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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. 91252 (December 16, 2016)

Dear Mr. Kirkpatrick:

The FIA Principal Traders Group ("**FIA PTG**") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("**Commission**") Notice of Proposed Rulemaking on Capital Requirements for Swap Dealers and Major Swap Participants ("**Proposed Rulemaking**"). We support transparent, competitive, and well-regulated markets and regulatory measures that support these goals.

FIA PTG is an association of more than 20 firms that trade their own capital primarily in the exchange-traded and cleared derivatives markets. FIA PTG members engage in manual, automated and hybrid methods of trading, and are active in a wide variety of asset classes, including equities, fixed income, foreign exchange and commodities.

FIA PTG members are a critical source of liquidity in the markets in which we trade, enabling those who use these markets, including commercial end-users, to manage their business risks and to enter and exit the markets efficiently. Participation by our members in swaps markets supports the changes to these markets envisioned by the Dodd-Frank Act by providing additional sources of liquidity and price discovery and diversifying the number and types of counterparties, which reduces systemic risk and benefits end-users.

Today, FIA PTG member firms' open [futures and cleared swaps] positions are fully margined, and minimum capital requirements related to a firm's [futures and cleared swaps] activity are imposed by the futures commission merchant ("**FCM**") guaranteeing that firm's obligations or, if self-clearing, by the relevant derivatives clearing organization ("**DCO**") . This framework has worked well, including during the financial crisis. Further capital requirements that are not proportionate or risk-sensitive risk impairing the ability of FIA PTG members to participate in the swaps markets.

Each FIA PTG member firm's decision to participate in the swaps markets, and to what extent, is dependent upon a number of factors, not the least of which are the costs associated with compliance with the applicable regulations. For this reason, the Commission should carefully consider the impact of regulatory costs on the continued development of a more competitive and diverse swaps market, particularly as banks continue to evaluate the amount of liquidity they are able to provide. In this regard, an important cost consideration will be the capital requirements that the Commission ultimately applies to a swap dealer.

We submit that, in proposing capital requirements that create an unnecessarily high barrier to entry, the Commission has not fulfilled its responsibilities under the Commodity Exchange Act. In this regard, we respectfully disagree with the Commission's preliminary conclusion set out in the Federal Register release accompanying the Proposed Rulemaking that "the proposal's effect on competition, liquidity and price discovery should be limited."[1] This conclusion is especially curious, since the Commission acknowledges at the beginning of the same paragraph that the proposal "may have a negative effect on competition, as a result of increasing costs, which may result in some [swap dealers] limiting or withdrawing from the swaps markets."[2]

Although it may be true, as the Commission notes, that many of the larger swap dealers or their parent entities "are already subject to capital requirements that impose capital charges for their swap activities",[3] liquidity provision in the swaps market today is highly concentrated. More importantly, however, we do not believe that the Commission's responsibilities under section 15 of the Commodity Exchange Act ("**Act**") are limited to assuring that competition in the markets is not reduced. Rather, section 15(b) instructs the Commission, in issuing any order or adopting any rule or regulation, to "take into consideration the public interest to be protected by the antitrust laws and ***endeavor to take the least anticompetitive means of achieving the objectives***" of the Act.[4] [Emphasis supplied.] Section 15 further provides that, in evaluating the costs and benefits of the proposed rules, the Commission should balance considerations of "efficiency" and "price discovery" of the markets with considerations of the "financial integrity" of the markets.[5] For reasons discussed below, the Proposed Rulemaking creates unnecessary barriers to entry.

The standardized market and credit risk charges are impractical to use and not reflective of risk.[6] This methodology is fundamentally flawed because the standardized charges are based on the notional value of uncleared swaps and security-based swaps, rather than the actual risks associated with such positions. Notional amounts are not in and

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1 81 Fed. Reg. 91252, 91296 (Dec. 16, 2016).

2 *Id.*

3 *Id.*

4 Act, § 15(b). Section 15(b) provides that, in issuing any order or adopting any rule or regulation, the Commission "shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives" of the Act.

