ISDA Safe, Efficient Markets

May 15, 2017

Submitted Electronically

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 201581

Re: Capital Requirements for Swap Dealers and Major Swap Participants (RIN 3038-AD54)

Dear Mr. Kirkpatrick:

The International Swaps and Derivatives Association, Inc. (ISDA)[1] appreciates the opportunity to comment on the above-referenced notice of proposed rulemaking (the Proposal) published by the Commodity Futures Trading Commission (the CFTC), which would implement capital requirements for swap dealers and major swap participants (MSPs) that are not subject to capital rules of a U.S. prudential regulator[2] (referred to herein as "covered entities"), as well as financial reporting and recordkeeping requirements for all swap dealers and MSPs.

ISDA and its members welcome the opportunity to comment on the Proposal and support the CFTC's goals of protecting the safety and soundness of swap dealers and MSPs, while also taking into account the diverse nature of entities participating in the swaps market and the existing capital regimes that apply to these entities and/or their financial group.

Our comments below address the following key issues:

- Several aspects of the Proposal, including in particular the proposed processes for substituted compliance and model approval, would likely pose logistical issues that could affect covered entities' ability to comply with new capital requirements. As discussed

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 67 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and depositories, as well as law firms, accounting firms and other service providers. Additional information on ISDA is available at www.isda.org.
[2] The U.S. prudential regulators include the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

below, we support a presumption of substituted compliance for Basel Committee on Banking Supervision (BCBS) jurisdictions and a streamlined process for model approval that leverages approval by other regulators and that allows for sufficient time to review all models submitted.

- We commend the CFTC for proposing different requirements for different types of covered entities. However, we believe that even as drafted, the Proposal could result in competitive disadvantages among covered entities and would likely result in competitive disadvantages between covered entities and other swap dealers. Accordingly, we urge the CFTC to harmonize, to the maximum extent appropriate, capital requirements for covered entities with final capital requirements established by other domestic and foreign regulators of swap dealers and MSPs.
- As discussed below, several aspects of the Proposal, including in particular the requirement to hold capital for 8% of initial margin requirements for uncleared and cleared swaps, could result in a concentration of exposure among fewer counterparties and disincentivize central clearing for derivatives in contradiction of the 2009 G20 commitment. We therefore urge the CFTC to reconsider whether a flat 8% calculation is appropriate and also reconsider whether any such calculation should apply to cleared swaps.
- The Proposal's reporting requirements raise a number of logistical and technical compliance issues and apply to an overly broad data set. As noted below, ISDA and its members would welcome the opportunity to learn more about the CFTC's objectives in proposing these requirements and engage with the CFTC to best determine how swap dealers and MSPs could satisfy such objectives in a way that is less burdensome.

Substituted Compliance

ISDA is very focused on ensuring appropriate substituted compliance across all aspects of derivatives regulatory reform efforts in all relevant jurisdictions.[3] Of all derivatives reforms, substituted compliance for capital requirements may be most important. Reforms at the BCBS level are meant to establish global capital standards so that compliance in multiple jurisdictions is unnecessary. ISDA and its members therefore strongly support the substituted compliance contemplated by §23.106 of the Proposal.

ISDA does have concerns, however, regarding whether the Proposal's process for determining substituted compliance is appropriately streamlined and efficient. We believe that any final rulemaking should include a presumption that capital regimes in jurisdictions that are BCBS members are comparable for purposes of determining "whether a foreign jurisdiction's capital adequacy and financial reporting requirements and related financial recordkeeping and reporting requirements for swap dealing financial intermediaries are comparable to the CFTC's corresponding capital adequacy and financial recordkeeping and reporting requirements" under §23.106(a)(3). §23.106 of the Proposal sets out several factors for the CFTC to consider when

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[3] *See e.g.*, Letter from ISDA to the CFTC dated December 19, 2016 regarding Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants.

making substituted compliance determinations, including the scope and objectives of the requirements, comparability to BCBS standards and other standards applicable to securities brokers or dealers, comparability of outcomes achieved by the requirements, the ability of relevant regulatory authorities to supervise and enforce compliance with the requirements and anything else the CFTC deems relevant. We maintain that such an analysis would be redundant and unnecessary for BCBS jurisdictions because one of the primary purposes of negotiating capital requirements at the BCBS level is to ensure consistent objectives, outcomes and enforcement of such requirements. Accordingly, as stated above, substituted compliance should be presumed for covered entities subject to capital requirements in BCBS jurisdictions unless the CFTC determines that the requirements are not in fact comparable.

