



March 3, 2020

Chris Kirkpatrick  
Secretary  
Commodity Futures Trading Commission  
1155 21st Street NW  
Washington, DC 20581

**Re: Capital Requirements for Swap Dealers and Major Swap Participants, RIN 3038-AD54, 84 Fed. Reg. 69664 (Dec. 19, 2019)**

Dear Mr. Kirkpatrick:

The Institute of International Bankers (“**IIB**”), the International Swaps and Derivatives Association (“**ISDA**”), and the Securities Industry and Financial Markets Association (“**SIFMA**” and, together with IIB and ISDA, the “**Associations**”)<sup>1</sup> appreciate this opportunity to provide the Commodity Futures Trading Commission (the “**Commission**” or “**CFTC**”) with comments in response to the above-captioned release (the “**December 2019 Release**”) re-opening the comment period for the Commission’s 2016 release (the “**2016 Proposal**”) re-proposing capital and financial reporting requirements for swap dealers (“**SDs**”) and major swap participants (“**MSPs**”) and amended capital requirements for futures commission merchants (“**FCMs**”).<sup>2</sup>

We strongly support the Commission’s decision to solicit additional feedback regarding the 2016 Proposal, especially considering that key elements of the 2016 Proposal cross-referenced capital requirements of the Securities and Exchange Commission (“**SEC**”) for security-based swap (“**SBS**”) dealers (“**SBSDs**”), which were still pending in 2016 but which the SEC later finalized in 2019 (the “**Final SEC Rules**”).<sup>3</sup> In addition, during 2019, three federal banking regulatory agencies finalized key changes to their capital rules in relation to over-the-counter (“**OTC**”) derivative contracts (the “**SA-CCR Rules**”),<sup>4</sup> which also bear on certain aspects of the 2016 Proposal, and other aspects of the U.S. bank capital framework remain in flux as well.

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<sup>1</sup> Information regarding the Associations is set forth in Appendix C.

<sup>2</sup> Capital Requirements of [SDs] and [MSPs], 81 Fed. Reg. 91252 (Dec. 16, 2016). The 2016 Proposal was preceded by another proposal issued by the Commission in 2011. *See also* Capital Requirements of [SDs] and [MSPs], 76 Fed. Reg. 27802 (May 12, 2011).

<sup>3</sup> *See* Capital, Margin, and Segregation Requirements for [SBSDs] and Major [SBS] Participants [“**MSBSPs**”] and Capital and Segregation Requirements for Broker-Dealers, 84 Fed. Reg. 43872 (Aug. 22, 2019).

<sup>4</sup> *See* Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, 85 Fed. Reg. 4362 (Jan. 24, 2020). The SA-CCR Rules were adopted by the Board of Governors of the

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We generally support the overall framework reflected in the 2016 Proposal, under which (i) an SD that does not have a Prudential Regulator<sup>5</sup> (a “**nonbank SD**”) and is not an FCM could elect a capital requirement based on bank holding company capital rules adopted by the Federal Reserve (the “**Bank-Based Approach**”); (ii) a nonbank SD that is not an FCM could alternatively elect a capital requirement based on the Final SEC Rules for nonbank SBSs (the “**Net Liquid Assets Approach**”); (iii) a nonbank SD that meets defined conditions relating to the extent of its financial activities could elect a capital requirement based on its tangible net worth (the “**Tangible Net Worth Approach**”); and (iv) a nonbank SD that is an FCM would be subject to a modified version of the Commission’s existing FCM capital rule (the “**FCM Approach**”).<sup>6</sup>

Left unmodified, however, the 2016 Proposal would have a significant negative impact on the U.S. swaps markets. In particular, a nonbank SD would, in varying ways depending on which of the above capital approaches the SD follows, be subject to a minimum capital requirement based on 8% of the theoretical amount of initial margin (“IM”) calculable for its futures, cleared and uncleared swaps (including exempt foreign exchange (“FX”) swaps and forwards), and cleared and uncleared SBS (the “**8% IM Rule**”), in each case without regard to any exemption or exception from applicable margin requirements. Because this requirement would not take into account the risk-mitigating impact of hedges or collateral, it would discourage prudent risk management. This issue would be especially problematic for Net Liquid Assets Approach SDs and FCM Approach SDs because the 2016 Proposal would require those SDs to maintain capital equal to the sum of the 8% IM Rule and market and credit risk charges for most of the same derivatives positions covered by the 8% IM Rule—effectively double-counting the credit risk of those derivatives. Meanwhile, the 2016 Proposal would require Bank-Based Approach SDs and Tangible Net Worth Approach SDs to maintain capital equal to the greater of the 8% IM Rule or a calculation taking into account market and credit risk. There is no justification for putting Net Liquid Assets Approach SDs and FCM Approach SDs at a competitive disadvantage in this manner.

In addition, the 2016 Proposal would calibrate minimum capital requirements at higher levels than the SEC or the Prudential Regulators, even though the Commodity Exchange Act (“CEA”) requires the agencies to maintain comparable minimum requirements to the extent practicable.<sup>7</sup> For example, in the Final SEC Rules, the SEC calibrated a capital requirement analogous to the 8% IM Rule at 2%, with a process for increasing the required capital level to 4% or 8% only after extensive additional quantitative analysis. Also, rather than the 8% minimum capital requirement with a 20%

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Federal Reserve System (the “**Federal Reserve**” or “**Board**”), the Federal Deposit Insurance Corporation (“**FDIC**”), and the Office of the Comptroller of the Currency (“**OCC**”).

<sup>5</sup> In this letter, the “**Prudential Regulators**” refer to the Federal Reserve, the FDIC, the OCC, the Federal Housing Finance Agency, and the Farm Credit Administration.

<sup>6</sup> See 2016 Proposal, 81 Fed. Reg. at 91254, 91265–66.

<sup>7</sup> See 7 U.S.C. § 6s(e)(3)(D).

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early warning level that the 2016 Proposal would impose on Bank-Based Approach SDs—for an effective minimum capital requirement of 9.6%—analogous Prudential Regulator rules use a 6.5% capital minimum. The 2016 Proposal’s higher minimum requirements would put nonbank SDs at a significant competitive disadvantage relative to bank SDs and foreign SDs, without any clear justification for doing so.

Additional liquidity requirements for nonbank SDs would further exacerbate these issues by taking unjustifiably disparate approaches to otherwise similarly situated SDs based on which of the proposed capital approaches the SD follows, instead of relying on the existing and more flexible liquidity risk management rules the Commission has administered since 2013. We also are concerned about inconsistencies between the liquidity requirements that the 2016 Proposal would apply to the SD subsidiaries of firms already subject to liquidity requirements at the consolidated entity level.

Several technical changes to the 2016 Proposal are also necessary to conform to relevant aspects of the Final SEC Rules and the U.S. banking agencies’ capital requirements and to facilitate an efficient but appropriate process to permit firms to calculate capital requirements using risk-based models.

Finally, in the financial reporting area, the 2016 Proposal would go beyond the balance sheet, income, and other financial reporting requirements that traditionally accompany capital rules by requiring extensive and costly position and margin reports, on top of existing swap data reporting, large trader reporting, risk exposure reporting, and dispute reporting rules that apply to SDs. We respectfully recommend that the Commission defer adoption of these additional reporting requirements until it conducts a more holistic review of all the various ways it is collecting information from SDs. We also recommend that the Commission modify its financial reporting requirements to align them better with those of the SEC and the Prudential Regulators, including by eliminating new financial reporting requirements for bank SDs already subject to such requirements through their Prudential Regulators and over whom the Commission does not exercise responsibility for capital or margin requirements.

Overall, we therefore consider it important that the Commission balance the desirability of accommodating the different business models represented among nonbank SDs against the goal of maintaining a level competitive playing field, all while avoiding undue inconsistencies with the requirements of other regulatory authorities that apply to nonbank SDs. In light of these considerations, in this letter we propose a modified capital and liquidity framework that is summarized by the table on the following pages. In this table, we have assumed that the Commission adopts a minimum capital requirement that is calculated based on a percentage of a nonbank SD’s IM; however, as described in Part I.A.1 below, we do not believe that the Commission should adopt this requirement. If it does, however, the requirement should be modified as reflected in this table.

Summary of Recommended Capital and Liquidity Requirements for SDs				
Type of SD	Minimum Capital Requirement	Computation of Market Risk Charges	Computation of Credit Risk Charges	Liquidity Requirements
Nonbank SD electing the Bank-Based Approach	<p>(1) Common equity tier 1 capital (“CET1”) equal to the <u>greater</u> of:</p> <ul style="list-style-type: none"> <li>(a) \$20 million;</li> <li>(b) 4.5% of the SD’s risk-weighted assets (“RWAs”), with a 6.5% early warning trigger; or</li> <li>(c) capital requirements established by the National Futures Association (“NFA”); and</li> </ul> <p>(2) Total capital equal to 2% of the “<b>SD risk margin amount</b>,” which is defined as the excess of (i) the amount of IM for the SD’s uncleared swaps, FX swaps, and FX forwards computed on a counterparty-by-counterparty basis under CFTC Regulation § 23.154 without regard to any IM exemptions or exclusions over (ii) the amount of IM that the SD has collected and that is segregated under CFTC Regulation §§ 23.157 or 23.702.</p>	<p>If the SD is approved to use internal models for market risk, then it calculates market RWAs using subpart F of 12 C.F.R. part 217 as if the SD were a bank holding company, with the SD choosing whether or not to follow the provisions of such subpart applicable to advanced-approaches Board-regulated institutions.</p> <p>If the SD is not approved to use internal models for market risk, then it calculates market RWAs by increasing its RWAs by the product of 22 and the sum of the standardized market risk charges computed under CFTC Regulation § 23.103(b)(1), which in turn references the Commission’s FCM net capital rules and Final SEC Rules for nonbank SBSDs.</p>	<p>If the SD is approved to use internal models for credit risk, then it calculates credit RWAs using §§ 217.131-155 of subpart E of 12 C.F.R. part 217, as if the SD were a bank holding company. In accordance with those provisions, the SD chooses whether to calculate its RWAs in relation to OTC derivative contracts using either the internal models methodology (“IMM”) or the standardized approach to counterparty credit risk (“SA-CCR”), subject to certain adjustments to SA-CCR in relation to energy swaps and qualifying letters of credit.</p> <p>If the SD is not approved to use internal models for credit risk, then it calculates credit RWAs using subpart D of 12 C.F.R. part 217, as if the SD were a bank holding company. In accordance with those provisions, the SD chooses whether to calculate its RWAs in relation to OTC derivative contracts using either the current exposure method (“CEM”) or SA-CCR, subject to certain adjustments to SA-CCR in relation to energy swaps and qualifying letters of credit.</p>	Existing SD liquidity risk management requirements under CFTC Regulation § 23.600.

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Summary of Recommended Capital and Liquidity Requirements for SDs				
Type of SD	Minimum Capital Requirement	Computation of Market Risk Charges	Computation of Credit Risk Charges	Liquidity Requirements
Nonbank SD electing the Net Liquid Assets Approach	(1) Tentative net capital ( <i>i.e.</i> , net capital <u>before</u> market and credit risk charges) equal to the <u>greater</u> of:  (a) \$100 million (if the SD is approved to use internal models to calculate market or credit risk charges); or  (b) 2% of the SD risk margin amount; and  (2) Net capital equal to the <u>greater</u> of:  (a) \$20 million; or  (b) capital requirements established by NFA.	Calculated as though the SD were a nonbank SBSD subject to the Final SEC Rules, except that if the SD uses internal models to compute market risk then it must calculate the total market risk as the sum of the value-at-risk (“VaR”) measure, stressed VaR measure, specific risk measure, comprehensive risk measure, and incremental risk measure in accordance with CFTC Regulation § 23.102 and Appendix A thereto.	Calculated as though the SD were a nonbank SBSD subject to the Final SEC Rules, subject to adjustments permitting (i) recognition of IM posted to third-party custodians and (ii) risk-weighting of standardized credit risk charges for potential future exposure if the SD is approved to use market risk models but not credit risk models.	Existing SD liquidity risk management requirements under CFTC Regulation § 23.600.

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Summary of Recommended Capital and Liquidity Requirements for SDs				
Type of SD	Minimum Capital Requirement	Computation of Market Risk Charges	Computation of Credit Risk Charges	Liquidity Requirements
<b>SD Electing the Tangible Net Worth Approach<sup>8</sup></b>	Tangible net worth equal to the greater of:  (a) \$20 million plus market and credit risk charges;  (b) 2% of the SD risk margin amount; or  (c) capital requirements established by NFA.	Calculated either (i) in accordance with CFTC Regulation § 23.102 and Appendix A thereto if the SD is approved to use internal models to compute market risk or (ii) using the standardized market risk charges computed under CFTC Regulation § 23.103(b)(1).	Calculated either (i) in accordance with CFTC Regulation § 23.102 and Appendix A thereto if the SD is approved to use internal models to compute credit risk or (ii) using the standardized credit risk charges computed under CFTC Regulation § 23.103(c)(1).	Existing SD liquidity risk management requirements under CFTC Regulation § 23.600.

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<sup>8</sup> This approach should be made available to any SD that is predominantly engaged in swaps referencing agricultural commodities or exempt commodities, as further described in Section I.E of this letter, in lieu of the “predominantly engaged in non-financial activities” test set forth in the 2016 Proposal.

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Summary of Recommended Capital and Liquidity Requirements for SDs				
Type of SD	Minimum Capital Requirement	Computation of Market Risk Charges	Computation of Credit Risk Charges	Liquidity Requirements
Dually Registered SD/FCM	<p>(1) Net capital (<i>i.e.</i>, adjusted net capital <u>before</u> market and credit risk charges) equal to the <u>greater</u> of:</p> <p>(a) \$100 million (if the SD/FCM is approved to use internal models to calculate market or credit risk charges) or \$5 billion if the SD/FCM is an alternative net capital (“ANC”) broker-dealer; or</p> <p>(b) 2% of the SD risk margin amount; and</p> <p>(2) Adjusted net capital equal to the <u>greater</u> of:</p> <p>(a) \$20 million;</p> <p>(b) 8% of the FCM risk margin amount;</p> <p>(c) if the SD/FCM is also a broker-dealer, the amount required by the SEC in its broker-dealer net capital rule; or</p> <p>(d) capital requirements established by NFA.</p>	Calculated either (i) in accordance with SEC Rule 15c3-1(a)(7) if the SD/FCM is an ANC broker-dealer, (ii) in accordance with CFTC Regulation § 23.102 and Appendix A thereto if the SD is otherwise approved to use internal models to compute market risk, or (iii) using the standardized market risk charges computed under CFTC Regulation § 1.17.	Calculated either (i) in accordance with SEC Rule 15c3-1(a)(7) if the SD/FCM is an ANC broker-dealer, (ii) in accordance with CFTC Regulation § 23.102 and Appendix A thereto if the SD is approved to use internal models to compute credit risk, or (iii) using the standardized credit risk charges computed under CFTC Regulation § 1.17.	Existing SD liquidity risk management requirements under CFTC Regulation § 23.600.

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## **DISCUSSION**

Below we have included our detailed comments on the 2016 Proposal, including the topics raised by the December 2019 Release. In addition, in Appendix A, we have included technical comments regarding certain other aspects of the 2016 Proposal. Finally, in Appendix B, we have included selected revisions to the 2016 Proposal’s rule text, which would implement our comments.

### **I. Capital Requirements**

#### **A. 8% IM Rule**

The 2016 Proposal’s 8% IM Rule would, in varying ways depending on the SD, require a nonbank SD to maintain minimum capital equal to 8% of the IM calculated by the SD for its futures, cleared and uncleared swaps (including exempt FX swaps and forwards), and cleared and uncleared SBS positions, in each case without regard to any exemption or exception from applicable margin requirements.<sup>9</sup> In addition, an SD that is dually registered as an FCM would need to include IM for futures, swaps, and SBS positions cleared by the SD/FCM for affiliates and customers.<sup>10</sup>

The December 2019 Release requests comment on several aspects of the 8% IM Rule, including whether the Commission should eliminate the rule for certain types of SDs, lower the 8% level to 4% or 2%, or exclude certain types of derivatives positions from the calculation.<sup>11</sup> The December 2019 Release further requests comment regarding a potential leverage ratio requirement for SDs.<sup>12</sup> We address each of these topics below.

#### **1. The Commission Should Eliminate the 8% IM Rule for Nonbank SDs**

The 8% IM Rule is based on an existing requirement for an FCM to maintain adjusted net capital in excess of 8% of the risk margin amount for futures, foreign futures, and cleared swap positions carried by the FCM in customer and noncustomer (*i.e.*, affiliates’) accounts.<sup>13</sup> However, there are fundamental differences between the businesses and activities of FCMs and SDs, which make the application of the 8% IM Rule to SDs illogical. Also, as discussed in detail below, subjecting SDs to the 8% IM Rule despite these differences between the businesses and activities of FCMs and SDs

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<sup>9</sup> See 2016 Proposal, 81 Fed. Reg. at 91288–89.

<sup>10</sup> *Id.* at 91266.

<sup>11</sup> December 2019 Release, 84 Fed. Reg. at 69668–70.

<sup>12</sup> *Id.* at 69669.

<sup>13</sup> See 2016 Proposal, 81 Fed. Reg. at 91258.

would constitute a significant departure from the Commission's historic approach to capital and introduce inappropriate risk management incentives for SDs.

Also, although the 2016 Proposal does not explain why, it would apply the 8% IM Rule in very different ways based on the capital approach elected by the SD. Under both the Bank-Based Approach and the Tangible Net Worth Approach, a nonbank SD's minimum capital requirement would equal the greater of the 8% IM Rule or a measurement that takes into account the SD's market and credit risk exposures. In contrast, a nonbank SD electing the Net Liquid Assets Approach or a dually registered SD/FCM following the FCM Approach would need to maintain capital in excess of the sum of the 8% IM Rule and charges for its market and credit risk exposures. As demonstrated by these disparate standards, there is no consistent theory underpinning the purpose of the 8% IM Rule. These varying approaches could lead to competitive disparities between otherwise equally situated SDs that follow different capital approaches.

The 8% IM Rule also is not calibrated based on any empirical analysis of the derivatives positions of SDs. Rather, it leverages calibrations performed by the Commission in the early 2000s relating to the futures and options positions that FCMs clear for customers and affiliates. Considering that the Commission has never done a similar empirical analysis of the swaps markets or the activities of SDs relative to FCMs, it seems hard to defend calibrating the two rules the same.

Furthermore, by including SBS, proprietary futures, and cleared swaps in its IM calculation, the 8% IM Rule would foster conflicts with SEC requirements, as well as the Commission's own regulatory objective of encouraging clearing. Similarly, the 8% IM Rule's failure to take into account the risk mitigation benefits of segregated margin would contradict the Commission's own stance on that topic.

The 8% IM Rule also is not necessary because other aspects of the Commission's capital requirements will already require nonbank SDs to maintain capital against their residual market and credit risk exposures arising from futures, swaps, and SBS positions.

For these reasons, the Commission should not adopt the 8% IM Rule for any type of nonbank SD.

**a. The 8% IM Rule Fails to Account for Fundamental Differences Between the FCM and SD Businesses**

FCMs incur risk by guaranteeing their customers' positions to clearing organizations. The FCM business does not involve transacting as principal. Two fundamental considerations flow from these facts. First, because (i) an FCM's guarantee obligations are accounted for as contingent, off-balance sheet exposures and (ii) the Commission's adjusted net capital calculation for an FCM only takes into account on-balance sheet exposures, the Commission's net capital requirements would not take into account the risks incurred by FCMs through their guarantees unless those

requirements included something like the 8% IM Rule that increased capital requirements based on an FCM's off-balance sheet, guarantee-related exposures. Second, FCMs do not risk manage exposure incurred from one customer by entering into offsetting transactions with another; instead, they are agents for their customers, who are trading with the clearing organization.