5 Act, § 15(a)(2).

6 Proposed Rule 23.101(a)(1)(ii)(A).

of themselves reflective of risk and can add up very quickly. Thus, a swap dealer using the standardized method will likely have a grossly over assessed estimation of the risk of a portfolio of uncleared swaps.

Furthermore, it seems that the Proposed Rulemaking would require a swap dealer utilizing the net liquid assets capital approach to take a capital charge for market risk on cleared positions, both futures and swaps, of either 100 percent or 150 percent of the maintenance margin depending on their clearing status.[7] The 100 percent charge would apply to a member of a clearinghouse and the 150 percent charge would apply to all others.[8] We believe it is unnecessary to apply a higher percentage to non-clearing members and join FIA[9] in urging the Commission to apply no more than a 100 percent charge to all swap dealers. Not only does such a requirement place non-clearing members at an unnecessary competitive disadvantage, but the clearing system is actually put less at risk by a non-clearing member as there is now an independent third party subject to capital requirements, *i.e.* the clearing member, guaranteeing its trading activity. Presumably a clearinghouse's assessment of risk is well-founded and should suffice for all market participants.[10]

Further to our concerns about the standard methodology, because the market risk of a portfolio of cleared and uncleared positions will in many cases offset one another, both from a market and credit standpoint, the standardized approach using notional value will greatly overestimate the risk associated with the portfolio. We thus commend the Commission for recognizing this and providing in the Proposed Rulemaking for swap dealers to be able to use internal models to calculate market risk and credit charges. Further to the comment letter of the National Futures Association filed with the Commission on May 15, 2017,[11] we anticipate that both existing and aspiring swap dealers will have a high demand for approval of applications for internal models, which may tax the resources of the Commission and the National Futures Association. We thus recommend that the Commission include in any final regulations some preapproved, generally accepted portfolio based models as an alternative option to individually approved internal models.

The requirement that swap dealers using internal models must have $100 million in tentative net capital creates an unnecessary barrier to entry. For reasons discussed above**,** most firms using the net liquid assets capital method will have no choice but to use internal models to participate in the swaps market as a swap dealer. The Proposed Rulemaking would make swap dealers who use internal models subject to an additional

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7 Proposed Rule 23.101(a)(1)(ii)(A)*(l)(iii).*

8 *Id.*

9 https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61214&SearchText= at page 5.

10 We note that the risk determination of a clearinghouse for cleared instruments will not reflect the market risk of a portfolio of cleared instruments if the portfolio contains positions cleared in different clearinghouses.

11 https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61206&SearchText=

capital requirement, the $100 million tentative net capital requirement, over and above the $20 million net capital requirement.[12]

In considering the $100 million tentative net capital requirement, it is important to recall that the Securities and Exchange Commission ("**SEC**") first imposed the requirement in 1998 when the over the counter ("**OTC**") derivatives markets were effectively unregulated.[13] Regulators had limited understanding of swaps, swaps were not subject to centralized clearing, and swaps were not subject to margin requirements.

In the nearly 20 years since then, virtually everything has changed. Regulators are now well-versed in the intricacies and risks of swaps, the majority of interest rate swaps and credit default swaps are subject to centralized clearing, and both cleared and uncleared swaps are (or soon will be) subject to initial and variation margin requirements. As important, firm risk management models have become far more sophisticated.[14] In light of these changes, we believe it is appropriate for the Commission to consider whether the $100 million tentative net capital requirement is necessary at all.

As demonstrated in the following example, the $100 million tentative net capital requirement will not necessarily protect the swaps markets. Assume that a swap dealer (SD 1), applying the net liquid assets capital approach using an approved internal model, has a minimum adjusted net capital requirement equal to $25 million and net capital equal to $25 million. Under the proposed rules, the tentative net capital of the swap dealer would have to be a minimum of $100 million. Another swap dealer (SD 2), also using an approved model, has a minimum adjusted net capital requirement equal to $125 million and net capital of $125 million. Under the Proposed Rulemaking, and unlike SD 1, SD 2 would not be required to have a buffer of tentative net capital substantially above its required net capital notwithstanding that its positions may well pose a greater risk to both the swap dealer and other market participants. If SD 2 were to have a tentative net capital requirement in proportion to SD 1, the requirement would be $500 million.

