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U.S. Commodity Futures Trading Commission

Open Meeting

Provided by:

DeltaStrategy Group

OVERVIEW

For questions on the note below, please contact Kevin Batteh or Daniel Austin at (202) 547-3035.

Yesterday, the U.S. Commodity Futures Trading Commission (CFTC or Commission) held an open meeting to consider the following items: (1) Final Rule: Capital Requirements for Swap Dealers (SDs) and Major Swap Participants (MSPs); and (2) Proposed Rule: Margin Requirements for Uncleared Swaps for SDs/MSPs.

Key Takeaways

- The Commission approved by a vote of 3-2, with Commissioners Behnam and Berkovitz dissenting, to approve the final rule establishing capital requirements for SDs/MSPs. The final rule would provide SD registrants a choice of three methods to calculate their capital: (1) a bank-based approach; (2) a net liquid asset measure; and (3) a tangible net worth method for SDs primarily engaged in non-financial activities at the parent level.

- The rule provides a provisional process that allows an SD to submit an application to the Commission, while notifying the National Futures Association (NFA) as well, that it will be availing itself of an already-approved capital model. This will allow the NFA to focus its attention on the 12-14 SDs that could seek internal model approval with the NFA.

- The compliance date for the final rule is October 6, 2021, giving SDs/MSPs over 14 months to comply.

- Chairman Tarbert said the Commission was not prepared to vote on the proposed margin rules scheduled for today, and it will instead consider them through the seriatim process over the next few weeks. The Commission received a presentation on the proposals from CFTC staff, which included amendments to the definitions of material swaps exposure (MSE) and minimum transfer amount (MTA) and an alternative method for calculating initial margin that must be collected from the counterparty.

SUMMARY

Opening Statements

Chairman Heath Tarbert

Today, we will consider two important matters arising under Part 23 of our regulations. While the Commission is not prepared to vote on the margin rules, we will hear a staff presentation on these proposals, which we will consider in the seriatim process over the next few weeks. We are holding these presentations today to further transparency into our work.

We are a decade and a day from Dodd-Frank's signing into law. Amidst the changes since then, there has been an absence of capital requirements for SDs/MSPs for which the CFTC is responsible. Today, we are finalizing this capital rule and moving towards achieving our goal of full Dodd-Frank implementation.

The final rule is good for our markets and is designed to mitigate against systemic risk and further customer protections. Capital requirements are needed to ensure our markets can survive new difficulties.

Fifty-six of the 108 registered SDs with the CFTC will be subject to our capital rules, and all of the final rule's provisions are designed to provide flexibility for SDs to comply with our rules.

Commissioner Brian Quintenz

The capital rule is the capstone for the CFTC to appropriately calibrate our Dodd-Frank rules. Capital is designed to give the marketplace as a whole confidence that the market can survive volatile circumstances. If capital costs are too expensive, firms will restrict certain activities, perhaps exiting the markets altogether, leading to less liquidity, more concentration, and less competition. Finalizing capital requirements is the most consequential rulemaking of the post-crisis reforms.

Commissioner Rostin Behnam

Yesterday marks the ten-year anniversary since Dodd-Frank's enactment. We must keep the lessons we learned in the wake of the 2008 financial crisis in mind as we confront new challenges. There have been multiple iterations of a capital rule, going back to 2011, but today marks the first time the Commission is prepared to vote on a final rule.

Commissioner Dawn Stump

The rules we and our predecessors adopt require frequent review so that the regulations we put in place can change with the times. I anticipate the final rule will be subject to the same scrutiny with which we review rules that were passed in the wake of the financial crisis.

Commissioner Dan Berkovitz

The absence of swap market transparency and regulation led to the financial crisis. Since 2010, the CFTC has made much progress in implementing its Dodd-Frank rulemakings. Unfortunately, the rules we are considering over the next two days either confirm the status quo or cutback on the progress that has been made since the crisis. A global pandemic is no time to weaken our financial regulations.

Financial markets are currently facing their most difficult challenge since the financial crisis. The derivatives markets have experienced severe volatility and price extremes, but they have continued to serve their essential functions because our Dodd-Frank rulemakings helped make these markets more robust and resilient.

