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Exclusively via email to pubcom@finra.org

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

Re: Comments on FINRA Regulatory Notice 18-02: Liquidity Reporting and Notification

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is submitting this letter in response to the Financial Industry Regulatory Authority's ("FINRA") proposed amendments to FINRA Rule 4521 Notifications, Questionnaires and Reports (the "Notification Requirements") and to the new Supplemental Liquidity Schedule (the "SLS"), as described in Regulatory Notice 18-02 (the "Notice"). SIFMA appreciates the opportunity to provide comments on the proposed amendment and the new schedule as further described in the Notice (the "Liquidity Proposal").

SIFMA acknowledges the critical importance of liquidity to the U.S. capital markets, as SIFMA firms make possible the foundation for the deepest and most liquid global capital markets in the world. SIFMA member firms agree with the need for firms to have in place systems and processes to monitor their liquidity and their sources of funding. While SIFMA supports the goal that the Liquidity Proposal is intended to achieve, we have concerns with: (1) the regulatory process that is being used to address that goal, and (2) substantive flaws in the Liquidity Proposal, which flaws we believe result in substantial part from the deficiencies in that process.

Our comment letter is structured, first, respectfully to highlight our concerns with FINRA's regulatory process. We then follow with a thorough review of the Liquidity Proposal itself.

Section I of our comment letter explains our concerns with FINRA's regulatory process. Section II of the letter provides an overview of our substantive comments on the Liquidity

[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

Proposal. Section III of the letter suggests that the goals of the Liquidity Proposal would be better served by allowing firms the option to use liquidity models that are firm-specific and holistic. Sections IV - VII of the letter go through our substantive comments on the Liquidity Proposal in more detail. Section VIII of the letter raises concerns as to the confidentiality of the information provided to FINRA. Section IX sets out material questions as to the SLS including as to whether it is intended to be GAAP compliant and as to its "governance." Appendix A provides some questions as to the SLS.

I. The FINRA Rulemaking Process

Before commenting on the specifics of the Notice, we think it useful to review the history of the process by which the Notice was issued. FINRA's public attention to liquidity largely began with the issue of Notice 10-57. That notice set out a list of potentially relevant practices that FINRA stated that it had observed in a review of 15 mid-sized and large broker-dealers. In March 2014, FINRA initiated a further review of the policies and practices of liquidity management of 43 firms. Based upon this "best practice survey," Notice 15-33[2] provided "guidance" on liquidity risk management practices and described FINRA's review of policies and practices at these 43 firms. FINRA then included these liquidity and firm funding requirements in its 2016 Exam Priorities based upon its expectations described in Notice 15-33. FINRA expanded its expectations of firms' liquidity risk management in its 2017 Exam Priorities, reviewing firm funding and liquidity plans, contingency plans, stress testing, and other risk management mechanisms, again citing Notice 15-33 in the absence of rule-based authority or even of a survey that had been developed *with* member input.[3]

In summary, FINRA has subjected firms to exam requirements and has published the Liquidity Proposal based upon a March 2014 survey that was never put out for public comment or subject to cost-benefit review. While liquidity is an important aspect of financial soundness, SIFMA believes that the practice of FINRA establishing regulatory expectations in the absence of any of the processes that would accompany formal rulemaking raises material procedural issues and that these deficiencies of regulatory procedure are likely to result in deficiencies of substance.

FINRA is obviously aware that there is no current SEC liquidity regulation (or FINRA liquidity requirement). However, the SEC staff has indicated to SIFMA that it expects to propose and to adopt a substantive rule regarding liquidity. In adopting any such liquidity rule, the SEC will be obligated to follow the Administrative Procedure Act (the "APA") and perform a cost benefit analysis ("CBA"). Whatever the requirements of the initial SEC proposal on liquidity may be, there is little doubt that any such proposal would be reformulated to some extent as the SEC goes through the procedures required by the APA and evaluates its proposal pursuant to the CBA. While SIFMA understands that FINRA is a member organization and can amend its notification requirements, we do not believe it is appropriate for FINRA to require notification where there is no underlying statutory SEC requirement and, in essence, avoid Congressional requirements in an area so critical to the capital markets.

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2 Regulatory Notice 15-33 Liquidity Risk: Guidance on Liquidity Risk Management Practices (Sept. 2015).

3 http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf.

In short, FINRA should not adopt any notice requirement with regard to liquidity until the SEC adopts its own liquidity requirements (at which point any FINRA notice requirement should be made consistent). In this regard, we note that there is no urgency to the adoption of the Liquidity Proposal because, as a practical matter, FINRA already supervises firms' liquidity procedures. Therefore, FINRA would be better served by adopting any liquidity requirements deliberately, and in conjunction with the SEC, rather than proceeding with a new rulemaking based on information that has not been broadly or publicly vetted.

In sum, while we acknowledge the importance of broker-dealers' monitoring their liquidity and funding, that does not diminish the value of following appropriate regulatory process; indeed, good process is far more likely to result in good substance. Accordingly, we respectfully suggest that FINRA address the industry concerns regarding the regulatory process before proceeding further with the Liquidity Proposal. However, given our concern that FINRA may determine not to address this important procedural objection, the remainder of our comments represent our review of the Liquidity Proposal and our suggestions as to very substantial amendments and recalibration.

