2001 Pennsylvania Avenue NW
Suite 600 | Washington, DC 20006
T 202 466 5460
F 202 296 3184

By Electronic Mail

May 15, 2017

Mr. Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: RIN3038-AD54: Capital Requirements for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 91,252 (December 16, 2016)

Dear Mr. Kirkpatrick:

The Futures Industry Association ("**FIA**")[1] is pleased to submit this letter in response to the Commodity Futures Trading Commission's ("**Commission**") request for comments on its proposed capital requirements for swap dealers and major swap participants.

The proposed rules are complex, and their potential impact on individual registrants cannot be determined without careful analysis by each firm, taking into account the full scope of the activities in which that firm is engaged. This analysis is made more difficult because the Securities and Exchange Commission's ("**SEC**") proposed Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants, which are incorporated by reference in the Commission's proposed rules, remain pending.[2]

We understand that the trade associations that represent more directly the swap dealers that are subject to the Commission's jurisdiction intend to submit detailed comments addressing the

[1] FIA is the leading trade organization for the global futures, options and over-the-counter cleared derivatives markets. Its mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system and promote high standards of professional conduct. FIA's core constituency consists of futures commission merchants ("**FCMs**"), and the primary focus of the association is the global use of exchanges, trading systems and clearing organizations for derivatives transactions. FIA's members also include leading derivatives exchanges and clearing organizations from more than 20 countries.
FIA's FCM members serve as the primary clearing members of US futures exchanges. They handle more than 90 percent of the customer funds held for trading on the exchanges and provide the majority of the funds that support the clearing organizations of the exchanges. In providing these clearing services, they commit a substantial amount of their own capital to guarantee customer transactions.

[2] 77 Fed. Reg. 70,214 (Nov. 23, 2012). We understand that the SEC proposed rules were the subject of considerable comment and, therefore, the final provisions of those rules could change significantly.

effect that adoption of the proposed rules will have on their members.[3] Our comments focus, in particular, on the potential impact that the proposed amendments to Commission Rule 1.17 will have on FCMs, whether or not the FCM is registered as a swap dealer.

Requiring an FCM to include its proprietary swaps and security-based swaps positions in its calculation of eight percent of risk margin would place an unnecessary and unacceptable financial burden on FCMs. Commission Rule 1.17(a)(1)(i) currently provides that an FCM's minimum adjusted net capital must be equal to or in excess of the greatest of, *inter alia*, (A) $1,000,000; and (B) the FCM's risk-based capital requirement, computed as eight percent of the total risk margin[4] requirement for positions carried by the FCM in customer accounts and noncustomer accounts. The Commission has proposed to increase significantly the amount of minimum adjusted net capital that an FCM must maintain if the FCM also enters into swaps and security-based swaps, both cleared and uncleared, for its own account. This is the case whether or not the FCM is also registered as a swap dealer.[5]

As proposed to be amended, Rule 1.17(a)(1)(i) would provide that an FCM's minimum adjusted net capital must be the greater of, *inter alia*, (A) $1,000,000 or $20,000,000 if the FCM is also a swap dealer; and (B) the FCM's risk-based capital requirement, computed as eight percent of the sum of: (1) the total risk margin requirement for positions carried by the FCM in customer accounts and noncustomer accounts; (2) the total initial margin that the FCM is required to post with a clearing agency or broker for security-based swap positions carried in customer and noncustomer accounts; (3) the total uncleared swaps margin; (4) the total initial margin that the FCM is required to post with a broker or clearing organization for all proprietary cleared swaps positions carried by the FCM; (5) the total initial margin for all uncleared security-based swap positions carried by the FCM without regard to any initial margin exemptions or exclusions to such security-based swap positions; and (6) the total initial margin that the FCM is required to post with a broker or clearing agency for proprietary cleared security-based swaps.

