ABN·AMRO ING MIZUHO NOMURA

January 29, 2018

Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Capital Requirements of Swap Dealers and Major Swap Participants, RIN 3038-AD54

Secretary Kirkpatrick:

The undersigned firms (the "**Firms**") appreciate this opportunity to provide comments to the Commodity Futures Trading Commission (the "**Commission**" or "**CFTC**") in response to the above-captioned proposal (the "**Proposed Rule**")[1] regarding capital requirements for swap dealers ("**SDs**") that are not subject to capital rules of a Prudential Regulator ("**nonbank SDs**").[2]

As described below, we recommend that the Commission modify the Proposed Rule to permit a U.S. nonbank SD to use internal, risk-based capital models approved and periodically assessed by a Prudential Regulator, the Securities and Exchange Commission ("**SEC**") or its home country consolidated supervisor, without requiring additional pre-approval of those models by the Commission or National Futures Association ("**NFA**"). Instead, the Commission and NFA would have access to information regarding the other regulator's oversight of those models (including associated model governance) as necessary to fulfill their ongoing monitoring responsibilities for the SD.

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1 81 Fed. Reg. 91,252 (Dec. 16, 2016).

2 The Prudential Regulators are the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the Farm Credit Administration.

This change would be consistent with the Commission's broader efforts to make its regulations more efficient by promoting regulatory deference in appropriate circumstances. It also is necessary to avert a disruptive change to the operating model of U.S. nonbank SDs with foreign parent companies. Without this change, to avert such disruption the Commission should extend the compliance period for SD capital requirements significantly to provide enough time for Commission or NFA review and approval of internal capital models.

Background

The Proposed Rule would permit a nonbank SD (other than a futures commission merchant ("**FCM**")) to elect either a "bank-based" approach or "net liquid assets" approach to computing its capital requirements.[3] Under either approach, the nonbank SD could compute its market and credit risk capital charges using internal, risk-based models approved by the Commission or NFA.[4]

If the nonbank SD did not receive market risk model approval, however, the Proposed Rule would require it to compute market risk capital charges using standardized haircuts equal to a percentage of its gross notional swap positions.[5] Unlike a risk-based model, these standardized haircuts grossly overstate the risk of a swap portfolio because they provide limited or no recognition of risk offsets arising from hedging strategies commonly employed by SDs. As a result, standardized haircuts can result in capital charges in excess of 100 times the market risk charge calculated using a model compliant with Basel 2.5 capital standards.[6]

In addition, if the nonbank SD did not receive credit risk model approval, the Proposed Rule would likewise require it to compute its credit risk charges using standardized charges, based on either the Federal Reserve's standardized approach for banks (for a nonbank SD electing the bank-based approach) or the Commission's net capital rule for FCMs (for a nonbank SD electing the net liquid assets approach).[7] Either type of standardized credit risk charges would be notably higher than charges calculated using a risk-based model. These higher credit risk charges would make it challenging for a nonbank SD lacking model approval to compete with other SDs, especially when trading with non-financial end users not required to post margin.

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3 Proposed CFTC Regulations § 23.101(a)(1). Non-financial SDs could alternatively elect a "tangible net worth" approach, but that approach would not be available to SDs that are not predominantly engaged in non-financial activities. Proposed CFTC Regulations § 23.101(a)(2).

4 Proposed CFTC Regulations § 23.102.

5 Proposed CFTC Regulations § 23.101(a)(1).

6 *See* Letter from Mary Kay Scucci, Managing Director, SIFMA, to Chris Kirkpatrick, Secretary, the Commission, dated May 15, 2017 (link), at p. 15 (comparing capital requirements for a diversified portfolio of interest rate, equity and foreign exchange products).

7 Proposed CFTC Regulations § 23.101(a)(1).

Discussion

Due to the punitive capital charges generated by a standardized approach, a nonbank SD will need to obtain approval to use internal capital models in order to conduct its business in a commercially viable manner. As NFA itself has acknowledged, however, the review and approval of a large number of internal capital models will present significant challenges.[8] To mitigate these challenges, NFA recommended that, if an SD electing the bank-based approach will use internal credit and market risk capital models previously reviewed by a Prudential Regulator, the Commission or NFA should not have to formally approve the SD's use of those models prior to the capital rule's effective date.[9] Rather, NFA proposed to develop a framework as part of its ongoing examination process and capital compliance monitoring program to review SDs' models for compliance with SD capital requirements after the effective date (the "**NFA Proposal**").[10]

We strongly support NFA's recommendation to defer to model approvals by other comparable regulators. This approach is consistent with how the CFTC has historically deferred to SEC model approvals for FCMs that are dually registered as broker-dealers and participate in the SEC's alternative net capital program. It is appropriate to take the same approach for swap dealers subject to direct or indirect oversight by other regulators.

We recommend that the Commission adopt the NFA Proposal, with the following modifications.[11] First, the Commission should permit a nonbank SD to use internal credit and market risk models approved by a wider range of regulators, encompassing any (i) Prudential Regulator (including the Federal Reserve, as consolidated supervisor of a nonbank SD's ultimate parent bank holding company or U.S. intermediate holding company), (ii) the SEC, or (iii) a foreign regulator that is either based in a G20 jurisdiction or is a member of the Basel Committee or the Board of the International Organization of Securities Commissions (each of (i), (ii), and (iii), a "**Qualifying Regulator**"). Models approved by the Federal Reserve or a foreign regulator in its capacity as a consolidated supervisor would be eligible for this treatment, in addition to models approved by a Qualifying Regulator with which the nonbank SD is directly registered or licensed.