An SD, in contrast, faces clients and counterparties as principal. It incurs market and credit risk for its principal derivatives positions. These positions are reflected on its balance sheet where it has uncollateralized exposures. Regardless of the capital approach that applied to a nonbank SD under the 2016 Proposal, the SD would incur market and credit risk charges for all of its derivatives positions, including with respect to potentially adverse future market and credit risks. Therefore, unlike for FCMs, the 8% IM Rule would not fill a gap in the Commission's capital requirements for SDs; instead, it would merely supplement or, in some cases, double up on existing market and credit risk charge requirements. By doing so, and as discussed in greater detail below, the 8% IM Rule would introduce inappropriate risk management incentives, thus working at cross purposes with the objective in the CEA that the Commission's SD capital requirements promote safety and soundness.<sup>14</sup>

The 8% IM Rule would also represent a stark departure from the Commission's and SEC's historic approaches to computing net capital requirements. Both the Commission's FCM capital requirements and the SEC's 2% aggregate debit items test have been driven by customer-related activities rather than a firm's proprietary activities. More specifically, they have looked to the financing that the FCM or broker-dealer has provided to its customer, whether through the guarantee of a customer's positions or direct lending. These frameworks have not ignored a firm's proprietary activities, but captured them through market and credit risk charges. There is no reason for the Commission to depart from its traditional approach of applying market and credit risk charges to account for the risk of firms' proprietary activities, especially considering that using the 8% IM Rule instead of, or in addition to, those charges would discourage hedging and collection of margin because the 8% IM Rule would not take these risk-mitigating actions into account, as we describe in further detail below.

In line with the Commission's and SEC's historic approaches, the Commission should continue to capture proprietary activities through credit and market risk charges, whether assessed directly or through the asset risk-weighting provided for under the Bank-Based Approach, rather than through an independent IM-based requirement. This approach will ensure that the risks of a firm's proprietary positions are captured in a way that is risk-sensitive, aligns with historical capital measurements, and provides appropriate incentives.

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See 7 U.S.C. § 6s(e)(3)(A).

**b. The 8% IM Rule Would Discourage SDs From Hedging Market Risk**

Unlike positions that FCMs clear for customers, an SD's derivatives positions expose it to market risk. SDs will often hedge this market risk by entering into fully or partially offsetting positions with other counterparties. These offsetting positions decrease the SD's overall risk exposure by eliminating or substantially reducing the market risk of its positions, frequently without materially increasing its credit risk exposure since it is not possible that both counterparties of offsetting trades will owe money to the SD at the same time.

The 8% IM Rule, however, would not recognize the risk-mitigating effects of entering into such hedged positions. Instead, it would penalize an SD for hedging its exposure. As demonstrated in further detail below in the example in Section I.A.2.a, this is because a test based strictly on aggregate IM would require an SD that enters into offsetting derivatives to increase its regulatory capital by 8% of the IM that is calculable for the offsetting position. This additional capital requirement would make prudent market risk hedging substantially more expensive, and thus, discourage it.

**c. The 8% IM Rule Would Fail to Recognize Margin as Risk Mitigants**

In addition to discouraging hedging, the 8% IM Rule would fail to recognize the risk-reducing effects of collecting margin, as it would impose the same capital requirement regardless of whether the SD collects margin to mitigate its exposure. For example, an SD that chose to collect IM from a hedge fund, even below the \$50 million IM threshold in the Commission's margin rules, would have the same capital requirement under the 8% IM Rule as an SD that chose to incur uncollateralized exposure. This misbalances incentives, as it treats risk-mitigating activities no differently than risk-increasing activities.

**d. The 8% IM Rule Would Exacerbate Limits on Portfolio Margining**

Although the Commission has taken steps to promote portfolio margining through no-action relief and exemptive relief, in most instances, the various categories of derivatives that would be covered by the 8% IM Rule still must be margined separately—even if those derivatives exhibit offsetting risk profiles and the SD may net the derivatives together upon a counterparty's default. For example, absent further portfolio margining relief from the Commission and/or SEC, an SD dually registered as an SBSD will need to compute IM separately for its uncleared swaps and SBS with a counterparty, even if those positions offset each other (*e.g.*, an equity index swap and single-name equity SBS); these separate IM amounts would then flow into the 8% IM Rule calculation. By establishing a capital requirement that scales up with IM, not risk, the 8% IM Rule would exacerbate the distortions created by this aspect of the U.S. margin regime.

**e. The 8% IM Rule is not Necessary to Ensure That SDs Maintain Robust Capital Levels**

As noted above, even apart from the 8% IM Rule, nonbank SDs will be required to hold capital against their derivatives activities. For nonbank SDs that elect the Bank-Based Approach, the market and credit risk of these activities will count toward RWAs.<sup>15</sup> For Net Liquid Assets Approach SDs and FCM Approach SDs, market and credit risk charges to net capital will apply for all of a firm's derivatives positions.<sup>16</sup> Nonbank SDs that follow the Tangible Net Worth Approach will also be subject to market and credit risk charges.<sup>17</sup> Credit risk charges, in particular, effectively address the same exposures that the 8% IM Rule would address, as they are both computed based on the SD's potential future credit exposure to its derivatives counterparties. However, credit risk charges are more risk-sensitive because SDs will compute them on an aggregate, portfolio-wide basis (not in separate product silos, like IM requirements), and SDs will be able to reduce the charges to the extent they collect IM.

**f. Other Regulators do not Impose Comparable Requirements**

The CEA requires the Commission, SEC, and Prudential Regulators to maintain comparable minimum capital requirements to the maximum extent practical.<sup>18</sup> Other regulators do not impose a requirement similar to the 8% IM Rule, indicating that it is unnecessary for a robust capital framework. For example, the Prudential Regulators rely on the RWA capital approach for prudentially-regulated institutions, including those that engage in derivatives activities, without any additional requirements akin to the 8% IM Rule. Additionally, the Chicago Mercantile Exchange ("CME") imposes minimum capital requirements on its clearing members, which do not include anything similar to the 8% IM Rule.<sup>19</sup> The Commission has not articulated a rationale for departing from the approaches of these other regulators.

**g. The 8% IM Rule is not Necessary to Harmonize with the SEC**

The Final SEC Rules include a requirement for a nonbank SBSD to maintain minimum net capital in excess of 2% of the IM required for its cleared and uncleared SBS positions.<sup>20</sup> We discuss below the key aspects of the 2016 Proposal's 8% IM Rule

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<sup>15</sup> See 2016 Proposal, 81 Fed. Reg. at 91257.

<sup>16</sup> *Id.* at 91262, 91265.

<sup>17</sup> *Id.* at 91263–64.

<sup>18</sup> See 7 U.S.C. § 6s(e)(3)(D).

<sup>19</sup> See CME, Rules 970 (Financial Requirements), 972 (Reductions in Capital).

<sup>20</sup> See Final SEC Rules, 84 Fed. Reg. at 43874–75.

that would be inconsistent with this SEC requirement. But, at a higher level, it is important to note that the SEC’s regulatory framework for SBSDs differs in an important respect from the Commission’s framework for SDs, which makes it less justified for the Commission to adopt a minimum capital requirement scaled to IM than it was for the SEC. Specifically, the SEC permits SBSDs to rehypothecate counterparties’ IM through various exemptions from IM segregation.<sup>21</sup> In contrast, the Commission’s margin rules require all regulatory IM for uncleared swaps to be segregated at a third-party custodian. As a result, the SEC’s 2% IM requirement can, in some respects, be justified as a constraint on the leverage an SBSD can obtain through reuse of its counterparties’ IM. No similar justification applies in the context of SDs who are subject to the Commission’s segregation requirements.

**h. The 8% IM Rule Would Impose Unique and Extensive Operational Burdens**

Adoption of the 8% IM Rule would result in significant and expensive operational burdens for SDs. SDs would need to determine whether they have model approval for each of the products required to be included in the calculation, including products such as exempt FX swaps and FX forwards and SBS that are not subject to the Commission’s margin rules, as well as legacy swaps and swaps with counterparties such as commercial end users (“CEUs”) that are not subject to IM requirements. If an SD wants but does not have model approval to calculate IM for such a product, it would need to obtain NFA approval to do so, in addition to the model approvals potentially necessary for market and credit risk capital charges. If the SD could not get model approval, then it would be required to apply the standardized IM method, which would significantly increase the capital required by the 8% IM Rule. Moreover, even just the operational expense and burden of conducting IM calculations for products, transactions, and counterparties not subject to IM requirements is significant, as our members have found out in seeking to estimate the potential economic impact of the 8% IM Rule.

These additional burdens do not exist in the context of the FCM risk margin requirement on which the 8% IM Rule is based. The reason is that that FCM risk margin requirement looks to margin requirements established by clearing organizations, which by definition already apply to all futures and swaps that an FCM clears for its customers and affiliates, without any need for the FCM to perform separate calculations for products, transactions, or customers not otherwise subject to margin requirements.

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Under the SEC’s segregation rules, counterparties of SBSDs that are not broker-dealers can waive IM segregation. In addition, such an SBSD may be exempt from IM segregation requirements if it does not provide client clearing services. Moreover, SBSDs that are broker-dealers or are otherwise subject to the SEC’s omnibus segregation requirements are exempt from IM segregation for certain hedging activities.

**i. The 8% IM Rule Could Interfere with the London Interbank Offered Rate (“LIBOR”) Transition**

By increasing with IM, rather than risk, the 8% IM Rule could make it more difficult for SDs and other market participants to enter into swaps that facilitate the transition from interbank offered rates (“IBORs”) to other risk-free rates. As Commission staff has recognized, market participants may seek to transition swap or other portfolios that reference IBORs to alternative reference rates by means of a basis swap that swaps the entire IBOR basis of a portfolio with an alternative reference rate basis.<sup>22</sup> These basis swaps and other similar transactions serve to reduce risk, both to SDs and to their counterparties. However, they may also increase the aggregate gross notional amount of an SD’s swaps as well as the IM that an SD is required to collect. Recognizing this, the staff of the Division of Swap Dealer and Intermediary Oversight issued no-action relief last year for an SD’s failure to comply with the Commission’s margin rules with respect to certain basis swaps.<sup>23</sup> Such relief, however, would not apply to the Commission’s capital rules. As a result, absent adjustment, an IM-based capital requirement will make it more expensive for SDs and market participants to take the steps necessary to transition away from IBORs.

**2. If the Commission Adopts an IM-Based Minimum Capital Requirement, then it Should Modify the Rule to Mitigate the Adverse Consequences Noted Above and Avoid Undue Competitive Disadvantages**

If the Commission adopts an IM-based minimum capital requirement, then it should make the modifications described below. These changes are designed both to mitigate the adverse consequences noted above and to avoid undue competitive disparities between SDs. As mentioned above, the way the 2016 Proposal would implement the 8% IM Rule would require some nonbank SDs (*i.e.*, Net Liquid Assets Approach SDs and FCM Approach SDs), but not others, to double-count derivatives exposures. If left unchanged, this and other undue differences would create a significant competitive imbalance in the swaps market and curtail market liquidity.

We provide suggested rule text to implement these proposed modifications in Appendix B to this letter.

**a. If the Commission Adopts an IM-Based Minimum Capital Requirement, then it Should Modify the**

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<sup>22</sup> See Letter No. 19-28 (Dec. 17, 2019); Letter No. 19-27 (Dec. 17, 2019); Letter No. 19-26 (Dec. 17, 2019).

<sup>23</sup> See Letter No. 19-26 (Dec. 17, 2019).

### **Requirement to Avoid Double-Counting for Net Liquid Assets Approach SDs and FCM Approach SDs**

As applied to SDs that elect the Bank-Based Approach, the 8% IM Rule would function as an additional (and unnecessary) backstop to the RWA-based capital ratio: an SD that elects that approach must maintain common equity tier 1 capital (“**CET1**”) equal to 8% of the greater of (i) the SD’s RWAs or (ii) the aggregate IM for the SD’s positions.<sup>24</sup> Similarly, an SD that followed the Tangible Net Worth Approach would be required to maintain tangible net worth equal to the greater of (i) \$20 million plus applicable market and credit risk charges or (ii) 8% of its aggregate IM.<sup>25</sup> In each of these cases, there is a risk-based test, either using RWAs or market and credit risk charges, and a separate risk-insensitive test, the 8% IM Rule.

However, as applied to Net Liquid Assets Approach SDs and FCM Approach SDs, the 8% IM Rule would apply on top of the risk-based test, rather than as a backstop. This is because, unlike the calculation of regulatory capital under the Bank-Based Approach or Tangible Net Worth Approach, the calculation of net capital under the Net Liquid Assets Approach and the FCM Approach already incorporates market and credit risk charges. As a result, rather than acting as alternative binding constraints, the risk-based test and the risk-insensitive test would be aggregated into one test that double-counts a firm’s positions.

There is no logical reason for the 8% IM Rule to apply differently to SDs that follow the Bank-Based Approach or Tangible Net Worth Approach as opposed to those that follow the Net Liquid Assets Approach or FCM Approach. Instead, these varying approaches could lead to competitive disparities between otherwise similarly situated SDs that opt for different capital approaches.

To take a simplified example, assume that an SD enters into a long commodity swap that has a \$200 million notional amount and an IM requirement of \$37.5 million. If the SD elects the Bank-Based Approach, the uncleared swap will affect the calculation of the denominators under both the (i) RWA requirement and (ii) 8% IM requirement. Specifically, it will increase both the (i) SD’s RWAs by the amount specified in the Federal Reserve’s part 217 requirements and (ii) 8% IM amount by \$3 million. The swap will not, however, affect the calculation of the numerator of the SD’s capital calculation (*i.e.*, the amount of its regulatory capital).

By contrast, if the SD elects the Net Liquid Assets Approach or the FCM Approach, the uncleared swap will both reduce the firm’s net capital (through market and credit risk charges) and increase the firm’s minimum capital requirement (through the 8% IM Rule). Taking the same example above, assume that the market risk charge is, like

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<sup>24</sup> See 2016 Proposal, 81 Fed. Reg. at 91256–57.

<sup>25</sup> *Id.* at 91263.

the IM requirement, \$37.5 million, and that the firm does not collect IM because the amount falls below the \$50 million IM threshold. Under the 2016 Proposal, the firm would take a \$37.5 million market risk charge (to account for volatility of the position) and, assuming it does not have credit risk model approval, a \$37.5 million credit risk charge (to account for its potential future credit exposure to its counterparty). In addition, the firm would need to factor the same \$37.5 million potential future credit exposure amount into its 8% IM Rule calculation, resulting in an additional \$3 million of required net capital—even though the firm had already taken a \$37.5 million capital charge for its full potential future credit exposure to its counterparty.<sup>26</sup>

<b>Example 1: One Swap, with \$200M Notional and \$37.5M IM Amount (\$0 Collected)</b>					
<b>Notional</b>	<b>IM</b>	<b>Market Risk Charge</b>	<b>Credit Risk Charge</b>	<b>8% IM</b>	<b>Total Net Capital Needed</b>
\$200M	\$37.5M	\$37.5M	\$37.5M	\$3M	\$78M

If the firm enters into a perfectly offsetting, mirror commodity swap as a hedging position, this double-counting would only be exacerbated further. Although the firm would now take a \$0 market risk charge, it would take an aggregate \$75 million credit risk charge (to account for its potential future credit exposure to its counterparties for both the original position and the hedge) and the 8% IM Rule would increase by \$3 million to a total of \$6 million. By entering into an offsetting hedging position, the firm's total net capital requirement would actually increase from \$78 million to \$81 million—even though the firm is now fully hedged and it is logically impossible for both of its counterparties to default to the firm and owe money to the firm, as the firm must owe money to one of the two due to the offsetting nature of the positions. As a result, the firm would be penalized for hedging its exposure, thus discouraging prudent market risk hedging.

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We note this is a stylized example, and, in practice, we expect the 8% IM Rule calculation would often exceed the credit risk charge for two main reasons. First, SDs generally collect margin with respect to derivative contracts, which as discussed above in Section I.A.1.c, the 8% IM Rule fails to take into account. Second, more creditworthy counterparties have lower credit risk weights, resulting in lower credit risk charges, while the 8% IM Rule does not take into account creditworthiness.

Example 2: Two Offsetting Swaps, with \$200M Notional and \$37.5M IM Amount (\$0 Collected)						
Transaction	Notional	IM	Market Risk Charge	Credit Risk Charge	8% IM	Total Net Capital Needed
Long Commodity Swap	\$200M	\$37.5M	\$37.5M	\$37.5M	\$3M	\$78M
Short Commodity Swap	\$200M	\$37.5M	\$37.5M	\$37.5M	\$3M	\$78M
<b>Total</b>	<b>\$400M</b>	<b>\$75M</b>	<b>\$0</b>	<b>\$75M</b>	<b>\$6M</b>	<b>\$81M</b>

This double-counting not only overstates the risk that the swap presents, but also places Net Liquid Assets Approach SDs and FCM Approach SDs at an unwarranted competitive disadvantage relative to SDs that elect the Bank-Based Approach or the Tangible Net Worth Approach. This competitive disparity may limit the extent to which Net Liquid Assets Approach SDs and FCM Approach SDs are willing, or able, to enter into swaps with new counterparties or to hedge a counterparty's existing positions. This could increase counterparty concentration and limit liquidity.

To address these issues, if it adopts an IM-based capital requirement, then instead of adopting that requirement as a net capital minimum (for a Net Liquid Assets Approach SD) or adjusted net capital minimum (for an FCM Approach SD), the Commission should adopt the requirement as a tentative net capital minimum (for a Net Liquid Assets Approach SD) or net capital minimum (for an FCM Approach SD).

Tentative net capital (for a Net Liquid Assets Approach SD) and net capital (for an FCM Approach SD) represent net capital requirements before deductions for market and credit risk charges. The Commission and SEC have used such measures in the past to provide a backstop against the possibility that a firm's credit and market risk charges understate the risk of the firm's portfolio.<sup>27</sup> Consistent with that approach, if the Commission adopts an IM-based capital requirement, it should make such requirement a tentative net capital (for a Net Liquid Assets Approach SD) or net capital (for an FCM Approach SD) requirement that applies prior to market or credit risk charges, just as the

<sup>27</sup> See, e.g., Final SEC Rules, 84 Fed. Reg. at 43884 (Oct. 21, 2019); [ANC] Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34427, 34431 (Aug. 20, 2004); OTC Derivatives Dealers, 63 Fed. Reg. 59362, 59384 (Nov. 3, 1998).

Commission proposes to apply the IM-based capital requirement to Bank-Based Approach SDs and Tentative Net Worth Approach SDs prior to any credit or market risk adjustments or charges. By making this change, the Commission would avoid double-counting exposures by simultaneously subjecting them to the IM-based capital requirement and market and credit risk charges, aligning the way the Commission applies the IM-based requirement to FCM/SDs and Net Liquid Asset Approach SDs with how it proposes to apply such requirement to Bank-Based Approach SDs and Tangible Net Worth Approach SDs.

**b. If the Commission Adopts an IM-Based Minimum Capital Requirement, then it Should Reduce the Multiplier to 2%**

As discussed above, the 8% IM Rule is based on the existing requirement for FCMs to maintain adjusted net capital in excess of 8% of the risk margin amount for futures, foreign futures, and cleared swap positions carried by the FCM in customer and noncustomer (*i.e.*, affiliates') accounts. However, the 8% multiplier was never intended to apply broadly to the uncleared swaps markets. Instead, the Commission originally adopted the 8% multiplier in the FCM context based on a report issued in 2001 that reviewed the use of the Standard Portfolio Analysis of Risk ("SPAN") margining system by CME, the Board of Trade Clearing Corporation, and the Chicago Board of Trade to calculate margin requirements for futures and option positions.<sup>28</sup> Data collected almost two decades ago in the context of futures and option positions does not provide a logical foundation for adoption of the 8% IM Rule, as it does not reflect appropriately the risks faced by SDs today on their positions, particularly their uncleared positions, which are subject to significantly higher margin requirements (*i.e.*, requirements calculated using a 10-day liquidation horizon as opposed to the 1-day horizon common for futures).<sup>29</sup>

If the Commission is determined to adopt an IM-based capital requirement, it should reduce the multiplier to 2%. This calibration would be consistent with the Final

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<sup>28</sup> See Minimum Financial and Related Reporting Requirements for [FCMs] and Introducing Brokers, 68 Fed. Reg. 40835, 40837 (Jul. 9, 2003). See also CFTC Division of Trading and Markets, Review of [SPAN] Margin System as Implemented by the [CME], Board of Trade Clearing Corporation, and the Chicago Board of Trade (Apr. 2001).

