



## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Parts 1, 23, and 140

#### RIN 3038-AD54

#### Capital Requirements of Swap Dealers and Major Swap Participants

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Proposed rule; reopening of comment period; request for additional comment.

**SUMMARY:** The Commodity Futures Trading Commission (“Commission” or “CFTC”) is reopening the comment period and requesting additional comment (including potential modifications to proposed rule language) on proposed regulations and amendments to existing regulations to implement sections 4s(e) and (f) of the Commodity Exchange Act (“CEA”), as added by section 731 of the Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) previously published in 2011 and re-proposed in 2016. Section 4s(e) requires the Commission to adopt capital requirements for swap dealers (“SDs”) and major swap participants (“MSPs”) that are not subject to capital rules of a prudential regulator. Section 4s(f) requires the Commission to adopt financial reporting and recordkeeping requirements for SDs and MSPs. The Commission is reopening the comment period and soliciting further comment on all aspects of the SD and MSP capital and associated financial reporting proposal from 2016, as well as related proposed amendments to existing capital rules for futures commission merchants (“FCMs”) providing specific market risk and credit risk capital deductions for swaps and security-based swaps (“SBS”) entered into by FCMs.

**DATES:** Comments must be received on or before **[INSERT DATE 75 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

**ADDRESSES:** You may submit comments, identified by RIN 3038-AD54 and “Capital Requirements for Swap Dealers and Major Swap Participants”, by any of the following methods:

- CFTC website, via its Comments Online process: <http://comments.cftc.gov>. Follow the instructions for submitting comments through the website.
- Mail: Send to Chris Kirkpatrick, Secretary, Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, DC 20581.
- Hand delivery/Courier: Same as Mail above.

Please submit your comments using only one of these methods.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to <http://www.cftc.gov>. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures set forth in Regulation 145.9 of the Commission’s regulations.<sup>1</sup>

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from <http://www.cftc.gov> that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

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<sup>1</sup> Commission regulations referred to herein are found at 17 CFR Chapter 1. Commission regulations are accessible on the Commission’s website, <http://www.cftc.gov>.

**FOR FURTHER INFORMATION CONTACT:** Joshua Sterling, Director, 202-418-6056, [jsterling@cftc.gov](mailto:jsterling@cftc.gov); Thomas Smith, Deputy Director, 202-418-5495, [tsmith@cftc.gov](mailto:tsmith@cftc.gov); Joshua Beale, Associate Director, 202-418-5446, [jbeale@cftc.gov](mailto:jbeale@cftc.gov); Jennifer C.P. Bauer, Special Counsel, 202-418-5472, [jbauer@cftc.gov](mailto:jbauer@cftc.gov); Rafael Martinez, Senior Financial Risk Analyst, 202-418-5462, [rmartinez@cftc.gov](mailto:rmartinez@cftc.gov), Division of Swap Dealer and Intermediary Oversight; or Lihong McPhail, Research Economist, 202-418-5722, [lmchphail@cftc.gov](mailto:lmchphail@cftc.gov), Office of the Chief Economist; Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581.

**SUPPLEMENTARY INFORMATION:**

**I. Background**

Section 731 of the Dodd-Frank Act<sup>2</sup> amended the CEA<sup>3</sup> by adding section 4s(e), which requires the Commission to adopt rules establishing capital requirements for SDs and MSPs to help ensure their safety and soundness.<sup>4</sup> Section 4s(e) applies a bifurcated approach requiring each SD and MSP subject to the capital requirements of a prudential regulator to meet the capital requirements adopted by the applicable prudential regulator, and requiring each SD and MSP that is not subject to the capital requirements of a prudential regulator to meet the capital requirements adopted by the Commission.<sup>5</sup> Accordingly, SDs and MSPs that are not banking

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<sup>2</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at <http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm>.

<sup>3</sup> 7 U.S.C. 1 *et seq.*

<sup>4</sup> See 7 U.S.C. 6s(e)(3)(A). Section 4s(e) also directs the Commission to adopt regulations for SDs and MSPs imposing initial and variation margin requirements on all swaps that are not cleared by a registered clearing organization. The Commission adopted final SD and MSP margin requirements for uncleared swap transactions on December 18, 2015. See, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR 636 (Jan. 6, 2016).

<sup>5</sup> The term “prudential regulator” is defined in section 1a(39) of the CEA for purposes of the section 4s(e) capital requirements. Specifically, the term “prudential regulator” is defined to mean the Board of Governors of the Federal Reserve System (“Federal Reserve Board”); the Office of the Comptroller of the Currency (“OCC”); the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency.

entities, including nonbank subsidiaries of bank holding companies regulated by the Federal Reserve Board, are subject to the Commission’s capital requirements.<sup>6</sup> Further, Section 764 of the Dodd-Frank Act provides that the Securities and Exchange Commission (“SEC”) shall prescribe capital and margin requirements for security-based swap dealers (“SBSDs”) and major security-based swap participants (“MSBSPs”), and Section 4s(e)(3)(D) of the CEA provides that the CFTC, SEC, and prudential regulators shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements for SDs and MSPs.

In 2011, the Commission proposed capital and financial reporting requirements for SDs and MSPs, and proposed amendments to the capital requirements for FCMs to explicitly address swap and SBS transactions.<sup>7</sup> The Commission, however, elected to defer consideration of final capital and financial reporting rules until after the Commission adopted final margin rules for uncleared swaps, which were adopted in 2015.<sup>8</sup>

In 2016, the Commission re-proposed the capital and financial reporting requirements for SDs and MSPs, and re-proposed amendments to the existing capital requirements for FCMs.<sup>9</sup> The Commission drew on existing CFTC, prudential regulator, and SEC capital rules in developing the *2016 Capital Proposal*. Specifically, the *2016 Capital Proposal*, depending on the characteristics of the registered entity, would permit: (i) SDs to elect a capital requirement

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All references to an “SD” or an “MSP” in this proposal will mean an SD or MSP that is subject to the Commission’s capital rules, unless otherwise specified.

<sup>6</sup> The prudential regulators, including the Federal Reserve Board and OCC, that have capital responsibilities for SDs provisionally-registered with the Commission have adopted capital rules that incorporate capital requirements for swap and SBS transactions. In this regard, the Federal Reserve Board and OCC have adopted revised capital rules to incorporate Basel III capital adequacy requirements. *See, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 FR 62018 (Oct. 11, 2013).

<sup>7</sup> *See Capital Requirements of Swap Dealers and Major Swap Participants*, 76 FR 27802 (May 12, 2011).

<sup>8</sup> *See* 81 FR 636.

<sup>9</sup> *See Capital Requirements of Swap Dealers and Major Swap Participants*, 81 FR 91252 (Dec. 16, 2016) (the “2016 Capital Proposal” or the “Proposal”).

that is based on existing bank holding company capital rules adopted by the Federal Reserve Board (the “Bank-Based Capital Approach”); (ii) SDs to elect a capital requirement that is based on the existing CFTC FCM capital rule, the existing SEC broker-dealer (“BD”) capital rule, and the SEC’s proposed capital requirements for SBSDs, (the “Net Liquid Assets Capital Approach”); or (iii) SDs that meet defined conditions designed to ensure that they are predominantly engaged in non-financial activities to compute their minimum regulatory capital based upon the firms’ tangible net worth (the “Tangible Net Worth Capital Approach”).

The Commission received comments from a broad spectrum of market participants, industry representatives, and other interested parties in response to the *2016 Capital Proposal*. The commenters raised several topics in the *2016 Capital Proposal* including the use of models by SDs and MSPs for computing market risk and credit risk capital charges, the need for the harmonization of the Commission’s rules and requirements with the rules and the requirements of the prudential regulators and the SEC, and a desire for an additional opportunity to comment on the *2016 Capital Proposal* once the SEC finalized its SBSD and MSBSP capital and financial reporting requirements.

Since the *2016 Capital Proposal* was published in the *Federal Register*, the SEC in 2018 reopened its comment period and solicited further comment on its proposed capital, margin, and segregation requirements for BDs, SBSDs, and MSBSPs.<sup>10</sup> The SEC finalized these capital,

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<sup>10</sup> See *Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 83 FR 53007 (Oct. 19, 2018) (“*SEC Comment Reopening*”).

margin, and segregation requirements in 2019.<sup>11</sup> The SEC also finalized its financial reporting requirements for SBSBs and MSBSBs in 2019.<sup>12</sup>

The Commission has carefully considered the comment letters to the *2016 Capital Proposal* and believes it is in the public interest to provide an additional opportunity for comment on the proposed capital and financial reporting rules. The Commission believes that it is particularly appropriate to reopen the comment period in light of the *SEC Comment Reopening* and the *SEC Final Capital Rule*, and in recognition that the *2016 Capital Proposal* includes significant components of the SEC's SBSB capital rules that were recently adopted as final in the *SEC's Final Capital Rule*. In addition, the Commission believes the public should have the opportunity to provide comment on the potential economic effects of the *2016 Capital Proposal* in light of regulatory and market developments since the *Proposal* was published. Accordingly, the Commission is reopening the comment period for 75 days and is seeking comment on all aspects of the *2016 Capital Proposal*. The Commission also is seeking specific comment on certain aspects of the *2016 Capital Proposal* where further information would be particularly helpful to the Commission. In particular, the Commission is seeking comment on potential modifications contemplated in light of previously received comments as discussed herein and the *SEC Final Capital Rule*, and potential rule language that would modify rule text that was included in the *2016 Capital Proposal*. The modified rule language would be included in: Regulation 1.17(c)(5)(iii)(A), (B) and (C)(2); Regulation 23.102(c), (d) and (e); and, Regulation 23.105(d)(3) and (p)(2). Comment letters received by the Commission in response to the *2016*

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<sup>11</sup> See *Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers*, 84 FR 43872 (Aug. 22, 2019) (“*SEC Final Capital Rule*”).

<sup>12</sup> See *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers*, publication in the Federal Register forthcoming. A prepublication version of the document can be found at <https://www.sec.gov/rules/final/2019/34-87005.pdf>.

*Capital Proposal* previously need not be re-submitted as they will continue to be a part of the public comment file for this rulemaking and considered by the Commission.

## **II. Request for Comment**

The Commission renews its request for comment on all aspects of the *2016 Capital Proposal* and on the specific topics identified below. Commenters are requested to provide empirical data in support of any arguments and analyses. The Commission notes that comments are of the greatest assistance to rulemaking initiatives when accompanied by supporting data and analysis, and, if appropriate, accompanied by alternative approaches and suggested rule text language.

The Commission also requests comments and data on how the baseline of the economic analyses has changed since the publication of the *2016 Capital Proposal*. The swap market activity has experienced significant changes, in part due to the fact that participants in this market are now subject to various new rules. For example, the 2015 uncleared margin rules adopted by the prudential regulators and the Commission, which requires SDs to exchange variation margin, and in many cases initial margin, with financial end users and other SDs against uncleared swap positions, has been phased in for a significant number but not all participants. To comply with these margin rules, these entities in the uncleared swap markets have been exchanging margin. Additionally, as noted above the SEC has finalized capital, margin and segregation requirements for the SBSBs. Moreover, swap market participants also may be subject to other regulatory regimes, including foreign regulatory authorities. The Commission requests comments on how those changes in the baseline would impact the potential benefits and costs of capital requirements.

### **A. Capital**

The *2016 Capital Proposal* included proposed minimum capital requirements for SDs and MSPs, and proposed amendments to the minimum capital requirements for FCMs. Proposed Regulation 23.101(a)(1)(i) would require an SD electing the Bank-Based Capital Approach<sup>13</sup> to maintain regulatory capital equal to or in excess of the highest of the following:

- (1) Common equity tier 1 capital (“CET1 Capital”) of \$20 million;<sup>14</sup>
- (2) CET1 Capital equal to or greater than 8% of the SD’s risk weighted assets;<sup>15</sup>
- (3) CET1 Capital equal to or greater than 8% of the sum of:
  - (a) The amount of uncleared swap margin<sup>16</sup> for each uncleared swap position open on the books of the SD, computed on a counterparty by counterparty basis pursuant to the Commission’s margin rules for uncleared swap transactions (CFTC Regulation 23.154);
  - (b) The amount of initial margin that would be required for each uncleared SBS position open on the books of the SD, computed on a counterparty by counterparty basis pursuant to SEC Rule 18a-3(c)(1)(i)(B) (17 CFR 240.18a-3(c)(1)(i)(B)) without regard to any initial margin exemptions or exclusions that the SEC rules may provide to such SBS positions; and

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<sup>13</sup> Proposed Regulation 23.101(a)(1)(i) permits an SD that elects the Bank-Based Capital Approach to use market risk and credit models approved by the Commission or a registered futures association, or to use the standardized market risk charges in Regulation 1.17 and the standardized credit risk charges in subpart D of 12 CFR part 217.

<sup>14</sup> For purposes of the *2016 Capital Proposal*, CET1 Capital is defined in the rules of the Federal Reserve Board, and generally represents the sum of a bank holding company’s common stock instruments and any related surpluses, retained earnings, and accumulated other comprehensive income. See 12 CFR 217.20.

<sup>15</sup> See *2016 Capital Proposal*, 81 FR at 91310; Proposed Regulation 23.101(a)(1)(i)(B). Risk-weighted assets would be defined and computed in accordance with rules of the Federal Reserve Board, 12 CFR part 217.

<sup>16</sup> See *2016 Capital Proposal*, 81 FR at 91309-10. Proposed Regulation 23.100 would define the term “uncleared swap margin” to mean the amount of initial margin, computed in accordance with the CFTC’s uncleared swap margin rules (Regulation 23.154), that an SD would be required to collect from each counterparty for each outstanding swap position of the SD. An SD would have to include all swap positions in the calculation of the uncleared swap margin amount, including swaps that are exempt from the scope of the Commission’s uncleared swap margin rules. Furthermore, in computing the uncleared swap margin amount, an SD would not be able to exclude the “Initial Margin Threshold Amount” or the “Minimum Transfer Amount” as such terms are defined in Regulation 23.151.

(c) The amount of initial margin required by clearing organizations for cleared proprietary futures, foreign futures, swaps, and SBS positions open on the books of the swap dealer; or,

(4) The amount of capital required by a registered futures association of which the SD is a member.<sup>17</sup>

Proposed Regulation 23.101(a)(1)(ii) would require an SD electing the Net Liquid Asset Capital Approach to maintain regulatory net capital equal to or in excess of the highest of the following:

(1) \$20 million (and for SDs approved to use internal capital models, \$100 million of tentative net capital and \$20 million of net capital);

(2) Eight percent of the sum of:

(a) The amount of uncleared swap margin for each uncleared swap position open on the books of the SD, computed on a counterparty by counterparty basis pursuant to CFTC Regulation 23.154;

(b) The amount of initial margin that would be required for each uncleared SBS position open on the books of the SD, computed on a counterparty by counterparty basis pursuant to SEC Rule 18a-3(c)(1)(i)(B) (17 CFR 240.18a-3(c)(1)(i)(B)) without regard to any initial margin exemptions or exclusions that the rules of the SEC may provide to such SBS positions;

(c) The amount of “risk margin”, as defined in Regulation 1.17(b)(8), required by a clearing organization for proprietary futures, swaps, and foreign futures positions open on the books of the SD; and

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<sup>17</sup> Currently, the National Futures Association (“NFA”) is the only registered futures association registered with the Commission under section 17 of the CEA.

(d) The amount of initial margin required by a clearing organization for proprietary SBS open on the books of the SD; or

(3) The amount of capital required by a registered futures association of which the SD is a member.

The *2016 Capital Proposal* also included proposed amendments to the existing capital requirements applicable to FCMs that engage in swap and SBS transactions, and also would be applicable to entities dually-registered with the Commission as SDs and FCMs. The minimum capital requirements for FCMs and entities dually-registered as SDs and FCMs were proposed to be amended to require each entity to maintain adjusted net capital equal to or greater than the highest of the following;

(1) \$20 million (and for FCMs, including entities dually-registered as FCM/SDs, approved to use internal capital models, \$100 million of net capital and \$20 million of adjusted net capital);

(2) The FCMs risk-based capital requirement, computed as 8% of the sum of:

(a) The FCM's or FCM/SD's total "risk margin"<sup>18</sup> requirement for cleared swap, futures and foreign futures positions carried by the FCM or FCM/SD in customer and noncustomer accounts;

(b) The total initial margin that the FCM or FCM/SD is required to post with a clearing agency or broker for cleared SBS positions carried in customer and noncustomer accounts;

(c) The total "uncleared swaps margin", as defined in Commission Regulation 23.100;

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<sup>18</sup> The term "risk margin" is defined in Regulation 1.17(b) and generally means the level of maintenance margin or performance bond required for the customer or noncustomer positions by the applicable exchanges or clearing organizations.