Capital Requirements for SDs and MSPs

Staff from the Division of Swap Dealer and Intermediary Oversight (DSIO)

The final rule would implement provisions from Dodd-Frank that direct the Commission to adopt regulations for capital requirements for SDs/MSPs. Each SD/MSP for which there is not a prudential regulator must meet the Commission's capital requirements. The Commission first proposed capital rules in 2011, and in 2016, it re-proposed a more refined ruleset. Finally, in 2019, the Commission reopened the comment period and requested specific comments on the 2016 re-proposal.

The 56 SDs that will be subject to the CFTC's capital requirements represent a diverse set of firms. SD registrants are offered a choice of three methods to calculate their capital: (1) a bank-based approach; (2) a net liquid asset measure; and (3) a tangible net worth method for SDs primarily engaged in non-financial activities at the parent level. Each approach allows for the use of internal models, if they are approved by the Commission or NFA.

Commercial SDs and MSPs will be permitted to file quarterly, unaudited financial reports as opposed to monthly reports required for other SDs. SDs will continue to be subject to a general liquidity requirement under existing regulations.

The rule provides a compliance date of October 6, 2021, giving SDs/MSPs over 14 months to comply with the final rule.

Discussion and Questions

Chairman Tarbert

Q & A

Explain the current CFTC capital requirements in effect for SDs. *DSIO:* There is currently no such CFTC capital requirement for SDs/MSPs.

Explain why the net liquid asset approach uses a two percent calculation. *DSIO:* There is a difference between the calculations that warrant a different approach. The starting point to measure capital under each approach is consistent. Under the net liquid asset approach, there is a series of adjustments to the capital, including excluding illiquid assets and fixed assets; it is being narrowed down to the absolute, current liquid assets. There are also market risk charges applied to reduce the amount of capital compared to the risk-margin amount.

For the bank-based approach, is that the well-capitalized amount under Basel? *DSIO:* Yes, we are going for the well-capitalized regime, which is higher than the current minimum for banks.

Did Congress require a quantitative liquidity requirement? *DSIO:* No, but we have liquidity requirements currently in effect elsewhere in our regulations.

Explain the model approval process and NFA's anticipated role. *DSIO:* The rule would allow an SD to submit its capital calculation model to the NFA for approval, and the Commission will conduct a determination that the NFA decision is consistent with the CFTC's approach. If we find NFA's finding to be consistent, we would issue a letter, so that the public could be aware of this decision. There would be a separate process whereby an SD with a capital model approved by a prudential regulator, the SEC, or foreign regulator could certify to the CFTC that its capital model meets other regulatory requirements.

Commissioner Quintenz

The prior capital proposals would have had a highly-negative impact on an end-user's ability to hedge. If any of the Commission's prior capital proposals had been in place during the pandemic, there would have been a lot more bankruptcies and less access to derivative markets.

Today's capital rule establishes a firm foundation for future rules. In the future, I hope the Commission will address the standardized risk charges and work with the SEC to better calibrate these charges. I also hope that the Commission will begin to recognize additional forms of collateral.

Q & A

Is the net liquid asset calculation a more restrictive form of capital? *DSIO:* Yes.

Why were proprietary cleared swaps removed from the risk margin amount? *DSIO:* They are accounted for in the rule. The minimum capital level is an absolute floor that an SD would have to meet. If we did not have a floor, it does not mean a SD does not have to have capital. All of the cleared transactions are still subject to the market risk charges. There are capital implications for all of an SD's positions.

Commissioner Behnam

Q & A

Describe the thinking behind providing three separate calculation options? *DSIO:* One of the reasons for the three approaches is that Dodd-Frank requires minimum, comparable capital requirements from the U.S. financial regulators. Therefore, we decided to provide the SDs with these three approaches that are comparable to those with the banking regulators and the SEC. We wanted a harmonized approach with the SEC for dual-registrants. The tangible net worth option is reserved for commercial entities.