We appreciate that any swap dealer will necessarily have tentative net capital in excess of its adjusted net capital. However, in the case of a large swap dealer, the amount of such excess could be proportionally smaller, without regard to the risks associated with such swap dealer's positions. If the purpose of the buffer is to take into account the inherent weakness of any internal model, logic dictates that any tentative net capital requirement should be tied to the risk of the positions that the swap dealer maintains rather than the absolute amount of the swap dealer's capital.

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12 *Id.*; Proposed SEC Rule 240.18a-1(a)(2).

13 *See, e.g.*, "Long Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk", Report of the General Accounting Office to Congressional Requesters (October 1999).

14 We also note that, at least with respect to cleared swaps, an FCM that clears a swap dealer's positions has an obligation under Commission Rule 1.73 to (i) establish risk-based limits in each customer account based on position size, order size, margin requirements, or similar factors, and (ii) establish and maintain systems of risk management controls reasonably designed to ensure compliance with the limits.

The $100 million tentative net capital requirement will certainly cause some firms to decide not to become swap dealers. To ensure that swap dealers using the net liquid assets capital approach do not run on little or no capital, there is already a $20 million minimum net capital requirement in the Proposed Rulemaking. Given that positions and assets will be given a capital charge, either by the standardized method or approved internal models, the additional requirement is unnecessary and outdated.

The requirement that a swap dealer maintain net capital in excess of 8 percent of the risk margin required in connection with its positions creates an unnecessary barrier to entry. We oppose the provisions of proposed Rule 23.101, which would require a swap dealer to carry a minimum amount of net capital equal to 8 percent of all its required margin, including the margin related to its cleared futures, foreign futures, swaps and security-based swaps positions. The positions of a swap dealer will have already been assessed for market and credit risk through either the standardized method or internal models.

This is particularly true for cleared instruments on which the Proposed Rulemaking requires a charge of 100 or 150 percent. The Commission's approach is also inconsistent with the provisions of section 4s(e)(3) of the Act, which instructs the Commission to adopt capital requirements for swap dealers that are designed to "offset the greater risk to the swap dealer… and the financial system rising from the use of swaps that are not cleared."[15] At the least, therefore, the capital requirements for swap dealers should take into account the protections already in place with respect to cleared transactions.

Furthermore, 8 percent of all required margins can easily generate an inflated number if the positions are held across multiple clearinghouses and counterparties. While the positions may very well offset from a market risk perspective, the initial margin generally does not recognize similar positions across counterparties and clearinghouses. To rectify this, we recommend that if the Commission deems a charge to be necessary, it be applied on an internal portfolio margining basis.

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For all of the above reasons, we submit that the Proposed Rulemaking would present a significant and unnecessary barrier to entry that would likely render it uneconomic for many existing and aspiring swap dealers. As such, the rules are not the least anti-competitive means of achieving the purposes of the Act. In moving toward the adoption of final rules, we encourage the Commission to adopt capital requirements that more readily take into account portfolio margining, cleared instruments and financial models.

As evidenced in the futures markets, a broad and diverse group of liquidity providers enhance liquidity and price discovery and make markets deeper and safer. We ask the Commission to take special note of this as many banks have reduced, and may continue to reduce, the liquidity that they provide swaps markets. The Commission has the opportunity

[15] 7 USC § 6s(e)(3).

at this time to modernize the approach to capital requirements by recognizing the actual risks associated with swaps, both cleared and uncleared, for the benefit of all market participants.

If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Joanna Mallers (jmallers@fia.org).

Respectfully,

FIA Principal Traders Group

Joanna Mallers
Secretary

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