II. Overview of Principal Substantive Comments

Before providing a more detailed review, we are providing an overview of our comments and suggestions. They are, in broad strokes, as follows: (1) FINRA should permit the use of models and, in general, take a more holistic and aggregated approach to monitoring liquidity, (2) the notification triggers should be substantially revised, (3) FINRA should ensure the confidentiality of information contained in notifications, and (4) the SLS requires substantial clarification around both the content and process.

Holistic Approach

SIFMA acknowledges that it is important to address the liquidity and funding risks to which firms are exposed and that there is value in FINRA being made aware should a firm be vulnerable to a liquidity stress event. However, we believe that FINRA's objective could be better served by taking a conceptually very different approach than that taken in the Liquidity Proposal.

There are two major conceptual issues that underlie many of our comments. First, the adoption of a one-size-fits-all approach to liquidity is inconsistent with firms' very diverse business activities and sources of funding. Second, the Liquidity Proposal takes a very siloed approach to the monitoring of liquidity, treating the various forms of funding through repurchase agreements, securities lending and bank loans as if they were wholly distinct, implicitly assuming that a change in the level of funding that a firm receives under a particular type of contract would be an indication of stress. In fact, each of these funding contracts is fungible with the others. Firms manage liquidity and funding in a manner that is comprehensive and aggregated across funding contracts and counterparties.

Accordingly, we begin by proposing that FINRA allow firms the option to base their reporting and notifications upon firm-specific models that are developed specifically to model stress to funding sources in the aggregate, as opposed to the untailored and siloed approach taken by FINRA in the Liquidity Proposal. For firms that are part of financial organizations that are

subject to Regulation YY of the Board of Governors of the Federal Reserve, we recommend that they be permitted to use a model that is consistent with the requirements of Regulation YY, albeit with all the reporting done at the broker-dealer level, not the holding company level. Firms that are not subject to Regulation YY would also have the discretion to use their firm-specific models, albeit subject to FINRA review of those models.

Our letter then turns from models to a more specific discussion of the FINRA's Liquidity Proposal as it is set forth in the Notice. SIFMA proposes very substantial amendment and re-calibration of both the Notification Requirements and the SLS. We note that many of the specific, substantive comments on the Liquidity Proposal are consistent with our proposal that use of firm-specific models should be permitted. That is, any approach to monitoring liquidity should take a "holistic" view of a firm's financing sources, rather than, for example, being focused on the particular type of agreement under which a firm receives financing. This "Holistic Approach" should be conceptually applied to all firms. Under this Holistic Approach, FINRA would allow firms either (1) to use a firm-specific model, or (2) for firms not using a model, FINRA would revise the siloed approach it took in the Liquidity Notice so that reporting and trigger requirements were based on aggregate funding levels and not on contract-specific or counterparty specific funding amounts.

Amendments Required to Notification Requirements

The Notification Requirements in the Liquidity Proposal are intended to "...enable FINRA to be promptly alerted to a firm whose ability to fund its operations has been reduced significantly within a short period of time." That is, the Notification Requirements should establish triggers that are indicative of an oncoming liquidity risk event. SIFMA believes that the Notification Requirements do not work because they do not account for the fact that firms manage and optimize their liquidity on an aggregate basis. Accordingly, monitoring specific contract types and counterparties in isolation does not capture how firms manage and monitor their liquidity, and, more importantly, it does not capture a firm's actual liquidity position. Therefore, any notifications should be based upon a member firm's aggregate funding. Further, transactions on which member firms do not rely to fund their businesses (*i.e.*, free credit balances and margin balances), and ordinary business events, such as changes in counterparties, ought not be the basis of any Notification Requirements.

In later sections of this comment letter, we expand on the following key recommendations:

- *Tracking Liquidity on an Aggregate Basis.* The Liquidity Proposal requires that a firm report any loss of liquidity, or reduction in funding, based on the contract type (*e.g.*, repo, securities loan or bank loan) under which it had originally obtained the liquidity. However, a change in funding by contract type in isolation is simply not meaningful. As a practical matter, liquidity generated from one contract type, such as a repurchase agreement, can be replaced with funding from another contract type, such as a securities lending agreement or a bank loan. As such, Notification Requirements should be based on a member firm's aggregate funding, not funding by contract type.

- *One-Day Spikes.* SIFMA is of the view that a Notification Requirement should not be based upon a one day "spike" or event. The amount of a member firm's sources of funding is inherently subject to business-as-usual volatility; for example, as part of a member firm's liability management strategy, a firm may undertake actions to replace funding from one source to another on a particular day, which could result in a trigger of one of the Notification Requirements, as prescribed, but would not be indicative of a risk event. Therefore, a notification to FINRA should be required only if a trigger has been breached for three consecutive days in order to mitigate the risk of a meaningless notice.