Have there been any market changes since 2016 that would justify the change from an eight percent to two percent calculation? *DSIO:* There has not been a market evolution, but staff dug into the details as to where and how a net liquid asset margin would apply in scope. This is about calibration, so it will need to be adjusted as we move forward.

Did commenters say eight percent was too high? Was two percent driven in part by our efforts to harmonize our regulations with the SEC? *DSIO:* Yes. Part of the analysis was that the two percent approach would harmonize with the SEC's approach, which is consistent with the statutory language.

Any plans or expectations as to how the Commission or DSIO would conduct its review of the two percent calculation? *DSIO:* Our focus has been to take in data and analyze it. I imagine that our review will be ongoing and develop recommendations through continued oversight. Assessing capital going forward is part of a routine oversight program. Once we begin receiving financial reporting from SDs, that will help us assess the effectiveness of these rules.

Commissioner Stump

Today's final rule sets capital requirements for a subset for SDs, the rest of which are subject to other capital requirements. The rule is applicable to 55 SDs, many of which are non-U.S. financial entities. Many types of SDs are registered with the Commission, so it is appropriate to have the various options for calculating capital.

Q & A

How can an SD avail itself of applying and relying upon a capital model previously approved by another regulator? *DSIO:* There is a provisional process that allows an SD to submit an application to the Commission, and notifying the NFA as well, that it will be availing itself of that already-approved model. This will allow the NFA to focus its attention on the 12-14 SDs that could seek internal model approval with the NFA. There is a process by which the Commission will review the NFA's approval process, and DSIO will issue a letter that the determination is comparable to that of the CFTC's if it undertook that process itself. The certification process for existing models is to get firms over the 14-month compliance date.

Commissioner Berkovitz

Q & A

Do you anticipate the bank-based approach will be used primarily by SDs that are bank affiliates? *DSIO:* Yes. There are existing capital requirements, and our requirements could be met by existing capital within a banking organization.

Are there any additional costs associated with the other two capital calculations? *DSIO:* It is fair to assume that any SD, as they currently look, have no or little capital requirements, and any additional requirements will definitely result in increased costs to obtain that capital, even if it is existing capital at the parent level. Allocating capital across an organization does not mean that there are not additional costs.

Why do we not have data on this issue, and what data would be gathered under the final rule? *DSIO:* The financial reporting part of the rule about the capital standard is very important because we currently do not have this specific data. We were missing information about the firm, its capital, and margin.

Margin Requirements for Uncleared Swaps for SDs and MSPs

Staff from DSIO

Staff proposes to amend the definition of MSE to revise the period for calculation of average aggregate notional amount (AANA) to determine if an entity has MSE. September 1, 2021 would be the date of determination of MSE for future years after the phase-in schedule, reducing complexity with different compliance periods.

The second proposed amendment would provide an alternative method for calculating initial margin that must be collected from the counterparty. The amendment would be utilized primarily by covered swap entities (CSEs) that trade with SDs/MSPs.

The third proposed amendment would revise the definition of MTA.

Discussion and Questions

Commissioner Quintenz

Q & A

What types of SDs does DSIO anticipate would benefit from the second amendment? *DSIO:* Commercial firms and end-users of swaps.

Is the MTA proposal consistent with other international regulations? *DSIO:* It would align the CFTC's regulations regarding MTAs with those of the EU.

Commissioner Stump

These proposals will better ensure compliance with our margin rules. The Commission should also consider further revisions to its uncleared margin rules that have impacted a end-users that are a part of the implementation of Phase Six of the uncleared margin rules.

Commissioner Berkovitz

Q & A

Will the amendments to the MSE definition align our regulations with the BCBS-IOSCO timeline? *DSIO:* By conforming the calculation period for AANA and using March, April, May rather than June, July, and August, our rules will be in line with those of BCBS-IOSCO. The U.S. prudential regulators are not opposed to us moving forward in this regard.

Under the MTA amendment, would there be a possibility for less margin or splitting up accounts to avoid margin payments? *DSIO:* There are safeguards in the rule and in existing CFTC rules to prevent this kind of activity.