in miscellaneous ways, for example, for hedging purposes, or in a capacity of interdealer brokering arrangements.