- *Studies Should Be Conducted Before a Trigger Level Is Set.* Notification triggers should be set at a level that indicates a genuine problem. Based on our preliminary reviews, a 20% decrease in a firm's aggregate funding profile does not indicate a funding risk event. That said, we do not believe that there is sufficient basis for FINRA to establish a set Notification Requirement level at this time. Accordingly, we would recommend that FINRA establish a two-year quantitative study period during which it would observe changes in funding levels across various firms before setting any formal trigger level requirement.

- *Free Credit Balances and Customer Margin Balances Should Not Be Used as Notification Triggers.* In the ordinary course of business, the amount of free credit balances is extremely volatile because the amounts change very dramatically with ordinary course business events and weekly operational processes. To take two simple examples, periodic payments of interest on bonds and weekly sweeps of customer cash to money market funds or certificates of deposit would result in numerous false positive reports to FINRA, almost without regard to how high the trigger levels were set. As a practical matter, given the extreme volatility of free credit balances, member firms do not rely on these balances as a source of funding. On a related note, if the Notification Requirements are aimed at monitoring sources of funding, we do not believe that it is useful to monitor changes in customer assets (*i.e.*, margin debit balances).

- *Changes in Counterparties and Funding Agreements Should Not Be Used as Notification Triggers.* Firms may change the counterparties from which, or the agreements under which, they receive funding for any number of reasons, including a member firm's decision under normal course to change its funding composition and mix due to underlying business needs, changes in the firm's liability management strategy, lower cost of funding from other lending sources, etc. So long as a firm has adequate funding on an aggregate basis, there is no value in triggering notices on the basis of changes in a member firm's counterparties or use of particular funding agreements.

Confidentiality of the SLS and of the Notification Requirements

FINRA's Liquidity Proposal in its current form requires the regular disclosure to FINRA of a significant amount of sensitive information. SIFMA believes that it is critical that information communicated to FINRA by member firms be treated as confidential and sensitive so as to minimize the risk of public dissemination that could result in material damage to member firms. In particular, SIFMA members are extremely concerned that in the event of a liquidity notification to FINRA, were the making of the notification to become public, the notice itself could trigger a liquidity drain at the firm or could even lead to broader systemic liquidity events, even if the original notice were based on ordinary course business events having no economic significance.

Operation of the SLS Must Be More Fully Considered

We do not believe that FINRA has given sufficient consideration to many of the operational and logistical requirements of the SLS. For example, has FINRA considered that it is asking for numbers that are not generally consistent with a firm's GAAP accounts and that it will be operationally difficult to reconcile these numbers readily to GAAP numbers? Likewise, FINRA seems not to have considered who at a firm would be responsible for filing the SLS and any notifications.

As to the SLS itself, many of the requirements are not clear, and certain of the information is not knowable (for example, the dollar loss of an uncommitted line). Other information requested by FINRA does not enhance understanding of when a firm may be experiencing a liquidity stress or funding event (the top five stocks held in all margin accounts). We are also concerned with the requirement to disclose customer information, particularly as it seems to serve no value for the purpose of the SLS.

III. Alternative Proposal: Holistic Model Approach

The firms that would be subject to the requirements vary widely in the types of business that they conduct and in the manner in which they manage sources and uses of funding. Thus, we are first proposing that as an alternative to the standardized requirements set forth by the Liquidity Proposal, FINRA allows member firms the option of complying with any new liquidity requirement through the use of a Holistic Model Approach, which leverages existing liquidity and funding risk management processes that have been established by member firms.

A. Replacement of Factors-Based Notification Requirements with Firm-Specific Liquidity Risk Measure

SIFMA recognizes that FINRA's proposed Notification Requirements are intended to "...enable FINRA to be promptly alerted by a firm whose ability to fund its operations has been reduced significantly within a short period of time." To this end, the Trigger Requirements should address the specific types of liquidity risks to which a particular member firm may be exposed. FINRA's primary objective should be to determine the member firm's holistic liquidity risk position and its ability to pre-fund for all potential cash and collateral needs during a liquidity crisis. Thus, in lieu of monitoring specific risk events in isolation, FINRA should allow member firms to elect the use of a holistic liquidity risk measure that quantifies the member firm's funding sources relative to its aggregate liquidity requirement during a stress period. Firms using a Holistic

Model Approach would consider financing in aggregate, not on a contract-specific or counterparty-specific basis.

Member firms that are subsidiaries of U.S. bank holding companies ("BHCs") or U.S. intermediate holding companies ("IHCs") subject to Regulation YY have already been required to establish liquidity risk management processes. These firms would base their Holistic Model Approach on internal liquidity stress testing processes developed in accordance with Regulation YY requirements. Member firms would be able to develop Holistic Model Approaches based on processes either: (1) similar to the Regulation YY approach or (2) that are otherwise tailored to their specific activities, businesses and funding sources, so long as the internal processes that they establish meets the objectives of FINRA's Notification Requirements.

The following describes a Holistic Model Approach that is based upon Regulation YY, but where the relevant calculation *would be performed at the broker-dealer level*:

- **"Liquidity Buffer"** is defined as the amount available as unencumbered, highly liquid securities and cash instruments held at the member firm; and

- **"Liquidity Risk Requirement"** is defined as the member firm's net stress cash-flow need over a 30-day planning horizon of a liquidity stress test. This requirement captures potential contractual and contingent cash and collateral outflows during a liquidity stress scenario.