(d) The total initial margin that the FCM or FCM/SD is required to post with a broker or clearing organization for all proprietary cleared swaps positions carried by the FCM or FCM/SD;

(e) The total initial margin computed pursuant to SEC Rule 18a-3(c)(1)(i)(B) (17 CFR 240.18a-3(c)(1)(i)(B)) for all uncleared security-based swap positions carried by the FCM or FCM/SD without regard to any initial margin exemptions or exclusions that the SEC rules may provide to such SBS positions; and,

(f) The total initial margin that the FCM or FCM/SD is required to post with a broker or clearing agency for proprietary cleared SBS;

(3) The amount of adjusted net capital required by a registered futures association of which the FCM is a member; or

(4) For FCMs, including FCMs registered as SDs, that are registered with the SEC as securities brokers and dealers, the amount of net capital required by Rule 15c3-1(a) of the Securities and Exchange Commission (17 CFR 240.15c3-1(a)).

*1. Swap Dealer Capital - 8% Risk Margin Amount*

The proposed SD capital requirement would require an SD to maintain regulatory capital equal to or greater than 8% of the initial margin associated with the SD's proprietary cleared and uncleared futures, foreign futures, swap, and SBS positions (*i.e.*, the "risk margin amount"). The proposed minimum capital requirement was drawn from the Commission's experience with the "risk-based" capital requirements currently imposed on FCMs.<sup>19</sup> Under the existing FCM "risk-based" capital model, an FCM is required to maintain adjusted net capital equal to or greater than 8% of the aggregate of each customer's and non-customer's initial margin requirements associated with their respective portfolio of futures, foreign futures and cleared swaps

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<sup>19</sup> See Regulation 1.17(a)(1)(i)(B).

positions.<sup>20</sup> Accordingly, an FCM's minimum capital requirement increases/decreases as the total initial margin for its customers' and noncustomers' portfolios increases/decreases.<sup>21</sup>

The SD 8% capital component of the *2016 Capital Proposal* also is consistent with the approach adopted by the SEC for BDs and SBSDs. The *SEC Final Capital Rule* established a minimum net capital requirement for BDs and SBSDs that incorporates a component based upon a percentage of the margin associated with a BD's or SBSD's customer cleared and uncleared SBS positions.<sup>22</sup> The *SEC Final Capital Rule* implemented this financial ratio as a lower percentage, with the possibility of a scalable requirement to be implemented and increased over a number of years, beginning with a 2% requirement, and possibly under SEC orders increasing to a 4% requirement and ultimately to a 8% percent requirement.<sup>23</sup>

One commenter strongly supported the *2016 Capital Proposal's* 8% risk margin amount threshold on a comprehensive basis, noting concern that basing capital requirements on models could be manipulated, and that the 8% floor based on all calculated initial margin was therefore appropriate as a counterbalance to ensure internal modelling does not reduce loss absorbency.<sup>24</sup>

Several commenters, however, raised concerns with the 8% risk margin amount contained in the Bank-Based Capital Approach and the Net Liquid Asset Capital Approach.<sup>25</sup>

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<sup>20</sup> The *2016 Capital Proposal* includes a proposal to revise the FCM "risk-based" capital requirement to further include 8% of customer and non-customer cleared SBS positions, proprietary cleared SBS positions, and proprietary uncleared swap and SBS initial margin. See, *2016 Capital Proposal*, 81 FR at 91306.

<sup>21</sup> See CFTC Regulation 1.17(a)(1)(i)(B).

<sup>22</sup> See *SEC Final Capital Rule*, Rule 15c3-1(a)(7) (17 CFR 240.15c3-1(a)(7)) for BDs (including BDs dually-registered as SBSDs) approved to use internal capital models and Rule 15c3-1(a)(10) (17 CFR 240.15c3-1(a)(10)) for BDs dually-registered as SBSDs (84 FR at 44042), and Rule 18a-1(a)(2) (17 CFR 240.18a-1(a)(2)) for standalone SBSDs approved to use internal models (84 FR at 44052).

<sup>23</sup> *Id.*

<sup>24</sup> See Letter from Marcus Stanley, Americans for Financial Reform (May 15, 2017) (AFR 5/15/17 Letter). The comment letters for the *2016 Capital Proposal* are available at: <https://comments.cftc.gov/PublicComments/CommentList.aspx?id=1769> (the public comment file).

<sup>25</sup> See, e.g., Letter from Mary Kay Scucci, Securities Industry and Financial Markets Association (May 15, 2017) (SIFMA 5/15/17 Letter); Letter from Walt Lukken, Futures Industry Association (May 15, 2017) (FIA 5/15/17 Letter); Letter from Stephen John Berger, Citadel Securities (May 15, 2017) (Citadel 5/15/17 Letter); Letter from

These commenters generally stated that the 8% risk margin amount was both too high of a percentage and over-inclusive of the various types of business activities engaged in by SDs.<sup>26</sup>

Several of the commenters also stated that the proposed risk margin amount has a limited relationship to the actual risk of the SD's risk from swaps, SBS, futures, and foreign futures transactions.<sup>27</sup> Commenters also generally noted that under the *2016 Capital Proposal* the risk margin amount is computed on a counterparty-by-counterparty basis and not on the aggregate of all of the SD's positions across all counterparties, which may overstate the SD's risk by not taking into account offsetting positions across multiple counterparties, including hedging positions.<sup>28</sup>

A commenter also noted that the risk margin amount did not reflect the actual risk of a SD's proprietary cleared swap, SBS, futures and foreign futures positions as the risk margin amount is required to be computed on a clearing organization-by-clearing organization basis and, therefore, does not recognize hedging and risk-reducing portfolio margin across multiple clearing organizations.<sup>29</sup> Commenters further noted that under the Net Liquid Assets Capital Approach requiring net capital to exceed 8% of margin double counts the risks of various positions as these risks are counted once in the market and credit risk charges used to compute net capital and then again in computing the risk margin amount.<sup>30</sup>

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William Dunaway, INTL FCStone Markets, LLC (May 15, 2017) (IFM 5/15/17 Letter); Letter from Sebastien Crapanzano and Soo-Mi Lee, Morgan Stanley (May 15, 2017) (MS 5/15/17 Letter); Letter from Christine Stevenson, BP Energy Company (May 15, 2017) (BPE 5/15/17 Letter); Letter from Steven Kennedy, International Swaps and Derivatives Association (May 15, 2017) (ISDA 5/15/17 Letter); Letter from the Japanese Bankers Association (May 14, 2017) (JBA 5/14/17 Letter); and, Letter from Joanna Mallers, FIA Principal Traders Group (May 24, 2017) (FIA-PTG 5/24/17 Letter).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *See, e.g.*, ISDA 5/15/17 Letter; JBA 5/14/17 Letter; SIFMA 5/15/17 Letter.

<sup>29</sup> *See* FIA-PTG 5/24/17 Letter.

<sup>30</sup> *See* SIFMA 5/15/17 Letter; ISDA 5/15/17 Letter; FIA 5/15/17 Letter; FIA PTG 5/24/17 Letter; JBA 5/14/17 Letter; Letter from Sunhil Cutinho, CME Group, Inc. (May 15, 2017) (CME 5/15/17 Letter); and Citadel 5/15/17 Letter.

Other commenters took exception to the inclusion of the 8% risk margin amount computation for SDs electing the Bank-Based Capital Approach in proposed Regulation 23.101(a)(1)(i). Commenters noted that the current bank holding company capital rules adopted by the Federal Reserve Board, and incorporated as one of the components of the Commission's proposed minimum capital requirements for SDs electing the Bank-Based Capital Approach, does not include the 8% risk margin amount requirement. One of the commenters stated that the inclusion of the 8% risk margin amount would exaggerate the actual risk of the SD's transactions, and would place the SD at a competitive disadvantage to a SD subject to the capital rules of a prudential regulator, which are not subject to the 8% risk margin amount.<sup>31</sup>

One commenter suggested that the Commission consider limiting the 8% risk margin amount solely to uncleared swaps subject to the uncleared margin rules<sup>32</sup> and another asked the Commission to reconsider the application of the 8% risk margin threshold to cleared swaps.<sup>33</sup>

Several commenters also requested that if the Commission were to retain a minimum capital requirement for SDs based upon a percentage of the risk margin amount as defined in the *2016 Capital Proposal*, that the Commission adjust the 8% to a lower multiplier, such as 2%, for a period of time to allow the Commission to gather empirical data in order to determine an appropriate level.<sup>34</sup>

As noted in the *2016 Capital Proposal*, capital serves as an overall financial resource for the SD and is intended to cover potential risks that are not adequately covered by other risk management programs (i.e., "residual risk") including margin on uncleared swaps.<sup>35</sup> Therefore,

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<sup>31</sup> See SIFMA 5/15/17 Letter; ISDA 5/15/17 Letter; and JBA 5/14/17 Letter.

<sup>32</sup> See IFM 5/15/17 Letter.

<sup>33</sup> See ISDA 5/15/17 Letter.

<sup>34</sup> See SIFMA 5/15/17 Letter and MS 5/15/17 Letter.

<sup>35</sup> See *2016 Capital Proposal*, 81 FR at 91259.

the *Proposal* expanded the types of financial instruments included in the computation of the risk margin amount to include an SD's futures, foreign futures, swaps, and SBS positions, which is a more expansive list than the SEC imposed on SBSDs, as the Commission believed that it was appropriate for SDs to maintain a minimum level of capital that reflects the extent of the risks and activities posed by the full, broad range of the SD's proprietary positions.<sup>36</sup>

Commenters, however, have identified significant issues and raised important questions regarding the effect that the 8% risk margin amount may have on driving the minimum requirement and consequentially the funding and business activities of each SD. Therefore, the Commission is seeking further comments on the following areas in an attempt to ensure that the 8% risk margin amount is appropriately calibrated and consistent with the statutory mandate of helping to ensure the safety and soundness of the SDs subject to the Commission's capital requirements, or if another percentage or approach is more appropriate.<sup>37</sup> In this regard, the Commission invites comments on all aspects of the proposed risk margin amount, including comments regarding the possible increase or decrease of the risk margin percentage in coordination with the inclusion or exclusion of certain products in order to establish the most optimal capital requirement.

1-a. The Commission requests comment and supporting data on the quantification of the potential minimum capital requirements that would be required of SDs electing the Bank-Based Capital Approach, the Net Liquid Assets Capital Approach, or the Tangible Net Worth Capital Approach as a result of the proposed 8% risk margin amount threshold. How would the amount of potential minimum capital based upon the 8% risk margin requirement compare with the amount of capital currently maintained by entities that are provisionally registered as SDs? How

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<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 91258.

would such amounts compare with the amounts of capital required of SBSBs under the *SEC Final Capital Rule*? Please provide data in support of comments provided.

1-b. The Commission requests comment on whether the proposed 8% risk margin amount should be modified for SDs electing the Bank-Based Capital Approach, the Net Liquid Assets Capital Approach, or the Tangible Net Worth Capital Approach to a lower percentage requirement, such as 4%. If so, is 4% risk margin properly calibrated to the inherent risk of an SD and the activities that it engages in? If not 4%, what percentage of the risk margin should the Commission consider including in the regulations, and why is the percentage an appropriate percentage properly calibrated to the inherent risk of an SD and the activities that it engages in? Please quantify the difference in the amount of capital that would be required of an SD pursuant to the proposed 8% risk margin amount and 4% or any other suggested lower percentage of risk margin amount. To the extent it is possible to model the impact of different percentages of risk margin on the minimum capital requirements for an actual or hypothetical portfolio of positions, please provide such information. How would the suggested modified risk margin amount percentage be appropriate and consistent with the statutory objective of establishing capital requirements designed to help ensure the safety and soundness of the SD? Are there differences in the products, size and activities between SDs subject to the CFTC's proposed capital rule, SDs subject to the prudential regulators' capital rules, and SBSBs subject to the SEC's capital rule, (such as trading strategies or market share) that lead to practical differences in the CFTC's capital rule? Please provide data and analysis in support of any suggested modified percentage of the risk margin amount.

1-c. The Commission requests comment on whether the proposed 8% risk margin amount should be modified to be harmonized with the approach adopted by the SEC for SBSBs

in the *SEC Final Capital Rule*. Specifically, should the Commission modify the regulation to lower the risk margin amount percentage from 8% to 2%, and further modify the regulation to authorize the Commission by order to increase the risk margin amount percentage in stages from 2% to 4% or less, and from 4% to 8% or less based upon the Commission's future experience with SD capital levels after the implementation of the final regulations? In responding to this question, please address the significant differences in the size, complexity and scope of the swap products and markets as compared to the SBS products and markets.

1-d. The Commission requests comment on whether the types of derivatives positions included in the computation of the risk margin amount threshold for SDs should be modified. Should the Commission exclude any particular asset classes or positions from the computation of the risk margin amount? For example, should the Commission exclude cleared transactions from the risk margin amount? If so, explain why such asset classes or positions should be excluded, how such exclusion is consistent with the statutory objective of the safety and soundness of the SD, and quantify the impact on the proposed minimum capital requirement of excluding such asset classes or positions and the overall risk to the financial system. Should the Commission consider modifying a combination of the percentage of the risk margin amount and the products that are included in the computation? If so, please suggest how the Commission may determine an appropriate balance between products and the risk margin percentage. Please provide data in support of any modified list of asset classes or positions included in the risk margin amount computation and the possible costs and benefits that may result in such a change.

1-e. If the Commission modifies the capital requirements by, for example, lowering the 8% risk margin amount to a lower level or by removing certain transactions from the risk margin amount computation, the Commission believes that this may result in a lower amount of required

capital for SDs, which may increase the level of risk at some SDs. The Commission requests comment as to whether lowering the percentage of risk margin to a 4% level, the SEC's 2% level or a different level, or removing transactions from the risk margin amount computation would result in an SD not holding a sufficient level of capital to help ensure its safety and soundness. Specifically, given the size, breadth and complexity of the swaps market, does a 2% or 4% capital level serve the intended goals as established in the CEA? Alternatively, what percentage of risk margin would result in capital levels that were so high that certain current swaps and futures activities of the SD would become uneconomic? How does the capital requirement impact that ability of an SD to service certain types of clients, to provide liquidity to the marketplace, or otherwise impact the efficiency and competitiveness of the swaps market? The Commission further invites comments on the general costs and benefits of modifying the risk margin amount as discussed above. Please provide data with any comment or analysis.

1-f. The Commission requests comment on whether Regulation 23.101 should be modified by removing the minimum capital requirement based upon the 8% of risk margin amount calculation from the Bank-Based Capital Approach and the Net Liquid Assets Capital Approach. If the Commission were to modify Regulation 23.101 to remove the 8% risk margin amount from the Net Liquid Assets Capital Approach, SDs electing that capital approach would be required to maintain net capital equal to or in excess of \$20 million and, if approved to use capital models, \$100 million of tentative net capital and \$20 million of net capital. Does this level of minimum regulatory capital provide adequate assurance that an SD can meet its obligations and is it consistent with the objective of helping to ensure that safety and soundness of the SD?

1-g. The *2016 Capital Proposal* did not include a leverage ratio requirement. The Commission requests comment on whether it would be appropriate, at a future date after notice and comment, to revise the capital requirements by adopting a leverage ratio for SDs in lieu of the proposed percentage of the risk margin amount if adopted as final. To assist the Commission in its assessment of this possible future action, the Commission requests comment on the cost, if any, in terms of additional required capital under each of the proposed capital methods and how the adoption of a leverage ratio requirement would affect the efficiency, competitiveness, integrity, safety and soundness, and price discovery of swap markets. Please provide any supporting data with your comment.