We support the proposed amendment to Rule 1.17(a)(1)(i)(A), which would require an FCM that is also registered as a swap dealer to maintain minimum adjusted net capital of at least $20,000,000. As the Commission notes, this requirement is consistent with the proposed requirements for swap dealers that are not registered as FCMs. However, the proposed amendments to subparagraph (B) of the rule differ from the current rule in several important respects and, as noted above, could increase significantly the amount of minimum adjusted net capital that an FCM must maintain, if the FCM also enters into swaps, both cleared and uncleared, for its own account. In particular, subparagraphs (3)-(6) of the proposed amendments would, for the first time, require an FCM to include its proprietary swaps and security-based

[3] In this regard, we have had an opportunity to review the comment letter on the proposed rules that the Securities Industry and Financial Markets Association ("**SIFMA**") has filed with the Commission. We support the views expressed therein. *See*, Letter from Mary Kay Scucci, Managing Director, SIFMA, to Christopher J. Kirkpatrick, Secretary of the Commission, CFTC, May 15, 2017 ("**SIFMA Letter**").

[4] Risk margin is defined at Commission, Rule 1.17(b)(8).

[5] We note that in the Federal Register release accompanying the proposed rules, the Commission states that the proposed amendments to Rule 1.17 would apply to FCMs that are also registered as swap dealers. However, as we read the proposed amendments, they would apply as well, with limited exceptions, to all FCMs that enter into swaps for their own account, whether or not registered with the Commission as swap dealers.

swaps positions (cleared and uncleared) in its calculation of eight percent of risk margin.[6] For the reasons explained below, the proposed rules represent an unnecessary and unexplained change in established Commission policy that would place an unacceptable financial burden on FCMs that also enter into swaps, both cleared and uncleared, for their own account.[7]

As the Commission will recall, prior to the amendments to Rule 1.17 adopted in 2004, an FCM was required to maintain minimum adjusted net capital equal to or greater than the greatest of, *inter alia*, $250,000 or four percent of the total funds required to be segregated under section 4d(2) of the Commodity Exchange Act ("**Act**"), plus the funds required to be held in a Commission Rule 30.7 account. Further, noncustomer positions were not taken into account at all.

In 2004, the Commission promulgated amendments to Rule 1.17 that replaced the flat four percent of customer funds calculation with the risk-based capital calculation that had previously been adopted by the National Futures Association ("**NFA**"), the Chicago Board of Trade (and the Clearing Corporation) and the Chicago Mercantile Exchange.[8] As amended, the revised rule set the risk-based capital requirement as the sum of eight percent of total risk margin requirement for positions carried by the FCM in customer accounts, plus four percent of the total risk margin requirement for positions carried by the FCM in noncustomer accounts. Significantly, the Commission determined that the risk-based margin requirements would not apply to an FCM's proprietary positions. As the Commission noted in the Federal Register release accompanying the proposed rules and reconfirmed in the adopting release, an FCM's proprietary positions would be excluded "because such positions currently are included in the calculation of adjusted net capital to the extent that uncovered proprietary positions result in a charge or "haircut" to net capital based on clearinghouse or exchange margin requirements."[9]

In 2009, the Commission again amended Rule 1.17 for the purpose, *inter alia*, of: (i) increasing the minimum adjusted net capital requirement from $250,000 to $1,000,000; (ii) increasing the risk-based capital calculation for noncustomer positions from four percent of the total risk margin requirement for positions carried by the FCM in noncustomer accounts to eight percent; and (iii) extending the risk-based capital requirement calculation to all cleared over-the-counter derivatives positions.[10] In doing so, the Commission again elected not to include FCM proprietary positions in the calculation of risk-based margin requirements. Instead, the

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[6] We note that the Commission has proposed that an FCM calculate its risk-based capital requirement for proprietary swap and security-based swap positions, both cleared and uncleared, based on the FCM's initial margin requirements. In contrast, the calculation with respect to customer and noncustomer positions is based on the maintenance margin or performance bond requirements for such positions. If the Commission moves forward with the proposed rules, we ask the Commission to revise proposed Rule 1.17(a)(1)(i)(B)(2) and (4)-(6) to require an FCM to calculate its risk-based capital requirement based on the FCM's risk margin requirements for its proprietary swap and security-based swap positions, rather than its initial margin requirements.