Under the proposed framework, a member firm would divide the Liquidity Buffer by Liquidity Risk Requirements each day. If the member firm maintains a ratio of greater than or equal to 100%, then the member firm is sufficiently liquid and has pre-funded for its estimated potential cash needs, considering its various sources of funding. If the member becomes aware that its ratio falls below a level of 100% for three consecutive days, it would be required to notify FINRA in writing within two business days that it may not currently have sufficient liquidity to meet its liquidity requirements during a stress period.

Although the Holistic Model Approach described above has been built on the requirements set forth by Regulation YY, member firms that are not subject to Regulation YY also ordinarily employ internal liquidity stress testing models that are specifically tailored to their own businesses. All firms with appropriate business-specific models should be permitted to use such models, assuming that they are commercially reasonable, in place of a one-size-fits-all approach. These models would be subject to oversight by FINRA to ensure that they provide adequate monitoring of liquidity risk consistent with FINRA's goals.

B. Replacement of SLS with Firm-Specific Liquidity Reporting

Under the Holistic Approach, firms would work with FINRA to develop reports that are consistent with the manner in which they manage liquidity in their businesses. Many firms already provide FINRA with information that is based upon their existing models and we believe that this information that is already provided to FINRA will, in many cases, be sufficient for FINRA and, in fact, superior to the standardized information required by the SLS.

IV. True Funding Metrics

A. Customer Margin Balances and Free Credit Balances

SIFMA believes that it would be of little utility to include changes in either customer margin balances or customer free credit balances as a basis for FINRA notification requirements as to liquidity, and that their inclusion would result in numerous false positive reports. Such balances are highly volatile based on ordinary course events, such as weekly operational processes, corporate actions, regularly scheduled bond interest and maturity payments into customer accounts, and sweeps of cash from customer accounts into money market funds or certificates of deposit. Further, our limited back-testing analysis determined that the triggers for customer margin balances and free credits impacts firms with wholly different business models (*i.e.*, institutional vs. retail), different automation levels (*i.e.*, daily vs weekly reserve account calculations) and different sizes (*i.e.*, large vs regional) but, in all cases, for reasons that were wholly unrelated to liquidity or funding problems. Although firms can use free credit balances in funding margin loans, given the volatility of such balances, firms do not rely upon customer free credit balances as a funding source, and changes in the amounts of such balances do not provide a meaningful view into firms' liquidity.

One factor that makes free credit balances so volatile is that many firms routinely sweep these balances into money market funds or certificates of deposit, rather than keeping them in a reserve bank account. This means that for many firms, these balances tend to be kept small, which makes them appear very volatile as money flows in and out of customer accounts to and from money market funds or certificates of deposit.

In light of the above, we do not believe that the inclusion of a notice requirement on customer free credit balances can be addressed by raising the trigger level. While SIFMA has not conducted a full quantitative impact survey of its member firms, anecdotally we understand that the 5% notification threshold would have been hit by surveyed wholesale and retail firms dozens of times (or more) within the past year because of ordinary course customer cash management, trading activities or market events without signaling any material liquidity concerns at broker-dealers. Two regional retail firms performed back-testing at the 5% notification trigger and found that, for each of them, it would have triggered notifications more than 100 times per year. If the trigger were raised to 20%, these firms would have triggered notifications approximately 20 times in a year for one firm, and 50 times for the other. Two large banking firms also performed back-testing at the 5% notification trigger and found that, for each of them, it would have triggered notifications; in the case of one firm very few notifications at the 5% level and, in the case of the other, more than 30 in a single year. Notifications for these firms would have been materially reduced, but not eliminated, at the 20% trigger level.

As is implicit in the findings of this review, the frequent "triggers" would not have been the result of any liquidity or funding problems at the firms but, rather, because notification requirements based on customer activity will inherently result in numerous notices that are not indicative of any adverse change liquidity or funding. Below we outline some of the reasons why customer free credit balances are inherently volatile:

(a) At many firms, customer cash routinely accumulates during the week and then is swept out on a single day into money market funds as part of ordinary business processing. For retail firms, this routine weekly processing by itself would often trigger a weekly notice to FINRA of a (non-existent) liquidity issue.

(b) The DTC settlement process for maturity and interest payments can double normal cash balances on particular days of the month, such as the first or the fifteenth. These payments serve to inflate customer free credit balances for a short period before they are withdrawn or re-invested. For example, at a retail firm, the July 1 interest payments may result in a doubling of free credit balances and then a subsequent halving as the money is swept out into a money market account on the next weekly processing date.

(c) Similar to the above, corporate events such as the paydown of the principal amount of a bond, or a corporate acquisition, may result in large cash payments to customers' accounts that are shortly withdrawn or reinvested.

(d) A private fund that is liquidating may sell off its assets and accumulate cash before making a payout to its investors.

(e) Customers may shift their balances from "cash" at a broker-dealer to a sweep account held through the same broker-dealer. This would typically be because the customer is seeking a higher interest rate or it could be because a firm routinely sweeps money into money market funds on a particular date or day of the week.