In addition, if the CFTC does have to undertake a detailed review of the capital requirements in a foreign jurisdiction, covered entities subject to such capital requirements should not be penalized because of the time required for the CFTC's review. Substituted compliance should be presumed until the CFTC's review is complete to avoid unnecessary duplication of regulatory requirements and unnecessary burdens on covered entities.

Model Approval

As part of its capital advocacy globally, ISDA has consistently supported appropriate use of risk-based internal models. Accordingly, we strongly support the Proposal's inclusion of a model-based approach and the CFTC's statement in the preamble that internal models "can provide a more effective means of measuring economic risk from complex trading strategies involving uncleared swaps and other investment instruments."

As a result of the relatively punitive nature of the Proposal's standardized rules-based approach, we estimate that most, if not all, covered entities will elect to use internal models. Due to the varying nature of currently registered swap dealers and the complexity of capital models, we have serious concerns regarding whether the National Futures Association (NFA)[4] has the resources that would be required to approve potentially 50 or more different models in accordance with the requirements in §23.102 of the Proposal.

In the preamble to the Proposal, the CFTC notes that it expects a prudential regulator's or foreign regulator's review and approval of capital models that are used throughout the corporate family to be a significant factor in the NFA's determination of the scope of its review, provided that appropriate information would be available to the CFTC and the NFA. We support this deference to previously-approved models but strongly believe that any final rulemakings should go further. Specifically, we believe that any final rulemakings should provide for recognition of models used throughout corporate families if such models have been approved by the U.S. prudential regulators, the U.S. Securities and Exchange Commission (SEC) or foreign regulators

[4] In the Proposal the CFTC permits use of internal models that have been approved by the NFA or another registered futures association of which the covered entity is a member.

in BCBS jurisdictions,[5] provided that the relevant regulator has ongoing periodic assessment power with regard to the model and provides the CFTC and the NFA with appropriate information.[6] Additional approval by the NFA of these models would be redundant and overly time consuming without furthering the Proposal's policy objectives of protecting the safety and soundness of swap dealers and MSPs.

In addition, we believe that the model approval process for models that the NFA does have to review should be significantly streamlined in any final rulemakings. Based on experience with model approval for capital models in the U.S. and in foreign jurisdictions, as well as with model approval for the initial margin model used for uncleared swaps, model approval could require the full-time attention of multiple staff over multiple years. We therefore believe that Appendix A to §23.102 should be amended to ensure that the NFA's model approval process is outcome based and focused strictly on the model's ability to accurately account for relevant risks and achieve the Proposal's objectives.

Finally, we believe that it is crucial for the effective date of any final regulations to account for the time that NFA will require to approve models, which, as discussed above, will likely involve unprecedented resources and complexity. In the alternative, all models submitted should be deemed "provisionally approved" while under review by the NFA. In no event should covered entities be required to use the Proposal's standardized rules-based approach while awaiting model approval.

Harmonization with the SEC

Harmonization between any final capital requirements imposed by the CFTC for covered entities and the SEC's *final* capital requirements for security-based swap dealers is crucial. Such harmonization must be with respect to both the substance and effective dates of the two sets of requirements. ISDA is highly engaged in advocating for consistency between the CFTC's and the SEC's derivatives reforms generally. While we maintain that such consistency across all aspects of derivatives regulatory reform is vital to a functioning derivatives market in the United States, harmonization across capital requirements may be most crucial. It is hard to envision any material benefits of subjecting a domestic entity to two different sets of capital requirements by two domestic regulators.

We commend the CFTC for considering the SEC's proposed capital requirements but we note that the industry submitted a number of material comments to the SEC's proposal, none of which the CFTC incorporated in the Proposal. We hope that both the SEC and the CFTC will incorporate these comments in any final rulemakings. In order to do so, we believe the CFTC must re-propose at least the Net Liquid Assets Approach portion of the Proposal once the SEC

[5] This would include both a covered entity's internal models that have been reviewed and approved, and are currently subject to supervision, by the U.S. prudential regulators, the SEC or foreign regulators in BCBS jurisdictions, as well as internal models used by a member of the covered entity's affiliated banking group if such models have been reviewed and approved, and are currently subject to supervision, by the U.S. prudential regulators, the SEC or foreign regulators in BCBS jurisdictions.
[6] Such information would include copies of regulatory approvals evidencing review, approval and supervision of the internal models, to the extent permitted by applicable law.

finalizes its capital requirements. Otherwise, covered entities would not have a meaningful opportunity to comment on the applicable requirements. As a general matter, we urge the CFTC to work with the SEC to ensure harmonization of final capital requirements. It would be hugely problematic for capital requirements to result in competitive disadvantages between security-based swap dealers and swap dealers.