[7] As noted earlier, the SEC's proposed margin requirements for security-based swap dealers and security-based major swap participants remain pending. As a result, the full impact of the Commission's proposed amendments is uncertain.

[8] 69 Fed. Reg. 49,784 (Aug. 12, 2004).

[9] 68 Fed. Reg. 40,835, 40838 (July 9, 2003); 69 Fed. Reg. at 49,788.

[10] 74 Fed. Reg. 69,279 (Dec. 31, 2009).

Commission amended Rule 1.17(c)(5)(x) to "require FCMs to take proprietary capital deductions for their cleared OTC derivative positions similar to the capital deductions required for their proprietary futures and options positions."[11]

The current proposed amendments make no substantive change to Rule 1.17(c)(5)(x). FCMs will continue to be required to deduct at least 100 percent of the margin required by the applicable clearing organization.[12] In addition, the Commission has proposed to add a new subparagraph (c)(5)(xv) to Rule 1.17, which would require the FCM to also deduct the amount of the uncleared swap margin that the FCM has not collected from a swap counterparty, less any amounts owed by the FCM to the swap counterparty for uncleared swap transactions. This requirement would apply to margin for all uncleared swaps, even if the counterparty is exempt or excluded from such margin requirements and, therefore, no margin is actually due or owing.

The proposed amendments, therefore, would require an FCM to include margin related to its proprietary swaps and security-based swaps positions in its eight percent risk-based capital calculation and also deduct that same margin from its net capital in computing its adjusted net capital. The Commission has not explained why it has proposed such a dramatic change from the position it first adopted in 2004, nor has it identified any changes in the markets that would support this change. Indeed, the Commission has not even acknowledged that its proposal represents a change from its prior position.

In the absence of support to justify this change and the potentially significant increase in an FCM's adjusted net capital requirement that will result, in particular, the lack of any meaningful cost-benefit analysis with respect to the proposed amendments, we submit that it is inappropriate to require an FCM both to include margin related to its proprietary positions in its eight percent risk-based capital calculation and to deduct that same margin from its net capital in computing its adjusted net capital.[13]

This is particularly the case since the proposed amendments will likely affect most dramatically those less well-capitalized FCMs that are not also registered as broker-dealers. As the Commission noted elsewhere in the Federal Register release, these FCMs "may be more willing to provide swaps markets in commodities to agricultural firms and smaller commercial end users such as farmers and ranchers that might not otherwise be able to use such markets to manage risks in their businesses or might have to pay higher fees to engage in swaps."[14] The Commission's rules should not have the effect of denying such market participants use of swaps to hedge their business activities.

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11 *Id* at 69,281.

12 The rule requires an FCM to take a charge of 100 percent of the margin required by the applicable clearing organization if the FCM is a member of the organization and 150 percent of the applicable maintenance margin required by the clearing organization if the FCM is not a member of the organization. Rule 1.17(c)(5)(x)(A)(B).

13 The increased adjusted net capital requirement will necessarily increase the amount of adjusted net capital that an FCM must maintain to stay above the early warning requirement set out in Commission Rule 1.12(b). FCMs generally maintain sufficient capital to assure that they are not required to file a notice under Rule 1.12(b).

14 81 Fed. Reg. at 91,268.

Similarly, requiring a swap dealer to include eight percent of risk margin required in connection with its cleared proprietary positions in calculating its capital requirement would place an unnecessary and unacceptable financial burden on swap dealers. For the same reasons that an FCM should not be required to include margin related to its cleared proprietary positions in its eight percent risk-based capital calculation and to deduct that same margin from its net capital in computing its adjusted net capital, we submit that a swap dealer should not be required to include eight percent of risk margin related to its cleared proprietary positions in calculating its net capital requirements under Commission Rule 23.101. The proposed rules require swap dealers to take a charge of at least 100 percent of required margin for such all such positions,[15] and requiring swap dealers to add an additional eight percent of risk-based margin to this calculation is unnecessary.