(f) Customers may shift their balances from a broker-dealer to an affiliate of the broker-dealer, such as a bank. This, again, would indicate that the customer is seeking a higher interest rate and does not have any concerns with the financial organization.

(g) A customer may bring in significant cash in advance of an acquisition and then withdraw the cash or employ that cash through the broker-dealer.

(h) Prior to year-end, trustees frequently transfer money from estate accounts to beneficiaries' accounts as part of an annual distribution directive. This creates a short-term free credit surge in the beneficiaries' accounts until the money is swept to a money market fund.

(i) A customer may deliver cash to buy a security in an RVP/DVP transaction. If the settlement fails, the firm's free credit balances will surge for a day.

Unless firms were able to account for (which is to say "subtract out") the effects of these predictable short-term events that cause increases in cash balances and subsequent reductions, firms (particularly more retail-oriented firms) would be required to make constant routine notices of "triggers" that are not indicative of an adverse liquidity event. While it would be possible in theory to subtract out events of the type described above, it would be very difficult to do that in an automated fashion. Trying to account for these events by hand would be expensive and time-consuming: to do it on a daily basis, as would be required by the Liquidity Proposal, with a two-day notice requirement to FINRA, if a trigger were hit, would be impossible.

Likewise, we do not believe that it would be meaningful for firms to report swings in their customer margin balances. As a starting matter, these balances represent a use of funds, not a source of funding. Secondly, these balances swing for a wide variety of reasons, having nothing to do with the broker-dealer itself. For example, customers may shift the legal entity at which they hold balances (for example, from a U.S. broker-dealer to offshore or vice versa) or they may change the form in which they finance themselves (from margin lending to swap or vice versa).[4]

As to both free credit balances and customer margin balances, there does not appear to be a compelling reason to include a hard dollar $5 billion notification requirement. As a practical matter, a hard dollar threshold would only be relevant for the largest broker-dealers. These firms are generally subject to comprehensive consolidated liquidity risk management regulatory programs. The $5 billion threshold appears arbitrary and ungrounded in any existing liquidity risk management framework. While the SEC's capital rules require notifications when an "alternative net capital rule" broker-dealer's "Tentative Net Capital" declines below $5 billion,[5] there is no analogue between the calibration of a broker-dealer capital minimum capital standard and day-to-day fluctuations in customer margin balances or free credit balances.

For smaller firms, a 5% notification threshold would result in a significant number of false positive reporting events as noted previously.

B. Identification of Counterparties

Given the numerous factors that impact the funding decisions made by both member firms and their counterparties, SIFMA believes that there is no reason to name funding counterparties or to use a change in funding counterparties as a basis for any notification requirements. For example, a member firm may choose to terminate a funding agreement with a counterparty, or vice versa, due to business-as-usual events that do not indicate a liquidity stress. A member firm may replace this funding source with new funding from a different counterparty with no change in net funding. Thus, using a counterparty change as a funding notification trigger is overly simplistic and will result in false positives.

V. Funding Contract Types and Contractual Issues

A. Siloing

The Notification Requirements are intended to enable FINRA to monitor a situation in which a member firm is experiencing difficulty in funding its operations. In order to effectively monitor a member firm's funding, FINRA should focus on monitoring changes across a member firm's funding in the aggregate. However, the Notice Requirements in the Liquidity Proposal are based on the assumption that broker-dealers have separate and distinct funding sources based upon the type of contract used to document that funding: a repurchase agreement, a securities lending agreement or a bank loan. Segmenting liquidity in this way, by contract type, does not have any economic basis and will increase notifications that are essentially false positives. Any trigger

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[4] While we believe that this trigger should be eliminated entirely, if it is retained, the trigger percentage should be raised very substantially.

[5] *See* Rule 15c3-1(a)(7)(ii).

notice requirement should be based on a firm's aggregate funding amount, not its contract-type funding amounts.

To provide an example, the Liquidity Proposal, as currently drafted, would require a firm to: notify FINRA if it either suffers (1) a 20% decrease in funding via any of repurchase agreement, securities lending or lines of credit extended by banks or (2) a loss of any one of its type five counterparties in either repurchase or securities lending agreements. This segmentation of a firm's funding profile by contract type and counterparty runs directly counter to the way in which firms view liquidity (and the way that FINRA should view liquidity): which is in the aggregate.

Suppose, for example, that a firm receives one third of its funding from each of these types of contracts. In that case, a 20% reduction in funding from one type of contract would trigger a notice to FINRA even though (i) all else being equal, the firm had lost less than 7% of its funding and (ii) the firm might very well have increased funding from other sources, so that its funding was net positive. This might seem an extreme case but, in fact, it is an understatement of the issue. That is, a firm is likely to have the largest percentage swings (whether positive or negative) in the smallest funding sources. So if a firm derives only 10% of its funding from one of the three types of contracts, a 20% "loss" of funding in that contract would represent only 2% of the firm's funding and it is very likely that the firm would replace that with other types of funding, if it needed to do so, from its primary funding agreement types.