<sup>29</sup> Additionally, if the Commission does not modify the IM-based requirement to avoid the double-counting described in Section I.A.2.a above, then reducing the 8% multiplier would be necessary to prevent undue competitive disparities and problematic incentives. Based on the data we have compiled, an 8% multiplier would be sufficiently high that it would require SDs that elect the Net Liquid Assets Approach and SD/FCMs to dramatically increase the amount of capital required to support their derivatives activities well beyond not only the current capital requirements applicable to such SDs, but also what bank SDs, foreign SDs, and SDs that follow the Bank-Based Approach or Tangible Net Worth Approach are required to hold for similar positions. For such SDs, the 8% IM Rule would dictate incentives, discouraging these firms from hedging their market or credit risk and treating firms that elect not to collect margin the same as firms that always obtain credit support.

SEC Rules, which, as noted above, use a 2% multiplier, at least as an initial matter so that the SEC can obtain further data and examine the effects of its net capital requirements. Like the Commission, the SEC originally proposed an 8% multiplier, but it ultimately adopted a 2% multiplier after taking into account feedback from commenters.<sup>30</sup> Consistency with the SEC will be particularly important if, as proposed, the requirement covers SBS in addition to CFTC-regulated positions—otherwise the Commission would indirectly be undermining the SEC’s calibration decision.

**c. If the Commission Adopts an IM-Based Minimum Capital Requirement, then it Should Expand the Numerator Under the Bank-Based Approach to Include Total Capital**

As discussed in Section I.B below, we generally support the requirement that an SD that elects the Bank-Based Approach maintain an amount of CET1 equal to or greater than a specified percentage of its RWAs. However, to the extent the Commission maintains an IM-based minimum capital requirement, the relevant numerator for Bank-Based Approach SDs should be total capital, rather than CET1.

As the Commission acknowledged, the definition of “net capital” encompasses a broader array of loss-absorbing instruments than CET1, including, in particular, subordinated debt.<sup>31</sup> To ensure parity between Bank-Based Approach SDs, on the one hand, and FCM Approach SDs and Net Liquid Assets Approach SDs on the other, Bank-Based Approach SDs should be able to incorporate a similar set of instruments into their calculation for purposes of the 8% IM Rule. In particular, Bank-Based Approach SDs should be able to include “additional tier 1” (“AT1”) and “tier 2” capital in the numerator of the calculation. These instruments are just as, if not more, loss absorbing than subordinated debt and are well-defined under the Basel Committee on Bank Supervision (“BCBS”) capital rules.<sup>32</sup> As a result, a test based on total capital (*i.e.*, CET1 plus AT1 and tier 2 capital) would place Bank-Based Approach SDs on a more level playing field with FCM Approach SDs and Net Liquid Assets Approach SDs while still allowing Bank-Based Approach SDs to leverage existing, BCBS-compliant systems.

**d. If the Commission Adopts an IM-Based Minimum Capital Requirement, then it Should Recognize Segregated IM as an Offset**

Members of the Commission have previously recognized on numerous occasions that the risk-reducing benefits of segregated IM posted in connection with a swap or SBS

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<sup>30</sup> See Final SEC Rules, 84 Fed. Reg. at 43874–75.

<sup>31</sup> See 2016 Proposal, 81 Fed. Reg. at 91260.

<sup>32</sup> *Id.*

should not be ignored in calculating exposures for such positions.<sup>33</sup> Unlike margin that a firm is free to reuse, segregated IM does not increase total leverage. It remains at the custodian, available to be applied in the event the counterparty defaults. As four Commissioners recently stated in response to proposed changes to the U.S. banking regulators' standardized approach for calculating the exposure amount of derivatives contracts, “[s]egregated margin is, by definition, risk-reducing. Failing to reduce a clearing member's exposure by the segregated client margin it holds results in an inflated measure of the clearing member's exposure for a cleared trade.”<sup>34</sup>

Although much of the Commission's advocacy on this point has focused on the treatment of IM posted in connection with cleared transactions, the same basic principles apply to margin that is segregated in accordance with the Commission's margin or segregation rules. Such margin is, by definition, risk-reducing, and failing to recognize it in the 8% IM Rule would not only result in a mismeasurement of an SD's credit risk exposure, but also create improper incentives. This is because the 8% IM Rule would treat IM that a counterparty elects or is required to keep at a third-party custodian no differently from margin that the counterparty elects not to segregate. When combined with the lower costs SDs are able to provide counterparties that do not elect segregation—lower costs that result from the fact of increased leverage—the 8% IM Rule would tip the balance in favor of not segregating.

**e. If the Commission Adopts an IM-Based Minimum Capital Requirement, then it Should Exclude SBS, Proprietary Futures, and Cleared Swaps**

Unlike the comparable requirement under the Final SEC Rules, the 8% IM Rule would require a nonbank SD to incorporate into the IM calculation not only the amount of the SD's uncleared swap positions (and, if it is also an FCM, swaps and futures cleared for customers and affiliates) and exempt FX swaps and forwards, but also its (i) customer and proprietary cleared and uncleared SBS positions and (ii) proprietary cleared swaps and futures positions.<sup>35</sup> We are concerned that this broad scope would frustrate congressional objectives, interfere with other agencies' regulatory regimes and create undue competitive disadvantages, in addition to proving operationally burdensome for

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<sup>33</sup> See, e.g., Letter from the Commission Re: Capital Adequacy: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, Feb. 15, 2019, available at <https://www.cftc.gov/sites/default/files/2019-02/SA-CCRCommentLetter021519.pdf>; Remarks of Chairman Massad before the 3<sup>rd</sup> Annual Derivatives Summit North America, Sept. 29, 2015, available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-28>; Keynote Address by Chairman Massad before the [IIB], Mar. 2, 2015, available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-13>.

<sup>34</sup> Letter from the Commission Re: Capital Adequacy: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, Feb. 15, 2019, available at <https://www.cftc.gov/sites/default/files/2019-02/SA-CCRCommentLetter021519.pdf>.

<sup>35</sup> Except, uniquely, an SD/FCM would need to take into account proprietary futures positions.

firms to recalculate their IM positions in accordance with the positions covered by the requirement.

## **1. The Commission Should not Include SBS in the IM Calculation**

Under the Commission's and SEC's existing capital requirements, a dually registered broker-dealer/FCM is generally required to maintain net capital equal to the greater of (i) 8% of the IM required for the futures and cleared swaps carried by the FCM for customers and affiliates or (ii) 2% of the debit items calculated in respect of the broker-dealer's customer securities positions.<sup>36</sup> Neither the Commission nor the SEC generally dictates that a dual registrant must hold a specified minimum amount of capital calculated with respect to the positions regulated by the other agency (though both agencies require credit or market risk deductions from net capital to reflect the risk of those positions).

The approach of setting separate, as opposed to aggregate, requirements for Commission- and SEC-regulated products serves to allow the agency that Congress selected to regulate a given product determine the appropriate balance between robust capital cushions and robust market liquidity. In adopting its capital requirements for nonbank SBSDs, the SEC continued to follow this approach, prescribing a calculation based on the amount of IM that the SBSD calculates for its customer cleared SBS and proprietary uncleared SBS. The SEC did not include Commission-regulated products in its risk margin amount calculation, and so its capital framework remains complementary to the Commission's.

In a stark departure from that approach, however, the 2016 Proposal would require a nonbank SD to maintain regulatory capital equal to 8% of the IM associated with not only the SD's CFTC-regulated positions, but also its SBS positions.<sup>37</sup> Because many SDs will be dually registered as SBSDs, the 2016 Proposal's approach would effectively override the SEC's decision on the appropriate level of capital requirements. In relation to such SD/SBSDs, the Commission would essentially be changing the SEC's prescribed capital requirements for SEC-governed products. This approach would be especially problematic if the Commission adopted any other multiplier than the 2% adopted by the SEC.

We further note that excluding SBS from the IM calculation would help to address the issue noted in Section I.A.1.d above that the 8% IM Rule would inappropriately exacerbate limits on portfolio margining because such exclusion would prevent artificial separation in IM calculations from affecting minimum capital requirements.

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<sup>36</sup> See 17 C.F.R. §§ 1.17(a); 240.15c3-1.

<sup>37</sup> See 2016 Proposal, 81 Fed. Reg. at 91255.

## 2. The Commission Should not Include Proprietary Futures or Cleared Swaps in the IM Calculation

In a departure from both its existing capital requirements applicable to FCMs and the approach of the Final SEC Rules, the 2016 Proposal would require nonbank SDs to incorporate into the 8% IM Rule calculation proprietary cleared positions.<sup>38</sup> This inclusion would not only fail to recognize the limited risk and leverage associated with cleared positions, but also conflict with Congress's intent in enacting Title VII of the Dodd-Frank Wall Street Transparency and Accountability Act ("Title VII").

Unlike customer cleared positions or proprietary uncleared positions, proprietary futures and cleared swaps present minimal credit risk, as the SD's only exposure is to the clearing organization.<sup>39</sup> In addition, centrally cleared transactions present limited leverage since the IM associated with such transactions is not reused, but maintained at the clearing organization or its custodian. For these reasons, among others, Title VII not only mandates central clearing, but also seeks to incentivize it. Indeed, in enacting Title VII, Congress appears to have contemplated that the Commission would only base its capital requirements for SDs on their uncleared swaps, stating that the capital requirements should be designed to "offset the greater risk to the [SD] or [MSP] and the financial system arising from the use of swaps that are not cleared."<sup>40</sup>

The 8% IM Rule, however, would treat proprietary cleared positions no differently from uncleared swaps, thereby eliminating a powerful incentive to enter into cleared transactions and subjecting product types that present markedly different risks to the same capital treatment.

## 3. The Commission Should not Adopt a Leverage Ratio Requirement

While leverage ratios have been argued to serve as effective backstops to guard against miscalculations of credit or market risk, they are very blunt instruments that create perverse incentives. The Commission previously has recognized these perverse incentives created by a leverage ratio and noted that such a binding capital constraint is a "poor regulatory construct."<sup>41</sup> It also has noted that the leverage ratio requirement under

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<sup>38</sup> *Id.* As noted above, an SD/FCM would not need to include proprietary positions in futures, but other nonbank SDs would.

<sup>39</sup> We note that the FCM net capital rule does not even require an FCM to deduct its unsecured receivables from a clearing organization from its net capital. *See* 17 C.F.R. § 1.17(c)(2)(ii)(C).

<sup>40</sup> 7 U.S.C. § 6s(e)(3) (emphasis added).

<sup>41</sup> *See, e.g.*, Remarks of Commissioner Brian Quintenz before the Structured Finance Industry Group Vegas Conference, Feb. 26, 2018, available at <https://cftc.gov/PressRoom/SpeechesTestimony/opaquintenz7> ("[A]s a binding capital constraint, especially on conditional or probabilistic off-balance sheet exposures, a leverage ratio creates many perverse outcomes and is a poor regulatory construct."); Haynes, Richard, McPhail, Lihong

the BCBS framework has shifted market activities, which may have effects on market liquidity and risk.<sup>42</sup> The Commission should not adopt a leverage ratio requirement in recognition of these issues that it has raised in the context of other regulators' leverage ratios.

In addition, if the Commission retains an IM-based minimum capital requirement, then adoption of a leverage ratio requirement would only duplicate the problems posed by such approach. As discussed in detail above, an IM-based minimum capital requirement would require an SD to hold a specific amount of capital based principally on the volume of its derivatives transactions, rather than the market or credit risk of those transactions. A leverage ratio would expand the scope of relevant activities to cover all of an SD's activities, not just derivatives. Consequently, for example, a leverage ratio would discourage an SD from maintaining a reserve of lower-yielding, and hence safer, securities and cash positions, despite the liquidity and safety and soundness benefits of this practice.

## B. Bank-Based Approach

Under the 2016 Proposal, a nonbank SD that is not an FCM could elect to compute its risk-based capital requirements using the Federal Reserve's bank holding company capital rules. An SD that elects to follow the Bank-Based Approach would be required to maintain CET1 equal to or greater than the greater of (i) 8% of the SD's RWAs, measured in accordance with the Federal Reserve's part 217 regulations or (ii) the 8% IM Rule.<sup>43</sup> In addition, a Bank-Based Approach SD would be required to notify the Commission if its CET1 falls below 9.6% of its RWAs (*i.e.*, 120% of the 8% requirement).<sup>44</sup>

We support the Commission's proposal to allow SDs to calculate risk-based capital using the Bank-Based Approach. Proposing distinct capital approaches recognizes that SDs have a wide range of business models, many of which do not fit easily, if at all, within the other proposed capital frameworks. In particular, nonbank SDs that are not dually registered as SBSDs or FCMs generally do not maintain custody of customer assets nor are they subject to insolvency regimes premised on liquidation and

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and Zhu, Haoxiang, *When the Leverage Ratio Meets Derivatives: Running Out of Options?*, p. 27, Apr. 2019, available at [https://www.cftc.gov/sites/default/files/2019-05/oce\\_leverage\\_and\\_options\\_ada.pdf](https://www.cftc.gov/sites/default/files/2019-05/oce_leverage_and_options_ada.pdf) ("[W]e find that the leverage ratio requirement has shifted market activities toward less constrained market segments, and by a significant amount. This change in the competitive landscape could, in turn, have important implications on market liquidity, the distribution of risks in financial markets, and access to key market infrastructure such as central clearing.").

<sup>42</sup> See *id.*

<sup>43</sup> 2016 Proposal, 81 Fed. Reg. at 91256–57.

<sup>44</sup> December 2019 Release, 84 Fed. Reg. at 69670.

the return of customer assets. For these SDs, it makes sense for the Commission not to apply the Net Liquid Assets Approach or FCM Approach because those approaches are premised on the customer profile and insolvency regime applicable to SBSDs or FCMs, respectively. Instead, it makes sense for the Commission to look to the tried and tested approach to capital standards developed by the Federal Reserve and other peer regulators. Through alignment with the Federal Reserve's existing framework, this approach would also limit competitive disparities between nonbank and bank SDs.

Additionally, if SDs that opt for the Bank-Based Approach are subsidiaries or affiliates of bank holding companies or other institutions subject to capital requirements modeled on the BCBS framework, such SDs would be able to leverage their affiliates' existing internal systems to comply with their capital requirements.<sup>45</sup> This would serve to reduce the costs to these SDs of having to develop new internal systems and processes or alter their business models altogether in order to comply with the Commission's capital requirements.

We recommend, however, that the Commission make certain changes to the 2016 Proposal's Bank-Based Approach in order to further these goals. In particular, we urge the Commission to calibrate the CET1 requirement to align with comparable bank capital requirements. In addition, it would be helpful to provide further clarity regarding the application of the Federal Reserve's capital rules and to make minor adjustments to tailor them more appropriately to the risks faced by SDs. Finally, it is essential for the Commission to adopt a framework for the Bank-Based Approach that is sufficiently flexible to incorporate the significant transformations currently occurring in the Federal Reserve's capital framework in light of new standards being developed by the BCBS.

We set out some of these recommendations below. In addition, we have included in Appendix B suggested technical changes to the text of the 2016 Proposal to provide clarity regarding how the Federal Reserve's part 217 rules should apply.

### **1. A Bank-Based Approach SD Should be Required to Maintain CET1 Equal to 4.5% of RWAs, with a 6.5% Early Warning Trigger**

As proposed, the Bank-Based Approach applies an effective CET1 requirement of 9.6% of a nonbank SD's RWAs (*i.e.*, an early warning level set at 120% of the 8% CET1 minimum capital requirement).<sup>46</sup> We support requiring Bank-Based Approach SDs to maintain CET1 equal to a specified percentage of RWAs, as both the BCBS and U.S. regulators have recognized that CET1 is the most loss-absorbent form of capital.<sup>47</sup>

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<sup>45</sup> 2016 Proposal, 81 Fed. Reg. at 91256.

<sup>46</sup> See December 2019 Release, 84 Fed. Reg. at 69670.

<sup>47</sup> See, e.g., Basel III: A global regulatory framework for more resilient banks and banking systems 2 (June 2011).

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However, we are concerned that a 9.6% requirement is not aligned appropriately with comparable bank capital requirements.

As discussed above, the CEA requires the Commission and Prudential Regulators to maintain comparable minimum capital requirements to the maximum extent practical.<sup>48</sup> As SDs are more similar to bank subsidiaries than bank holding companies in their structure and risk profiles, we recommend that the Commission refer to the U.S. prompt corrective action (“PCA”) framework as a benchmark.<sup>49</sup>

The PCA framework sets forth tiered capital categories that correspond with certain regulatory restrictions.<sup>50</sup> A bank must maintain 6.5% of RWA in CET1 in order to qualify as “well capitalized” under the PCA framework.<sup>51</sup> A bank that falls below this threshold is required to notify the Federal Reserve and may be subject to activity limitations.<sup>52</sup>

Similarly to the PCA framework, the Commission’s risk-based capital requirements are designed to support the safety and soundness of SDs, and the early warning trigger is to notify the Commission that an SD is in or approaching financial difficulty that may require intervention.<sup>53</sup> In order to align the Commission’s requirements with the PCA framework, we recommend that the Commission require a Bank-Based Approach SD to maintain an amount of CET1 equal to or greater than 4.5% of its RWAs, with a 6.5% early warning trigger. In contrast, retaining a greater requirement of 9.6% of a nonbank SD’s RWAs would not be supported by the principles underlying the bank capital framework and would fundamentally conflict with the goal under the CEA of promoting comparable capital requirements.

Furthermore, the Commission does not need to align the multiplier of the Bank-Based Approach’s risk-based capital calculation with the multiplier it applies to any IM-based capital requirement because the RWA and IM-based calculations are fundamentally different measurements. The RWA calculation examines the firm’s risk-calibrated exposures. By contrast, an IM-based calculation is more like a volume-based test because it fails to capture both risks and risk mitigants, and so should be subject to a lower multiplier if it is adopted. However, regardless of the multiplier the Commission

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<sup>48</sup> See 7 U.S.C. § 6s(e)(3)(D).

<sup>49</sup> See 12 C.F.R. subpart D.

<sup>50</sup> See 17 C.F.R. § 208.43.

<sup>51</sup> *Id.*

<sup>52</sup> 17 C.F.R. § 208.42(c).

<sup>53</sup> 2016 Proposal, 81 Fed. Reg. at 91279.

applies to any IM-based requirement, there is no reason to apply the same multiplier to any RWA calculation.

A CET1 requirement equal to 4.5% of RWAs with an early warning trigger at 6.5% would serve to place bank SDs and nonbank SDs that follow the Bank-Based Approach on a level playing field. It would also promote the Commission's stated goal of requiring an SD to "maintain a level of [CET1] that is comparable to the level it would have to maintain if it were subject to the capital rules of the Federal Reserve."<sup>54</sup>

## **2. The Bank-Based Approach Should be Sufficiently Flexible to Incorporate Changes to the Bank Capital Framework**

The Federal Reserve's capital approach currently is undergoing a significant transformation, as the Federal Reserve is implementing the revised Basel III framework adopted in December 2017. In November 2019, the Federal Reserve finalized the SA-CCR Rules.<sup>55</sup> However, the Federal Reserve's implementation of other fundamental aspects of the Basel III framework, including approaches for credit, market, and operational risks, remains pending. The BCBS also is making further revisions to the credit valuation adjustment risk framework to further align it with other capital requirements.<sup>56</sup> It is, therefore, essential that the Commission adopt a Bank-Based Approach that provides SDs with certainty of application despite these and other future changes to the bank capital framework.