2. *FCM Minimum Capital Requirement*

The *2016 Capital Proposal* included a proposed revision to the FCM net capital requirement to require an FCM (or dually-registered FCM/SD) to include in its minimum capital requirement eight percent of the uncleared swaps margin for uncleared swaps and eight percent of the initial margin for uncleared SBS for which the FCM or FCM/SD was a counterparty, as well as eight percent of the total initial margin that the FCM or FCM/SD was required to post with a broker or clearing organization for all proprietary cleared swaps and proprietary cleared SBS. These proposals were contained at a proposed revised Regulation 1.17(a)(1)(i)(B). The Commission's general rationale for proposing such revisions was that an FCM's or FCM/SD's capital should reflect exposures to all swap counterparties, in order to promote safety and soundness.<sup>38</sup>

Several commenters focused their comments on the impact on FCMs. Several commenters stated that the proposed inclusion of an FCM's or FCM/SD's proprietary cleared

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<sup>38</sup> See *2016 Capital Proposal*, 81 FR at 91266.

swaps and SBS positions in the 8% risk margin amount would place an unnecessary financial burden on FCMs and would not properly recognize that the same proprietary positions are subject to an existing net capital charge based upon exchange or clearinghouse margin requirements under Regulation 1.17(c)(5)(x).<sup>39</sup> One commenter referred specifically to this as duplicative, and argued it would unnecessarily increase the amount of adjusted net capital an FCM would hold for swaps and SBS exposures which could burden smaller SD FCMs which are not BDs and threaten their ability to provide clearing services for swaps.<sup>40</sup> This commenter noted that the Commission had noted that such types of FCMs were often ones that may be willing to provide swaps markets in commodities to agricultural firms and smaller commercial end-users, and this commenter suggested that overburdening smaller SD FCMs in this manner could further exacerbate the concentration of clearing among larger FCMs. Considering these comments, specifically that existing net capital charges already apply to proprietary cleared swaps and SBS in Regulation 1.17, and that the Commission also proposed additional net capital market risk charges applicable to swaps and SBS in other parts of Regulation 1.17, the Commission is reconsidering the proposed FCM amendments to Regulation 1.17(a)(1)(i)(B) contained within the *2016 Capital Proposal*.

2-a. The Commission requests additional comment on the advisability of deleting the proposed changes to Regulation 1.17(a)(1)(i)(B) to the net capital requirement for all FCMs and dually-registered FCM/SDs, which would leave such section as currently in effect, instead of adopting the changes proposed within the *2016 Capital Proposal*.<sup>41</sup> The Commission would rely on net capital charges proposed and applicable to proprietary cleared and uncleared swaps and

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<sup>39</sup> See CME 5/15/17 Letter; FIA 5/15/17 Letter; Citadel 5/15/17 Letter; and the SIFMA 5/15/17 Letter.

<sup>40</sup> See CME 5/15/17 Letter.

<sup>41</sup> The modification to Regulation 1.17(a)(1)(i)(B) would result in the customer and noncustomer cleared swaps, futures, and foreign futures being included in the computation of the risk margin amount.

SBS to reflect the risks to FCMs (and dually-registered FCM/SDs) from swaps and SBS business, without any add-on minimum capital requirement for swap dealing, other than the higher minimum dollar threshold of \$20 million, which the Commission still would retain from the *2016 Capital Proposal*. If the Commission adopts this change, the Commission believes that this would lower the amount of required capital under this *Proposal*; however, FCMs would still be required to deduct market risk charges for cleared and uncleared proprietary positions in computing their net capital and adjusted net capital, which is intended to provide a capital cushion to protect against future adverse price movements in the positions. Please provide comment on how this change would affect the overall costs and benefits of the *Proposal* and the efficiency, competitiveness, financial integrity, and price discovery of the swaps market?

### 3. *Composition of Common Equity Tier 1 Capital*

The *2016 Capital Proposal* would require SDs electing the Bank-Based Capital Approach to maintain a minimum level of regulatory capital of CET1 Capital equal to or in excess of the highest of: (1) \$20 million; (2) 8% of the SD's risk-weighted assets; or (3) 8% of the SD's risk margin amount.<sup>42</sup> For purposes of the *Proposal*, CET1 Capital is defined by rules of the Federal Reserve Board, and generally represents the sum of a bank holding company's common stock instruments and any related surpluses, retained earnings, and accumulated other comprehensive income.<sup>43</sup> The *2016 Capital Proposal* also would require an SD to file a notice with the Commission if its net capital was below 120% of the SD's minimum capital requirement ("Early Warning Notice").<sup>44</sup>

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<sup>42</sup> See *2016 Capital Proposal*, 81 FR at 91310; Proposed Regulation 23.101(a)(1)(i). Risk-weighted assets would be defined and computed in accordance with rules of the Federal Reserve Board, 12 CFR part 217.

<sup>43</sup> See 12 CFR 217.20.

<sup>44</sup> See *2016 Capital Proposal*, 81 FR at 91318; Proposed Regulation 23.105(c)(2).

As noted in the *2016 Capital Proposal*, the Commission proposed to limit the forms of capital that a SD electing the Bank-Based Capital Approach could recognize to CET1 capital as such capital is a more conservative form of capital than Additional Tier 1 capital or Tier 2 capital, particularly as it relates to the permanence of the capital and its availability to absorb unexpected losses.<sup>45</sup> Moreover, the Commission believed that limiting the capital to CET1 Capital was appropriate as the Commission did not propose to include several capital add-ons maintained in the rules of the Federal Reserve Board, including, for instance, the capital conservation buffer and the countercyclical capital buffer.<sup>46</sup>

The Commission received comments regarding the proposed requirement to limit regulatory capital to only CET1 Capital. One commenter supported the proposed requirement that an SD electing the Bank-Based Capital Approach must satisfy its capital requirement with only CET1 Capital.<sup>47</sup> This commenter stated that the more conservative CET1 Capital requirement is appropriate given that the *2016 Capital Proposal* does not contain all of the add-ons and supervisory safeguards that are set forth in the prudential regulators' capital framework.<sup>48</sup>

Other commenters stated that the proposed minimum capital requirement of CET1 Capital equal to or greater than 8% of risk-weighted assets would impose a capital requirement on SDs that is materially higher and more restrictive than the prudential regulators' capital requirement for banks and bank holding companies.<sup>49</sup> These commenters noted that the prudential regulators' minimum capital requirements provide that an entity is "adequately

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<sup>45</sup> *Id.* at 91259-91260. Under the rules of the Federal Reserve Board, Additional Tier 1 capital includes certain types of non-cumulative preferred stock instruments and Tier 2 capital includes qualifying subordinated debt. (*See* 12 CFR 217.20).

<sup>46</sup> *Id.* at 91260, footnote 45.

<sup>47</sup> *See* AFR 5/15/17 Letter.

<sup>48</sup> *Id.*

<sup>49</sup> *See* ISDA 5/15/17 Letter; MS 5/15/17 Letter; SIFMA 5/15/17 Letter.

capitalized” if its CET1 Capital is equal to or greater than 4.5% of the SD’s risk-weighted assets, and is “well capitalized” if its CET1 Capital is at least 6.5% of its risk-weighted assets.<sup>50</sup> These commenters further stated that the proposed Early Warning Notice requirement would effectively require SDs to maintain CET1 Capital equal to at least 9.6% (120% x 8%) of risk-weighted assets as entities subject to the Early Warning Notice requirements generally ensure that regulatory capital exceeds such requirements.<sup>51</sup> Another commenter stated that the *Proposal* may make it difficult for SDs subject to the CFTC capital rule to compete with SDs subject to the capital rules of a prudential regulator, and more generally would deviate from the more tailored risk-based approach taken by the prudential regulators.<sup>52</sup>

In addition, a commenter requested that the Commission revise its Bank-Based Capital Approach to recognize subordinated debt as capital in meeting the 8% of risk-weighted assets capital ratio.<sup>53</sup> This commenter noted that prudential regulators’ capital requirements permit a bank or bank holding company to recognize certain subordinated debt as capital in meeting the 8% of risk-weighted assets capital ratio requirement.<sup>54</sup>

The Commission continues to support the concept of aligning, as appropriate, the requirements of the proposed Bank-Based Capital Approach with the capital requirements imposed on SDs subject to the prudential regulators’ jurisdiction. Consistency between the Bank-Based Capital Approach requirements and the prudential regulators’ requirements satisfies the Commission’s objective of providing capital alternatives that are based upon existing bank requirements, while also providing market participants with greater certainty as to the operation

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<sup>50</sup> *Id.*

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

<sup>52</sup> JBA 5/15/17 Letter.

<sup>53</sup> SIFMA 5/15/17 Letter.

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

of the capital requirements and regulations, and should assist in addressing potential competitive disadvantages that SDs subject to the CFTC Bank-Based Capital Approach may be subject to relative to prudentially regulated SDs. Accordingly, the Commission is considering adjusting the CET1 Capital approach based on comments received, particularly those which identified a possible competitive disadvantage to a SD under the CFTC's jurisdiction relative to a SD subject to the capital requirements of a prudential regulator.

3-a. The Commission requests comment on whether Regulation 23.101(a)(1)(i)(B) should be modified to permit SDs electing the Bank-Based Capital Approach to recognize capital other than CET1 Capital in meeting the 8% of risk-weighted assets ratio requirement. Should the proposed Regulation be modified to permit an SD to recognize Additional Tier 1 capital and/or Tier 2 capital (as such terms are defined in 12 CFR 217.20) in meeting its 8% of risk-weighted assets capital ratio requirement? If so, are there particular elements of Additional Tier 1 capital or Tier 2 capital that the Commission should prohibit or otherwise limit an SD from recognizing in meeting the 8% of risk-weighted assets capital ratio?

3-b. The Commission requests comment on whether Regulation 23.101(a)(1)(i)(B) should be modified such that an SD is required to maintain a CET1 Capital ratio of at least 6.5% of risk-weighted assets, with an additional 1.5% of risk-weighted assets permitted to be held in the form of Additional Tier 1 capital or Tier 2 capital? Should the Commission place any restrictions or conditions on the type of instruments that would qualify as Additional Tier 1 capital or Tier 2 capital in meeting the capital ratio?

3-c. The Commission requests comment on whether Regulation 23.101(a)(1)(i)(B) should be modified such that an SD is required to maintain a CET1 Capital ratio of 4.5% of risk-weighted assets, with the remaining 3.5% of risk-weighted assets permitted to be held in the

form of Additional Tier 1 capital or Tier 2 capital? Should the Commission place any restrictions or conditions on the type of instruments that would qualify as Additional Tier 1 capital or Tier 2 capital?

3-d. The Commission recognizes that an FCM is permitted to exclude subordinated debt that complies with the conditions set forth in Regulation 1.17 from its liabilities in computing its adjusted net capital.<sup>55</sup> In addition, an SD that elects the Net Liquid Assets Capital Approach also would be permitted to exclude subordinated debt that satisfies the conditions specified in SEC Rule 18a-1d (17 CFR 240.18a-1d) from its liabilities in computing its net capital.<sup>56</sup> The Commission requests comment on whether an SD that elects the Bank-Based Capital Approach should be permitted to include subordinated debt in computing the amount of capital available to meet the 8% of risk-weighted assets ratio requirement? If so, should the subordinated debt be subject to the same conditions as set forth in Regulation 1.17(h) and/or SEC Rule 18a-1d (17 CFR 240.18a-1d) for Satisfactory Subordination Agreements? Should the subordinated debt be classified as Tier 2 capital in the modified rule? Please suggest rule language to effect any modification to the Regulation.

3-e. The Commission requests comments and supporting data on how the various modifications to the CET1 discussed in questions 3-a through 3-d above would affect the capital adequacy of an SD. Would such modifications encourage regulatory arbitrage between SDs subject to the capital rules of a prudential regulator and SDS subject to the capital rules of the CFTC? What impact would the proposed modifications have on an SD's cost of capital. How would the various modifications affect efficiency, competitiveness, financial integrity, and price discovery of swaps market?

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<sup>55</sup> See Commission Regulation 1.17(h).

<sup>56</sup> See SEC Rule 18a-1(c)(1)(ii)(17 CFR 240.18a-1(c)(1)(ii)).

4. *Standardized Market Risk Charges – Netting of Uncleared Currency and Commodity Swaps.*

The *2016 Capital Proposal* contained standardized market risk capital charges for uncleared swaps and uncleared SBS for FCMs and SDs not approved to use internal models.<sup>57</sup> The standardized market risk capital charges for swaps and SBS for FCMs and dually-registered FCM/SDs were proposed in revised Regulation 1.17(c)(5)(iii) and (iv), respectively.<sup>58</sup> The standardized capital charges for SDs that are not dually-registered as FCMs (*i.e.*, “Standalone SDs”) are set forth in proposed Regulation 23.101(a)(1). Proposed Regulation 23.101(a)(1)(i)(B) sets forth the standardized capital charges for Standalone SDs that elect the Bank-Based Capital Approach and effectively imposes the same standardized capital charges as set forth in Regulation 1.17(c)(5)(iii) for FCMs and dually-registered FCM/SDs. Proposed Regulation 23.101(a)(1)(ii)(A) sets forth the standardized capital charges for Standalone SDs electing the Net Liquid Assets Capital Approach, and effectively imposes the same standardized capital charges as set forth in the *SEC’s Final Capital Rule* for SBSs.<sup>59</sup>

FCMs and SDs must maintain capital to cover the market risk of their swap portfolios. Standardized capital charges provide an option for FCMs and SDs to calculate the amount of capital necessary to cover the risk of their portfolios. Using standardized charges to measure risk capital is relatively easy and cheap to implement, compared to using internal models. Therefore, standardized charges reduce the operational cost of being an SD and potentially encourage more

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<sup>57</sup> FCMs or SDs may seek Commission approval to use internal models to compute market risk charges for proprietary positions. The internal models would have to meet certain qualitative and quantitative requirements set forth in proposed Regulation 23.102 and Appendix A to Regulation 23.102.

<sup>58</sup> See *2016 Capital Proposal*, 81FR at 91307.

<sup>59</sup> Proposed Regulation 23.101(a)(ii)(A), which applies to Standalone SDs electing the Net Liquid Assets Capital Approach, would incorporate the SEC’s standardized market risk and credit risk capital charges as it provides that the Standalone SDs must compute regulatory capital in accordance with the SEC’s capital rules as if the Standalone SDs were SBS subject to the SEC’s capital rules.

firms to enter the swap dealing business. However, simple standardized haircuts are less risk-sensitive than model-based charges and less likely to recognize appropriate netting for different portfolios. Netting is critical in managing risk of derivative portfolios and needs to account appropriately for different portfolios. Without a netting provision, standardized charges can be too high, particularly for uncleared swap portfolios made of long and short positions simultaneously, therefore netting/offsetting provisions are critical when standardized charges are used to measure risk capital for the swap dealing book. Due to these reasons, sometimes standardized charges may not be tailored appropriately to the risk of the relevant positions. To be a viable alternative to models for calculating risk capital for FCMs and SDs, the Commission recognizes that standardized charges need to recognize netting benefits and must be subject to recalibration and refinement.

Proposed Regulation 1.17(c)(5)(iii) sets forth the standardized market risk charges for uncleared credit default swaps (“CDS”) referencing broad-based securities indices, interest rate swaps, currency swaps, commodity swaps, and SBS. The standardized market risk charges for uncleared CDS referencing broad-based securities indices generally would be determined by multiplying the notional amount of the swap by a fixed percentage based upon the remaining length of the time to maturity of the swap and the current basis point spread of the swap. The proposed regulation would further provide for certain netting or offsetting of long and short uncleared CDS positions.<sup>60</sup>

The proposed standardized market risk charge for uncleared interest rate swap positions would be determined by multiplying the notional amount of the swap by a fixed percentage based upon the remaining term of the swap. The FCM or dually-registered FCM/SD also would

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<sup>60</sup> *Id.*

be permitted to net or offset long and short uncleared interest rate swap positions that are in the same time to maturity groupings or categories, provided that the market risk capital charge deduction may not be less than 0.5% of the amount of the long positions netted against the short positions in each individual categories with a maturity of three months or more.<sup>61</sup>

Proposed Regulation 1.17(c)(5)(iii) would further require an FCM or dually-registered FCM/SD to incur standardized market risk charges for uncleared currency swaps and commodity swaps. The standardized market risk capital charges for uncleared currency swaps would be based upon a fixed percentage of the notional amount of the currency swaps.<sup>62</sup> The standardized market risk capital charge for uncleared commodity swaps would be based upon a fixed 20% of the market value of the commodity underlying the commodity swaps. Proposed Regulation 1.17(c)(5)(iii), however, did not include a provision that would provide for any netting or offsetting of the uncleared currency or uncleared commodity swaps positions in computing the standardized market risk charges. Proposed Regulation 1.17(c)(5)(iii) would require a standardized market risk charge equal to the sum of the standardized charge applicable to each long and short uncleared currency swap and each long and short uncleared commodity swap position.