In addition to the foregoing, we urge the CFTC to coordinate with the SEC to establish a clear and transparent plan that would avoid duplicative regulation of covered entities that are dually registered with both the CFTC and SEC. As noted above, such duplication would be costly, confusing and operationally challenging without advancing the Proposal's policy objectives or the safety and soundness of U.S. derivatives markets.

Coordination with the U.S. Prudential Regulators

Reliance on prudential regulators' RWA standards. Per statute, any capital requirements promulgated by the CFTC would not apply to swap dealers or MSPs that are subject to capital requirements of a U.S. prudential regulator. Under § 101(a)(1)(i)(B) of the Proposal, swap dealers not subject to such capital requirements could elect to be governed by the U.S. prudential regulators' risk-based capital standards. We support this approach, which would advance the statutory mandate of adopting "comparable" regulatory capital requirements "to the maximum extent practicable."[7]

The U.S. prudential regulators' risk-based capital standards, which are grounded in BCBS standards, may evolve in the coming years in response to changes in BCBS standards and implementation of such revised standards in the United States.[8] To ensure harmonization, we recommend that the CFTC's capital rule incorporate by reference the risk-weighted assets (RWA) methodologies contained in the Board of Governors of the Federal Reserve System's Regulation Q (Regulation Q) without any modifications by the CFTC.

This approach has several clear advantages. First, it would ensure comparability in RWA calculations between swap dealers that are subject to capital requirements of a U.S. prudential regulator and swap dealers that are not. Second, it provides the CFTC with immediately available RWA methodologies, avoiding the need for the CFTC to engage in further detailed technical rulemakings that would necessarily delay adoption of capital requirements. Third, it would ensure that the CFTC's RWA standards remain consistent with those of the U.S. prudential regulators in the future, because any revisions to RWA methodologies in Regulation Q would automatically flow through.

CET1 requirement. The Proposal would require swap dealers to meet an effective regulatory capital requirement of 9.6% CET1, which results from application of the 120% early warning standard to an 8% CET1 minimum. The Proposal includes no analysis to justify or explain this calibration, which is well in excess of risk-based capital standards imposed by the

[7] 7 U.S.C. § 4s(e)(3)(D)(ii).
[8] See BCBS, Press Release: "The Chairman of the Basel Committee reaffirms commitment to finalise post-crisis Basel III reforms" (Mar. 2, 2017).

U.S. prudential regulators. Recognizing that the CFTC may wish to include an "early warning" threshold in its capital rules for swap dealers, we recommend that the CFTC set the CET1 requirements for swap dealers at 6.5% (early warning) and 4.5% (regulatory minimum), which would align the CFTC's standards with the "well capitalized" and "adequately capitalized" standards in the U.S. prudential regulators' risk-based capital rules.[9] On these issues, we support Section IV.E. of the comment letter dated May 15, 2017, submitted in response to the Proposal from the Securities Industry and Financial Markets Association (SIFMA).

8% Initial Margin Minimum Capital Requirements Generally

ISDA urges the CFTC to reconsider the Proposal's requirements to hold capital against 8% of aggregate initial margin requirements for cleared and uncleared swaps. We question this calculation from a policy perspective, as it is not based on principles of prudential regulation and could in fact incentivize market behavior that is contrary to sound risk management. In particular, aggregate initial margin does not account for the offset in market risk between different counterparties. Requiring covered entities to hold capital based on such a calculation could therefore incentivize covered entities to limit the number of counterparties with whom they transact, which could in turn result in significant exposure concentrations among a few large counterparties.

We assume that the 8% of aggregate initial margin requirement is based on the requirement applicable to futures commission merchants (FCMs). However, we believe that the risks that such a requirement is intended to address are less applicable to other covered entities that do not clear swaps for customers and, to the extent such risks are applicable to these covered entities, we believe that other aspects of the CFTC's proposed capital requirements account for the risks. In particular, we believe that the 8% margin standard plays no role under the Proposal's bank approach, which is based on bank-style RWA calculations.

Treatment of Cleared Swaps

To the extent that the CFTC maintains capital requirements based on a covered entity's initial margin requirements, ISDA urges the CFTC to reconsider whether it is appropriate for such requirements to apply to cleared swaps. Applying the same calculation to initial margin for cleared and uncleared swaps ignores the risk mitigation aspects of derivatives clearing and, in turn, does not advance the 2009 G20 commitment to central clearing. Moreover, we note that the CFTC's statutory mandate is limited to setting capital requirements to address the risk of *uncleared* swaps.[10]

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[9] 12 C.F.R. §§ 6.4(c)(1)(iii), 6.4(c)(2)(iii) (OCC); 12 C.F.R. §§ 208.43(b)(1)(iii), 208.43(b)(2)(iii) (Federal Reserve); 12 C.F.R. § 324.403(b)(1)(iii) (FDIC).