Specifically, Bank-Based Approach SDs should have flexibility in choosing how to calculate their market and credit RWAs given that the Federal Reserve and BCBS are still in the process of modifying these requirements. To account for this unsettled reality, Bank-Based Approach SDs approved to use internal models to compute market risk exposures should be permitted to choose whether or not to apply the Federal Reserve's provisions for advanced approaches Board-regulated institutions. Other regulators have successfully employed this approach for incorporating changing frameworks in order to promote certainty and flexibility within their own regimes.<sup>57</sup> For the same reason, consistent with the Federal Reserve's rules, Bank-Based Approach SDs should also be permitted to compute their credit RWAs using either CEM, IMM, or SA-CCR, as modified in the manner described below.

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<sup>54</sup> *Id.* at 91275.

<sup>55</sup> See 85 Fed. Reg. at 4362.

<sup>56</sup> See BCBS, Consultative Document Credit Valuation Adjustment risk: targeted final revisions (Nov. 2019), available at <https://www.bis.org/bcbs/publ/d488.pdf>.

<sup>57</sup> For example, the OCC gave firms three options for calculating credit exposure for derivatives transactions to provide firms with greater flexibility in an environment where such methodologies were unsettled. See Lending Limits, 78 Fed. Reg. 37930, 37932 (Jun. 25, 2013).

In addition, if the Federal Reserve adopts material changes to its capital rules in the future, the Commission should revisit its incorporation of this framework into the Bank-Based Approach and consult with market participants and the public as to what, if any, changes would be appropriate at that time.

### **3. The Bank-Based Approach Should Incorporate the Federal Reserve's Existing Model-Based Requirements**

Since the publication of the Basel II framework, many bank holding companies have determined their capital requirements using credit and market risk models. Specifically, the Federal Reserve has required certain bank holding companies to use credit risk models to calculate their RWAs under its “advanced approaches” capital framework under subpart E to part 217 and market risk models to calculate market risk exposure under subpart F to part 217.

Although the Bank-Based Approach would allow an SD to calculate its RWAs using the Federal Reserve’s standardized credit risk weights, it generally would not permit an SD to calculate credit or market risk exposure using the models firms have developed in connection with the Federal Reserve’s advanced approaches and market risk rules. Instead, the 2016 Proposal would require Bank-Based Approach SDs looking to use models to submit a new application to the Commission or NFA with the information set forth in proposed Appendix A to CFTC Rule 23.102.<sup>58</sup> The information required by Appendix A is not the same as the information that the Federal Reserve requires. As a result, bank holding companies may be required not only to develop new applications, but also to modify existing models or develop brand new models to satisfy the Appendix A requirements.

In addition, upon obtaining model approval, a Bank-Based Approach SD would need to calculate its credit and market risk charges using Appendix A, rather than the Federal Reserve’s advanced approaches or market risk rules. As with models, the Federal Reserve’s advanced approaches and market risk rules impose materially different requirements than the requirements set forth under Appendix A. As a result, if the Bank-Based Approach is adopted without adjustment, many Bank-Based Approach SDs would not be able to leverage their existing systems and would instead be required either to use the less risk-sensitive standardized approach or to develop brand new models.

We, therefore, recommend that the Commission revise the Bank-Based Approach to incorporate the Federal Reserve’s models provisions. In particular, the Commission should allow a Bank-Based Approach SD to use a model to calculate credit or market risk exposure if that model satisfies the relevant Federal Reserve requirements for credit or market risk models, as appropriate. Further, the Commission should permit an SD that has obtained approval to use credit risk models to calculate its credit risk exposure using the Federal Reserve’s advanced approaches capital framework, contained in subpart E of

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<sup>58</sup> See 2016 Proposal, 81 Fed. Reg. at 91269.

the Federal Reserve's part 217 regulations. Lastly, a Bank-Based Approach SD that has approval to use market risk models should be permitted to calculate its market risk exposure using the Federal Reserve's market risk rules contained in subpart F of the Federal Reserve's part 217 regulations. Those rules set out different requirements for firms that are required to comply with the Federal Reserve's advanced approaches capital regulations and those that are not. Since Bank-Based Approach SDs may be subsidiaries of different kinds of bank holding companies, the Commission should allow a Bank-Based Approach SD to elect the approach that is appropriate to it.

These adjustments would allow Bank-Based Approach SDs to calculate credit and market risk exposures consistently with how bank SDs and many foreign SDs calculate their exposures for capital purposes. They would thus ensure a level playing field between Bank-Based Approach SDs and bank SDs and foreign SDs, and further the Commission's goal of allowing SDs that are subsidiaries of bank holding companies to use their established systems and procedures.<sup>59</sup>

We also note that the approach we set out above would have the benefit of incorporating the Federal Reserve's current requirements for operational risk capital, thereby further increasing the safety and soundness of SDs that follow the Bank-Based Approach. We believe that this approach further justifies the 6.5% CET1 requirement that we propose above.

#### **4. The Commission Should Tailor the Federal Reserve's Standardized Approach to Counterparty Credit Risk Based on the Commission's Expertise in Derivatives Markets**

Under the 2016 Proposal, an SD electing the Bank-Based Approach that does not have credit risk model approval would be required to apply the Federal Reserve's standardized approach calculations.<sup>60</sup> Under the Federal Reserve's standardized approach, as revised by the SA-CCR Rules, a Bank-Based Approach SD would be permitted to elect whether to calculate its exposure to OTC derivative contracts using CEM or SA-CCR. If the Commission adopts the recommendations described related to the incorporation of the Federal Reserve's model-based requirements, a Bank-Based Approach SD that has credit risk model approval would be required to calculate its exposure to OTC derivative contracts using IMM or SA-CCR, as subpart E of the Federal Reserve's part 217 rules provides for such election. We agree with allowing Bank-Based Approach SDs to elect SA-CCR, CEM, or IMM, as applicable, but believe the Commission should use its expertise with derivatives to tailor the SA-CCR framework.

The SA-CCR Rules, which the Federal Reserve adopted just last year (*i.e.*, after the 2016 Proposal), require a firm that elects to use SA-CCR to calculate the exposure

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<sup>59</sup> See *id.* at 91256.

<sup>60</sup> See *id.* at 91257.

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amount for a netting set of OTC derivatives contracts by multiplying an alpha factor by the sum of the netting set's replacement cost and potential future exposure. To calculate potential future exposure, a firm must undertake specified calculations. One such calculation requires a firm to multiply the adjusted notional amount of a "hedging set" of transactions that reference similar underliers by a specified supervisory factor. The supervisory factor is meant to represent the volatility of derivatives that reference those assets.

As the Commission has recognized, the SA-CCR method has in some instances overstated risks or failed to recognize risk mitigants.<sup>61</sup> In addition, a Commission economist noted in a 2018 working paper, "[t]he SA-CCR expected exposure is sometimes lower than [IM] suggests it should be, but more often is considerably higher. . . . Together these results suggest that a re-examination of the calibration of SA-CCR might be justified, with a view to reducing its variability."<sup>62</sup> When it adopted the final SA-CCR Rules, the Federal Reserve made significant improvements to the risk-sensitivity of SA-CCR compared to its initial proposal. However, as adopted by the Federal Reserve, SA-CCR continues to overstate certain risks. In particular, the Federal Reserve adopted a supervisory factor of 40% for electricity derivatives and 18% for other energy derivatives. To calibrate this factor, the Federal Reserve followed energy derivative calibrations adopted by the BCBs in its 2014 rules on SA-CCR, which we understand were based on spot market evidence that now dates back almost a decade.<sup>63</sup> Even if the data were current, the volatility of spot prices poorly reflects the volatility of long- and medium-term derivatives. These artificially inflated supervisory factors will substantially increase the cost of entering into energy derivatives.

We therefore recommend that the Commission adopt appropriate modifications to SA-CCR to improve its risk-sensitivity. The Commission is uniquely positioned to determine the appropriate calibration of supervisory factors for derivatives transactions given its expertise with the regulation of the U.S. derivatives market. We would further urge the Commission to share its derivatives expertise with other regulatory agencies that would benefit from the Commission's unique insights and experience. In particular, the Commission should enter into a dialogue with other regulators to share its conclusions relating to targeted revisions to the supervisory factors in order to encourage consistent

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<sup>61</sup> See Commission, Comment Letter on Capital Adequacy: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, OCC Docket ID OCC-2018-0030 and RIN 1557-AE44; Board Docket No. R-1629 and RIN 7100-AF22; FDIC RIN 3064-AE80 (Feb. 15, 2019), available at <https://www.cftc.gov/sites/default/files/2019-02/SA-CCRCommentLetter021519.pdf>.

<sup>62</sup> Roberson, Michael, *An Empirical Analysis of Initial Margin and the SA-CCR*, CFTC working paper, p. 19 (Jul. 2018), available at <https://www.cftc.gov/sites/default/files/2018-07/SA-CCRPaper0718.pdf>.

<sup>63</sup> See BCBS, The standardized approach for measuring counterparty credit risk exposures, paragraph 183, Table 2 (Mar. 2014, rev. Apr. 2014), available at <https://www.bis.org/publ/bcbs279.pdf>.

implementation of such revisions, which the industry supports. The Commission proposed to similar measures with the Net Liquid Assets Approach by selectively modifying the SEC's SBSR net capital rule. In that instance, the SEC ended up adopting many of the Commission's modifications.<sup>64</sup> We hope that the Federal Reserve would do the same here, particularly as the preamble to the SA-CCR Rules mentions that further adjustments to the supervisory factors for derivatives transactions may be considered as part of the implementation of the revised BCBS market risk standards.<sup>65</sup>

### C. Net Liquid Assets Approach

As an alternative to the Bank-Based Approach, the 2016 Proposal would permit a nonbank SD to calculate capital requirements using the Final SEC Rules, with certain adjustments. An SD that elects to follow the Net Liquid Assets Approach would be required to maintain "net capital" (*i.e.*, after credit and market risk deductions) equal to or greater than the greater of: (i) \$20 million or (ii) the 8% IM Rule.<sup>66</sup> In addition, if the Net Liquid Assets Approach SD was approved to use market or credit risk models, it would need to maintain tentative net capital equal to or greater than \$100 million.<sup>67</sup>

For the reasons discussed in Section I.A.2.a above, to avoid double-counting, Net Liquid Assets Approach SDs should only be required to maintain net capital equal to or greater than \$20 million. Any test based on aggregate IM should require an SD to maintain an amount of tentative net capital (*i.e.*, prior to any market or credit risk deductions) equal to the specified percentage of IM. Additionally, for the reasons discussed below in Section I.D.4, the Commission should allow a Net Liquid Assets Approach SD with approval to use market risk models but not credit risk models to calculate its credit risk charge for uncollected IM by multiplying its potential future exposure by a counterparty risk weight for the counterparty and then by 8%, which would help to avoid creating unwarranted competitive disparities between SDs with and without credit model approvals.

With these modifications and certain others that the Commission proposed (as described in Appendix A), we generally support the proposed Net Liquid Assets Approach, as it aligns with the Final SEC Rules. Aligning with the Final SEC Rules would promote harmonization and allow SDs that are dually registered as SBSRs to leverage a single set of systems to implement the standardized charges.

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<sup>64</sup> See, e.g., Final SEC Rules, 84 Fed. Reg.

<sup>65</sup> Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, 85 Fed. Reg. at 4383 ("Further adjustments to the supervisory factor for equity derivative contracts to align with the revised Basel III market risk standard, as recommended by commenters, potentially could be considered if that standard is implemented in the United States in a future rulemaking.").

<sup>66</sup> See 2016 Proposal, 81 Fed. Reg. at 91260–61.

<sup>67</sup> Id. at 91261.

**D. FCM Approach**

Under the 2016 Proposal, a dually registered SD/FCM would be subject to a modified version of the existing FCM net capital rule. A dually registered SD/FCM would be required to maintain “adjusted net capital,” as computed under the existing rule, subject to certain adjustments, equal to or greater than the greater of: (i) \$20 million or (ii) the 8% IM Rule.<sup>68</sup> In addition, if the SD/FCM was approved to use market or credit risk models, it would need to maintain net capital equal to or greater than \$100 million.<sup>69</sup>

As discussed in Section I.A.2.a above, SD/FCMs should only be required to maintain adjusted net capital equal to or greater than \$20 million in order to avoid double-counting. If a test is based on aggregate IM, an SD/FCM should be required to maintain an amount of net capital (*i.e.*, prior to any market or credit risk deductions) equal to the specified percentage of IM.

With this modification, we generally support the proposed amendments to the FCM Approach. However, we believe certain adjustments to the standardized market risk and credit risk charges are required in order to ensure that the deductions do not render SD/FCMs without model approval unable to compete with SDs that have such approval. Also, because the Bank-Based Approach, the Final SEC Rules (and thus the Net Liquid Assets Approach) and the Tentative Net Worth Approach each to varying extents cross-reference CFTC Rule 1.17 for standardized market or credit risk charges for certain positions, modifications to that rule are important for SDs that follow these other approaches. Appendix B contains draft rule text that would implement the modifications to Rule 1.17 discussed below.

**1. The Commission Should Harmonize its Standardized Market Risk Charges with the SEC’s**

The December 2019 Release requests comment on harmonizing the standardized haircuts contained in CFTC Rule 1.17 with those adopted by the Final SEC Rule.<sup>70</sup> We support this harmonization. In particular, we support incorporating into CFTC Rule 1.17 the SEC’s recognition of netting, including the SEC’s treatment of offsetting uncleared interest rate swaps. As the Commission has acknowledged, accurately reflecting offsetting positions is critical to ensuring that the standardized charges correctly capture the risk to which an SD is subject.<sup>71</sup> Failing to recognize such offsets could subject an SD/FCM to capital charges far in excess of what is appropriate to address its risk and

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<sup>68</sup> *Id.* at 91265–66.

<sup>69</sup> *Id.* at 91268.

<sup>70</sup> December 2019 Release, 84 Fed. Reg. at 69672.

<sup>71</sup> *See id.* at 69671.

place it at a steep disadvantage relative to an SD that is able to recognize netting in its models.

The Commission should also adopt the SEC's approach with respect to cleared derivatives in CFTC Rule 1.17. Specifically, the SEC imposes market risk charges based on the IM requirements imposed by the relevant clearing organization. Although the 2016 Proposal would largely take the same approach, it would impose a greater 150% charge on SD/FCMs that are not clearing members of the clearing organization. There is no justification for this requirement, as the market risk of a position does not vary depending on whether a firm holding that position is a self-clearing member or not. Arbitrarily higher market risk charges for SD/FCMs that are not self-clearing members would disproportionately impact smaller SD/FCMs.

## **2. The Commission Should Re-Calibrate its Standardized Market Risk Charges for Uncleared FX Derivatives to be Consistent with its Uncleared Swap Margin Rules**

The 2016 Proposal would impose standardized market risk charges for uncleared FX derivatives equal to 20% of the notional amount of the derivative.<sup>72</sup> Given the generally high liquidity of the FX market, this requirement is clearly too high. In particular, we note that the Commission's margin rules for uncleared swaps set standardized IM requirements for uncleared FX derivatives at 6% of notional amount.<sup>73</sup> As both IM requirements and market risk capital charges are intended to be calibrated to the estimated volatility of a derivative, there is no justification for this wide divergence. Accordingly the Commission should re-calibrate its standardized market risk charges for uncleared FX derivatives to be consistent with the standardized IM requirements that apply to these derivatives under the Commission's uncleared swap margin rules.

## **3. The Commission Should Work with the Industry to Adopt Appropriate Netting and Offset Provisions for Commodity Derivatives**

The netting and offset provisions applicable to underlying commodity positions in CFTC Rule 1.17 are unduly restrictive relative to the types of business activities engaged in by many SDs, including in particular SDs that may need to rely on standardized market risk charges as part of the Bank-Based Approach or Tentative Net Worth Approach. Therefore, we encourage the Commission to engage further with the industry to consider additional amendments to CFTC Rule 1.17 that would recognize a broader range of

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<sup>72</sup> See 2016 Proposal, 81 Fed. Reg. at 91266–67.

<sup>73</sup> See 17 C.F.R. §23.154(c).

offsets for commodity derivatives, similar to the recognition the SEC has given to various products, such as interest rate swaps with different maturities.<sup>74</sup>

In the December 2019 Release, the Commission requested comment on whether it should incorporate the Basel III approach to netting for commodity derivatives.<sup>75</sup> We believe such incorporation would be premature at this time given that, as the Commission acknowledged, the Prudential Regulators have yet to propose their implementation of this approach.

#### **4. The Commission Should Allow Firms with Market Risk Model Approval but not Credit Risk Model Approval to Apply an 8% Multiplier and Credit Risk Weights to Credit Risk Charges for Uncollected IM**

Under the 2016 Proposal, an SD/FCM following the FCM Approach or an SD following the Tangible Net Worth Approach that does not have credit risk model approval would face 100% standardized credit risk charges for any IM that it does not collect from a counterparty on the basis that an exception from the margin rules applies.<sup>76</sup> This treatment would serve to undermine the exemptions from the IM requirements that Congress mandated for physically-settled FX forwards and swap and swaps with CEUs, as well as the exemptions for other swaps that the Commission did not subject to IM requirements. Congress determined that subjecting CEU swaps to IM requirements would unduly increase the cost to CEUs of hedging transactions. The Secretary of Treasury (“**Treasury**”) similarly determined not to apply IM requirements to FX forwards and swaps, given that structural characteristics of these transactions, particularly the certainty of payment amounts, shorter maturities, and market characteristics, made such transactions less risky, such that application of Title VII to these products, with some limited exceptions, was not necessary or appropriate.<sup>77</sup> The Commission similarly determined that it was more harmful than beneficial to require SDs to post and collect IM in respect of swaps with non-financial end users, with financial end users that do not have material swaps exposure, or below a \$50 million IM threshold.

Requiring an SD to take a dollar-for-dollar capital deduction if it elects not to collect IM in accordance with these exemptions would undercut these determinations by increasing economic pressure on SDs to collect IM on exempted trades or to pass on the

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<sup>74</sup> See 17 C.F.R. §§ 240.15c3-1(c)(2)(vi)(A) and 15c3-1b(b)(2)(ii)(A)(3).

<sup>75</sup> December 2019 Release, 84 Fed. Reg. at 69672.

<sup>76</sup> See 2016 Proposal, 81 Fed. Reg. at 91262.

<sup>77</sup> Determination of Foreign Exchange Swaps and For Exchange Forward under the [CEA], 77 Fed. Reg. 69694 (Nov. 20, 2012).

cost of additional capital for not collecting IM to the relevant counterparty. This would generally serve to increase hedging costs and weaken the liquidity of FX markets.

Moreover, for transactions subject to an IM exception, 100% charges would place SDs that use the standardized charges at a large competitive disadvantage relative to SDs that have credit model approval. This is because the Commission's model requirements would generally require an SD with model approval to calculate its credit risk charge for uncollected IM by multiplying its potential future exposure by a risk weight for the counterparty and then by 8%.<sup>78</sup> In many instances, this will lead to the SD having a total capital charge of 8% or less, which is a much smaller figure than the dollar-for-dollar charge an SD using the standardized approach would need to take. It is hard to imagine how an SD that has capital requirements ten times that of a competitor would be able to compete with that competitor, or why the ability to use models justifies this great disparity.

We further note that firms that have market risk model approval but not credit risk model approval will be subject to a \$100 million tentative net capital requirement, as well as back testing requirements for the IM models that they use to compute IM requirements (and, correlatively, potential future exposure capital charges).<sup>79</sup> Given these safeguards, and to promote greater competitive parity among SDs, the Commission should allow a firm with approval to use market risk models, but not credit risk models, to calculate its credit risk charge for uncollected IM by multiplying its potential future exposure by a credit risk weight for the counterparty and then 8%.

#### E. Tangible Net Worth Approach

Under the 2016 Proposal, an SD that is “predominantly engaged in non-financial activities” would be permitted to calculate its capital requirements using the Tangible Net Worth Approach.<sup>80</sup> Tangible net worth refers to a firm’s net worth calculated using U.S. generally accepted accounting principles (“GAAP”), with exclusions for goodwill and general intangibles.<sup>81</sup> As such, it is generally substantially greater than a firm’s tentative net capital, which reflects deductions for certain illiquid assets.