The *SEC Final Capital Rule* included similar standardized market risk charges for uncleared swaps for BDs and SBSBs, however the SEC adopted a netting proviso applicable to

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<sup>61</sup> *Id.* Proposed Regulation 1.17(c)(5)(iii)(B) would provide that the capital charge for uncleared interest rate swaps would be determined by reference to SEC Regulation 15c3-1(c)(2)(vi)(A) (17 CFR 240.15c3-1(c)(2)(vi)(A)). The Commission had proposed a minimum standardized market risk capital charge on matched long and short interest rate swap positions equal to 0.5% of net notional amount in each grouping or category of swaps. The SEC proposed a minimum standardized market risk capital charge on matched long and short interest rate swaps equal to 1% of the net notional amount in each grouping or category of swaps. *See SEC Comment Reopening.*

<sup>62</sup> Proposed Regulation 1.17(c)(5)(iii)(C)(1)(ii) would provide that the standardized market risk capital charge for currency swap is 6% of the notional amount of currency swaps referencing euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs, and 20% of the notional amount in the case of currency swaps referencing any other foreign currencies.

both BDs and SBSs, permitting a reduction of the resulting capital charge by an amount equal to any reduction recognized for a comparable long or short position in the reference asset or interest rate under Regulation 1.17 or SEC Rule 15c3-1 (17 CFR 240.15c3-1). This netting proviso is adopted in the *SEC Final Capital Rule* at Rule 15c3-1b(b)(2)(ii)(B) (17 CFR 240.15c3-1b(b)(2)(ii)(B) and Rule 18a-1b(b)(2)(ii)(B) (17 CFR 240.18a-1b(b)(2)(ii)(B)). The Commission intends to maintain consistency with the *SEC Final Capital Rule* with respect to the applicability of the standardized market risk charges for uncleared currency and commodity swaps, and therefore requests comment on including the same netting proviso appended to the proposed Regulation 1.17(c)(5)(iii)(C), which would provide that the deduction under Regulation 1.17(c)(5)(iii)(C)(1) may be reduced by an amount equal to any reduction recognized for a comparable long or short position in the reference asset under § 1.17 or 17 CFR 240.15c3-1.

4-a. The Commission requests comment and supporting data on the potential modification to the standardized market risk charges as proposed, through new rule text that would be appended to the proposed Regulation 1.17(c)(5)(iii)(C), that would provide for the netting or offsetting of currency swaps and commodity swaps as discussed above. How would various changes regarding netting or offsetting provisions affect an FCM's or SD's risk management, liquidity provision, and capacity to serve end users in commodity swap and currency swap markets? How would various changes affect efficiency, competitiveness, integrity, and price discovery in commodity swap and currency swap markets?

4-b. Would rule language as described above affect this potential modification to the rule text in the *2016 Capital Proposal*? If not, please explain why and suggest alternative rule language.

4-c. The Commission notes that the Federal Reserve Board's current capital framework does not include a standardized calculation for market risk which recognizes offsets across commodity positions. The Basel III framework, however, does include provisions for such offsets.<sup>63</sup> While it is anticipated that the prudential regulators will adopt a standardized market risk calculation based on Basel III, they have not done so to date.

The Commission requests comments on whether Regulation 1.17(c)(5)(iii) should be modified to include the Basel III simplified standardized approach of market risk for commodity swaps.<sup>64</sup> If the Commission were to modify Regulation 1.17(c)(5)(iii) consistent with the current Basel III framework for the simplified standardized approach for computing market risk, should the Commission consider amending Regulation 1.17(c)(5)(iii) with the objective of maintaining a harmonized approach with the prudential regulators if and when they adopt the corresponding aspect of the Basel III framework? How would such revisions impact FCMs or SDs that are dually-regulated as BDs or SBSBs? While the intent of the Commission would be to limit the incorporation of the Basel III approach only to those sections that describe allowable netting within the commodities class, it may be that the fusion of these sections or concepts into the rest of the Commission's proposed rule present additional challenges. Accordingly, the Commission requests comments identifying and addressing these challenges and suggestions on how the Commission may modify the regulations to overcome them. This may include for example, differences in definitions between the Basel III framework and definitions contained in the *Proposal*.

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<sup>63</sup> *BCBS Minimum Capital Requirements for Market Risk*, January 2019 (revised February 2019), BIS, <https://www.bis.org/bcbs/publ/d457.htm>.

<sup>64</sup> *Id.* See MAR 40.2 for commodities which references MAR40.63 to MAR40.73 (commodities risk), plus additional requirements for option risks from commodities instruments (non-delta risks) under MAR40.74 to MAR40.86 (treatment of options).

5. *Revision of Minimum Market Risk Capital Charge for Uncleared Interest Rate Swaps*

The *2016 Capital Proposal* included a standardized market risk capital charge for uncleared interest rate swaps.<sup>65</sup> The proposed standardized market risk capital charges for uncleared interest rate swaps was consistent with the SEC's proposed standardized market risk capital charges for uncleared interest rate swaps in an effort to harmonize the two rules to minimize operational costs on entities dually registered with the CFTC and SEC, and therefore subject to both CFTC and SEC capital rules.<sup>66</sup>

Pursuant to the *Proposal*, a Covered Firm that was not approved to use internal market risk models would be required to take a standardized market risk capital charge equal to a percentage of the notional amount of the uncleared interest rate swap. The percentage that would be applied to the notional amount would be based upon the remaining time to maturity of the interest rate swap, and would range from 0% (for interest rate swaps with a remaining time to maturity of less than 3 months) to 6% (for interest rate swaps with a remaining time to maturity of 25 years or more). The *2016 Capital Proposal* further provided that a Covered Firm may net certain of the long and short uncleared interest rate swaps to reduce the net notional amount, provided that the net notional amount is subject to a minimum floor standardized capital charge equal to 0.5%.<sup>67</sup>

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<sup>65</sup> See *2016 Capital Proposal*, 81 FR at 91307; Proposed Regulation 1.17(c)(5)(iii)(B). Regulation 1.17(c)(5)(iii)(B) would apply to FCMs, SDs that elect to follow the Bank-Based Capital Approach and are not approved to use internal capital models, and dually-registered FCM/SDs (collectively referred to as "Covered Firms").

<sup>66</sup> See *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 FR 70213 (Nov. 23, 2012) (the "SEC Proposed Capital Rule").

<sup>67</sup> The SEC proposed minimum standardized market risk charge of 1% of the net notional value of the interest rate swaps for SBSs and 0.5% for BDs. See SEC Proposed Capital Rule, 77 FR at 70345; Proposed Rule 18a-

Commenters objected to the proposed standardized market risk charges as being too punitive and not tailored to the risk posed by the relevant portfolios of positions.<sup>68</sup> Specifically, commenters noted that the proposed standardized market risk charges would be substantially higher than the capital charges based on clearing house maintenance margin requirements for cleared interest rate futures contracts.<sup>69</sup> These commenters indicated that the excessive capital requirements derived from the proposed standardized capital charges would particularly impact small to mid-sized Covered Firms that are not approved or otherwise do not use internal market risk models.

The Commission continues to believe that it is appropriate for the capital rule to include standardized market risk charges for uncleared interest rate swap positions to help ensure that a Covered Firm maintains capital to address potential decreases in the value of such positions, and as a general cushion to cover other types of risks. The Commission also believes that standardized market risk charges are necessary as not all Covered Firms will have internal models to compute market risk charges.

The Commission, however, recognizes that the *Proposal* would impose substantial capital charges that are not properly calibrated to the risks of the interest rate swap positions. In addition, the Commission acknowledges that the standardized market risk charges would impact Covered Firms that do not use internal models, which is expected to be smaller to mid-sized Covered Firms that are not part of a financial group that has obtained the approval of the SEC, prudential regulators, or a foreign regulator to use internal capital models. The Commission

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1b(2)(i)(C) (17 CFR 240.18a-1b(2)(i)(C)) for SBSs and Proposed Rule 15c3-1b(2)(i)(C) (17 CFR 240.15c3-1b(2)(i)(C)).

<sup>68</sup> SIFMA 5/15/17 Letter; Jefferies 5/12/17 Letter.

<sup>69</sup> SIFMA and Jefferies each estimated that the proposed standardized market risk charges for uncleared interest rate swaps would be approximately 144 times higher than the clearing house margin requirements. *See, Id.*

believes that establishing an appropriate level for the standardized capital charge for uncleared interest rate swaps would benefit market participants by encouraging smaller to mid-sized SDs to remain or to enter the market. Accordingly, the Commission request further comment on the proposed standardized market risk charge for uncleared interest rate swaps.

5-a. The Commission requests comment on modifying the proposed capital charges for interest rate swap positions for Covered Firms. Should the Commission modify the proposed regulation to include the 0.125% capital charge adopted by the SEC? Is the 0.125% capital charge appropriately calibrated to the risk of the interest rate swap positions? What would be the financial impact on Covered Firms' capital by modifying the regulation to provide for a 0.125% capital charge? How would the modified capital charge at a 0.125% level satisfy the statutory requirement of helping to ensure the safety and soundness of a SD? What would be the potential impact of having a capital charge that was not appropriately calibrated to the risk of the swap positions? Please provide empirical data and analysis in support for your responses.

5-b. The Commission requests comment on whether additional guidance concerning the method of applicable netting of uncleared interest rate swaps positions is necessary.

6. *Revision of the Length of Time to Maturity Categories for Credit Default Swaps*

The *2016 Capital Proposal* would require an FCM or SD to incur a standardized market risk capital charge for uncleared CDS. As noted above in section 4, the standardized market risk capital charge for uncleared CDS would be determined by multiplying the notional amount of the swap by a fixed percentage based upon the remaining length of time to maturity of the swap and the current basis point spread of the swap.

The *SEC Final Capital Rule* includes the same standardized market risk capital charges for uncleared CDS referencing broad-based security index.<sup>70</sup> However, the *SEC Final Capital Rule* contains slightly different categories of remaining length of maturity of the swap than the Commission's *2016 Capital Proposal*.<sup>71</sup> This difference was not intentional and is not deemed material.

The Commission and SEC have a long history of harmonizing CFTC and SEC capital requirements in order to reduce costs that would otherwise be imposed on dually-regulated entities, including dually-registered FCM/BDs, from having to comply with two different regulatory requirements. This approach to a uniform capital rule reduces costs to registrants and encourages entities to engage in activities that require registration with both the CFTC and SEC, while also providing appropriate regulatory requirements. To maintain this established system of uniform capital requirements, the Commission proposes to modify the grid of the final length of time to maturity of the CDS contract referencing broad-based security index in proposed Regulation 1.17(c)(5)(iii)(A)(I) to harmonize the standardized uncleared CDS contract market risk capital charges with the final SEC standardized capital charges.

6-a. The Commission requests comment on the potential modification of the standardized market risk charges for uncleared CDS referencing broad-based security index.

6-b. The potential modification to paragraph (c)(5)(iii)(A)(I) of Regulation 1.17 would revise the language of each row heading one month less, for example the first row would be titled less than 12 months as opposed to 12 months or less.

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<sup>70</sup> See SEC Final Rule; Rule 15c3-1b(b)(2)(i)(A) (17 CFR 240.15c3-1b(b)(2)(i)(A)) for BDs and Rule 18a-1b(b)(2)(i)(A) (17 CFR 240.18a-1b(b)(2)(i)(A)) for SBSs.

<sup>71</sup> The length of time to maturity component of the respective CFTC and SEC standardized grids were different by one month.

Would the potential modification described above appropriately address the harmonization of the CFTC and SEC standardized market risk capital charge for uncleared CDS referencing broad-based security index? If not, are there additional modifications that would need to be addressed, or different rule language necessary to appropriately harmonize the CFTC and SEC CDS standardized market risk charges? The Commission is of the view that the changes to the table above would have a de minimis effect on the required amount of capital; however, the Commission requests comments and supporting data on how the changes to the table would, if at all, affect efficiency, competitiveness, financial integrity, and price discovery of swaps market?

7. *Tangible Net Worth Capital Approach.*

The *2016 Capital Proposal* included a provision permitting SDs that are “predominantly engaged in non-financial activities” to compute their minimum regulatory capital based upon the firms’ “tangible net worth” (the “Tangible Net Worth Capital Approach”) in lieu of the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach.<sup>72</sup> Proposed Regulation 23.101(a)(2) defined the term “predominantly engaged in non-financial activities” by referencing the definition of the term “financial activities” under the Federal Reserve Board’s regulations establishing criteria for determining if a nonbank financial company is predominantly engaged in financial activities.<sup>73</sup> For purposes of the *Proposal*, an entity would be considered “predominantly engaged in non-financial activities” if: (1) the consolidated annual gross financial revenues of the entity in either of its two most recently completed fiscal years

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<sup>72</sup> See *2016 Proposed Capital Rule*, 81 FR at 91310-11; Proposed Regulation 23.101(a)(2). The term “tangible net worth” was proposed to be defined in Regulation 23.100, in relevant part, as the net worth of an SD as determined in accordance with generally accepted accounting principles in the U.S., excluding goodwill and other intangible assets.

<sup>73</sup> See 12 CFR 242.3. The Financial Stability Oversight Council uses the criteria when it considers the potential designation of a nonbank financial company for consolidated supervision by the Federal Reserve Board.

represents less than 15 percent of the entity's consolidated gross revenue in that fiscal year ("15% Revenue Test"), and (2) the consolidated total financial assets of an entity at the end of its two most recently completed fiscal years represents less than 15 percent of the entity's consolidated total assets as of the end of the fiscal year ("15% Asset Test"). For purposes of the 15% revenue test, consolidated annual gross financial revenues would mean that portion of the consolidated total revenue of the entity that are related to activities that are financial in nature. For purposes of the 15% asset test, consolidated total financial assets would mean that portion of the consolidated total assets of the entity that are related to activities that are financial in nature.

The Commission proposed a Tangible Net Worth Capital Approach in recognition that certain entities that engage primarily in non-financial activities may meet the statutory and regulatory definitions of the term "swap dealer" and, therefore, would be required to register as such with the Commission.<sup>74</sup> However, while these entities may engage in swap dealing activities, they are primarily commercial enterprises. The business activities and the composition of the balance sheet of these commercial entities may differ materially from entities predominantly engaged in financial activities, including the types of transactions they enter into, and the types of market participants and swap counterparties that they deal with. Because of these differences, the Commission believed that application of the Bank-Based Capital Approach or Net Liquid Assets Capital Approach to these SDs could result in inappropriate capital requirements that would not be proportionate to the risk associated with these entities.<sup>75</sup> The proposed Tangible Net Worth Capital Approach would provide that an SD that was

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<sup>74</sup> The term "swap dealer" is defined by section 1a(49) of the CEA and Regulation 1.3 of the Commission's regulations. Regulation 1.3 provides that an entity may apply to limit its designation as an SD to specified categories of swaps or specified activities in connection with swaps.

<sup>75</sup> Furthermore, as an SD, the entity is required to exchange variation margin on swaps entered into with other SDs or financial end users, and post and collect initial margin on swaps entered into with SDs or financial end users with material swaps exposure. *See* CFTC Regulations 23.152 and 23.153.

predominantly engaged in non-financial activities must maintain tangible net worth equal to or greater than the highest of:

(1) \$20 million plus the amount of the SD's market risk exposure requirement and credit risk exposure requirement associated with the SD's swaps and related hedge positions that are part of the SD's dealing activities;

(2) 8% of the sum of the:

(a) The amount of uncleared swap margin<sup>76</sup> for each uncleared swap position open on the books of the SD, computed on a counterparty by counterparty basis pursuant to the Commission's margin rules for uncleared swap transactions (Regulation 23.154);

(b) The amount of initial margin that would be required for each uncleared SBS position open on the books of the SD, computed on a counterparty by counterparty basis pursuant to SEC Rule 18a-3(c)(1)(i)(B) (17 CFR 240.18a-3(c)(1)(i)(B)) without regard to any initial margin exemptions or exclusions that the SEC rules may provide to such SBS positions; and

(c) The amount of initial margin required by clearing organizations for cleared proprietary futures, foreign futures, swaps, and SBS positions open on the books of the swap dealer; or

(3) The amount of capital required by a registered futures association of which the SD is a member.