The same type of difficulty arises with funding counterparties. The less that a firm makes use of a particular type of funding contract (whether securities lending, repurchase agreement or banking lending), the fewer counterparties using that type of agreement it will have (in fact, it may not even have five agreements of that type). By way of example, for firms that do not fund heavily through securities lending, it would not be unusual to have less than five funding counterparties that they use in that type of contract. Thus, the loss of a single such counterparty would require notice to FINRA, even if the loss were inconsequential in amount and even if the counterparty were immediately replaced. (As previously discussed, SIFMA is of the view that there should not be any triggers based on changes in counterparty.)

The multiplication of trigger events that results from FINRA segmenting liquidity by type of financing contract (or counterparty) results in "hair triggers" and will result in needless false positives. This problem could be alleviated by simply aggregating all of the different types of financing contracts, by requiring a trigger based upon events that have a meaningful effect in the aggregate, and by setting the trigger at a more substantial level, perhaps 25%.

We note that FINRA itself seems to acknowledge that it is the aggregate number that is meaningful (and not the contract-type number) since a firm would be subject to the rule if the aggregate of its financing under the different types of agreements exceeds $1 billion; *i.e.*, FINRA does not measure financing on a type of contract basis.

B. Financing through Swaps or Security-Based Swaps

In addition to the financing agreements identified by FINRA in the Notice, firms also use total return swaps as a source of financing. (For example, a firm may go synthetically long an asset through a total return swap, rather than purchase the asset and pledge it as collateral in respect

of a "cash market" financing agreement.) Accordingly, assuming that FINRA would rethink its triggers so as to view liquidity in the aggregate, rather than as contract-type specific, FINRA should also take account of the fact that firms may use swaps fairly interchangeably with other types of agreements to obtain financing.

SIFMA recommends that FINRA take account of total return swaps because any liquidity requirements should be based on a holistic view of a firm's liquidity position. Simply adding "swaps" as a new type of segmented financing category that has its own unique hair triggers would materially exacerbate the problems identified in the prior section of this letter.

VI. Material Issues with the Definitions in the Liquidity Proposal

The Liquidity Proposal uses various terms that are not defined and the meaning of which is not clear. In the table below, we have identified key undefined terms in the Liquidity Proposal and included our recommended definitions, to the extent that FINRA decides to incorporate these terms in the final rule.

Key Term	**SIFMA Recommendation**	**Explanation**
"Loss of access"	"Loss of access" to secured funding should be solely limited to instances in which the counterparty refuses to roll its outstanding contract at maturity with the respective member firm, citing specific credit concerns, and the member firm is not able to replace the loss of funding with another funding source. We note that a lender may choose not to roll secured funding trades due to its own internal liquidity needs. If the firm and the counterparty each independently choose not to roll the funding, this should not be considered a "loss of access."	SIFMA's recommended definition is designed to capture situations where a broker-dealer has truly "lost" funding that it needs to support its operations, as opposed to normal course rebalancing of funding relationships.
"Initiates termination"; "reduces access"; "initiate the option not to renew"	Consistent with the definition of "loss of access," these specific notification requirements should be limited to situations where a member firm becomes aware that a counterparty is generally willing to provide credit to other broker-dealers on the relevant type of collateral at competitive terms but will not provide credit to the	These terms are probably far more ambiguous than FINRA intends. For example, what does it mean that a counterparty "initiates the option not to renew" where it has no obligation to do so and the FINRA member may not, in any case, be seeking renewal.

Key Term	SIFMA Recommendation	Explanation
	relevant firm, and the firm is not able to replace the loss of funding with another funding source.	
"Reduction in an un-committed line"	SIFMA does not believe that there is any way to "quantify" the size or loss of any "uncommitted line"; thus, it is impractical to base any notification requirement on a metric that cannot be measured.	It is SIFMA's understanding that the credit departments of various lender counterparties would periodically determine how much of a credit line that a counterparty might extend to any particular broker-dealer. However, the counterparty would not generally inform the broker-dealer of the size of that credit line at any particular time, nor would it inform the broker-dealer of any changes to the credit line. Therefore, if a broker-dealer were to seek funding from the provider of uncommitted credit, and that funding were to be either denied or limited to a specified amount, the broker-dealer would have no means of determining the quantity of credit as to which it had supposedly "lost access."
"Material adverse change"	SIFMA recommends that this Notification Requirement only apply to material funding contracts that contain MAC clauses, and be limited to instances in which a MAC trigger breach occurs and is exercised.	Subject to the size of the member firm, broker-dealers may have a multitude amount of contracts that include trigger events that, if breached, would not represent a material funding risk event to that specific member firm.
"48 hours"	SIFMA assumes that this should be interpreted to mean within two business days.	The Notice requires the giving of notice of certain events within "48 hours" of a firm becoming aware of the relevant trigger.

VII. Use of Rolling Averages

A number of the FINRA triggers are based on numbers that change daily, in the case of free credit balances, or a thirty-five day "rolling average." This creates two types of problems. First, some measurements, for example, free credit balances, will be volatile because, for example,

one day may be very high because bond interest payments are made and another day might be very low because the firm makes a weekly sweep to money market funds.[6]

The use of the thirty-five rolling day average will unduly complicate tracking. Firms will not only need to track each day's funding; they will need to measure that funding against a base amount that changes every day.