This is particularly the case since section 4s(e)(3) of the Act makes clear that the capital requirements for swap dealers should be designed to "offset the greater risk to the swap dealer . . . and the financial system rising from the use of swaps that are <u>not</u> cleared."[16] The proposed rules, therefore, not only fail to take into account the reduced risks of cleared swaps but also appear to be contrary to Congressional intent.

Neither the use of standardized market risk and credit risk charges nor the use of market risk and credit risk internal models are viable alternatives for FCMs. The Commission has proposed to require an FCM to apply the standard deductions set out in Rule 1.17 to calculate its swaps market risk or credit risk charges. Because such calculations are based on the notional value of the swaps and security-based swaps, rather than market values, we understand that the resulting charges would likely be prohibitive. At the least, they would place FCMs that use the standard deductions at an extreme competitive disadvantage.[17]

In lieu of the standard deductions, the Commission has proposed to allow FCMs that are registered as swap dealers to use internal models to compute market risk and credit risk deductions.[18] However, this alternative will not be viable for many FCMs. In particular, we understand that the development of internal models is a significant undertaking that is uneconomical for less well-capitalized FCMs whose swaps activities are comparatively smaller. Since these FCMs will be unable to comply with either approach to calculate their market risk and credit risk charges, they will have no choice but to withdraw from engaging in swap dealing activities, further reducing competition and likely denying smaller commercial end-users access to the swaps markets.

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[15] In this regard, as noted above, Commission Rule 1.17 provides that a clearing member must take a charge of 100 percent of the maintenance margin required by the applicable clearing organization, while a non-clearing member must take a charge of 150 percent of the maintenance margin required by the applicable clearing organization. Since many swap dealers will not be clearing members, they would be at a significant competitive disadvantage to other swap dealers. If the Commission elects to go forward with this rule, we recommend that all swap dealers be subject to a charge of no more than 100 percent of the applicable maintenance margin requirement.

[16] 7 U.S.C. § 6s(e)(3) (emphasis added).

[17] An example of the significant charges to which FCMs that are required to use the standard deductions would be subject is set out on page 14 of the SIFMA Letter and is incorporated herein by reference.

[18] FCMs that are not registered as swap dealers would not be permitted to use internal models.

The compliance date of the proposed rule amendments must provide sufficient time to receive approval of and implement internal models to calculate market risk and credit risk. If the Commission elects to move forward with the proposed capital rules, we ask the Commission, in establishing the date by which swap dealers and major swap participants must comply with them, to keep in mind that firms will need sufficient time to increase their capital to meet the new capital requirements. Until the SEC adopts margin final rules, this task will be difficult, if not impossible.

We further note that it will take a considerable amount of time for the Commission, or the NFA, to develop the expertise and staff necessary to review and approve internal models to calculate market risk and credit risk. Once approved, the firms will need a significant amount of time modify their systems and procedures to implement these models.[19]

To facilitate this review, we encourage the Commission to approve automatically internal models that have been approved by the Prudential Regulators, the SEC or a "qualifying foreign regulator" whose oversight has been approved by a Prudential Regulator with respect to non-US banks that are swap dealers. Automatically approving internal models that have been approved by a qualifying foreign regulator will also facilitate international comity and assist U.S. firms that permitted to operate in such jurisdictions following a finding of substituted compliance.

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We appreciate the opportunity to submit these comments on the Commission's proposed capital requirements for swap dealers and major swap participants. If the Commission has any questions regarding the matters discussed in this letter or needs any additional information, please contact Allison P. Lurton, FIA's Senior Vice President and General Counsel, at 202.466.5460 or alurton@fia.org.

Sincerely,

Walt L. Lukken

Walt L. Lukken
President and Chief Executive Officer

cc: Honorable J. Christopher Giancarlo, Acting Chairman
Honorable Sharon Bowen, Commissioner

Division of Swap Dealer and Intermediary Oversight
Eileen T. Flaherty, Director
Thomas J. Smith, Deputy Director

[19] As discussed above, requiring a firm to take the standardized market risk and credit risk charges pending approval of the firm's internal model would be unacceptable, placing the firm at a significant competitive disadvantage to other swap dealers.