Certain commenters generally supported the Tangible Net Worth Capital Approach but questioned the criteria proposed to qualify for the approach as overly narrow and entity specific. These commenters generally noted that a parent entity that is predominantly engaged in non-financial activities would not be permitted in any practical way to establish an SD subsidiary that

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<sup>76</sup> See 2016 *Capital Proposal*, 81 FR at 91309-10.

would be able to use the Tangible Net Worth Capital Approach as the swaps activity of the SD would be considered financial activities.<sup>77</sup> Some commenters further noted that the proposed Tangible Net Worth Capital Approach would discriminate against corporate entities that are predominantly engaged in non-financial activities but elect to maintain their swap dealing activities in separate legal entities.<sup>78</sup> Another commenter stated that commercial enterprises may establish SD subsidiaries to perform centralized risk management operations for the commercial enterprise, and that such SD subsidiaries should have the option to elect a Tangible Net Worth Capital Approach.<sup>79</sup> These commenters generally suggested that the assessment of whether the entity satisfies the conditions for the use of the Tangible Net Worth Capital Approach should be made at an SD's parent level and not at the level of the SD.

The Commission continues to believe as it stated in the *2016 Capital Proposal* that certain SD entities which may engage in dealing activities but be associated with primarily commercial entities will need a more flexible capital requirement than either the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach. In consideration of the comments that the Tangible Net Worth Capital Approach may not be available to the full universe of SDs that it may best fit, based on the type of transactions and market functions fulfilled by such SDs, the Commission believes ensuring the continued viability of the current range of SD businesses merits seeking additional comment on possibly broadening the applicability of the Tangible Net Worth Capital Approach, while considering the need for associated additional risk mitigants if a broader application is adopted. Expanding the availability of the Tangible Net Worth Capital

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<sup>77</sup> See, e.g., Letter from Phillip Lookadoo, and Jeremy Weinstein, International Energy Credit Association (May 15, 2017); Letter from Scott Earnest, Shell Trading Risk Management LLC (May 15, 2017) (Shell 5/15/17 Letter); Letter from David McIndoe, Commercial Energy Working Group (May 15, 2017); and Letter from Michael P. LeSage, Cargill Risk Management, a unit of Cargill, Inc. (May 15, 2017) (Cargill 5/15/17 Letter).

<sup>78</sup> See e.g., Shell 5/15/17 Letter.

<sup>79</sup> See Letter from National Corn Growers Association and National Gas Supply Association, (May 15, 2017).

Approach to SDs that are subsidiaries of a corporate group that is predominantly engaged in non-financial activities would provide flexibility to allow such corporate groups to determine the most efficient and effective corporate structure to meet their business and operational needs without forcing such entities to elect either the Net Liquid Assets Capital Approach or Bank-Based Capital Approach, which are designed primarily for financial entities, for their SD subsidiaries. Providing SDs that are subsidiaries of corporate groups that are predominantly engaged in non-financial activities with a choice of using the Tangible Net Worth Capital Approach may also encourage non-financial firms to register as SDs, which may benefit commercial end users and other market participants that use such SDs to hedge their commercial risk. Accordingly, the Commission is requesting further information with respect to the consideration of the Tangible Net Worth Capital Approach as follows.

7-a. The Commission requests comment on whether the rules should permit an SD that is not “predominantly engaged in non-financial activities” as defined in proposed Regulation 23.100 to nevertheless to use the Tangible Net Worth Capital Approach if its parent entity or the ultimate parent of its consolidated ownership group otherwise satisfies the criteria? This approach would effectively permit SDs that are subsidiaries of commercial enterprises that are “predominantly engaged in non-financial activities” as defined by the proposed rules to elect to use the Tangible Net Worth Capital Approach in computing their capital requirements. What conditions should the Commission consider if it were to adopt such an approach? Under various conditions, how would cost of capital requirement change?

7-b. Should the Commission require an SD that relies on a parent entity to satisfy the “predominantly engaged in non-financial activities” criteria to elect the Tangible Net Worth Capital Approach to obtain parent guarantees, or some other form of financial support, for its

swaps obligations? In addition to parent guarantees, what other forms of financial support should the Commission consider? How and to what extent might such requirements help protect market participants and the public? If no guarantees or other forms of financial support are provided, how would the SD be ensured of meeting its financial obligations?

7-c. Should the Commission require a higher minimum capital requirement for SDs that rely on its parent to meet the criteria to be eligible to use the Tangible Net Worth Capital Approach? If so, what should the minimum capital requirement be for such SDs? How should the Commission determine such SD's minimum capital requirements?

7-d. Should the Commission consider any revisions to the 15% Asset Test and/or the 15% Revenue Test? If so, what revisions should the Commission consider? Why are such revisions necessary to achieve the purpose of the Tangible Net Worth Capital Approach?

7-e. Should the Commission further expand the use of the Tangible Net Worth Capital Approach to SDs that are subsidiaries of parent entities that are predominantly engaged in financial activities if such SDs are primarily engaged in commodity swap transactions? How would the minimum capital requirement for such SDs under the proposed Tangible Net Worth Capital Approach compare to the minimum capital requirement under the Bank-Based Capital Approach or Net Liquid Assets Capital Approach.

7-f. The Commission request comments and supporting data on how various choices regarding changes under Tangible Net Worth Capital Approach would affect SD's risk management, liquidity provision, and capacity of serving end users? How would these choices affect efficiency, competitiveness, integrity and price discovery of swaps markets?

7-g. Should the Commission include in the rules a procedure that would allow an SD to petition the Commission on a case-by-case basis to use the Tangible Net Worth Capital Approach?

8. *Quantitative and Qualitative Requirements for Internal Models*

The *2016 Capital Proposal* included proposed Appendix A to Regulation 23.102 which described the requirements for the calculation of market risk exposure using internal models.

8-a. Commenters noted that while proposed Regulation 23.101(a)(1)(i)(B) provided that an SD that elects the Bank-Based Capital Approach must compute its risk-weighted assets in accordance with the requirements of the Federal Reserve Board for bank holding companies and set forth in 12 CFR part 217, the internal capital model requirements in proposed Regulation 23.102 did not explicitly incorporate the market risk and credit provisions of 12 CFR part 217.<sup>80</sup> To address this omission, a commenter suggested that the Commission modify paragraph (c) of proposed Regulation 23.102 to provide that a swap dealer's application must include: (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 12 CFR 217 Subpart F, as if the swap dealer were 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 12 CFR 217 subpart E, sections 131-155, as if the swap dealer were a bank holding company subject to 12 CFR part 217; or (3) in the case of a swap dealer subject to the minimum capital requirements in § 23.101(a)(1)(ii), the information set forth in Appendix A of the section.

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<sup>80</sup> See SIFMA 5/15/17 Letter; MS 5/15/17 Letter.

In addition, the commenter suggested the Commission modify paragraph (d) of proposed Regulation 23.102 to provide that the Commission or the registered futures association may approve or deny the application, or approve an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission or registered futures association may require, if the Commission or registered futures association finds the approval to be appropriate in the public interest, after determining, among other things, whether the applicant has met the requirements of this section, and the appendices to this section. A swap dealer that has received Commission or registered futures association approval to compute market risk exposure requirements and credit risk exposure requirements pursuant to internal models must compute such charges in accordance with 12 CFR 217 subpart F, § 217 subpart E, sections 131-155 or Appendix A of the section, as applicable per paragraph (c).

The Commission requests comment on the suggested modifications to paragraphs (c) and (d) of proposed Appendix A to Regulation 23.102, which are intended to explicitly provide that SDs that elect to use the Bank-Based Capital Approach are subject to the Federal Reserve Board's market risk and credit risk model requirements. This modification would revise the text of Appendix A to be consistent with the Commission's stated objective and intent in the *2016 Capital Proposal* that SDs that elect the Bank-Based Capital Approach would be subject to the Federal Reserve Bank's capital requirements, including the market risk and credit risk model requirements contained in 12 CFR part 217. Would the rule language accurately reflect the potential modification and properly address the issue? If not, please provide alternative rule language to affect the modification.

8-b. Commenters to the *2016 Capital Proposal* requested clarification whether an SD applying for approval to use internal models would need to apply for models for market risk and

credit risk or if they could request approval to use models for only one of the exposure types, market or credit, while opting for the standardized calculation method for the other.<sup>81</sup> The Commission invites comments and supporting data on this issue. How different would capital requirements be under various choices? Some commenters also inquired whether an SD's application for internal model approval had to encompass asset classes or asset types in which it is not actively dealing. The Commission would like to clarify that the suitability of internal models is to be evaluated for the specific activities of the SD and not for activities that the SD does not engage in.

#### 9. *Model Approval Process*

The *2016 Capital Proposal* would require SDs and FCMs, in computing their respective capital, to take market risk capital charges to protect against potential losses in the value of their proprietary trading positions, and to take counterparty credit risk charges to protect against potential counterparty credit risk. Proposed Regulation 23.102 would permit an SD (and an FCM that is registered as an SD), subject to the prior approval of the Commission or a registered futures association (*i.e.*, NFA), to compute market risk and credit risk capital charges using internal models in lieu of standardized market risk and credit risk capital charges.<sup>82</sup> The Commission proposed to permit market risk and credit risk modeling as it recognized that properly designed and monitored internal models, including value-at-risk models, are a more effective means of measuring economic risk from complex trading strategies involving swaps, SBS, and other investment instruments than the standardized capital charges, which are primarily computed based upon a fixed percentage of the notional or fair values of the instruments.

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<sup>81</sup> See *e.g.*, SIFMA 5/15/17 Letter.

<sup>82</sup> See *2016 Capital Proposal*, 81 FR at 91311-17; Proposed Regulation 23.102 and proposed Appendix A to Regulation 23.102.

The SD's application to use internal models would have to be in writing and filed with the Commission and with the NFA in accordance with the applicable instructions. The model application would have to include specified information, which is contained in proposed Appendix A to Regulation 23.102. For example, proposed Appendix A would require an SD to submit: (1) A list of categories of positions the SD holds in its proprietary accounts and a brief description of the methods the SD would use to calculate deductions for market risk and credit risk on those categories of positions; (2) A description of the mathematical models to be used to price positions and to compute deductions for market risk and credit risk; (3) A description of how the SD will calculate current exposure and potential future exposure for its credit risk charges; and, (4) A description of how the SD would determine internal credit risk weights of counterparties, if applicable.<sup>83</sup>

The *2016 Capital Proposal* would further provide that as part of the approval process, and on an ongoing basis, an SD would be required to demonstrate to the Commission or NFA that the models reliably account for the risks that are specific to the types of positions the SD intends to include in the model computations.<sup>84</sup> Finally, the *2016 Capital Proposal* provided that the Commission or NFA may approve, in whole or in part, an application or an amendment to the application, subject to any conditions or limitations the Commission or NFA may require.<sup>85</sup>

The Commission received several comments concerning the use of internal capital models. One commenter expressed a strong concern regarding the *2016 Capital Proposal's* potential heavy reliance on the use of internal models.<sup>86</sup> The commenter stated that a reliance on internal models can permit regulated entities to manipulate risk controls to increase their own

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<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> See *2016 Capital Proposal*, 81 FR at 91312; Proposed Regulation 23.102(d).

<sup>86</sup> See AFR 5/15/17 Letter.

profits at the cost of increasing risks to the public. The commenter pointed out that analysis of the crisis experience evidenced manipulation of models to reduce capital charges. While the commenter acknowledged post-crisis refinements to internal model requirements, both in technique and governance, it argued that resource limitations at regulators, as well as continuing pressure from industry, may limit regulators' ability to prevent weakening standards and model misuse. The commenter thus advocated for strong limitations and floors on the use of internal models.<sup>87</sup>

Other commenters generally supported the Commission's proposal to permit internal capital models in lieu of standardized capital charges.<sup>88</sup> Another commenter stated that it strongly supports permitting SDs the flexibility to use internal models, when appropriate.<sup>89</sup>

Several commenters stated that it was necessary for the Commission to develop an efficient approach to the review and approval of internal models. In this regard, one commenter stated that it believed that the Commission's final rule should provide for the recognition of internal capital models used throughout corporate families if such models have been approved by a prudential regulator, the SEC, or a foreign regulator in a jurisdiction that has adopted the Basel capital requirements, provided that the relevant regulatory authority has ongoing periodic assessment power with regard to the model and provides the CFTC and the NFA with appropriate information.<sup>90</sup> Another comment stated that the Commission should modify the *Proposal* to permit SDs that are U.S. non-bank entities to use internal capital models approved and periodically assessed by a prudential regulator, the SEC, or the SDs' home country supervisor (if applicable), without requiring additional pre-approval of those models by the

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<sup>87</sup> *Id.*

<sup>88</sup> *See, e.g.*, ISDA 5/15/17 Letter; SIFMA 5/15/17 Letter; and, MS 5/15/17 Letter.

<sup>89</sup> *See* IFM 5/15/17 Letter.

<sup>90</sup> *See* ISDA 5/15/17 Letter.

Commission or NFA.<sup>91</sup> Several commenters stated that the Commission should automatically approve market risk models and credit risk models of SDs that have already been approved by a prudential regulator, the SEC, or certain foreign regulators.<sup>92</sup> Another commenter stated that all models should be deemed “provisionally approved” while under review by the Commission or NFA, and that in no event should an SD be required to use the proposed standardized capital charges while awaiting model approval.<sup>93</sup> One commenter requested that the Commission clarify that no SD would be required to use the proposed standardize capital charges while awaiting model approval.<sup>94</sup>

The Commission continues to believe the regulations should provide for the appropriate use of internal market risk and credit risk models in lieu of the standardized capital charges. As the Commission noted in the *2016 Capital Proposal*, the Commission considered the degree to which its *Proposal* would be consistent with existing regulatory frameworks. Currently, prudential regulators permit SDs subject to their capital requirements to use internal capital models. In addition, the SEC Final Rule will permit SBSs to seek approval from the SEC to use internal capital models. Accordingly, the Commission continues to support a capital requirement that would permit SDs to use internal capital models, which will allow such firms to compete with prudentially regulated or SEC regulated entities.

The use of models by firms that demonstrate compliance with both the quantitative and qualitative requirements also will potentially benefit market participants. As noted above, the Commission believes that properly designed and monitored internal models are a more effective means of measuring economic risk from complex trading strategies than the standardized capital

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<sup>91</sup> Letter from ABN, ING, Mizuho and Nomura (May 15, 2017).

<sup>92</sup> See, e.g., FIA 5/15/17 Letter; SIFMA 5/15/17 Letter.

<sup>93</sup> See ISDA 5/15/17 Letter.

<sup>94</sup> See IFM 5/15/17 Letter.

charges, which are primarily computed based upon a fixed percentage of the notional or fair values of the instruments. SDs authorized to use models will generally have lower capital costs as compared to SDs that use standardized capital charges. The lower costs may result in the SDs engaging in more swaps with counterparties or lower transaction costs for the SDs and counterparties.

The Commission requests comment on the following with respect to the model approval process.

9-a. The Commission requests comment on whether the proposed process for an SD to obtain regulatory approval to use internal models should be modified. If so, how should the Commission modify the model approval process? Should the Commission have different processes for SDs and for FCMs (including FCMs that are dually-registered as SDs)?

9-b. The Commission requests comment on permitting the Commission or NFA to accept market risk and/or credit risk models of an SD, or SD affiliate, that have been approved by a prudential regulator, the SEC, or a foreign regulator to be used by the SD to comply with the Commission's model requirements? What conditions should the Commission or NFA consider in permitting SDs to use models of affiliates that have been approved by other regulators? How would the Commission or NFA address possible situations where the SD's positions are materially different, such as a heavy concentration in a particular asset class or a particularly illiquid asset, from the positions of the affiliate that obtained model approval?