For purposes of the 2016 Proposal, an SD would be considered “predominantly engaged in non-financial activities” if: (i) its consolidated annual gross financial revenues in either of its two most recently completed fiscal years represent less than 15% of its

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<sup>78</sup> See 2016 Proposal, 81 Fed. Reg. at 91262.

<sup>79</sup> We believe these safeguards respond to the objections raised by the SEC to permitting firms without credit risk model approval to risk weight the standardized charges for uncollected IM. See Final SEC Rules, 84 Fed. Reg. at 43904.

<sup>80</sup> See 2016 Proposal, 81 Fed. Reg. at 91263.

<sup>81</sup> *Id.*

consolidated gross revenue in that fiscal year; and (ii) its consolidated total financial assets at the end of its two most recently completed fiscal years represent less than 15% of its consolidated total assets as of the end of the fiscal year.<sup>82</sup>

Given the diversity of SDs' business models, we support the Commission's efforts to provide a workable alternative for commodity-focused SDs that would allow such SDs to use a simplified tangible net worth approach. However, the proposed "predominantly engaged in non-financial activities" test would screen out most commodity-focused SDs. As noted by commercial firms that commented on the 2016 Proposal, the test would force them to engage in substantial corporate restructuring to avoid conducting their commodity swap dealing activity in a separate subsidiary.<sup>83</sup> This test also would typically screen out the commodity-focused SD subsidiaries of financial holding companies.

Rather than focusing solely on exposure to financial vs. non-financial activities, the test for whether a nonbank SD is eligible for the Tangible Net Worth Approach should also focus on whether the SD's swap dealing activities relate predominantly to the commodity markets. Specifically, a nonbank SD should be eligible for the Tangible Net Worth Approach so long as 85% or more of the aggregate gross notional amount ("AGNA") of the SD's swaps connected with dealing activities entered into during the previous calendar year was composed of swaps referencing agricultural commodities or exempt commodities, subject to (i) a re-evaluation period of an additional calendar year if 70% or more of the AGNA of the SD's swaps connected with dealing activity during the previous calendar year was composed of swaps referencing agricultural commodities or exempt commodities (*i.e.*, if its commodity swaps AGNA fell between 70% and 85% of its total AGNA) and (ii) a transition period of one calendar year before the SD must comply with either the Bank-Based Approach or Net Liquid Assets Approach after it loses eligibility for the Tangible Net Worth Approach.

SDs that satisfy this test (*i.e.*, commodity-focused SDs) are more likely to trade in or hold physical assets in addition to swaps and thus face challenges in applying capital approaches designed for firms that predominantly trade in or hold financial assets. By using a test that looks to engagement with the commodity markets, the Commission would promote competitive parity, ensuring that all SDs engaged principally in commodity swap dealing are treated equally regardless of whether such SD is organized as the same legal entity as a commercial firm or as a separate legal entity that is formed strictly for swaps activities or whether such SD is a subsidiary of a commercial firm or a financial firm. In each of these cases, SDs engaged principally in commodity swap dealing have similar business models and have similar risk profiles and, thus, should be eligible for the same capital approach.

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<sup>82</sup> *Id.*

<sup>83</sup> See, e.g., Letter from David McIndoe on behalf of the Commercial Energy Working Group, dated May 15, 2017.

**F. Model-Based Credit and Market Risk Charges**

**1. The Commission Should Allow SDs to use Models Approved by Other Regulators**

As we have detailed in past comment letters, the Commission’s standardized charges will require capital well in excess of the amount of capital that will be required under the Commission’s models-based requirements. This difference has the potential to create significant, and untenable, competitive disparities between firms that have and have not obtained model approval.

To ensure that firms are able to compete on a level playing field, it will be necessary to streamline the model approval process and limit the extent to which smaller and mid-size firms are required to develop new models. In its letter to the Commission regarding the 2016 Proposal, however, NFA advised that the model-approval process would be a very time-consuming undertaking. NFA explained that reviewing credit and market risk models would require substantially more time and resources than NFA’s previous review of margin models.<sup>84</sup> This is because, unlike with margin, there is not an industry-wide model to provide a point of reference. In addition, each SD will likely submit multiple models for review, and the models will be more complex than the industry-standard margin model. Moreover, the NFA’s review of margin models will likely continue through September 2021, spreading its time and resources even more thinly.

To the extent SDs are required to use the standardized charges while awaiting NFA review or simply decline to undertake the expense of developing brand new models, they will be substantially limited in their ability to compete with firms that have obtained model approval. As such firms pull back from the swaps market, more business will be concentrated in the larger SDs, making the swaps market more susceptible to systemic disruption.

We, therefore, recommend that the Commission allow SDs to use models approved by the SEC, a Prudential Regulator, or a foreign regulator, including an SD’s parent or home country consolidated supervisor, whose capital adequacy requirements are consistent with the BCBS framework. These authorities have substantial experience developing market and credit risk models and have adhered to standards adopted by the international community. Moreover, the Commission would still retain its right of oversight and ability to require a firm to remediate a model that it later determines to be deficient. We previously submitted proposed rule text to the Commission in furtherance of this recommendation, which we recommend the Commission adopt.

If the Commission does not allow SDs to use models approved by other regulators, it should calibrate the compliance date to be after a sufficient time for NFA to

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<sup>84</sup> NFA, RIN 3038-AD54: Capital Requirements of [SDs] and [MSPs] (May 15. 2017).

approve all model applications. To the extent this date is too far in the future to be the compliance date, the Commission should allow SDs that have submitted models approved by other regulators to NFA to continue to use such models on a provisional basis. Otherwise, as discussed above, SDs without model approval will be at a substantial competitive disadvantage.

## **2. The Commission Should Consider a Provisional Approval Process for Models**

Even if the Commission allows SDs to use models approved by other regulators, many SDs (especially those that are part of commercial firms) will still face a time-consuming model approval process with NFA. If the Commission's capital rules took effect before NFA completed this process, then the SDs subject to it would face a significant competitive disadvantage. Accordingly, based on the extent to which it allows SDs to use models approved by other regulators, the Commission should consult with NFA to determine how long it will likely take NFA to approve other SDs' models. If the Commission believes that it would not be appropriate to extend the compliance date for its capital rules to take place after NFA realistically believes it will have finished its model approval process, then the Commission should adopt a provisional model approval framework such that those SDs that have submitted their models to NFA for approval at least a specified amount of time in advance of the compliance date for the capital rules will be permitted to use those models for computing market and credit risk charges on a provisional basis, subject to further NFA review and approval.

## **3. The Commission Should Clarify that an SD may use Models for Only Market Risk or Only Credit Risk**

Although not entirely clear, the 2016 Proposal appear to indicate that an SD would be able to obtain approval for only market risk models or only credit risk models or for both. We support this approach since many SDs may have developed only one type of model. For example, an SD whose parent organization is required to comply with the Federal Reserve's market risk requirements, but not the advanced approaches rules, may be able to leverage its parent's existing market risk model systems, but would need substantially more time to develop a credit risk model.

Considering the increased risk-sensitivity that models provide, we see no reason why an SD would be required to obtain approval of both market and credit risk models at the same time. As discussed above, the substantially higher capital requirements under the standardized approach eliminate any incentive to develop only a credit risk model or market risk model. Firms may simply be constrained due to the time and financial resources it may take to create, test, and institutionalize new models. Further, allowing SDs to use the models they have available to them would limit competitive disparities.

#### **G. Treatment of Undrawn Letters of Credit**

The December 2019 Release requests comment regarding whether the Commission should recognize letters of credit provided by CEUs in computing credit risk charges.<sup>85</sup> Due to market practice, CEUs rarely post financial collateral to margin their derivatives. However, on many occasions, SDs will require such CEUs to provide letters of credit in order to limit their exposure to the CEU's credit risk. So long as these letters of credit are issued by firms with strong credit and allow the SD to collect in the event of a CEU default, including bankruptcy, they provide equivalent, if not better, credit protection than most forms of financial collateral.

However, under the 2016 Proposal, undrawn letters of credit are currently not recognized. For Bank-Based Approach SDs, the Federal Reserve's standardized approach permits firms that collect margin in connection with OTC derivatives contracts to recognize the risk-mitigating effect of such credit support, but the collateral must be considered "financial collateral." "Financial collateral" encompasses cash, gold, and various kinds of securities, but does not include letters of credit.<sup>86</sup> Similarly, Net Liquid Assets SDs, Tangible Net Worth Approach SDs, and FCM Approach SDs are not able to avoid a credit risk charge even if they obtain letters of credit to secure a swap.

By not recognizing letters of credit, these approaches inappropriately calibrate the risk, and correspondingly increase the cost, of derivatives with CEUs. This issue is particularly relevant in the commodity swaps markets, where SDs often face CEUs and obtain letters of credit in lieu of margin. We therefore propose that SDs be able to recognize the risk-mitigating effects of letters of credit in their capital calculations by treating such letters of credit like they were collateral in the form of debt securities issued by the letter of credit issuer and pledged to the SD. Such treatment would not allow the SD to disregard its credit risk exposure on the letter of credit or the swap, but recognize it in a way that is consistent with the credit risk the SD actually faces.

Appendix B contains draft rule text that would implement this modification.

#### **H. Treatment of Foreign Bank SDs that do not Operate a U.S. Branch**

We note that the Federal Reserve declined to adopt minimum capital requirements for an SD that is a foreign bank that does not operate an insured branch but is not otherwise a "foreign banking organization," as defined in the Federal Reserve's regulations. Currently, these SDs are all located in BCBS-compliant jurisdictions. Nonetheless, the Federal Reserve remains the Prudential Regulator for these SDs, and the Federal Reserve's capital and margin regulations apply to them.<sup>87</sup> As drafted, the 2016

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<sup>85</sup> December 2019 Release, 84 Fed. Reg. at 69681.

<sup>86</sup> See 12 C.F.R. § 217.37.

<sup>87</sup> See 7 U.S.C. § 1a(39)(A)(iii), 12 C.F.R. § 237.2 (definition of "covered swap entity").

Proposal could be read to suggest that these SDs are instead subject to the Commission’s capital rules because they are not “subject to minimum capital requirements established by the rules or regulations of a [Prudential Regulator].”<sup>88</sup> We do not believe that the Commission intended the 2016 Proposal to be read this way because the Federal Reserve retains sole authority to adopt minimum capital rules for such entities. This same ambiguity applies to the proposed financial recordkeeping and reporting requirements applicable to nonbank SDs.<sup>89</sup> Accordingly, the Commission should revise its capital, liquidity, and financial recordkeeping and reporting requirements for nonbank SDs so that they do not apply to an SD that has a Prudential Regulator.

## **II. Liquidity Requirements**

The 2016 Proposal would impose quantitative liquidity requirements on SDs. The specific requirements would depend on the approach to capital the SD elects. A Bank-Based Approach SD would be required to satisfy the Federal Reserve’s “liquidity coverage ratio” (“LCR”), which requires firms to maintain “high quality liquid assets” (“HQLA”) equal to their total net outflows over a thirty-day period.<sup>90</sup> All other SDs (other than Tangible Net Worth Approach SDs, which the Commission has proposed to exempt from its quantitative liquidity requirements) would be required to perform monthly stress testing that takes into account certain assumed conditions.<sup>91</sup>

The December 2019 Release requests comment on whether the Commission should adopt liquidity requirements at this time (considering that the SEC declined to do so) and, if it does, how the requirements should apply to different types of firms or whether the Commission should modify the requirements in certain ways.<sup>92</sup>

### **A. The Commission Should Continue to Rely on Qualitative Liquidity Risk Management Requirements in Rule 23.600 Instead of Adopting Quantitative Liquidity Risk Requirements**

Consistent with the SEC’s approach in the Final SEC Rule, the Commission should not adopt standard quantitative liquidity requirements. SDs have a diversity of business models, making standard quantitative liquidity requirements difficult to apply across SDs. Instead, the Commission should rely on the qualitative requirements laid out in CFTC Rule 23.600 to evaluate the sufficiency of SDs’ liquidity programs based on their specific businesses and the associated risks. CFTC Rule 23.600 requires that SDs have liquidity risk policies and procedures to: (i) measure liquidity needs on a daily basis,

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<sup>88</sup> 2016 Proposal, § 23.101(a)(3).

<sup>89</sup> *See id.*, § 23.105(a)(2).

<sup>90</sup> 2016 Proposal, 81 Fed. Reg. at 91273–74.

<sup>91</sup> *Id.* at 91274.

<sup>92</sup> December 2019 Release, 84 Fed. Reg. at 69678.

(ii) assess procedures to liquidate non-cash collateral in a timely manner and without significant effect on price, and (iii) apply appropriate collateral haircuts that accurately reflect market and credit risk. It also requires that SDs establish and enforce a system of risk management policies and procedures to monitor and manage market and credit risk associated with their swap dealing activities.

For an SD, liquidity needs arise mainly in connection with two obligations: (i) posting margin and (ii) performing on its swaps. The requirements of CFTC Rule 23.600 are tailored specifically to address these liquidity needs. First, the rule helps ensure that an SD has a balanced book by subjecting an SD to market risk requirements and credit risk requirements; an SD with a balanced book can generally rely on margin and payments from its counterparties to post margin and make payments to other counterparties. Second, as noted above, the liquidity risk requirements of the rule require an SD to measure its liquidity needs and help ensure that the SD will have ready access to liquid collateral in order to meet its margin or payment obligations. Rule 23.600 achieves these objectives flexibly, without any one-size fits all approach that is drawn from other regulatory frameworks inapposite to the SD business.

We note that the Commission implicitly acknowledged the lesser liquidity risk associated with swap dealing business when, in the 2016 Proposal, it decided not to subject SDs eligible for the Tangible Net Worth Approach to quantitative liquidity requirements. In so doing, the Commission differentiated the business operations of these SDs from the “traditional business activities of financial firms and financial market intermediaries whose need for access to liquidity is crucial to make daily payments to their clients and to meet other daily funding obligations.”<sup>93</sup> However, it is not the swap dealing businesses of these different types of firms which sets them apart; rather it is the other business lines in which these firms engage aside from swap dealing. But the Commission does not need to impose quantitative liquidity requirements on SDs in order to address non-SD business lines.

If an SD also engages in another business line with a different liquidity risk profile, then the regulatory framework applicable to that other business line will address those risks. For example, if an SD is also a broker-dealer or FCM, then it will be subject to net capital requirements (under the Net Liquid Assets Approach or FCM Approach) that address liquidity risk through net capital deductions for nonmarketable or otherwise illiquid assets, which help to ensure that the firm maintains a sufficient buffer of liquid assets to meet its obligations to or on behalf of customers who transact through the firm and maintain customer property with it. In contrast, the SD business, whether conducted by a firm eligible for the Tangible Net Worth Approach or the Bank-Based Approach, does not involve acting as agent or custodian for customers, and so the only liquidity risks presented by the business are those which Rule 23.600 is already designed to address.

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<sup>93</sup> 2016 Proposal, 81 Fed. Reg. at 91273.

Moreover, quantitative standards that mandate specified liquid assets to be held at an SD subsidiary would serve to trap liquid assets within its holding company group and make the overall group less resilient by removing the flexibility to liquidate those assets and deploy the cash where it is needed.

**B. If the Commission Goes Beyond Existing Qualitative Liquidity Requirements, it Should Only do so After a Three-Year Reporting and Monitoring Period and Issuing a Notice of Proposed Rulemaking with Specific Liquidity Requirements**

If the Commission goes beyond existing qualitative liquidity requirements, it should do so only after adopting reporting and monitoring requirements for three years to gather additional data. Any additional liquidity requirements should be based on data so that the requirements can be tailored specifically to SDs' businesses and the associated risks.<sup>94</sup> A three-year period will give the Commission time to observe how potential liquidity requirements will affect an SD's business, impacts on the market resulting from incremental trapped liquidity at firms, and whether variations in liquidity merit quantitative requirements.

A deferral will also allow the Commission to implement liquidity requirements that are aligned with those of other regulators, as appropriate. The liquidity requirements of other regulators, including the SEC and Federal Reserve, are continuing to evolve. For example, the Federal Reserve's liquidity framework is changing through further rulemakings and guidance. The SEC has not adopted liquidity requirements for broker-dealers or SBSDs. Seeing existing regulatory requirements in practice will allow the Commission to develop more risk-sensitive liquidity requirements in the future, if such requirements appear necessary.

In light of the alternative liquidity requirements the Commission is considering, we believe any specific quantitative liquidity requirement should be issued as a subsequent notice of proposed rulemaking after the three-year reporting and monitoring period. This would provide the public with the appropriate transparency and opportunity to comment on specific details of a requirement that would significantly impact SDs.

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<sup>94</sup> In the December 2019 Release, the Commission noted that liquidity requirements are particularly necessary for SDs that elect the Bank-Based Approach. December 2019 Release, 84 Fed. Reg. at 69678. However, this assertion was not supported by data from the FR 2052a Complex Institution Liquidity Monitoring Support or by an analysis of the development of the LCR. Until the Commission conducts its own analysis of nonbank SD liquidity, we do not think it is appropriate to base the adoption of significant, onerous new requirements on vague analogies to banks or bank holding companies.

C. **If the Commission Adopts Quantitative Liquidity Requirements, it Should Modify the Proposed Requirements to Reduce Adverse Consequences**

If the Commission adopts quantitative liquidity requirements without first obtaining appropriate data as noted above, it should seek to reduce the resulting adverse consequences by carefully calibrating the requirements in a way that better takes account of an SD's organizational structure and the risks swap dealing presents.

1. **Liquidity Requirements Should not Apply to SD Subsidiaries of Parent Companies Already Subject to Consolidated Liquidity Requirements**

Certain bank or intermediate holding companies and depository institutions are subject to comprehensive liquidity standards issued by the Federal Reserve or foreign regulators. For example, in the United States, Regulation YY requires bank holding companies and U.S. intermediate holding companies that satisfy specified thresholds to establish comprehensive liquidity risk management programs through standards addressing: (i) board of directors' oversight responsibilities for liquidity risk management; (ii) liquidity risk management strategies, policies, and procedures; (iii) liquidity stress testing, including combined market and idiosyncratic stresses projected for overnight, 30-day, 90-day and one-year planning horizons; (iv) maintenance of a liquidity buffer to meet projected 30-day net stress cash outflow need; (v) liquidity risk limits, including with respect to concentrations in sources of funding; (vi) liquidity risk independent review functions; (vii) cash flow projections; (viii) contingency funding plan requirements; (ix) liquidity event management processes; (x) collateral and intraday liquidity monitoring; and (xi) legal entity monitoring, including with respect to cash flow projections and liquidity risk exposures and funding needs.<sup>95</sup>

These requirements are meant to ensure that a bank or intermediate holding company not only has sufficient liquid resources, but also the capacity and the planning necessary to deploy those resources to the subsidiaries that may need it. This approach promotes safety and soundness, as it allows liquidity to go to the subsidiary that may be facing a liquidity drain. Moreover, in a few instances, the Federal Reserve has effectively required prepositioning of liquidity. For example, the LCR applies to firms on a consolidated basis, thus accounting for entity-level liquidity needs and restricting the transferability of assets from entities to the parent organization. Similarly, under the Resolution Liquidity Adequacy and Positioning and Resolution Liquidity Execution Need frameworks set forth in the Federal Reserve's resolution plan guidance, many bank

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12 C.F.R. part 252.

and intermediate holding companies are required to preposition liquidity at the entity-level.<sup>96</sup>

Were the Commission to impose quantitative entity-level liquidity requirements on SDs that are subsidiaries of these institutions, it would force these companies to trap liquidity in SD subsidiaries in order to meet the Commission's liquidity requirements in amounts that differ from what consolidated entity supervisors have imposed. Such requirements would reduce the flexibility under the Federal Reserve's and other supervisors' liquidity frameworks and decrease the resilience of the relevant company as a whole. This is because the holding company would be more limited in its ability to send liquid assets to the subsidiaries that need it, as the company would be required to hold liquidity at each subsidiary based on the most stringent requirement. Additionally, this requirement would likely encourage other regulators to similarly ensure that liquidity is trapped in the particular subsidiary it regulates without regard to consolidated entity liquidity requirements, further reducing holding companies' flexibility to move liquidity around the whole group in the most efficient and risk-reducing manner. While overlapping regulatory liquidity requirements serve to address the same risks, they would generally reduce the safety and soundness of the holding company or depository institution, as well as its ability to address a liquidity need at a particular subsidiary.