In order to simplify the calculations required by any ultimate notice requirement, firms should be able to calculate their funding against a base level that is fixed for the month as measured by their funding on a particular day in the month.

VIII. Requirement to Ensure Confidentiality

In light of the likelihood that the Liquidity Proposal will require over-reporting of liquidity events by firms, SIFMA urges that, at least initially, any notice that firms are required to give to FINRA be oral only. Further, it is critical that FINRA state that any notification is not intended to trigger other forms of notification, such as an 8-K filing. Lastly, should there be any related notification requirement to other regulatory bodies, it is imperative the information be provided under strict controls. Any dissemination of a member firm's trigger events beyond FINRA could result in meaningful harm to the firms and potentially could result in a broader destabilizing event across the financial sector.

SIFMA is extremely concerned that any notification that signals that a firm is or may be experiencing liquidity stress, even if the triggering event is non-substantive, could very well result in a true liquidity risk event. For instance, if a member firm's funding counterparty were to learn that a member firm had filed a notification, then the counterparty could react negatively, withdrawing existing funding from the member firm, creating a real liquidity event. An inaccurate misinterpretation of a member firm's liquidity and funding position could quickly lead to real liquidity deterioration or even worse, lead to a systemic liquidity crisis.

These concerns are exacerbated by the short notice period requirement between the time in which the member becomes aware of the specific event occurring, and required notification to FINRA. Thus, in the event that FINRA chooses to adopt a finalized version of the Liquidity Proposal, SIFMA believes it is imperative that FINRA maintain strict control over the information. Otherwise, FINRA will be not be merely overseeing risk; it will be creating risk.

IX. Supplemental Liquidity Schedule

A. Purpose of the SLS

The specific objective that FINRA wants to achieve with the SLS is not clear. Is the SLS intended to be a traditional accounting report, similar to the FOCUS report, but for liquidity? Or is the purpose of the report to develop a new type of FINRA liquidity risk report?

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[6] Retail firms commented that reconciling free credit movements daily would present a massive operational challenge.

We observe that if the purpose is to have the amounts reported in the traditional standard FOCUS approach, the numbers in the SLS will not agree to the amounts reported on the FOCUS balance sheet due to, among other reasons:

- the instructions to SLS indicate that collateral upgrade transactions (*i.e.*, securities for securities) should be reported. However, these amounts are off-balance sheet transactions and, therefore, not included in the FOCUS balance sheet amounts, and

- the FOCUS balance sheet includes netting in accordance with U.S. GAAP, so the instructions for reporting reverse repos and repos in SLS as gross balances will create reconciliation issues.

SIFMA believes that FINRA would be best served by an SLS whose purpose is a new type of liquidity risk report, focused on true funding triggers, and where the information requested is not under U.S. GAAP but is specifically defined by regulation. Once the purpose of the report is fully clarified, that clarification will also raise significant governance questions.

B. Governance

SIFMA is concerned that FINRA has not sufficiently clarified the governance structure it is proposing as to the Liquidity Proposal. SIFMA is unable to determine specifically who, if anyone, would be required to attest to the information in the SLS and/or the Liquidity Notifications (*i.e.*, would it be the FINOP, Chief Compliance Officer, Treasurer or some other person?). We are also unable to ascertain if liability will attach to any individual(s) attesting to the accuracy of the SLS Reports and providing the Notifications. Will there be liability for an individual if a Notification is not provided? Will there be liability for an individual who attests to the SLS and then finds a clerical error? Or will the firm be the responsible for any error?

SIFMA recommends that firms that should have latitude to determine the reporting individual within the firm. In this regard, SIFMA observes that the procedures firms would be required to institute a Liquidity Proposal whose purpose is a new liquidity risk report, as opposed to one under GAAP, would not ordinarily be carried out by a firm's Accounting Department or by a firm's Financial and Operational Professional.

C. SLS Questions/Clarifications

(a) Reporting Dates

Once the purpose of the SLS is clarified, SIFMA requests that FINRA clarify the reporting date for the SLS. We believe that all data should be as of month-end.

(b) Summary of Appendix A

SIFMA has provided detailed questions regarding the definitions and clarifications questions regarding the form in Appendix A. The industry will gladly meet with FINRA and discuss those more detailed questions. The major issues addressed in our review are:

1. Inappropriate Information. Counterparty and customer information is generally confidential, and we believe it is inappropriate to report it on forms that may be more broadly circulated.

2. Unhelpful Information. The SLS requires reporting many items (*i.e.,* CUSIPs in a margin account) that SIFMA does not believe provide any insight into a firm's liquidity.

3. Unclear Goals. The SLS requires reporting certain items in a way where the goal is not clear (*i.e.*, asking for both the amount required to be posted and the amount actually posted for deposits at clearing organizations).

4. Information that Is Not Currently Tracked. The SLS creates new operational issues by asking for information that is not ordinarily tracked by all firms, such as the highest day-to-day margin changes at clearing corporations.

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Thank you for this opportunity to provide you with the industry's concerns regarding the new liquidity notification rules. SIFMA would be pleased to discuss our views with FINRA or provide any additional information needed to address our comments. Please contact me at (212) 313-1331 if you have questions concerning our letter.