9-c. One commenter provided suggested rule language to modify Regulation 23.102 to permit SDs to use internal market risk and/or credit risk models without obtaining the prior

written approval of the Commission or the NFA.<sup>95</sup> The ability for an SD to use a model without obtaining the prior written approval would be subject to the following conditions: (1) the model had been approved by the SEC, a prudential regulator, or a foreign regulatory authority whose capital adequacy requirements are consistent with the Basel-based capital requirements for banks; (2) the SD makes available to the Commission copies of underlying documentation; and, (3) for models approved by foreign regulators, a description of how the relevant foreign jurisdiction capital adequacy framework addresses the elements of the Commission's capital requirements.<sup>96</sup> The potential modification would establish a new paragraph (e) to Regulation 23.102 which would provide a swap dealer subject to the minimum capital requirements in Section 23.101(a)(1) may use an internal credit risk or an internal market risk capital model without the prior written approval of the Commission or a registered futures association if: (1) the relevant model has been approved and currently is in use, either by the relevant swap dealer or by an affiliated entity, under the supervision of the Securities and Exchange Commission, a prudential regulator or a foreign regulatory authority whose capital adequacy requirements are consistent with the Basel-based capital requirements for banking institutions; and (2) the swap dealer has made available to the Commission any copies of underlying documentation, including regulatory approvals, evidencing review, approval and supervision of the internal capital models, to the extent permitted by applicable law.

Further, this modification would provide, in the case of a model approved by a foreign regulatory authority, the swap dealer has submitted to the Commission: (i) a description of the

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<sup>95</sup> See SIFMA 5/15/17 Letter, Appendix A. SIFMA also recommended corollary changes to their proposed subparagraph (f) (as proposed by the Commission in subparagraph (e)) which would refer to their proposed additional subparagraph (e) and retains the Commission or NFA's ability to determine if the models are no longer sufficient.

<sup>96</sup> *Id.*

objectives of the relevant foreign jurisdiction's capital adequacy requirements; (ii) a description (including specific legal and regulatory provisions) of how the relevant foreign jurisdiction's capital adequacy requirements address the elements of the Commission's capital adequacy requirements for swap dealers, including, at a minimum, the methodologies for establishing and calculating capital adequacy requirements; and (iii) a description of the ability of the relevant foreign regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's capital adequacy requirements. Such description should discuss the powers of the foreign regulatory authority or authorities to supervise, investigate, and discipline entities for compliance with capital adequacy requirements, and the ongoing efforts of the regulatory authority or authorities to detect and deter violations, and ensure compliance with capital adequacy requirements. The description should address how foreign authorities and foreign laws and regulations address situations where an entity is unable to comply with the foreign jurisdiction's capital adequacy requirements.

The Commission requests comments on the suggested new paragraph (e) to Regulation 23.102. Please suggest any modifications that are necessary to the new paragraph (e). In addition, what types of information do registrants feel they may be restricted under law from providing to the Commission? Please be specific and identify the legal requirements and/or privileges that may impact the registrant's provision of information to the Commission or NFA. How can the Commission and NFA ensure they receive the information they need to supervise the use of the model on a going forward basis?

9-d. The Commission requests comments and supporting data on how various changes to the model approval process would affect the efficiency, competitiveness, financial integrity, and price discovery of the swaps market? Would the various changes affect the ability of the

Commission to effectively meet the safety and soundness mandate established for capital requirements in the CEA?

## ***B. Liquidity***

### *10. Liquidity Requirements*

The *2016 Capital Proposal* included liquidity requirements for SDs, which would include SDs that also are registered as FCMs.<sup>97</sup> Proposed Regulation 23.104(a) would require each SD electing the Bank-Based Capital Approach to meet the liquidity coverage ratio established by the Federal Reserve for bank holding companies under 12 CFR part 249. The proposed liquidity coverage ratio would require an SD to maintain each day an amount of high quality liquid assets (“HQLAs”)<sup>98</sup> that is no less than 100 percent of the SDs total net cash outflows over a prospective 30 calendar-day period (the “HQLA Test”).<sup>99</sup>

For SDs that elect the Net Liquid Assets Capital Approach, and for FCMs dually-registered as SDs, proposed Regulation 23.104(b) would require each SD/FCM to perform stress testing on at least a monthly basis that takes into account certain assumed conditions lasting for 30 consecutive days (the “Liquidity Stress Test”). The assumed conditions for the Liquidity Stress Test would include a decline in creditworthiness of the SD/FCM severe enough to trigger contractual credit related commitment provisions of counterparty agreements; the loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding; and, the potential for a material net loss of secured funding. The Commission’s proposed Liquidity Stress Test was consistent with the liquidity

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<sup>97</sup> See *2016 Capital Proposal*, 81 FR at 91317-38; Proposed Regulation 23.104.

<sup>98</sup> HQLAs are assets that are unencumbered by liens and other restrictions on the ability of the SD to transfer the assets (*see* 12 CFR 249.22(b)).

<sup>99</sup> See 12 CFR 249.10. Federal Reserve Board rules require a regulated institution to maintain a liquidity coverage ratio of HQLAs to net cash outflows that is equal to or greater than 1.0 on each business day.

stress testing requirements proposed by the SEC for BDs and SBSBs.<sup>100</sup> The SEC, however, elected not to adopt final liquidity requirements for BDs and SBSBs.<sup>101</sup>

Commenters raised issues with the proposed HQLA Test and the Liquidity Stress Test. One commenter suggested that SD entities should be able to elect either the HQLA Test or the Liquidity Stress Test requirement unrelated to the SD's chosen capital approach.<sup>102</sup> Another commenter stated that the requirements of the HQLA Test and the Liquidity Stress Test should be revised to be more similar to each other given that both approaches have the comparable regulatory objective of helping to ensure that an SD has sufficient access to liquidity to meet its obligations during periods of expected and unexpected market activity.<sup>103</sup> The commenter specifically noted that the Liquidity Stress Test's definition of liquidity reserves is materially narrower than the HQLA Test's definition of high quality liquid assets, and that the Commission should expand the definition under the Liquidity Stress Test to match the definition under the HQLA Test so as to recognize the full range of assets that are actually available to a firm to support its liquidity needs.<sup>104</sup>

Commenters also raised the concept of a third alternative, which would be the application of a more qualitative than quantitative requirement applicable to SDs that are subsidiaries of bank holding companies and already subject to comprehensive overall liquidity risk management program requirements at a parent level.<sup>105</sup>

The Commission proposed liquidity requirements to address the potential risk that an SD may not be able to efficiently meet both expected and unexpected current and future cash flow

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<sup>100</sup> See *SEC Proposed Capital Rule*; Proposed Rule 18a-1(f) (17 CFR 240.18a-1(f)).

<sup>101</sup> See *SEC Final Capital Rule*, 84 FR 43872, 43874.

<sup>102</sup> See, e.g., MS 5/15/17 Letter.

<sup>103</sup> See, SIFMA 5/15/17 Letter.

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

<sup>105</sup> See, SIFMA 5/15/17 Letter; MS 5/15/17 Letter.

and collateral needs as a result of adverse events impacting the SD's daily operations or financial condition.<sup>106</sup> The proposed liquidity requirements would apply to SDs electing the Bank-Based Capital Approach and the Net Liquid Assets Capital Approach, but were not proposed for entities electing the Tangible Net Worth Capital Approach, as such SDs must be predominantly engaged in non-financial activities, which would limit their activities as counterparties or financial intermediaries to other parties.

The Commission recognizes that SDs are subject to existing CFTC requirements to maintain a general risk management program that addresses liquidity risk. Regulation 23.600(b)(1) provides that an SD must establish, document, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the swaps activities of the SD. Regulation 23.600(c)(4)(iii) provides that the risk management program must include liquidity risk policies and procedures that take into account, among other things, a daily measurement of liquidity needs; the assessment of procedures to liquidate all non-cash collateral in a timely manner and without significant effect on price; and the application of appropriate collateral haircuts that accurately reflect market and credit risk. The Commission, however, proposed the Liquidity Stress Test and the HQLA Test to provide specific quantitative and qualitative criteria that an SD must use in measuring its liquidity under defined scenarios. The Commission continues to believe that liquidity requirements are a necessary complement to the SD capital requirements, particularly for SDs that elect the Bank-Based Capital Approach. As previously discussed, the Bank-Based Capital Approach is not a liquidity-based capital requirement in the manner similar to the Net Liquid Assets Capital Approach.

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<sup>106</sup> See, *2016 Capital Proposal*, 81 FR at 91273.

The Commission requests further comments on the proposed liquidity requirements as set forth below.

10-a. The Commission requests comment on all aspects of the liquidity proposals contained in the *2016 Capital Proposal*. Please provide modified regulatory text in support of any comments provided, if applicable.

10-b. Should the Commission modify the *Proposal* to permit an SD to elect the HQLA Test or the Liquidity Stress Test, irrespective of the capital approach followed by the SD?

10-c. Should the Commission modify the definition of liquidity reserves to make the definition in the Liquidity Stress Test similar to the HQLA Test? If so, how should the definition be modified? Please suggest rule language to modify the regulation.

10-d. Should the Commission modify the *Proposal* to permit an SD to consider relying on the existing application of qualitative liquidity controls applicable at bank holding companies for SDs which are subsidiaries of bank holding companies in lieu of requiring the quantitative HQLA Test requirement proposed in Rule 23.104(a) as suggested by commenters as a third alternative? How would such approach apply to SDs electing the Bank-Based Capital Approach?

10-e. Should the Commission, similar to the SEC, not adopt the Liquidity Stress Test requirement as proposed in Rule 23.104(b)? If so, should the Commission impose an alternative liquidity requirement on SDs that elect the Net Liquid Assets Capital Approach beyond the general risk management requirements of Regulation 23.600? If the Commission does not adopt the Liquidity Stress Test or an alternative liquidity requirement, would this raise any competitive impact on SDs electing the Bank-Based Capital Approach? If so, how should the Commission address the competitive issues?

10-f. Should the Commission consider eliminating specific quantitative liquidity requirements for SDs electing either the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach, in consideration of the requirement of all SDs to have comprehensive risk management programs including liquidity risk as in effect under Rule 23.600?

10-g. Should the Commission include any additional quantitative or more specific qualitative liquidity risk requirements in connection with any consideration of additional expansion of the Tangible Net Worth Capital Approach to a broader subset of SDs?

10-f. The Commission requests comments and supporting data on how various choices regarding changes to liquidity requirements would affect the cost of SD's participation in the swap markets? How would various choices affect the efficiency, competitiveness, integrity, and price discovery of swap markets?

### ***C. Financial Reporting***

The *2016 Capital Proposal* included proposed financial reporting requirements for SDs and MSPs. SDs and MSPs that are subject to the Commission's capital requirements would be required to, among other things: (1) maintain current ledgers and other similar records summarizing transactions affecting their assets, liabilities, income, and expenses; (2) file notices of certain events with the Commission, including notices of failing to comply with the minimum capital requirements; (3) file monthly unaudited and annual audited financial statements with the Commission; and (4) respond to requests from the Commission for additional information as requested.<sup>107</sup>

The *2016 Capital Proposal* would also require SDs and MSPs that are subject to the capital rules of a prudential regulator to file certain information with the Commission. Such

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<sup>107</sup> See *2016 Capital Proposal*, 81 FR at 91318-22; Proposed Regulation 23.105.

information includes: (1) quarterly balance sheet, regulatory capital computations, and aggregate swaps position information; (2) notice filings, including notice of a failure to maintain the minimum applicable capital requirement; and (3) additional information as requested by the Commission.<sup>108</sup>

#### 11. *Use of International Financial Reporting Standards*

The *2016 Capital Proposal* would permit certain SDs and MSPs to submit unaudited and audited financial statements in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board (“IFRS”) in lieu of generally accepted accounting principles established in the United States (“U.S. GAAP”).<sup>109</sup> To be eligible to use IFRS, the SD or MSP may not be organized under the laws of a state or other jurisdiction of the United States, and may not be otherwise required to prepare financial statements in accordance with U.S. GAAP.<sup>110</sup>

Commenters generally supported the Commission approach of permitting non-U.S. SDs and MSPs to use IFRS in lieu of U.S. GAAP in the preparation of required financial statements. Commenters, however, requested that the *Proposal* be modified to permit U.S.-based SDs that are subsidiaries of non-U.S. parent entities to prepare required financial statements in accordance with IFRS.<sup>111</sup> These commenters stated that U.S. SDs that are subsidiaries of foreign-based holding companies may prepare their financial statements in accordance with IFRS as the subsidiary is consolidated with the parent in producing the parent’s consolidated financial statements, and further stated that requiring U.S. GAAP financial statements in such situations

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<sup>108</sup> *Id.*

<sup>109</sup> *Id.*; Proposed Regulation 23.105(d)(2) and (e)(3).

<sup>110</sup> *Id.*

<sup>111</sup> *See e.g.*, Shell 5/15/17 Letter; BPE 5/15/17 Letter.

would impose unnecessary costs on SDs without providing substantial enhancements to the regulatory objectives.<sup>112</sup>

As stated in the *2016 Capital Proposal*, the Commission recognized that several SDs or MSPs domiciled outside the U.S. may not use U.S. GAAP as their native accounting principles and that requiring these registrants to maintain two separate accounting records and systems to satisfy two separate financial reporting requirements would involve substantial expense and burden.<sup>113</sup> The Commission also does not want to burden or create an unfair advantage to U.S. domiciled SDs or MSPs that do not otherwise prepare financial statements in accordance with U.S. generally accepted accounting principles.

11-a. The Commission requests comment as to whether the *2016 Capital Proposal* should be modified to permit U.S. domiciled SDs or MSPs that are subsidiaries of foreign parent entities or holding companies to submit required unaudited or audited financial statements prepared in accordance with IFRS in lieu of U.S. GAAP. If so, should the modification be limited to U.S. SDs that are consolidated into foreign entities that are predominantly engaged in non-financial activities?

11-b. The Commission further requests comment regarding material differences between IFRS and U.S. GAAP, and how such differences may impact the financial condition of the SDs or MSPs?

## 12. *Certified Financial Statements of Certain Non-bank SDs*

The *2016 Capital Proposal* would require in proposed Regulation 23.105(e)(5) that an SD or an MSP subject to the Commission's capital rules file an annual audited financial report as of the close of its fiscal year no later than sixty days after the close of the SDs or MSPs fiscal

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<sup>112</sup> *Id.*

<sup>113</sup> See *2016 Capital Proposal*, 81 FR at 91275.

year-end. Several commenters expressed concern that the sixty day timeline was not practical for many large non-financial companies as they are typically permitted to provide audited financial statements within ninety days of the end of the year.<sup>114</sup> In *2016 Capital Proposal* the Commission noted that the sixty day financial reporting timeline is consistent with the timeline required by both the SEC and that currently required of FCMs. Further, timely financial reporting ensures that the Commission and its oversight functions can assess equally across all firms compliance with its capital rule, as well as, promote a culture of compliance at the firm and with its auditor that is at least as stringent as other similarly situated registrants. However, the Commission recognizes that not all SDs may be subjected to the same operational burdens and is cognizant that imposing an accelerated reporting cycle on certain SDs may unnecessarily increase costs of compliance without much added benefit.

12-a. The Commission requests comment as to whether the *2016 Capital Proposal* should be modified to recognize an exception to the proposed requirement for SDs to file annual audited financial report with the Commission within sixty-days of the SD's year-end date.

12-b. Should the Commission modify the requirement to permit a ninety-day period for SDs or MSPs that are not predominantly engaged in financial activities or that consolidate into parent entities that are not predominantly engaged in financial activities?

12-c. Are there other alternatives of how the Commission should define SDs that would be eligible to file annual audited financial statements within ninety days of the SDs' year-end dates?

12-d. How much additional cost will a SD save if they are permitted to file their audited financial statements within a ninety day period as opposed to a sixty day period?

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<sup>114</sup> See e.g., Shell 5/15/17 Letter; Cargill 5/15/17 Letter.

### 13. *Public disclosures.*

Proposed Regulation 23.105(i)(3) and 23.105(p)(7)(ii) would require that certain financial information be publically posted to the SD's or MSP's website within ten business days after the SD or MSP is required to file the financial information with the Commission. Several non-bank SDs that are subsidiaries of public companies requested that the posting period on firm's web site be extended from ten days to twenty days for the quarterly information, noting that additional timeframe would be necessary to allow for internal and external auditors to review the information.<sup>115</sup> One commenter stated that public disclosure of financial reports will be onerous for commercial SDs, while others requested elimination of public disclosures by prudentially regulated SDs.<sup>116</sup>

The Commission noted in the *2016 Capital Proposal* that its approach was consistent with the financial reporting information the Commission had previously determined should not qualify as exempt from the Freedom of Information Act for FCMs. For the bank SDs, the Commission noted the Proposal was consistent with publicly available information provided by bank entities in call reports.<sup>117</sup> The Commission also noted that the SEC requires similar public posting of financial information pursuant to Regulation 17 CFR 240.18a-7(b)(1) and (2).<sup>118</sup> The Commission continues to agree that public disclosure of basic financial information is in the public's best interest, but wishes to ensure that manner in which disclosure is accomplished does not create an unnecessary burden on similarly situated or dual-registered registrants.