We further note that the Commission's proposed framework would effectively treat all nonbank SD subsidiaries of bank holding companies, regardless of size or complexity, as though they were bank holding companies. The LCR does not apply to a bank holding company unless it meets certain thresholds. However, few, if any, nonbank SDs would meet this threshold for being subject to the LCR on a standalone basis if they were bank holding companies subject to the Federal Reserve's recently adopted tailoring framework. Under the tailoring framework, the LCR applies on a mandatory basis to large bank holding companies (*i.e.*, Categories I, II, and III), all of which have at least \$250 billion of consolidated assets. Category IV bank holding companies (*i.e.*, those with less than \$250 billion of consolidated assets) are only subject to the LCR if their short-term wholesale funding exceeds \$50 billion.

## **2. If the Commission Applies Liquidity Requirements to SD Subsidiaries of Holding Companies Subject to Consolidated Liquidity Requirements, it Should Modify Those Requirements to be Consistent with the Holding Company's Requirements**

If the Commission nonetheless imposes entity-level liquidity requirements on an SD that is a subsidiary of a bank or financial holding company, the Commission should, at a minimum, calibrate such requirements to reflect the bank holding company's comprehensive liquidity risk management. As noted above, under the Federal Reserve's liquidity requirements, for example, a bank holding company with more than \$50 billion in consolidated assets is required to conduct internal liquidity stress testing and maintain

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<sup>96</sup> See Final Guidance for the 2019, 84 Fed. Reg. 1438 (Feb. 4, 2019).

a liquidity buffer based on this stress testing.<sup>97</sup> This liquidity buffer is based on the firm's internal assessment of how much liquidity it should need.

To limit the extent to which the Commission's liquidity requirements unduly force an SD to trap liquidity in a specific entity, the Commission should allow an SD whose holding company is subject to these requirements to maintain an amount of liquidity based on its holding company's internal stress test. This will ensure that the liquidity requirement is tailored to the holding company's specific assessment of how much liquidity it and its affiliates will need, and limit the extent to which the Commission's requirements render a bank holding company less resilient.

### **3. The Commission Should Not Apply Liquidity Requirements to Commodity-Focused SDs**

As noted above, the Commission has proposed to exempt Tangible Net Worth SDs from its quantitative liquidity requirements. We support this proposal due to the unique nature of the business of such SDs, practically all of which will be commodity-focused SDs. However, not all commodity-focused SDs may be eligible or elect to follow the Tangible Net Worth Approach. But all of them have substantially the same liquidity profile. First, because they transact mainly with CEUs, commodity-focused SDs often do not post or collect margin. Second, as noted above, commodity-focused SDs often hold physical assets in order to settle or hedge their obligations. As a result of these differences, a commodity-focused SD is likely to have very different, and substantially lower, liquidity needs than other SDs.

The qualitative framework set out in CFTC Rule 23.600 provides a more appropriate way to ensure commodity-focused SDs maintain sufficient liquid resources than quantitative, asset-based requirements. As discussed above, Rule 23.600 requires an SD to measure its liquidity needs, assess its procedures for liquidating non-cash collateral in a timely manner, and take appropriate haircuts for market and credit risk. A commodity-focused SD's consideration of these issues in light of its particular business is more likely to result in accurate liquidity requirements than the application of quantitative standards based on traditional financial activities

For these reasons, a commodity-focused SD (*i.e.*, an SD that satisfies the 85% AGNA test described in Section I.E above) should be exempt from any quantitative liquidity requirements, regardless of whether such SD elects the Bank-Based Approach or the Tangible Net Worth Approach.

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12 C.F.R. § 252.35.

#### **4. SDs Should be Permitted to Elect Which Set of Liquidity Requirements to Apply**

Unlike with respect to capital requirements, the 2016 Proposal would not give SDs the ability to elect their preferred approach to calculating liquidity requirements. Instead, a Bank-Based Approach SD would be required to satisfy the LCR, while Net Liquid Assets Approach and FCM Approach SDs would be subject to liquidity stress test. This mandatory approach ignores the fact that there is no inherent connection between the approaches an SD takes to capital and liquidity. Neither the BCBS capital framework nor the SEC net capital rule are premised on a particular level of liquidity. Instead, they are intended to function independently. This independence is clear in the Federal Reserve's capital and liquidity requirements. Under the Federal Reserve's rules, banks that meet certain thresholds are required to apply the LCR and meet liquidity stress tests to comply with their liquidity requirements.<sup>98</sup> In fact, under the Federal Reserve's tailoring rules, more banks are required to meet liquidity stress tests than comply with the LCR.<sup>99</sup> However, in all of these cases, the banks use an RWA methodology to calculate capital. Therefore, SDs should be permitted to elect the manner in which to calculate their liquidity requirements without regard to their chosen capital approach.

Furthermore, mandating that an SD adopt a particular liquidity requirement based on its approach to capital would unduly limit the ability of the SD to leverage its affiliates' existing liquidity systems. An SD that is a subsidiary of a bank holding company and dually registered as an SBSD, for example, may elect to adopt the Net Liquid Assets Approach so as to leverage its existing, SEC-compliant net capital systems and models. As relates to liquidity, however, such an SD may seek to use the LCR (unless exempted as we request above) since its parent organization has implemented the Federal Reserve's LCR and the SEC has not adopted any quantitative liquidity requirements. Nonetheless, the Commission's mandatory approach would preclude such an approach and require an SD that has the capacity to implement a robust liquidity test to develop systems to perform an entirely different liquidity calculation. This would impose unnecessary costs, with minimal regulatory gains.

Additionally, allowing an SD to elect the set of liquidity requirements to apply would improve organizations' overall liquidity risk management frameworks by ensuring that an SD's liquidity requirement is well-integrated into such framework. Organizations typically approach liquidity risk management with respect to the whole group, rather than on an entity-by-entity basis, making it essential that an SD's liquidity requirements fit

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<sup>98</sup> See Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59230 (Nov. 1, 2019).

<sup>99</sup> See Board of Governors of the Federal Reserve System, Draft final rules to tailor prudential standards to large banking organizations; draft proposed rule to amend assessment fees to align with the tailoring framework (Oct. 3, 2019), available at <https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-board-memo-20191010.pdf> (showing that Category IV banks are required to meet quarterly liquidity stress tests, but not to apply the LCR).

into the larger framework. The Commission’s mandatory approach would preclude this flexibility, potentially raising additional risks with respects to organizations, with minimal regulatory gains.

### **5. If the Commission Instead Adopts an LCR-Based Requirement, it Should Apply a 70% Haircut to Net Outflows**

If the Commission instead applies the Federal Reserve’s LCR, it should apply a 70% haircut to net outflows. This approach would be consistent with that of the Federal Reserve and BCBS framework generally, which apply a 70%, rather than 100%, haircut to net outflows to smaller bank holding companies.<sup>100</sup> In making this determination, the Federal Reserve noted that this haircut was appropriate for such institutions given that these companies would likely not have as great a systemic impact if they experience liquidity stress given their smaller size.<sup>101</sup>

It is appropriate for the Commission to apply the 70% haircut to net outflows based on similar reasoning. SDs are closer in size to bank holding companies subject to a 70% haircut. Additionally, adopting this change would further align the Commission’s approach with that of the Federal Reserve and BCBS framework generally, thus promoting the synchronicities the Commission stated it was seeking to achieve.

### **6. The Liquidity Stress Test Should not be Measured “At All Times”**

Under the 2016 Proposal, an SD subject to the liquidity stress test would be required to maintain the required liquidity reserves “at all times.”<sup>102</sup> Such a requirement would massively limit the extent to which SDs are able to engage in business-as-usual intraday financing, whereby SDs repo out liquid securities in order to obtain cash to conduct their operations. This intraday financing facilitates the ability of SDs to enter into transactions, exit positions, and hedge exposures. Limiting this financing would massively increase the cost of swap dealing, and thereby drain the liquidity of the swaps

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<sup>100</sup> 12 C.F.R. part 249 subpart D.

<sup>101</sup> Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59230, 59255 (Dec. 31, 2019). See Board of Governors of the Federal Reserve System, Draft final rules to tailor prudential standards to large banking organizations; draft proposed rule to amend assessment fees to align with the tailoring framework (Oct. 3, 2019), available at <https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-board-memo-20191010.pdf>.

<sup>102</sup> 2016 Proposal, § 23.104(b)(3).

market. Additionally, it would substantially increase the costs for CEUs to enter into hedging transactions.

## **7. The Liquidity Stress Test Should Include a Broader Range of Liquid Assets**

Under the 2016 Proposal, an SD subject to the liquidity stress test would be required to maintain an amount of unencumbered cash or U.S. government securities,<sup>103</sup> whereas an SD subject to the LCR would be required to maintain an amount of HQLA, as defined in 12 C.F.R. § 249.20.<sup>104</sup> HQLA encompasses a broader range of assets than cash and U.S. government securities, as its primary focus is that the assets are unencumbered by liens and other restrictions on the ability of the SD to transfer the assets. Certain corporate debt securities, equity securities, municipal obligations and securities issued by a foreign sovereign entity or multilateral development bank qualify as HQLA.<sup>105</sup> SDs subject to the liquidity stress test would, therefore, be required maintain an overall more expensive pool of assets to meet the test than those SDs subject to the HQLA test. This would result in unnecessary disparities between SDs, as transactions for SDs subject to the liquidity stress test will be more expensive.

## **8. The Liquidity Stress Test Should Exclude Flows Between Affiliates**

The 2016 Proposal would require cash and asset flows between affiliates to be included in the liquidity stress test calculations. Such a requirement is inconsistent with the Commission's approach to affiliate transactions in its margin regulations. For example, under CFTC Rule 23.519, SDs are not required to collect or post IM in transactions with affiliates, subject to certain specified conditions.<sup>106</sup> In reaching this decision, the Commission noted that imposing margin requirements on inter-affiliate transactions would increase the cost of such transactions without a commensurate benefit to risk reduction for the overall group.<sup>107</sup> The same issues would be present if affiliate flows were included in the liquidity stress test. The liquidity risks of SDs would be materially overstated, increasing the costs of transactions between affiliates and

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<sup>103</sup> *Id.* at 91274.

<sup>104</sup> *Id.* at 91273.

<sup>105</sup> 12 C.F.R. § 249.20.

<sup>106</sup> 17 C.F.R. § 23.519.

<sup>107</sup> Margin Requirements for Uncleared Swaps for [SDs] and [MSPs], 81 Fed. Reg. 635, 673 (Jan. 6, 2016).

unnecessarily restricting the movement of cash and assets between affiliates. This could lead to an overall reduction in market liquidity.

### **III. Financial Reporting Requirements**

#### **A. The Commission Should Align its Proposed Financial Reporting Rules with Existing Requirements**

We recommend that the Commission align the timing, content, signature, and public disclosure requirements of its proposed financial reporting rules with the existing requirements prescribed by the Commission, SEC, and Prudential Regulators.<sup>108</sup> Firms subject to the Commission's financial reporting rules are also often subject to comparable existing requirements from other regulators. These firms have structured their internal financial reporting structures and processes to comply with such existing requirements. The Commission's approval of different requirements will be highly disruptive to existing internal procedures. It will require SDs to adjust such procedures at additional expense and time without the Commission deriving any substantial additional oversight benefit, given that comparable information is available based on other similar regulatory requirements.

Furthermore, financial reports to the Prudential Regulators are prepared on a consolidated basis. Therefore, financial information from bank SDs and SDs that are affiliates of bank holding companies, including nonbank SDs that are subject to the Commission's financial reporting rules, are incorporated into such consolidated reports. Subjecting such SDs to different requirements will undermine the Commission's goal of allowing SDs that are subject to other regulatory regimes to leverage existing internal procedures to comply with the Commission's requirements.

If such procedures are not aligned, SDs may be subject to potentially duplicative and inconsistent requirements. For example, banks must report financial information to their regulators 30 calendar days after each quarter end (or 35 days for most institutions with foreign offices); bank holding companies must report such information 40 to 45 calendar days after the quarter end. This 30- to 45-day period is used by banks and bank holding companies to verify and reconcile financial information, address any issues created by consolidation, and resolve discrepancies. Requiring an SD to report financial information on an earlier timetable, such as the proposed 17 business days, would obligate the SD to supply financial information to the Commission before the financial group has "closed the books" for the period. Adopting a different due date will pose a major disruption to existing financial reporting systems and processes, particularly if the Commission continues to require quarterly financial reports from bank SDs. Similarly,

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<sup>108</sup> For example, we would support incorporating into Appendices A and B of CFTC Rule 23.105 the SEC's form instructions for analogous reports provided by SBSDs. Such incorporation would align the Commission's requirements with the SEC's existing regulatory requirements. It would support the Commission's aim of allowing SDs that are subject to other regulatory regimes to use existing internal procedures to comply with the Commission's regulatory requirements without being subject to duplicative or inconsistent requirements.

given that Bank-Based Approach SDs will follow capital requirements modeled on the Federal Reserve's capital requirements for bank holding companies, it seems inapposite to subject them to monthly financial reporting requirements modeled on what the Commission requires for FCMs and the SEC requires for broker-dealers. It would be more appropriate to require Bank-Based Approach SDs to submit quarterly financial reports like what the Commission proposes to require for bank SDs, but with a 45-day due date as noted above.

**B. SDs that Have a Prudential Regulator or Rely on Substituted Compliance Should be Exempt from Financial Reporting and Position and Margin Reporting Requirements**

SDs that have a Prudential Regulator should be exempt from the Commission's financial reporting or position and margin reporting requirements, given that Congress does not subject them to the Commission's capital or margin requirements. Such SDs are already subject by their respective Prudential Regulators to comprehensive disclosure requirements, including public disclosure requirements. In adopting financial reporting requirements, the Prudential Regulators calibrated such requirements for entities subject to their oversight. If the Commission imposes its own financial reporting requirements on such SDs, the Commission would effectively override the Prudential Regulator's choices. Additionally, the Commission would be imposing requirements that are duplicative and inconsistent with existing requirements applicable to SDs that have a Prudential Regulator. For example, SDs that have a Prudential Regulator would be required to provide financial reports with somewhat different information (especially in the case of foreign bank SDs) and, as discussed above, on a tighter timeline after quarter end than those they must submit to their Prudential Regulators. This would necessitate such SDs to adjust existing internal procedures at additional expense and time, which far outweigh any additional oversight benefit the Commission would derive.

Similar considerations apply to nonbank SDs that are eligible to rely on substituted compliance. The home country regulators of those SDs will be primarily responsible for their safety and soundness, and the substance of the capital and margin requirements applicable to those SDs will be what applies under home country rules. Imposing financial reporting or position and margin reporting rules on those SDs would likely create conflicts or, at best, duplicate what is required under home country rules.

If the Commission does not exempt SDs that have a Prudential Regulator or that rely on substituted compliance from all financial reporting and position and margin reporting requirements, it should exempt such SDs from public disclosure requirements. SDs that are subject to the Prudential Regulators' requirements are currently required to make certain information public pursuant to existing regulations. When promulgating their regulations, the Prudential Regulators determined the propriety of making certain information public. Similar considerations also apply to SDs that rely on substituted compliance. The Commission's imposition of its own public disclosure requirements

would override the balances that were struck, and it is unclear what additional regulatory benefits would be derived from requiring greater public disclosure.

**C. The Commission Should Permit Non-U.S. SDs and U.S. SD Subsidiaries of Non-U.S. Parent Companies to use IFRS**

The 2016 Proposal would allow SDs that are not organized in the United States and not otherwise required to prepare financial statements in accordance with GAAP to submit required financial statements prepared in accordance with International Financial Reporting Standards (“IFRS”).<sup>109</sup> We support this proposal. However, we urge the Commission to allow all non-U.S. SDs to submit required financial statements prepared in accordance with IFRS, regardless of whether the non-U.S. SD is required to maintain any books and records in accordance with GAAP. This would be consistent with the SEC’s approach, which allows foreign private issuers to provide financial statements to the SEC in accordance with IFRS.<sup>110</sup> Financial statements prepared in accordance with IFRS will provide the Commission with the information it needs to analyze a non-U.S. SD’s financial condition, particularly given the increasing convergence between IFRS and GAAP.

In the December 2019 Release, the Commission asked for comment on whether its financial reporting requirements should be modified to permit a U.S. SD that is a subsidiary of a non-U.S. entity to submit required financial statements prepared in accordance with IFRS. We support this modification.

IFRS is widely used by non-U.S. companies doing business in the U.S. commodity markets. Therefore, this modification would allow such an SD to leverage the internal financial reporting processes of its parent company. Requiring a U.S. SD that consolidates with a parent company that uses IFRS to prepare its own financial statements based on U.S. GAAP will cause such an SD to incur additional material costs for its internal and external audit teams at no additional benefit to the market. Additionally, such an SD may be subject to unwarranted competitive disparities vis-à-vis an SD with a U.S. parent entity, as the former would be required to conduct its accounting under both GAAP to comply with the Commission’s regulations and separately under IFRS for purposes of consolidated reporting with its parent entity.

Allowing a U.S. SD that is a subsidiary of a foreign parent to prepare its financials in accordance with IFRS also would be consistent with the SEC’s existing disclosure rules, which, as noted, do not require financial statements prepared pursuant to IFRS to be reconciled to GAAP. Accepting IFRS as an alternative to GAAP would

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<sup>109</sup> 2016 Proposal, 81 Fed. Reg. at 91275–76.

<sup>110</sup> See Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP, 73 Fed. Reg. 986 (Jan. 4, 2008).

reduce the costs for SDs that currently prepare their financial statements pursuant to IFRS and would be consistent with the requirements and policy direction of the SEC.

**D. The Commission Should Defer the Adoption of Position and Margin Reporting Requirements Until it Completes its Overhaul of Part 45**

The 2016 Proposal would impose weekly position and margin reporting requirements on all SDs, including bank SDs.<sup>111</sup> These requirements would apply in addition to Part 45's swap data reporting requirements, which provide trade-by-trade information that should be aggregable into position-level information, and other existing Commission and NFA reporting requirements, such as risk exposure reports, risk metrics reports, margin dispute reports, and large trader reports. Simply put, at this time there are already more than enough reporting requirements on SDs, each designed to capture slightly different information.

Moreover, the Commission is currently working on revisions to Part 45. These revisions to Part 45 include reports relating to margin and collateral information from SDs.<sup>112</sup> It is thus premature for the Commission to adopt a separate position and margin reporting requirement under the auspices of its capital rules. The Commission should wait until it determines whether to collect similar information under Part 45.

If and when it adopts position and margin reporting requirements, the Commission also should incorporate them into its existing regulatory reporting regime under Part 45, instead of as new requirements under Part 23. These reports, like the requirements of Part 45, are intended to facilitate market monitoring and market risk mitigation.<sup>113</sup> Because SDs would be required to report on a position-by-position basis, they will also need to inform their counterparties of the new requirements and obtain their consent to report information. By including similar reporting obligations in a single rule, the Commission will facilitate this aspect of compliance. We also note that existing

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<sup>111</sup> See 2016 Proposal, 81 Fed. Reg. at 91279–80.

<sup>112</sup> Amendments to the Swap Data Recordkeeping and Reporting Requirements, RIN 3038-AE31, Fed. Reg. forthcoming p. 50-53 (Feb. 20, 2020).