[10] Then Commissioner (now Acting Chairman) Giancarlo emphasized this point in his statement in Appendix 3 to the Proposal and also noted that in its final swap dealer definition rule, the CFTC said it will "in connection with the promulgation of final rules relating to capital requirements for swap dealers and major swap participants, consider institution of reduced capital requirements for entities or individuals that fall within the swap dealer definition and that execute swaps only on exchanges, using only proprietary funds."

Additionally, we believe that the CFTC should reconsider whether the Proposal's market risk charges for cleared swaps are appropriately calibrated to recognize the risk mitigation benefits of central derivatives clearing. Among other things, we believe that market risk charges for cleared swaps should be computed based on related CCP initial margin requirements as opposed to notional amounts.

Liquidity Requirements

On liquidity issues, we support Section IV.H. of the SIFMA comment letter dated May 15, 2017, submitted in response to the Proposal.

Implications for Smaller Swap Dealers if the *De Minimis* Threshold Level Falls to $3 Billion

As noted in previous comments to the CFTC, ISDA does not support a lower *de minimis* threshold for swap dealers. At this time, it is extremely difficult, if not impossible, to predict what the Proposal's implications would be for smaller swap dealers. Therefore, in the event that the CFTC does lower the *de minimis* threshold, we maintain that the CFTC must reexamine its regulations applicable to swap dealers, including capital requirements, and make appropriate adjustments.

Recordkeeping, Reporting and Notification Requirements

ISDA and its members have a number of concerns regarding the financial recordkeeping, reporting and notification requirements in §23.105 of the Proposal. In general, we find these requirements duplicative of requirements under other regulations, including the reporting requirements set by U.S. prudential regulators and foreign prudential regulators. To address this duplication, we believe that §23.105(p) of the Proposal should be revised to allow prudentially regulated swap dealers to submit to the CFTC the financial reports that they currently submit to their primary regulator, as and when they submit such reports. Requiring these swap dealers to follow different reporting requirements and/or submit financial reports to the CFTC earlier than they submit such reports to their primary regulators would be extremely disruptive without providing any material benefit to the CFTC.

If the CFTC does not accept the substituted compliance approach described above, we believe that at a minimum, the CFTC should allow prudentially regulated non-U.S. swap dealers to provide an unaudited "convenience" translation of the consolidated financial reports that they deliver to their home jurisdiction primary regulator, at the time they provide such reports. These translations would maintain the applicable local accounting standard (*e.g.*, IFRS) and not require conversion to GAAP, as such a conversion would impose significant costs on non-U.S. swap dealers without providing a material benefit to the CFTC. In preparing the translations, non-U.S. SDs could convert local currency into U.S. dollars based on an agreed upon exchange rate on a specific date, which could be consistent across all non-U.S. swap dears.

Separately, we do not think that any reporting requirements should apply to legacy swaps or uncleared swaps that are not subject to margin requirements set by either the CFTC or the U.S. prudential regulators because any such requirements would be contrary to the policy objectives underlying the exemptions and exceptions to the uncleared margin requirements. We also have several technical concerns regarding the Proposal's recordkeeping, reporting and notification requirements, including in particular how to differentiate between specific transactions for purposes of the required margin reporting. This is because the defined calculations in the Proposal are solely mapped onto trades included in initial margin calculations, which we believe would be problematic for all swap dealers and major swap participants, including in particular, smaller swap dealers that likely do not have processes in place to extract such information. To address this concern, we believe that such reporting requirements should apply only to transactions related to initial margin requirements.

Finally, we note that the reporting requirements cover information about specific counterparties, which raises privacy concerns in a number of non-U.S. jurisdictions, including non-U.S. jurisdictions in which registered swap dealers currently do business. In these jurisdictions, swap dealers would be precluded legally from providing the requisite information.

To address the foregoing more holistically, ISDA would welcome the opportunity to learn more about the CFTC's objectives in proposing the new recordkeeping, reporting and notification requirements and engage with CFTC staff to determine how the industry could satisfy such requirements in a less duplicative and burdensome way. One plausible alternative may be a streamlined set of reporting requirements that are specific to initial margin for uncleared swaps and only apply to entities required to collect such initial margin.

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We appreciate the opportunity to comment on the Proposal and look forward to working with the CFTC as it continues to consider appropriate capital requirements for covered entities. Please contact me, Assistant General Counsel Ann Battle (202-683-9333) or Head of U.S. Public Policy Chris Young (202-683-9339) if you have any questions.

Steven Kennedy
Global Head of Public Policy