Second, we recommend that the Commission and NFA generally defer to the Qualifying Regulator's ongoing oversight of the nonbank SD's models (including associated model governance). This approach would be consistent with how the

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8 *See* Letter from Carol Wooding, Vice President and General Counsel, NFA, to Chris Kirkpatrick, Secretary, the Commission, dated May 15, 2017 (link).

9 *Id.*

10 *Id.*

11 Our proposal responds to the Commission's request for comments regarding whether the Commission should "provide for automatic approval or temporary approval of capital models already approved by a prudential or foreign regulator" and "on what conditions such models should be approved." 81 Fed. Reg. 91,252, 91,273 (Dec. 16, 2016).

Commission has approached substituted compliance in other instances. The Commission and NFA would have access to information regarding the Qualifying Regulator's model oversight as necessary to fulfill their ongoing monitoring responsibilities for the SD.

For a U.S. nonbank SD to qualify for this treatment, we would propose the following conditions:

- the models used by the nonbank SD should: (1) cover the material risks arising from the swaps activities of the nonbank SD; (2) satisfy the Qualifying Regulator's implementation of Basel 2.5 or Basel 3 capital standards; and (3) be subject to prior approval and periodic assessment by the Qualifying Regulator;

- if the Qualifying Regulator is the nonbank SD's consolidated supervisor, the nonbank SD's use of the models should be subject to internal risk management controls and governance processes applied consistently across the holding company group (which, in the case of the Federal Reserve, may be an intermediate holding company) and subject to oversight by the Qualifying Regulator;

- if the Qualifying Regulator is the nonbank SD's consolidated supervisor, the nonbank SD's holding company's model governance processes should involve representation from a member of the nonbank SD's "governing body" or "senior management," as defined in CFTC Regulations § 23.600; and

- the nonbank SD should make available to the Commission and NFA sufficient information regarding its models and related internal risk management controls and governance processes to assess them for compliance with SD capital requirements.

Recognizing Qualifying Regulators' model approvals and oversight as described above would, consistent with the NFA Proposal, further conserve Commission and NFA resources without compromising the Commission's objective of ensuring strong quantitative and qualitative standards for internal capital models. Such recognition would also be consistent with the Commission's proposal that a non-U.S. SD be eligible for substituted compliance in connection with capital requirements.[12] Presumably, if the Commission determines it appropriate to defer to a foreign capital regime in its entirety, then it would be appropriate to defer to internal model approval and assessment by a regulatory authority administering such a regime in connection with a U.S. SD using the same internal models as a holding company supervised by that regulatory authority.

Importantly, recognizing Qualifying Regulators' model approvals and oversight would help permit foreign financial institutions to operate U.S. nonbank SD subsidiaries subject to full application of the Commission's internal and external business

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12 *See* Proposed CFTC Regulations § 23.101(a)(5).

conduct standards and direct, onshore examination and supervision by the Commission and NFA. In contrast, if forced to compute capital charges under a standardized approach, U.S. nonbank SD subsidiaries would not be able to conduct business as the excessive amount of capital required would make swap dealing activities unsustainable. Transitioning U.S. swap dealing activities to a non-U.S. affiliate would, in turn, be costly and disruptive for affected SDs and their U.S. counterparties, likely lead to a migration of personnel and resources to the non-U.S. affiliate, and make the examination process less seamless for the Commission and NFA.

In connection with this proposal, we also wanted to note the following related points:

- We believe that the capital and margin rules of the CFTC and SEC should be harmonized. If harmonization is not achievable, the rules should coordinated so that the SEC defers to the capital and margin rules of the CFTC for a registrant that is not a broker-dealer or FCM and whose security-based swaps constitutes a very small proportion of its business (less than 10% of the notional amount of its outstanding swap positions), and vice versa. Without this coordination, or otherwise completely harmonized rules, registrants would face incentives to split their trading activities into multiple legal entities, with resulting loss of netting and risk management efficiencies.

- If the relief requested above with respect to recognition of models approved by Qualifying Regulators is not granted, it will be particularly important that the capital requirements for nonbank SDs be phased in over a period sufficient to prevent significant market disruption. Additionally, existing registrants are likely to be required to transition U.S. swap dealing activities to non-U.S. affiliates, which will require considerable time, cost and effort to implement from governance, operational and documentation perspectives. To address these issues, we respectfully request that the Commission provide a period of at least two years from adoption before its capital requirements fully take effect.

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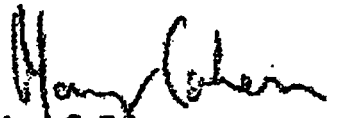
The Firms appreciate the opportunity to submit these comments in connection with the Proposed Rule. If you have any questions or if we can be of assistance to the Commission, please do not hesitate to contact Colin Lloyd (212-225-2809) of Cleary Gottlieb Steen & Hamilton LLP, outside counsel to the Firms.

Respectfully submitted,

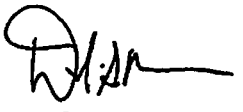
Alexander Lange
President
ABN AMRO Securities (USA) LLC

Michael Bando
President and Chief Executive Officer
ING Capital Markets LLC



Marcy S. Cohen
General Counsel and Managing Director
ING Capital Markets LLC

Adam Hopkins
Managing Director and General Counsel
Mizuho Capital Markets LLC



David Moser
Chief Financial Officer and Managing Director
Nomura Holding America Inc.

cc: J. Christopher Giancarlo, Chairman
Brian Quintenz, Commissioner
Rostin Behnam, Commissioner

Matthew B. Kulkin, Director
Thomas Smith, Deputy Director
Division of Swap Dealer and Intermediary Oversight