<sup>113</sup> See Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136, 2138 (Jan. 13, 2012).

industry-wide efforts to notify counterparties about the Commission's reporting requirements direct counterparties to Part 45.<sup>114</sup>

**E. If it Adopts Them, the Commission Should Apply Position and Margin Reporting Requirements to Non-U.S. SDs Only for Swaps with a U.S. Nexus**

As discussed in Section V.A below, non-U.S. SDs eligible for substituted compliance should not be subject to the Commission's position and margin reporting requirements. This would allow non-U.S. SDs to rely on home country rules and related existing internal processes, lowering their barrier to entry into the U.S. market.

However, if the Commission adopts position and margin reporting requirements, and applies them to non-U.S. SDs that rely on substituted compliance, such requirements should apply to non-U.S. SDs only for swaps that have a U.S. nexus. Specifically, a non-U.S. SD that is either a bank SD or qualifies for substituted compliance with capital requirements should not be required to file position or margin information regarding (i) cleared transactions with a non-U.S. clearing organization that is not registered with the Commission or the SEC or (ii) uncleared transactions with counterparties that are not subject to U.S. margin requirements.<sup>115</sup> In light of the limited nexus that these transactions have to the U.S., requiring non-U.S. SDs to report this information would likely impose costs that exceed their regulatory benefits. Tailoring these reports to exclude these transactions would help align the scope of position and margin reports with the scope of other risk-based regulations adopted by the Commission under Title VII.

**IV. The SEC's Alternative Compliance Mechanism**

SEC Rule 18a-10 provides an alternative compliance mechanism pursuant to which a dually registered SD-SBSD may elect to comply with the Commission's capital, margin, segregation, recordkeeping, and financial reporting requirements in lieu of complying with applicable SEC rules.<sup>116</sup> The Commission specifically requested comment on what revisions are needed to the Commission's regulations in order to accommodate SD-SBSDs that elect to use this alternative compliance mechanism.

We recommend that the Commission require a dually registered SD/SBSD that elects to use the SEC's alternative compliance mechanism to treat all SBS as swaps for purposes of the Commission's margin, segregation, and recordkeeping requirements.<sup>117</sup>

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<sup>114</sup> See ISDA August 2012 DF Supplement, Schedule 2.

<sup>115</sup> For example, a non-U.S., nonbank SD that qualifies for substituted compliance with capital requirements and that is neither a foreign consolidated subsidiary nor guaranteed by a U.S. person should not be required to file position or margin reports relating to its uncleared swaps with a non-U.S. counterparty that is not a foreign consolidated subsidiary or guaranteed by a U.S. person.

<sup>116</sup> 17 C.F.R. § 240.18a-10.

<sup>117</sup> The Commission's capital and financial reporting requirements would already apply to SBS.

This revision is necessary to ensure that SD-SBSDs electing the alternative compliance mechanism become subject to the requisite Commission regulations necessary to make them eligible for the SEC's alternative compliance mechanism.

## V. Substituted Compliance

### A. We Support the Commission's Proposal to Permit Substituted Compliance with Comparable Home Country Capital, Liquidity, and Financial Reporting Requirements

The 2016 Proposal would permit a non-U.S. SD to comply with comparable home country capital, liquidity, and financial reporting requirements in lieu of Commission requirements.<sup>118</sup> We support this proposal, as it will allow non-U.S. SDs to rely on existing internal processes and lower the barrier to entry for non-U.S. SDs into the U.S. market. If substituted compliance is not available, non-U.S. SDs may be forced to implement potentially duplicative Commission requirements in addition to their home country requirements. The expenses and time associated with implementing potentially duplicative requirements may cause non-U.S. SDs to withdraw from the U.S. market, reducing liquidity.

### B. If a Non-U.S. SD is Subject to BCBS-Compliant Home Country Capital Requirements in Certain Jurisdictions, it Should Automatically Qualify for Substituted Compliance with the Commission's Capital Requirements

Under the 2016 Proposal, to qualify for substituted compliance with the Commission's capital requirements, a non-U.S. SD's home country would need to receive a comparability determination from the Commission, based on consistency with BCBS capital standards for banking institutions, among other factors.<sup>119</sup> We recommend that a non-U.S. SD automatically qualify for such substituted compliance if it is subject to BCBS-compliant home country capital requirements administered by a regulatory authority in Australia, Canada, France, Germany, Japan, Singapore, Switzerland, or the United Kingdom.

Pursuant to this approach, qualifying non-U.S. SDs will be subject to requirements that are comparable in scope, objectives, outcomes, and supervisory authority to the Commission's capital requirements. This is because the Commission's capital requirements incorporate those of the Federal Reserve, which are themselves BCBS-compliant. Additionally, in applying its own capital requirements, the Federal Reserve's approach has been that a foreign banking organization whose home country has adopted BCBS-compliant standards may calculate its capital ratios under the home

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<sup>118</sup> See 2016 Proposal, § 23.101(a), (o).

<sup>119</sup> See *id.*, § 23.101(a)(3).

country standard.<sup>120</sup> Therefore, adopting this approach would be consistent with the Federal Reserve’s approach. This approach would also be consistent with that of the SEC, as the jurisdictions listed above are “listed jurisdictions” for purposes of the SEC’s cross-border SBSD rules.<sup>121</sup> In determining qualifying “listed jurisdictions,” the SEC examined the comparability of such jurisdictions’ capital and margin requirements and the applicable regulator’s supervisory authority, among other things.<sup>122</sup>

Automatic qualification for substituted compliance with the Commission’s capital requirements would also reduce the strain on Commission resources associated with reviewing comparability determinations. This will be particularly helpful given that, as discussed previously, there are other aspects of the 2016 Proposal, such as NFA’s approval of SDs’ internal capital models, that could require a vast expenditure of Commission resources to coordinate and implement.

If a non-U.S. SD is subject to capital requirements administered by a regulatory authority in a jurisdiction not listed above, we recommend that the Commission undertake its proposed comparability determinations to determine whether a non-U.S. SD subject to such home country requirements should qualify for substituted compliance.

**C. A Non-U.S. SD that Qualifies for Substituted Compliance with Capital Requirements Should Automatically Qualify for Substituted Compliance with Liquidity Requirements**

If a non-U.S. SD qualifies for substituted compliance for the Commission’s capital requirements, we recommend that it automatically qualify for substituted compliance with the Commission’s liquidity requirements. BCBS-compliant capital and liquidity requirements are intended to work in tandem as part of a holistic approach to managing an SD’s risks and financial resources. For example, BCBS-compliant capital standards incorporate an LCR.<sup>123</sup> The Commission’s application of its liquidity requirements to non-U.S. SDs that qualify for substituted compliance with its capital requirements would, therefore, be duplicative and potentially inconsistent. Rather than

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<sup>120</sup> See 12 C.F.R. § 237.12(c).

<sup>121</sup> Order Designating Certain Jurisdictions as “Listed Jurisdictions” for Purposes of Applying the [SBSD] De Minimis Exception of Rule 3a71-3(d) Under the Exchange Act to Certain Cross-Border [SBS] Transactions, 85 Fed. Reg. 6355 (Feb. 4, 2020).

<sup>122</sup> See *id.*

<sup>123</sup> See BCBS, Basel III: The [LCR] and liquidity monitoring tools (Jan. 2013), available at <http://www.bis.org/publ/bcbs238.pdf>.

complying with multiple liquidity requirements, non-U.S. SDs may withdraw from the U.S. market, which would reduce liquidity to participants in such market.

**D. NFA Confirmation Should not be Required for an SD to Rely on Substituted Compliance**

The 2016 Proposal would require NFA to review and confirm that a non-U.S. SD may rely on substituted compliance with home country requirements that the Commission has already determined to be comparable.<sup>124</sup> However, the 2016 Proposal did not explain what NFA's role would be in conducting such reviews or why they are necessary given that no similar review and confirmation requirement exists for the many other requirements currently eligible for substituted compliance. Accordingly, the Commission should eliminate this requirement.

**VI. Compliance Dates**

Implementing the Commission's capital framework will be a time-consuming exercise for both market participants and the Commission. Nonbank SDs will need time to develop the systems and procedures to ensure compliance and proper reporting under the Commission's requirements. Additionally, SDs will need to submit, and potentially create, market and credit risk models. Even if the Commission permits SDs to use models approved by other regulators, NFA will still need substantial time to assess new models that other authorities have not previously approved.

Additionally, non-U.S. SDs will need time to submit, and the Commission will need time to review, substituted compliance applications. Non-U.S. SDs will need time to plan and potentially adjust their businesses in accordance with any substituted compliance determinations made by the Commission. To the extent the Commission grants automatic substituted compliance with respect to the jurisdictions listed above in Section V.B, the compliance dates noted below should provide non-U.S. SDs adequate time to comply with the Commission's requirements. However, if the Commission does not grant such automatic substituted compliance, the Commission should make the compliance date 18 months after the Commission has made its substituted compliance determinations with respect to these jurisdictions.

Moreover, to ensure that SDs are not kept out of the swaps markets during the pendency of the Commission's review of any models, the effective date of the Commission's capital and financial reporting requirements for all SDs that are not SD-SBSDs should be 18 months after the effective date of the rules if the Commission adopts our recommendations above to allow SDs to use models approved by other regulators and other SDs to use models on a provisional basis. If it does not, the Commission's capital

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<sup>124</sup>

See 2016 Proposal, § 23.105(a)(4).

and financial reporting requirements should not become effective until after a sufficient time for NFA to approve all model applications.

Finally, in order to avoid unnecessary additional expense and operational burdens for SD/SBSDs that elect to use the SEC's alternative compliance mechanism, such SD/SBSDs should become subject to the Commission's capital and financial reporting rules on the date that they register as SBSDs, which will be no earlier than the SBS Registration Compliance Date, October 6, 2021, but for most SD/SBSDs will be November 1, 2021.<sup>125</sup> While SD/SBSDs would be able to immediately comply with the Commission's capital, margin, segregation, recordkeeping, and financial reporting rules in lieu of the SEC's applicable rules, if SD/SBSDs were forced to come into compliance prior to this time, then such SD-SBSDs would need to build two sets of internal systems: one to comply with the SEC's requirements until the compliance date of the Commission's requirements and another to comply with the Commission's requirements.

<b>Recommended Compliance Schedule</b>	
SD/SBSDs Electing to Use the SEC's Alternative Compliance Mechanism	The date the SD/SBSDs register as SBSDs, which will be no earlier than the SBS Registration Compliance Date, October 6, 2021, but for most SD-SBSDs will be November 1, 2021
All Other SDs Subject to the Commission's Capital and Financial Reporting Rules, Including SD/SBSDs That Do Not Elect to Use the SEC's Alternative Compliance Mechanism and FCMs	18 months after the effective date of the rules, provided that the Commission (i) allows SDs to use market and capital risk models approved by other regulators and other SDs to use models provisionally and (ii) grants automatic substituted compliance with respect to the jurisdictions listed above in Section V.B; otherwise, the later of (i) after NFA has made all relevant model approvals and (ii) 18 months after the Commission has made its substituted compliance determinations with respect to the jurisdictions listed in Section V.B

\* \* \*

<sup>125</sup>

See SEC, Key Dates for Registration of [SBSDs] and [MSBSPs] (Feb. 7, 2020), available at <https://www.sec.gov/page/key-dates-registration-security-based-swap-dealers-and-major-security-based-swap-participants>.

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We would be pleased to provide further information or assistance at the request of the Commission or its staff. Please do not hesitate to contact the undersigned if you should have any questions with regard to the foregoing.

Respectfully submitted,

*Briget Polichene*

Briget Polichene

Chief Executive Officer

Institute of International Bankers



Scott O'Malia

Chief Executive Officer

International Swaps and Derivatives Association



Kenneth E. Bentsen, Jr.

President & Chief Executive Officer

Securities Industry and Financial Markets Association

cc: Heath P. Tarbert, Chairman

Brian D. Quintenz, Commissioner

Rostin Behnam, Commissioner

Dawn DeBerry Stump, Commissioner

Dan M. Berkovitz, Commissioner

Joshua Sterling, Director

Thomas Smith, Deputy Director

Division of Swap Dealer and Intermediary Oversight

## Appendix A: Technical Comments

### I. Capital Requirements

#### A. 8% IM Rule

1. **Inclusion of SBS in the IM Calculation.** As discussed above, in Section I.A.2.e.1, the Commission should not include SBS in the IM calculation for the 8% IM Rule. However, if the Commission does include SBS, it is unclear how an SD that is not dually registered as an SBSD, and thus would not have SEC approval to use risk-based models to compute its IM for uncleared SBS, would make this calculation. The Commission should therefore ensure that there is a process, and sufficient time, for NFA to approve IM models for SBS for SDs that are not dually registered as SBSDs.
2. **Definition of “Customer” and “Noncustomer” Accounts.** Under the FCM Approach, SD/FCMs would need to include IM in respect of non-proprietary cleared SBS positions (*i.e.*, SBS positions cleared for customers and affiliates).<sup>126</sup> This aspect of the 2016 Proposal cross-references the defined terms “customer” and “noncustomer” accounts. Read literally, these cross-references would have the effect of double-counting IM for cleared SBS positions portfolio margined with cleared swap positions in a cleared swap account. The Commission should clarify that such IM for cleared SBS positions portfolio margined with cleared swap positions in a cleared swap account should only be counted once under the 8% IM Rule.

#### B. Net Liquid Assets Approach

1. **Model-Based Credit Risk Charges.** Under the Net Liquid Assets Approach, a nonbank SD that has approval to use models to compute its credit risk charges may use such models to compute charges for swap and SBS transactions with all counterparties.<sup>127</sup> The Commission should remove this provision because the SEC expanded the ability to use credit risk models as part of the Final SEC Rules.<sup>128</sup>

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<sup>126</sup> 2016 Proposal, 81 Fed. Reg., § 1.17(a)(1)(i)(B).

<sup>127</sup> *Id.*, § 23.101(a)(1)(ii)(A)(3).

<sup>128</sup> Final SEC Rules, 84 Fed. Reg. at 43891-92.

2. **“Margin Difference” Definition.** The 2016 Proposal specifies that an SD may not deduct the “margin difference” (as defined in 17 C.F.R. § 240.18a-1(c)(viii)) in lieu of collecting margin for swap or SBS transactions.<sup>129</sup> The Commission should remove this provision since the SEC removed the requirement this provision appeared designed to supersede from the Final SEC Rules.<sup>130</sup>
3. **Receivables from Third-Party Custodians.** Under the Net Liquid Assets Approach, an SD would be able to recognize as a current asset receivables from third-party custodians holding IM that the SD posts in accordance with the CFTC’s or SEC’s margin rules.<sup>131</sup> However, these are not the only rules pursuant to which an SD may post IM that is segregated at a third-party custodian, as the Prudential Regulators and foreign regulators have similar requirements. In order to avoid creating unwarranted disparities depending on the parties with which an SD trades, the Commission should expand this provision to allow an SD to recognize IM posted in accordance with the margin rules of a Prudential Regulator or foreign jurisdiction for which the Commission has made a comparability determination.

C. **FCM Approach**

1. **Charge for Uncleared Swap Margin.** Under the FCM Approach, a charge would be imposed for the amount of uncleared swap margin that the FCM has not collected from a swap counterparty for uncleared swap transactions.<sup>132</sup> As “uncleared swap margin” would be defined to cover IM requirements for uncleared swaps, this provision would subject an FCM to capital charges in circumstances where the Commission’s margin rules do not require the FCM to collect IM, even if the failure to collect IM does not result in the FCM having an unsecured receivable. The definition of “uncleared swap margin” should be amended to cover IM requirements only for those uncleared swaps for which the FCM is required to collect IM.

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<sup>129</sup> 2016 Proposal, 81 Fed. Reg., § 23.101(a)(1)(ii)(A)(5).

<sup>130</sup> Final SEC Rules, 84 Fed. Reg. at 43890.

<sup>131</sup> 2016 Proposal, 81 Fed. Reg., § 23.101(a)(1)(ii)(A)(4).

<sup>132</sup> *Id.*, § 1.17(c)(5)(xiv).

## **II. Financial Reporting Requirements**

- A. **Timing of Annual Audited Submission.** The 2016 proposal would generally require nonbank SDs to submit their annual audited financial statements within 60 days of year-end. For SDs that are not already regulated as FCMs or broker-dealers, this deadline would create significant resource issues, both within those firms and at their auditors. We recommend that the Commission instead adopt a 90-day deadline for these firms. This 90-day deadline would also lessen the burden for firms with multiple required filings.
- B. **Application of Margin Reporting Requirements to Portfolio Margined Swaps.** It is unclear how the proposed weekly margin reports apply to portfolio margined swaps. If, and where, margin reporting requirements do apply, the Commission should confirm that the reports are to reflect the extent to which an SD margins its uncleared swaps on a portfolio basis with uncleared SBS and any other uncleared derivatives, whether in accordance with Commission no-action relief,<sup>133</sup> the Prudential Regulators' margin rules, or home country margin requirements that the Commission or the Prudential Regulators have determined to be comparable.

## **III. Substituted Compliance**

- A. **Substituted Compliance for Notice Requirements.** The 2016 Proposal applies various notice requirements for SDs that breach their capital or liquidity requirements, which cross-reference the Commission's capital and liquidity rules.<sup>134</sup> The Commission should clarify that a non-U.S. SD that qualifies for substituted compliance with capital and liquidity requirements can, in connection with such notice requirements that reference Commission capital or liquidity requirements, instead refer to corollary home country requirements. Non-U.S. SDs otherwise will not get the full benefit of substituted compliance. They will be required to monitor compliance with the Commission's capital and liquidity requirements, even though they are not subject to such requirements. This monitoring may require additional internal procedures, which non-U.S. SDs may find are prohibitively expensive and create unnecessary barriers to entering the U.S. market.

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<sup>133</sup> See Letter No. 16-71 (Aug. 23, 2016).

<sup>134</sup> See 2016 Proposal, § 23.105(c).

## **Appendix B: Rule Text Recommendations**

### **I. 8% IM Rule**

The following rule text implements our comments in Section I.A.2 describing how the IM-based minimum capital requirement, if adopted, should be modified with respect to each capital approach.

#### **a. Definitions Applicable to Capital Requirements**

In § 23.100, add the following definition:

*SD risk margin amount.* This term means the excess of (1) the swap dealer's uncleared swap margin computed on a counterparty-by-counterparty basis pursuant to § 23.154 of this chapter, over (2) the amount of initial margin that the swap dealer has collected in respect of such uncleared swap margin and that is segregated in accordance with § 23.157 or § 23.702 of this chapter.

In § 23.100, revise the following definition:

*Regulatory capital.* This term shall mean the amount of tier 1 capital or ratio based capital, tangible net worth, tentative net capital or calculated net capital of a swap dealer or major swap participant relevant to the associated applicable regulatory capital requirement.