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<sup>115</sup> See Shell 5/15/17 Letter; Letter from National Corn Growers Association and National Gas Supply Association, (May 15, 2017); and Letter from David McIndoe, Commercial Energy Working Group (May 15, 2017).

<sup>116</sup> See Shell 5/15/17 Letter; SIFMA 5/15/17 Letter; MS 5/15/17 Letter.

<sup>117</sup> See *2016 Capital Proposal*, 81 FR at 91277.

<sup>118</sup> SEC Rule 18a-7(b)(1) (17 CFR 240.18a-7(b)(1)) requires that every SBSB for which there is no prudential regulator to post annual financial information 10 days after firm is required to file with the SEC. SEC Rule 18a-7(b)(2) (17 CFR 240.18a-7(b)(2)) requires bi-annual unaudited financial information to be posted 30 calendar days within the date of the statements.

13-a. The Commission requests comment on modifying the *Proposal* by aligning the public disclosure requirements for SDs that are not affiliated with banks with that required by SEC for stand-alone SBSBs which would replace the quarterly public disclosure of financial information requirement with a bi-annual requirement? This modification would include change of the unaudited financial report posting requirement on the firm's web site from ten business days as proposed to thirty calendar days following the date of the statements, while the annual audited requirement would be required to be posted ten days following the date they are filed. The Commission invites comment as to whether these changes are practicable, especially for those swap dealers which are not otherwise required to publicly disclose financial information currently, and whether the modifications would continue to provide the public with meaningful information on a timely basis?

13-b. The Commission requests comment on whether it would be appropriate to remove the proposed requirement that bank SDs (SDs subject to the capital requirements of a prudential regulator) be publicly posted on their web site under the rationale that this information is already provided to the public on a timely basis as a result of separate disclosure requirements imposed by the prudential regulators?<sup>119</sup>

#### 14. *Technical Amendments Addressing Harmonization*

Several commenters noted the importance with harmonizing the Commission's financial reporting and notification requirements with requirements of other regulators, namely the SEC and the prudential regulators. The Commission agrees on this general principle. Since the *2016 Capital Proposal*, the SEC has finalized its recordkeeping, notification and reporting rule for

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<sup>119</sup> See, generally 12 CFR 3.61-63.

SBSDs, which includes several detailed forms and accompanying instructions.<sup>120</sup> However, the Commission in the *2016 Capital Proposal* did not propose specific forms for the monthly and annual financial reporting requirements, aside from the specific schedules found in Appendices A and B to proposed Regulation 23.105. Further, under proposed Regulation 23.105(d)(3) all dual registered SD and SBSBs are permitted to file SEC forms in lieu of the Commission's financial reporting requirements.

The Commission continues to believe that proposing a detailed form at this time is premature given the diversity of registrants under the Commission's jurisdiction and the several ways in which capital compliance can be achieved under the Commission's proposed approach.

Nonetheless, a commenter noted that the proposed appendices did not contain accompanying form instructions, despite having defined terms in both the column headings and rows.<sup>121</sup> The *2016 Capital Proposal* noted that the Appendices are based on identical information found in SEC forms now finalized in FOCUS Report Part II Schedules 1-4 of FORM X-17A-5, and FOCUS Report Part IIC of FORM X-17A-5.<sup>122</sup>

14-a. Accordingly, the Commission is considering including the following explanatory footnote in the appendices to Regulation 23.105 which will incorporate by reference the form instructions published by the SEC and invites comment as to whether this approach and language will be sufficient. The footnote would state that the information required to be reported within this form is intended to be identical to that required to be reported by Security Based Swap Dealers and Security Based Major Swap Participants under SEC FORM X-17A-5 FOCUS

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<sup>120</sup> See *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers*, publication in the Federal Register forthcoming. A prepublication version of the document can be found at <https://www.sec.gov/rules/final/2019/34-87005.pdf>.

<sup>121</sup> See SIFMA 5/15/17 Letter.

<sup>122</sup> See *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers*, publication in the Federal Register forthcoming. A prepublication version of the document can be found at <https://www.sec.gov/rules/final/2019/34-87005.pdf>.

Report Part II. Please refer to FOCUS REPORT PART II INSTRUCTIONS and related interpretations published by the SEC in the preparation of this form.

In addition, the Commission requests comment on the following technical amendments to the financial statement forms and rules to ensure that harmonization is better achieved in financial reporting:

14-b. References to FORM SBS in Rule 23.105(d)(3) would be replaced with FORM X-17A-5 Focus Report Part II.

14-c. Regulation 23.105(p)(2) would be revised to require that SDs or MSPs that are the subject to the capital requirements of a prudential regulator would be required to file Appendix B to the Commission within thirty calendar days after the end of each calendar quarter.

14-d. Appendix A Schedule 1 column headings will be revised to include the words LONG/BOUGHT and SHORT/SOLD.

14-e. Appendix A Schedule 1 rows will be reorganized and renamed to require the identical information as found on FOCUS report Part II Schedule 1 of SEC FORM X-17A-5.

14-f. Appendix A Schedule 2, 3, and 4 column heading Total Exposure will be revised to state Current Net and Potential Exposure.

14-g. Appendix B column headings and rows will be revised to include identical information in the SEC FORM X-17A-5 FOCUS Report Part IIC and include the Cover Page included therein.

#### ***D. Additional Requests for Comment***

##### *15. SEC's Alternative Compliance Mechanism*

SEC Rule 18a-10 (17 CFR 240.18a-10) provides an alternative compliance mechanism pursuant to which a dual registered SD and SBSB may elect to comply with the capital, margin,

and segregation requirements of the CEA and the Commission's rules in lieu of complying with applicable SEC rules. In order to qualify for alternative CFTC compliance, the SD/SBSD must be predominantly engaged in swaps business and may not be registered as a BD or and OTC Derivatives Dealer with the SEC.<sup>123</sup>

15-a. What, if any, revisions need to be made to the Commission's regulations or requirements in order to accommodate SD/SBSDs electing to use the SEC's alternative compliance mechanism?

16. *Commercial End Users – Margin Collateral to Offset Credit Risk Charges*

Should SDs recognize alternative forms of collateral (e.g., letters of credit or liens) provided by commercial end users that are exempt from clearing and from the uncleared margin requirements in computing the SDs' counterparty credit risk charges for uncleared swap transactions?<sup>124</sup> Please provide comments with respect to SDs that are approved to use internal credit risk models and SDs not approved to use internal credit risk models. What would be the impact on the liquidity, efficiency, and vibrancy of the swap markets, particularly the commodity swaps markets, if alternative forms of collateral were taken into account in computing credit risk charges?

17. *Compliance Date of the Regulations*

In response to the *2016 Capital Proposal*, commenters expressed a general need for an appropriate period of time between the effective date and the compliance date for any final rules to operationally and legally prepare to implement capital and financial reporting regimes. This

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<sup>123</sup> In order to qualify, the aggregate gross notional amount of the SD/SBSD's SBS positions must not exceed the lesser of a maximum fixed dollar amount or 10% of the combined aggregate gross notional amount of the firm's SBS and swap positions. The maximum fixed-dollar amount is set at a transitional level of \$250 billion for the first 3 years after the compliance date of the rule and then drops to \$50 billion thereafter unless the SEC issues an order.

<sup>124</sup> In the prudential regulators' recently adopted rule on the standardized approach for calculating the exposure amount of derivatives contracts ("SA-CCR"), the prudential regulators removed the alpha factor for derivative transactions with commercial end users.

included an appropriate amount of time for both the Commission and NFA to review and approve the capital models of individual SDs, and for the Commission to conduct and issue comparability determinations for SDs domiciled in foreign jurisdictions. Commenters also raised concerns regarding the implementation of final rules prior to the effective date of the final phase-in of the uncleared margin requirements.

The Commission invites comments on an appropriate compliance schedule for the final capital and financial reporting requirements. Comments are particularly necessary now as the SEC issued its final SBSD capital, margin, segregation and financial reporting rules since the Commission's *2016 Capital Proposal*.

#### *18. Economic Implications*

Regulatory capital is designed to ensure that a firm will have enough capital, in times of financial stress, to cover the risk inherent of the activities in the firm. Regulatory capital's framework can be designed differently, but its primary purpose remains the same—to meet this objective. Although a firm may mitigate its risks through other methods, including risk management techniques (e.g., netting, credit limits, margin), capital is viewed as the last line of defense of an entity, ensuring its viability in times of financial stress. In designing SD's capital requirement, the Commission is cognizant of the purpose of capital and the potential trade-off between the costs of requiring additional capital and the Commission's statutory mandate of helping to ensure the safety and soundness of SDs thereby promoting the stability of the U.S. financial system.

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its discretionary actions before promulgating a regulation under the CEA or issuing certain orders. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of

five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of swaps markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.

The Commission requests comments and data on how the baseline of the economic analyses has changed since the publication of the *2016 Capital Proposal*. The swap market activity has experienced significant changes, in part due to the fact that participants in this market are now subject to various new rules. The Commission requests comments and data on how the baseline of the economic analyses has changed since the publication of the *2016 Capital Proposal*. The swap market activity has experienced significant changes in the past three years and the Commission requests comments on how those changes in the baseline would impact the potential benefits and costs of capital requirements

The Commission requests comments and data on how potential alternatives set out above in response to questions would impact the potential costs and benefits of capital and reporting requirements with respect of the section 15(a) factors:

18-a. Protection of market participants and the public:

- i. How much additional capital, if any, might be required for the SD and/or the system relative to current levels? How much capital to cover credit risk?
- ii. How much capital would be required to cover market risk?
- iii. How much capital would need to be required to safeguard against model risk, operational risk, and etc.?
- iv. How would SDs source funds for these capital charges?
- v. What might be the cost of raising additional capital for an SD and the combined cost for all the SDs?

vi. What sorts of costs do SDs expect to incur as a result of capital requirements and how should the costs of SDs exiting certain business lines as a result of holding more capital in reserve be factored into the cost benefit consideration?

vii. What business lines would SDs not participate in, if any?

viii. What would happen to liquidity provision? Would smaller clients and end users not be serviced in swaps market?

ix. What might be the cost of meeting reporting requirements for an SD and the combined cost for all the SDs?

x. How and to what extent might such requirements help protect market participants and the public?

18-b. Efficiency, competitiveness, and financial integrity of swaps markets:

i. How might such requirements affect SD's competitiveness in swap market?

ii. For each SD, how much capital might be required for the net liquid asset approach, relative to the recently finalized SEC requirements?

iii. How much capital might be required for the bank-based approach, relative to the current banking capital requirement, as Prudential Regulators continue to revise their capital requirements?

iv. How much capital might be required, relative to substituted compliance from foreign jurisdictions?

v. How might such requirements affect SD's liquidity provision in swap market?

vi. How might such requirements affect SD's ability to serve end users in various segments of swaps markets?

18-c. Price discovery:

i. How might such requirements affect price discovery in the swaps markets?

18-d. Sound risk management practices:

i. What are SD's current risk management practices for dealing with losses stemming from the market risk, credit risk, and operational risk?

ii. In the event that losses from trading activities exceed the available resource, how are excess losses dealt with?

iii. How might such requirements affect these risk management practices?

18-e. Other public interest considerations.

i. Are there other public interest considerations that the Commission should consider? Please explain.

Issued in Washington, DC, on December 12, 2019, by the Commission.

Robert Sidman,

*Deputy Secretary of the Commission.*

**Note:** The following appendices will not appear in the Code of Federal Regulations.

**Appendices to Capital Requirements of Swap Dealers and Major Swap Participants—  
Commission Voting Summary and Commissioners' Statements**

**Appendix 1—Commission Voting Summary**

On this matter, Chairman Tarbert and Commissioners Quintenz and Stump voted in the affirmative. Commissioners Behnam and Berkovitz voted in the negative.

**Appendix 2—Supporting Statement of Commissioner Brian Quintenz**

I have long said that finalizing capital requirements for swap dealers (SDs) and futures commission merchants (FCMs) is perhaps the most consequential rulemaking of the post-crisis reforms to get right.

The financial crisis exposed serious vulnerabilities in the financial system – uncollateralized, opaque, bilateral exposures which, under the right circumstances could have, and did, cause a panic and liquidity freeze due to concerns around that counterparty credit risk. This panic, in my opinion, transformed a significant recessionary event into the crisis as we know it. Importantly, since the financial crisis, global regulators and certainly those in the U.S. have implemented many policy reforms, like central clearing requirements and margin for uncleared swaps, designed to bring transparency to those exposures.

I have long lamented prior regulators' implementation of the important swaps market regulatory reforms by viewing them in isolation of each other – calibrating each to try to think it alone could have prevented the crisis. In fact, the elegance of the reforms is that they work together and build upon each other.

Therefore, in my view, it is wrong to think of capital in terms of what levels should have existed during the financial crisis that could have prevented it. Very few capital regimes could have provided the market with enough certainty, given the size, nature, and opacity of these exposures, to remove the possibility of the panic, and the capital levels which could have done so would have rendered the entire swaps market obsolete and uneconomic. Therefore, regulatory capital regimes implemented to respond to the last crisis need to respect the increased transparency and certainty which other reforms have already brought to the market. I believe we are asking the right questions in this reopening to respect that progress in calibrating our own capital regime appropriately.

The final pillar of our Dodd-Frank Act reforms, capital ensures that firms are able to continue to operate during times of economic and financial stress by providing an adequate cushion to protect them from losses. Just as important as the safety and soundness of individual firms, capital is designed to give the marketplace confidence that any given firm has a high probability of surviving the next crisis.

Capital requirements also create important incentives that drive market behavior. The cost of capital may be the most determinative factor in a firm's decision to remain, or become, a swap dealer, or to continue to provide clearing services to clients, in the case of an FCM. If capital costs are too expensive, firms will restrict certain business activities, end unprofitable business lines, or, in some cases, exit the swaps or futures markets altogether. As a result, over time, the swaps and futures markets would become less liquid, less accessible to end users, more heavily concentrated, and less competitive. These are not the hallmarks of a healthy financial system.

Therefore, appropriate capital levels are directly linked to *both* the health and vibrancy of the derivatives markets and to the sustainability of the entire financial system more broadly.

To promote a vibrant derivatives market, I believe it is critically important that the CFTC finalize a capital rule that is appropriately calibrated to the true risks posed by an SD's or FCM's business. I am pleased to support the re-opening and request for comment before us today. This document solicits comment on the key issues the Commission *must* get right in the final rule to ensure that capital requirements are appropriate and commensurate to a firm's risk. I appreciate that market participants have commented on two prior capital proposals and the Commission will continue to consider all past comments in moving forward with a final rule. Nevertheless, I hope commenters use this opportunity to provide the Commission with much needed data and

quantitative analysis demonstrating the impact that various choices contemplated in this proposal would have on a firm's minimum capital level – and, by extension, on that firm's ability to participate in the market and adequately service clients. Data will be vital to the Commission's ability to evaluate various capital alternatives and identify those alternatives that would render certain business lines or activities uneconomic. It will also be vital to the Commission's assessment that the capital requirements established ensure the safety and soundness of the firm. I welcome comments on all aspects of the reopening, but there are a few areas I am particularly interested in hearing from commenters.

*The eight percent risk margin amount.* We heard from many commenters that, of all the alternatives, the eight percent risk margin amount would act not as a capital floor as intended, but rather as the primary driver of firms' capital requirements and as a potential binding constraint on their businesses. Whereas FCMs are currently required to include in their minimum capital requirement eight percent of the margin required for their futures and cleared swaps customer positions, the 2016 proposal expanded the eight percent risk margin amount to include *proprietary* futures, swaps and security-based swap (SBS) positions for FCMs and for SDs electing the net liquid asset capital approach. In addition to these proprietary positions being included in the risk margin amount, these FCMs and SDs would also be subject to capital charges on these proprietary positions. I hope commenters can provide us with data showing the capital costs of including proprietary positions, for the first time, in an FCM's risk margin amount. To the extent possible, it also would be helpful to see how different risk margin percentages, or a different scope of products included in the margin amount, impacts the minimum capital requirements for an actual or hypothetical portfolio of positions. I would also be interested to hear from commenters about whether it makes sense to remove the risk margin

amount altogether for standalone SDs electing the net liquid asset approach or bank-based approach, given the other minimum capital level requirements in the proposal.