Regards,



Mary Kay Scucci, PhD, CPA
Managing Director
SIFMA

cc:
Robert Cook, President and CEO, FINRA
William Wollman, EVP Risk Oversight & Operational Regulation, FINRA
Kris Dailey, Vice President, Risk Oversight & Operational Regulation, FINRA
Robert Colby, General Counsel, Office of General Counsel, FINRA
Adam H. Arkel, Associate General Counsel, Office of General Counsel, FINRA
Susan Schroeder, Executive Vice President and Head of Enforcement, FINRA

Brett Redfearn, Director, Trading and Markets, SEC
Michael Macchiaroli, Associate Director, Trading and Markets, SEC
Tom McGowan, Associate Director, Trading and Markets, SEC
Kevin Goodman, National Associate Director of the FINRA and Securities Industry Oversight Examination Program, SEC

Steven Lofchie, Partner, Cadwalader, Wickersham & Taft LLP

APPENDIX A

Review of the Supplementary Liquidity Schedule

(a) Information as to Reverse Repurchase and Repurchase Agreements. SIFMA does not believe that information about individual contracts is meaningful for the purposes of assessing firms' liquidity. Likewise, information as to changes in types of collateral provided is not meaningful.

(b) Repo and Reverse Repo Counterparties. SIFMA does not believe that this information should be included in the form, as we do not believe that it is meaningful. Further, this information is generally confidential, and while we understand that FINRA can obtain the information, we generally object to having to report it on forms that will inevitably be the subject of some broader circulation.

(c) Information as to Securities Lending and Borrowing Agreements. SIFMA believes that amounts relating to conduit securities lending transactions should be excluded from the relevant calculations as these reflect customer demand as of any time and are not "funding" transactions.

(d) Securities Lending and Borrowing Counterparties. SIFMA does not believe that counterparty information should be included in the form.

(e) Information as to Bank Loan and Other Credit Facilities. SIFMA notes that a number of the questions in this section of the form cannot be answered. For example, it is not clear what FINRA means by asking as to the "uncommitted" portion of a term lending facility: isn't any term facility committed? What does it mean to have an uncommitted term agreement? Similarly, FINRA asks as to the unused portion of an "uncommitted facility." But if the facility is "uncommitted," there is no definitive amount available and, thus, the question cannot be answered.

(f) Total Available Collateral (Free Box). The question asks the total value of U.S. Government securities that the firm has available. The request would be more meaningful if firms provided information as to all "high quality liquid assets," not just U.S. Government securities. Is this question referring to proprietary assets only? What about affiliate subordinated non-seg assets? What about customer non-seg assets?

(g) Top Five Equity and Fixed Income (but Not U.S. Government Agency, GSE) Securing Margin Loans. SIFMA does not believe that this information has any value at all. Firms do not make margin loans based on individual securities but rather based on the aggregate market value of liquid securities. Thus, the five equity securities that are in margin loan portfolios will simply be five securities that are broadly owned by customers. For many firms, these are likely to be securities in the S&P 50 as those securities are likely to be in the accounts of many customers. Further, when a customer is concentrated in a particular security, firms will generally lend materially less against that security, which will make it seem as if the firm is more dependent on that particular security as collateral when, in fact, the firm has taken a larger haircut on the security. (Although we would hope that FINRA would determine that this question is not meaningful, if FINRA does determine

to ask it, one question is whether the results would be reported on a trade date or settlement date basis. In addition, it is not clear whether the amounts requested by FINRA are limited to customer transactions or would include loans to PAB accounts or to subordinated accounts.)

(h) Top Five Fixed Income Securities (but Not U.S. Government Agency, GSE) Securing Margin Loans. For the reasons above, SIFMA does not believe that this question will provide meaningful information. Given the tremendous number of individual debt CUSIPs, the five largest fixed income securities are likely to be fairly random collection of securities although, again, likely concentrated in the largest issuers.

(i) Deposits at Clearing Organizations. As to deposits as clearing organizations, we do not understand why the form asks for separate answers as to the amount required to be posted and the amount actually posted. We would expect these amounts to be essentially the same. Likewise, it is not clear what is meant by "proprietary." Is there an expectation that there is a proprietary clearing amount and a customer clearing amount at each clearing agency? The form asks for information as to "other greater than 10% of total." As a starting matter, does the "total" include or exclude the "other"? Additionally, we are concerned that this data will require that firms develop new operations or reporting procedures, for example, to track the largest call in any day.

(j) Cash and Securities Delivered in to Collateralize Receivable and Delivered out to Collateralize Payables. The information to this question will not provide any information as to a firm's liquidity. Generally, if a firm has received in collateral in respect of a receivable, it will be "in-the-money" on a derivative, and the collateral will be essentially freely usable as a proprietary asset. (If the firm did not receive collateral, it would generally have an unsecured receivable, and so could not take any in-the-money amount into account in determining its regulatory capital.) Similarly, if a firm has lost money on a derivative, it may deliver out assets, but that delivery out will already have been reflected as a reduction from its net capital. As we have stated above, firms also do not believe that there is any reason for them to disclose the names of counterparties on the SLS.