#### **b. Bank-Based Approach**

In § 23.101, revise paragraph (a)(1)(i)(C) to read as follows:

(a)(1)(i) A swap dealer that elects to meet the capital requirements in this paragraph (a)(1)(i) must maintain regulatory capital that equals or exceeds the greatest of the following:

\* \* \* \*

(C) Total capital, as defined under 12 CFR 217.2, equal to or greater than two percent of the swap dealer's SD risk margin amount; or

#### **c. Net Liquid Assets Approach**

In § 23.101, revise paragraph (a)(1)(ii) to read as follows:

(a)(1)(ii) A swap dealer that elects to meet the capital requirements in this paragraph (a)(1)(ii) must maintain regulatory capital that equals or exceeds the greatest of the following:

(A) An amount of tentative net capital, as defined in and computed in accordance with, § 240.18a-1 of this title as if the swap dealer were a security-based swap dealer registered

with the Securities and Exchange Commission and subject to § 240.18a-1 of this title, equal to or greater than two percent of the SD risk margin amount;

(B) An amount of net capital, as defined in and computed in accordance with, §240.18a-1 of this title as if the swap dealer were a security-based swap dealer registered with the Securities and Exchange Commission and subject to § 240.18a-1 of this title, equal to or greater than \$20,000,000; *Provided, however,* that the calculation is subject to the following adjustments:

(1) A swap dealer that uses internal models to compute market risk for its proprietary positions under § 240.18a-1(d) of this title must calculate the total market risk as the sum of the VaR measure, stressed VaR measure, specific risk measure, comprehensive risk measure, and incremental risk measure of the portfolio of proprietary positions in accordance with § 23.102 and Appendix A of § 23.102;

(2) A swap dealer may recognize as a current asset, receivables from third-party custodians that maintain the swap dealer's initial margin deposits associated with uncleared swap, security-based swap, or other derivatives transactions under § 23.152, § 240.18a-3(c)(1)(ii) of this title, margin requirements of a prudential regulator, as defined in section 1a(39) of the Act, or margin requirements of a foreign jurisdiction covered by a Comparability Determination issued by the Commission pursuant to § 23.160;<sup>135</sup> and

(3) A swap dealer that is approved to use internal models to compute market risk exposure but not credit risk exposure may multiply the deductions for credit risk arising from transactions in derivatives instruments pursuant to paragraphs (c)(1)(iii) and (c)(1)(ix)(A) and (B) of §240.18a-1 of this title times (I) eight percent and (II) a credit risk weight of either 20 percent, 50 percent, or 150 percent based on an internal credit risk rating that the swap dealer determines for the counterparty.<sup>136</sup>

(C) If the swap dealer is permitted to use internal models to compute credit and market risk charges for purposes of calculating net capital under § 23.102, an amount of tentative net capital, as defined in and computed in accordance with, § 240.18a-1 of this title as if the swap dealer were a security-based swap dealer registered with the Securities and Exchange Commission and subject to § 240.18a-1 of this title, equal to or greater than \$100,000,000; or

(D) The amount of capital required by a registered futures association of which the swap dealer is a member.

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<sup>135</sup> This rule text also implements our comment set forth in Section I.B.3 of Appendix A.

<sup>136</sup> This rule text also implements our comment set forth in Section I.C of the letter.

**d. FCM Approach**

In § 1.17, revise paragraphs (a)(1)(i)(B) and (b)(8), and add paragraph (a)(1)(iii), to read as follows:

(a)(1)(i) Except as provided in paragraph (a)(2)(i) of this section, each person registered as a futures commission merchant must maintain adjusted net capital equal to or in excess of the greatest of:

\* \* \* \* \*

(B) The futures commission merchant's risk-based capital requirement, computed as eight percent of the FCM risk margin requirement (as defined in paragraph (b)(8) of this section) for positions carried by the futures commission merchant in customer accounts and noncustomer accounts;<sup>137</sup>

\* \* \* \* \*

(iii) A futures commission merchant that is registered as a swap dealer must maintain net capital equal to two percent of the future commission merchant's SD risk margin amount, as defined in § 23.100 of this chapter.

\* \* \* \* \*

(b) For purposes of this section:

(8) FCM risk margin for an account means the level of maintenance margin or performance bond required for the customer or noncustomer positions by the applicable exchanges or clearing organizations, and, where margin or performance bond is required only for accounts at the clearing organization, for purposes of the FCM's risk-based capital calculations applying the same margin or performance bond requirements to customer and noncustomer positions in accounts carried by the FCM, subject to the following.

(i) FCM risk margin does not include the equity component of short or long option positions maintained in an account;

(ii) The maintenance margin or performance bond requirement associated with a long option position may be excluded from FCM risk margin to the extent that the value of such long option position does not reduce the total risk maintenance or performance bond requirement of the account that holds the long option position;

(iii) The FCM risk margin for an account carried by a futures commission merchant which is not a member of the exchange or the clearing organization that requires

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<sup>137</sup>

This rule text also implements our comment set forth in Section I.D.4 of the letter.

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collection of such margin should be calculated as if the futures commission merchant were such a member; and

(iv) If a futures commission merchant does not possess sufficient information to determine what portion of an account's total margin requirement represents FCM risk margin, all of the margin required by the exchange or the clearing organization that requires collection of such margin for that account, shall be treated as FCM risk margin.

**e. Tangible Net Worth Approach**

In § 23.101, revise paragraph (a)(2)(ii)(B) to read as follows:

(B) Two percent of the SD risk margin amount, as defined in § 23.100 of this chapter; or

**II. Bank-Based Approach**

The following rule text implements our comments in Section I.B of the letter.

Revise § 23.100 to add the following definitions:

*Advanced approaches Board-regulated institution.* This term shall have the meaning ascribed to it in 12 CFR part 217.

*Approved models regulator.* This term shall mean any of the Securities and Exchange Commission, a prudential regulator, or a foreign regulatory authority whose capital adequacy requirements are consistent with the capital requirements for banking institutions issued by the Basel Committee on Banking Supervision.

*BHC equivalent risk-weighted assets.* This term shall mean the risk-weighted assets of a swap dealer that elects to meet the capital requirements in § 23.101(a)(1)(i) calculated as follows:

(1) If the swap dealer is not permitted to use internal models to calculate credit risk exposure under § 23.102, it shall calculate its credit risk-weighted assets using the bank holding company regulations in subpart D of 12 CFR part 217, as if the swap dealer itself were a bank holding company, with the swap dealer permitted to calculate its exposure amount for OTC derivative contracts using either the current exposure method or the standardized approach for counterparty credit risk, without regard to the status of any affiliate of the swap dealer as an advanced approaches Board-regulated institution, except that:

(A) If the swap dealer elects to calculate the exposure amount for its OTC derivative contracts using the standardized approach for counterparty credit risk, it shall apply to OTC derivative contracts in the energy category of the commodity asset class of Table 2 to 12 CFR § 217.132 a supervisory factor determined by the Commission based on data from the U.S. energy derivatives market; and

(B) Undrawn qualifying letters of credit that are issued in favor of the swap dealer in connection with an OTC derivative contract shall be considered “financial collateral” as though such letters of credit were debt securities issued by the issuer of the letter of credit and subject to a collateral agreement that provided the swap dealer with a perfected security interest in the debt securities to secure the OTC derivative contract;

(2) If the swap dealer is permitted to use internal models to calculate credit risk exposure under § 23.102, it shall calculate its credit risk-weighted assets using the bank holding company regulations in subpart E of 12 CFR part 217, as if the swap dealer itself were a bank holding company, with the swap dealer permitted to calculate its exposure amount for OTC derivative contracts using either the internal models methodology or the standardized approach for counterparty credit risk, without regard to the status of any affiliate of the swap dealer as an advanced approaches Board-regulated institution, except that:

(A) If the swap dealer elects to calculate the exposure amount for its OTC derivative contracts using the standardized approach for counterparty credit risk, it shall apply to OTC derivative contracts in the energy category of the commodity asset class of Table 2 to 12 CFR § 217.132 a supervisory factor determined by the Commission based on data from the U.S. energy derivatives market; and

(B) Undrawn qualifying letters of credit that are issued in favor of the swap dealer in connection with an OTC derivative contract shall be considered “financial collateral” as though such letters of credit were debt securities issued by the issuer of the letter of credit and subject to a collateral agreement that provided the swap dealer with a perfected security interest in the debt securities to secure the OTC derivative contract;

(3) If the swap dealer is not permitted to use internal models to calculate market risk exposure under § 23.102, it shall calculate its market risk-weighted assets by increasing its risk-weighted assets by the product of 22 and the sum of the market risk capital charges computed under § 23.103(b)(1); and

(4) If the swap dealer is permitted to use internal models to calculate market risk exposure under § 23.102, it shall calculate its market risk-weighted assets using subpart F of 12 CFR part 217; *Provided, however,* that the swap dealer may elect to apply either the provisions of such sections that are applicable to advanced approaches Board-regulated institutions or those that are applicable to Board-regulated institutions that are not advanced approaches Board-regulated institutions.

*OTC derivative contract.* This term shall have the meaning ascribed to it in 12 CFR part 217.

*Qualifying letter of credit.* This term means a letter of credit:

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- (1) That is an “eligible guarantee” within the meaning of 12 CFR part 217;
- (2) That is provided by an “eligible guarantor” within the meaning of 12 CFR part 217;
- (3) In which the reference exposure is an OTC derivative contract the obligated party of which is not a financial end user as defined in § 23.151;
- (4) With respect to which the swap dealer has conducted sufficient legal review to conclude with a well-founded basis (and maintained sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from a default or receivership, insolvency, liquidation, or similar proceeding of the obligated party) the relevant court and administrative authorities would find a claim by the swap dealer, as the beneficiary, to enforce the effective notional amount of the letter of credit to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions.

\* \* \* \*

Revise the definitions of “credit risk exposure requirement” and “market risk exposure requirement” in § 23.100 to read as follows:

*Credit risk exposure requirement.* This term refers to the amount that a swap dealer (other than a swap dealer subject to the minimum capital requirements of § 23.101(a)(1)(i)) is required to compute under § 23.102 if approved to use internal credit risk models, or to compute under § 23.103 if not approved to use internal credit risk models.

*Market risk exposure requirement.* This term refers to the amount that a swap dealer (other than a swap dealer subject to the minimum capital requirements of § 23.101(a)(1)(i)) is required to compute under § 23.102 if approved to use internal market risk models, or § 23.103 if not approved to use internal market risk models.

\* \* \* \*

In § 23.101, revise paragraph (a)(1)(i)(B) to read as follows:

(a)(1)(i) Except as provided in paragraphs (a)(2) through (a)(5) of this section, each swap dealer must elect to be subject to the minimum capital requirements set forth in either paragraphs (a)(1)(i) or (a)(1)(ii) of this section:

\* \* \* \*

(B) Common equity tier 1 capital, as defined under the bank holding company regulations in 12 CFR 217.20, equal to or greater than four and one half percent of the swap dealer’s BHC equivalent risk-weighted assets; *provided, however,* that the swap dealer shall provide the Commission or a registered futures association of which the swap dealer is a member with an early warning notification, as described in § 23.105(c)(1) and (2), if its

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common equity tier 1 capital is less than six and one half percent of the swap dealer's BHC equivalent risk-weighted assets;

\* \* \* \*

In § 23.102, revise paragraph (c) to read as follows:

(c) A swap dealer's application must include the following:

(1) In the case of a swap dealer subject to the minimum capital requirements in § 23.101(a)(1)(i) applying to use internal models to compute market risk exposure, the information required under subpart F of 12 CFR part 217, as if the swap dealer were itself a bank holding company subject to 12 CFR part 217.

(2) In the case of a swap dealer subject to the minimum capital requirements in § 23.101(a)(1)(i) applying to use internal models to compute credit risk exposure, the information required under subpart E of 12 CFR part 217 in order to calculate credit risk-weighted assets in accordance with sections 217.131 through 217.155 of that subpart, as if the swap dealer were itself a bank holding company subject to 12 CFR part 217.

(3) In the case of a swap dealer subject to the minimum capital requirements in § 23.101(a)(1)(ii) or § 23.101(a)(2), the information set forth in Appendix A of this section.

\* \* \* \*

In § 23.103, revise paragraphs (a), (b), and (c) to read as follows:

(a) *Non-model approach.* A swap dealer that (1) does not compute its regulatory capital requirements under § 23.101(a)(1)(i) and (2) either (A) has not received approval from the Commission, a registered futures association of which the swap dealer is a member, or an approved models regulator to compute its market risk exposure requirement and/or credit risk exposure requirement pursuant to internal models under § 23.102, or (B) has had its approval to compute its market risk exposure requirement and/or credit risk exposure requirement pursuant to internal models under § 23.102 revoked by the Commission, the registered futures association, or the approved models regulator, must compute its market risk exposure requirements and/or credit risk exposure requirements pursuant to paragraphs (b) and/or (c) of this section.

(b) *Market risk exposure requirements.* (1) A swap dealer that computes its regulatory capital requirements under § 23.101(a)(1)(ii) or (a)(2) shall compute a market risk capital charge for the positions that the swap dealer holds in its proprietary accounts using the applicable standardized market risk charges set forth in § 240.18a-1 of this title and § 1.17 of this chapter for such positions.

(2) In computing its net capital under § 23.101(a)(1)(ii), a swap dealer shall deduct from its tentative net capital the sum of the market risk capital charges computed under paragraph (b)(1) of this section.

(3) In computing its minimum capital requirement under § 23.101(a)(2), a swap dealer must add the amount of the market risk capital charge computed under this section to the \$20 million minimum capital requirement.

(c) *Credit risk charges.* (1) A swap dealer that computes regulatory capital under § 23.101(a)(1)(ii) shall compute counterparty credit risk capital charges using the applicable standardized credit risk charges set forth in § 240.18a-1 of this title and § 1.17 of this chapter for such positions; *Provided, however,* that a swap dealer may reduce the counterparty credit risk for a particular counterparty by the undrawn amount of any qualifying letter of credit that secures the counterparty's exposure under any uncleared derivative transaction.

(2) In computing its net capital under § 23.101(a)(1)(ii), a swap dealer shall reduce its tentative net capital by the sum of the counterparty credit risk capital charges computed under paragraph (c)(1) of this section.

(3) In computing its minimum capital requirement under § 23.101(a)(2), a swap dealer must add the amount of the credit risk capital charge computed under this section to the \$20 million minimum capital requirement.

### **III. Tangible Net Worth Approach**

The following rule text implements our comments in Section I.E of the letter.

Revise § 23.100 to add the following definition:

*Commodity-focused swap dealer.*

(1) *Commodity Swap Dealing Threshold.* A swap dealer that is not subject to the capital requirements of a prudential regulator shall qualify as a “commodity-focused swap dealer” so long as 85 percent or more of the aggregate gross notional amount of the swaps connected with the swap dealer’s dealing activities during the previous calendar year referenced agricultural commodities, as defined in § 1.3 of this title, or exempt commodities, as defined in section 1(a)(20) of the Act.

(2) *Timing requirements.* A person that did not qualify as a commodity-focused swap dealer by meeting the threshold in paragraph (1) of this definition during the previous calendar year, but that qualified as a commodity-focused swap dealer by meeting such threshold during the calendar year immediately prior to the previous calendar year, shall no longer qualify as a commodity-focused swap dealer as of the end of the current calendar year.

(3) *Reevaluation period.* Notwithstanding paragraph (1) of this definition, if between 70 percent and 85 percent of the aggregate gross notional amounts of swaps connected to a swap dealer’s dealing activities during the previous calendar year referenced agricultural commodities, as defined in § 1.3 of this title, or exempt commodities, as defined in section 1(a)(20) of the Act, and the swap dealer qualified as a commodity-focused swap

dealer by meeting the threshold in paragraph (1) of this definition during the calendar year immediately prior to the previous calendar year, then (a) such swap dealer shall continue to qualify as a commodity-focused swap dealer, but (b) if such swap dealer does not qualify as a commodity-focused swap dealer by meeting the threshold in paragraph (1) of this definition during the current calendar year, then such swap dealer shall no longer qualify as a commodity-focused swap dealer as of the end of the next calendar year.

\* \* \* \*

In § 23.101, revise paragraph (a)(2)(i) to read as follows:

(a) \* \* \*

(2)(i) A swap dealer that is a commodity-focused swap dealer, as defined in § 23.100 of this chapter, may elect to meet the minimum capital requirements in this paragraph (a)(2) in lieu of the capital requirements in paragraph (a)(1) of this section.

#### **IV. CFTC Rule 1.17**

##### **a. The Commission Should Harmonize its Standardized Market Risk Charges with the SEC's**

In § 1.17, revise paragraphs (C)(5)(iii)(A)(1) and (2), (C)(5)(iii)(B), and (C)(5)(x)(B) to read as follows:

(C)(5)(iii) Swaps—(A) *Uncleared swaps that are credit-default swaps referencing broad-based securities indices*—(I) *Short positions (selling protection)*. In the case of an uncleared short credit default swap that references a broad-based securities index, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

Length of time to maturity of credit default swap contract	Basis point spread					
	100 or less %	101-300 %	301-400 %	401-500 %	501-699 %	700 or more %
Less than 12 months	1.00	2.00	5.00	7.50	10.00	15.00
12 months but less than 24 months	1.50	3.50	7.50	10.00	12.50	17.50
24 months but less than 36 months	2.00	5.00	10.00	12.50	15.00	20.00
36 months but less than 48 months	3.00	6.00	12.50	15.00	17.50	22.50

Length of time to maturity of credit default swap contract	Basis point spread					
	100 or less %	101- 300 %	301- 400 %	401- 500 %	501- 699 %	700 or more %
48 months but less than 60 months	4.00	7.00	15.00	17.50	20.00	25.00
60 months but less than 72 months	5.50	8.50	17.50	20.00	22.50	27.50
72 months but less than 84 months	7.00	10.00	20.00	22.50	25.00	30.00
84 months but less than 120 months	8.50	15.00	22.50	25.00	27.50	40.00
120 months and longer	10.00	20.00	25.00	27.50	30.00	50.00

(2) *Long positions (purchasing protection).* In the case of an uncleared swap that is a long credit default swap referencing a broad-based securities index, deducting 50 percent of the deduction that would be required by paragraph (c)(5)(iii)(A)(I) of this section if the swap was a credit default swap, each such deduction not exceeding the current market value of the long credit default swap.

\* \* \*

(B) *Interest rate swaps.* In the case of an uncleared interest rate swap, deducing the percentage deduction specified in § 240.15c3-1(c)(2)(vi)(A) of this title based on the maturity of the interest rate swap, provided that the percentage deduction must be no less than one eighth of 1 percent of the amount of a long position that is netted against a short position in the case of an uncleared swap with a maturity of three months or more;

(C)(5)(x) \* \* \*

(B) For an applicant or registrant which is a member of a self-regulatory organization, the applicable maintenance margin requirement of the applicable board of trade, or clearing organization, whichever is greater;

\* \* \* \* \*

In § 1.17, add paragraph (c)(5)(iii)(D) to read as follows:

(iii) \* \* \*

(D) A futures commission merchant may reduce the deduction under paragraph (c)(5)(iii)(B) or (C) by an amount equal to any reduction recognized for a comparable

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long or short position in the reference asset or interest rate under this section or § 240.15c3-1 of this title.

**b. The Commission Should Re-Calibrate its Standardized Market Risk Charges for Uncleared FX Derivatives to be Consistent with its Uncleared Swap Margin Rules**

The following rule text implements our comments in Section I.D.2 of the letter.

In § 1.17, revise paragraph (C)(1)(ii) to read as follows:

(C)(1) \* \* \*

(ii) Six percent in the case of a currency swap; or

**c. The Commission Should Allow Firms with Market Risk Model Approval but not Credit Risk Model Approval to Apply an 8% Multiplier and Credit Risk Weights to Credit Risk Charges for Uncollected IM**

The following rule text implements our comments in Section I.D.4 of the letter.

In § 1.17, revise paragraph (c)(5)(xv) to read as follows:

(c)(5) \* \* \*

(xv) In the case of a futures commission merchant that is a swap dealer approved to use internal models to compute market risk exposure but not credit risk exposure, the amount of the uncleared swap margin that the futures commission merchant has not collected from a swap counterparty, less any amounts owed by the futures commission merchant to the swap counterparty for uncleared swap transactions, multiplied by (A) eight percent and (B) a credit risk weight of either 20 percent, 50 percent, or 150% based on an internal credit risk rating that the futures commission merchant determines for the counterparty.

### **Appendix C: Information Regarding the Associations**

**IIB** is the only national association devoted exclusively to representing and advancing the interests of the international banking community in the United States. Its membership is comprised of internationally headquartered banking and financial institutions from over 35 countries around the world doing business in the United States. The IIB's mission is to help resolve the many special legislative, regulatory, tax, and compliance issues confronting internationally headquartered institutions that engage in banking, securities and other financial activities in the United States. Through its advocacy efforts the IIB seeks results that are consistent with the U.S. policy of national treatment and appropriately limit the extraterritorial application of U.S. laws to the global operations of its member institutions. Further information is available at [www.iib.org](http://www.iib.org).

Since 1985, **ISDA** has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 73 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: [www.isda.org](http://www.isda.org). Follow us on Twitter @ISDA.

**SIFMA** is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets, and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. 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>.