*Model approval process.* The Commission must have a workable model approval process. I am interested to hear commenters' views on how the Commission or NFA should review or accept capital models that have already been approved by another regulator. Should such models be granted automatic or temporary approval, while the Commission or NFA conducts its own review?

In closing, I have often worried that the accepted mantra on regulatory capital requirements has become “the higher, the better.” Respectfully, I disagree. There is a direct tradeoff between the amount of capital regulators require firms to hold to ensure firms' resilience and viability, and the amount of available capital firms have to deploy in financial markets to support the market's ongoing liquidity and health. There is a balance necessary between capital levels that protect firms from losses on certain products, and capital levels that allow firms an economic benefit in servicing their customers' risk management needs through those products. I hope the feedback we receive from commenters on this reopening helps the Commission establish *appropriate* capital requirements that are commensurate to a firm's risk and not detrimental to its clients. I would also like to thank the staff of the Division of Swap Dealer and Intermediary Oversight for answering my questions and incorporating many of my comments into this document.

### **Appendix 3—Dissenting Statement of Commissioner Rostin Behnam**

I respectfully dissent from the Commodity Futures Trading Commission's (the “Commission” or “CFTC”) decision today to reopen the comment period and request additional comment on proposed regulations and amendments to implement section 731 of the Wall Street

Reform and Consumer Protection Act,<sup>1</sup> which requires the CFTC to establish capital rules for all registered swap dealers (“SDs”) and major swap participants (“MSPs”) that are not banks, including nonbank subsidiaries of bank holding companies, as well as associated financial recordkeeping and reporting requirements (the “Reopening”). While I would have been comfortable supporting the Reopening as a matter of moving this critical Dodd-Frank Act rule forward to finalization, to the extent it introduces supplementary avenues for future rulemaking such as a leverage ratio requirement, it is a deception. Impulsively inviting comment on matters tangential to the 2016 Capital Proposal<sup>2</sup>, but perhaps relevant to determining appropriate capital standards and methodologies, as opposed to a thoughtful re-proposal sacrifices discipline for expediency, and runs afoul of proper process for notice and comment. I will not be complicit in supporting Commission action that I believe could invite backdoor rationalization when finalization is before us. The public deserves--and our integrity demands--that we play by the rules.

Today’s action is a reopening of the comment period and a request for comment, rather than a true proposal, and thus the 2016 Capital Proposal remains the only concrete indicator to the public of the Commission’s intentions. If the 2016 Capital Proposal is an extreme overshoot, the appropriate way to provide the public with an opportunity to comment is to issue a reproposal. Asking further questions, without a clear signal as to where the Commission is going, at the minimum risks further slowing this nearly ten-year effort to finalize a capital rule by adding an unnecessary step to the process in the form of a reproposal at some time in the

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<sup>1</sup> See The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 section 731(e), 124 Stat. 1376, 1704-6 (2010) (the “Dodd-Frank Act”).

<sup>2</sup> Capital Requirements of Swap Dealers and Major Swap Participants, 81 FR 91252 (proposed Dec. 16, 2016).

future; and at the worst, incites the agency towards an exercise in creative reasoning outside the bounds of process.

Too often over the last couple of years, I believe this agency has slowed its own progress by snaking outside clear Administrative Procedure Act (“APA”) trajectories and adding unnecessary steps to the rulemaking process. In part, I fear that we are doing the same thing today. The competing threads throughout the Reopening make it harder for the public to discern what the Commission is proposing to do, and will make it more difficult to effectively comment on the existing proposal from 2016. This creates undue risk under the APA, and arguably poisons the well in regard to the reachable goals of this new request for comment.

To reiterate sentiments made in my first speech as a CFTC Commissioner,<sup>3</sup> capital is a cornerstone financial crisis reform<sup>4</sup> that is critical to protecting our financial institutions and our financial system as a whole, specifically from systemic risk and contagion, but also from unintended consequences if capital (and margin) levels are applied and set without due regard to the uniqueness of our financial markets and market participants. I appreciate that in moving forward, we must heed our directive to establish capital standards appropriately and in due consideration of other activities engaged in by SDs and MSPs such that we ensure that we do not penalize commercial end-users who need choices and benefit from competition in our markets.

The Reopening’s overarching premise is that the chosen response to certain uncertainties at the time of the Commission’s prior proposals<sup>5</sup> resulted in recommending standards that, in

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<sup>3</sup> See Rostin Behnam, *The Dodd-Frank Inflection Point: Building on Derivatives Reform*, Remarks of CFTC Commissioner Rostin Behnam at the Georgetown Center for Financial Markets and Policy (Nov. 14, 2017), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam>.

<sup>4</sup> G20, *Leaders’ Statement, Framework for Strong, Sustainable and Balanced Growth*, The Pittsburgh Summit (September 24-25 2009), <http://www.g20.utoronto.ca/2009/2009communique0925.html> (“We committed to act together to raise capital standards...”).

<sup>5</sup> See *Capital Requirements of Swap Dealers and Major Swap Participants*, 76 FR 27802 (proposed May 12, 2011); 2016 Capital Proposal.

application, could in no way be justified as appropriate to offset the greater risk to SDs, MSPs, and the financial system,<sup>6</sup> such that the only solution for the potentially extreme overshoot is to dial it back. With the passage of time comes a nagging amnesia to the pain that the financial crisis brought on American households and the global economy. We cannot forget that undercapitalization was at the heart of the crisis.

The overall changes to the derivatives market over the last several years, the Commission's adoption and implementation of margin rules for uncleared swaps and growing knowledge and experience with SDs, and recent movement by the Securities and Exchange Commission in finalizing capital, margin, and segregation requirements as well as financial reporting requirements for security-based swap dealers and major security-based swap participants,<sup>7</sup> provide a reasonable basis for affording the public an opportunity to reevaluate the 2016 Capital Proposal. However, to the extent the Reopening seeks additional comment on both broader issues of harmonization and more targeted proposals regarding what amount of capital is appropriate and what methodology is used, its focus on solidifying a data-driven approach should send a strong signal that the Commission must justify its final determinations with respect to capital standards.

To reiterate, I would have liked to support today's Commission action. To the extent it would move us toward a final rule on a matter that is critical to the safety and resiliency of our markets, the supplemental concepts for consideration and overarching premise that we overshot the mark badly in the 2016 Capital Proposal raise concerns. If the 2016 Capital Proposal is an

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<sup>6</sup> See *Id.* at section 731(e)(2)(C) and (e)(3)(A)(ii); 7 U.S.C. 6s(e)(2)(C) and (e)(3)(A)(ii).

<sup>7</sup> See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 84 FR 43872 (Aug. 22, 2019); Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers, SEC Release No. 34-87005 (Sept. 19, 2019), available at <https://www.sec.gov/rules/final/2019/34-87005.pdf>.

extreme overshoot, and if there are alternative methodologies and concepts to consider because of new market data, the appropriate way to provide the public with an opportunity to comment is to issue a reproposal. While I would have liked to stand with my fellow Commissioners today in supporting this first step towards a final capital rule, I cannot justify it under these circumstances.

#### **Appendix 4—Dissenting Statement of Commissioner Dan M. Berkovitz**

I dissent from the document that is called a “Proposed Rule” on the Capital Requirements of Swap Dealers and Major Swap Participants (the “Document”). My objections are both procedural and substantive. Procedurally, the Document asks many open ended questions, is vague about what is being proposed, and lacks sufficient supporting data to serve as the basis for a final rule under the Administrative Procedure Act (“APA”).<sup>1</sup> The Document as structured is not a proposal that can lead to a final rule; rather it appears to be more in the nature of an advance notice of proposed rulemaking.

Substantively, I dissent because the Document encourages mostly changes that only weaken what the Commission had previously proposed. The path forward suggested by the proposed changes would undermine the statutory purpose of requiring swap dealers to retain an appropriate minimum level of capital to serve as a buffer of last resort after all other sources of credit support (e.g. initial and variation margin) have been exhausted.

#### *The Document is not a Proposal that can Lead to a Final Rule*

The Document asks over 140 questions regarding capital requirements that the Commission proposed in 2011 and again in 2016. We received numerous public comments on both prior proposals. The Document briefly discusses these comments, most of which were

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<sup>1</sup> It is ironic that on the very day this “proposal” is voted on, the Commission is also adopting an amendment to Part 13 that expressly confirms the APA as the procedures by which the Commission will propose and adopt its regulations.

critical of the proposals, and then asks open-ended questions about various alternatives to the initial proposals. The discussion of the rationale behind the general alternatives posed in the questions is often superficial.

For the most part, the Document does not propose any new rule text or amendments to previously proposed rule text, but rather summarizes comments and asks for further comments, data, and analysis to support suggested alternatives to the previously proposed regulations. In many cases, a wide range of alternatives are suggested, such as capital levels ranging from 0 to 8% of risk margin. In a number of places, the Document asks commenters to propose new rule text for the Commission. The Document states “[t]he Commission notes that comments are of the greatest assistance to rulemaking initiatives when accompanied by supporting data and analysis, and, if appropriate, accompanied by alternative approaches and suggested rule text language.”<sup>2</sup> As an illustrative example, the Document asks commenters to, “Please provide data and analysis in support of any suggested modified percentage of the risk margin amount.”<sup>3</sup>

To the extent that some commenters provide significant new information or data that the Commission intends to rely upon in formulating or justifying a final rule, the public must be afforded notice of and an opportunity to comment on the new information. Under the APA it is not permissible for an agency to ask a wide range of questions about potential approaches, and then proceed to promulgate a final rule supported by new reasons and data sourced from the comments received. Data that is relied on by an agency to support its final rule and that is not merely supplemental or confirming data must be subjected to the notice and comment process.<sup>4</sup>

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<sup>2</sup> Document, introductory paragraph to section II.

<sup>3</sup> Document, question 1-b.

<sup>4</sup> See *Idaho Farm Bureau Fed'n v. Babbitt*, 58 F.3d 1392, 1402-03 (9th Cir. 1995).

Under the APA, an agency has a “duty to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules. . . . An agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow meaningful commentary.”<sup>5</sup>

I have stated many times that when practical, the Commission should be guided by objective data in writing regulations. An excellent example is our rule setting the minimum swap dealer registration threshold at \$8 billion. The CFTC staff undertook an exhaustive, objective data analysis that, when completed, showed that the \$8 billion level captured the vast majority of swap dealing activity. I voted for the rule based on that analysis. However, we cannot rely on data submitted by commenters in the final rule without first allowing the public to comment on that data.

#### *A Weaker Capital Rule is the Purpose*

After reading the 140-plus questions in the Document, it is clear that the Commission is headed in the wrong direction. The Document does not pursue the goal stated by Congress for the capital requirements to help assure the safety and soundness of the swap dealers.<sup>6</sup> In virtually every instance, the questions and accompanying discussion seek alternatives that would reduce the level of capital required or create greater flexibility for the swap dealers to comply.<sup>7</sup> The Document reads like an extensive diner menu offering up every type of rule reduction that a hungry swap dealer might desire.

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<sup>5</sup> *Owner-Operator Indep. Drivers Assoc. v. Fed. Motor Carrier Safety Admin.*, 494 F.3d 188, 199 (D.C. Cir. 2007) (quoting *Solite Corp. v. EPA*, 952 F.2d 473, 484 (D.C. Cir. 1991) and *Conn. Light & Power Co. v. NRC*, 673 F.2d 525, 530-31 (D.C. Cir. 1982).

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

<sup>7</sup> In some instances, the questions are premised on the desire to harmonize with the provisions of the SEC’s securities-based swap dealer capital rules. However, the SEC’s final rules were often premised on comments received on the CFTC’s earlier capital rule proposals and result in reduced requirements, as discussed later in my statement.

Let's consider two significant examples. Under one approach proposed in the prior proposals, a swap dealer would be required to hold capital equal to or exceeding 8% of uncleared swap margin and initial margin for certain swaps and futures positions of the swap dealer. As explained in the Document, the 8% level is drawn from the Commission's experience with its risk-based capital requirements for futures commission merchants.<sup>8</sup>

Based on comments received on the prior proposals, and in an effort to harmonize with the SEC, the Document now proposes dropping that level to 2% (or 4% or perhaps another level that a commenter may propose) and allowing swap dealers to "exclude any particular asset classes or positions from the computation of risk margin amount." No data is offered in the Document to explain why 2% would be a sufficient level. Maybe 8% is not the right number, but how does 2% in a formula that potentially excludes more asset classes or swap positions from the calculation even enter the realm of possibility when FCMs are held to much higher levels? The Document provides no clear rationale related to the statutory purpose of the rule. The rationale in the Document boils down to saying 2% would harmonize our rule with the SEC's security-based swap dealer capital rule. But the security-based swap market is very small and relatively narrow in scope. The Document includes virtually no analysis of whether a 2% level makes sense in the much larger, complex, and varied swap market. An individual swap dealer may maintain a portfolio of hundreds of different swap products with a notional amount in excess of a trillion dollars with thousands of counterparties. The dealer may make over a million trades a year. Asking generic questions about the differences in these two markets is helpful. However, it is apparent that any significant new data or analysis provided by commenters in

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<sup>8</sup> See 17 CFR 1.17(a)(1)(i)(B).

response to this Document that the Commission uses to support the final rule will need to be presented to the public for consideration and comment.

As a further example, the Document asks questions about permitting expanded use of netting of offsetting positions when calculating the exposures against which minimum capital must be held. Netting of offsetting positions is an important function for intermediaries like swap dealers for day-to-day cash flow, liquidity, and risk management. In some respects, netting is the basis on which certain types of intermediaries build their business by dealing derivatives to different parties that want or need long positions when other parties need or want corresponding short positions.

However, when it comes to minimum capital requirements, which are intended to serve as a source of funding of last resort at all times, we must be very careful when proposing netting offsets. Should a large swap dealer with a complex dealing book only be required to hold some minimum amount of collateral simply because it is able to net out its book? That would not appear to serve the statutory purpose for a minimum capital requirement of helping to assure the safety and soundness of the swap dealer.<sup>9</sup> While I am not suggesting that netting should play no role in the capital requirement calculations, my concern is that the Document provides little in the way of data, analysis, or rationale as to how the netting provisions discussed, which could net significant portions of the requirement down to nothing, would serve the intended purpose. That is a concerning approach to take for a capital requirement and it is difficult to see how a final rule could be built on such questions in the Document.

*Harmonization and Cost Reduction Alone are not Valid Policy Goals*

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<sup>9</sup> See 7 U.S.C. 6s(e)(3)(A).

In the Document, the costs of compliance and harmonization with the SEC’s capital rule are repeatedly mentioned as reasons for various possible changes. Compliance cost reduction and rule harmonization, when feasible without undermining the policy goals of the regulations, are certainly important considerations in writing regulations. However, as I have stated in other contexts, these are secondary considerations and should not supplant achieving the policy goals stated by Congress in the Commodity Exchange Act. While the Document acknowledges that safety and soundness of each swap dealer is the stated purpose of the capital rule, and asks generic questions about the impact on swap dealer safety and soundness, that purpose is not mentioned as the reason for any of the proposed changes to the capital requirements. This odd omission belies the purported goals of the Document.

The Document also exposes the one-sided nature of the “harmonization” rationale. In several instances it relies almost completely on harmonizing the CFTC regulation with the comparable SEC regulation. In each of those instances, the result is always a weaker regulatory requirement. And yet in a other instances,<sup>10</sup> the Document acknowledges that a change to the existing capital rule proposals would conflict with the SEC’s rules, but then goes on to support implementing a different rule. It seems that harmonization is used as a rationale for action only when it is convenient for reducing regulation and therefore obfuscates the real reason for the action.

### *Conclusion*

For the reasons stated above, I dissent.

Notwithstanding my dissent, I want to acknowledge the hard work of the staff in trying to address my many questions and comments in the limited time we had to consider the Document.

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<sup>10</sup> See e.g., Document, sections II.A.5 and 10.

Capital requirements are one of the most complex and highly technical areas in our regulations. We had a little less than a month to review the Document, which was not enough time given the heavy schedule currently set for the Commission and the complexity and history behind the Document and the two prior capital rule proposals. Notwithstanding this short time frame, I appreciate the staff's efforts to incorporate a number of my requested changes and address several complicated issues.

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