BETTER MARKETS

March 3, 2020

By Electronic Submission

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

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

Ladies and gentlemen,

Better Markets, Inc. ("Better Markets")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC") re-proposal of certain elements of the 2016 proposal on capital requirements for certain swap dealers ("SDs"), and others, under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] The general conceptual framework that appears to be retained in the CFTC's capital re-proposal would be fundamentally sound. In particular, we commend the CFTC for seeking to account for the continuing domination of the derivatives markets by, and concentration of risks in, dealers affiliated with a mere four U.S. bank holding companies ("BHCs").[3] Better Markets does not object to SD capital requirements reasonably tailored to the business models and market presence of different categories of legal entities competing with these BHCs. In fact, we believe that is reasonable and appropriate, provided safety and soundness and other statutory mandates are met and implemented in a manner that, first and foremost, protect financial resiliency of SDs and the U.S. financial system and fair competition within the markets.

Better Markets does have serious concerns, however, about the re-proposal. More than 140 questions with undisclosed and perhaps unknowable consequences for the capital position of SDs and no

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 Pub. L. 111–203, 124 Stat. 1376 (2010).

3 Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, Third Quarter 2019 (Dec. 2019), available at https://www.occ.gov/publications-and-resources/publications/quarterly-report-on-bank-trading-and-derivatives-activities/files/pub-derivatives-quarterly-qtr3-2019.pdf (noting that "[a] small group of large financial institutions continues to dominate trading and derivatives activity in the U.S. commercial banking system" and that "four large commercial banks represented 87.2 percent of the total banking industry notional amounts and 83.2 percent of industry net current credit exposure").

accompanying rule text or cost-benefit considerations on potential contemplated alternatives appear to open the door to materially, if not dramatically, lower capital requirements relative to those proposed on a bi-partisan basis a mere three years ago.[4] The potential scope and actual application and effect of the re-proposal are highly speculative, however, making meaningful public comment on identifiable regulatory outcomes impossible.

For these reasons, final regulations arising solely from the re-proposal's questions and requests for comment would violate even the minimal procedural requirements for proposed rulemakings under the Commodity Exchange Act ("CEA")[5] and the Administrative Procedures Act ("APA").[6] The CFTC must therefore re-propose specific capital requirements in consideration of the administrative records for the present release and the 2016 capital proposal. This re-proposal should be developed, moreover, only after capital-related financial reporting regulations have been finalized and SD capital reporting has commenced for a short but reasonable period of time. Financial reporting is not the just the best—but the only—practical way for the CFTC to use its agency expertise to assess critical capital-related information with respect to subject SDs (information that the CFTC acknowledges it does not have) without relying on unvalidated SD assertions and claims. Indeed, the CFTC can be confident that capital requirements are attentive to statutory objectives only if the actual application and effect of capital requirements can be assessed through financial reporting provided under penalty of law.

I. Adequate high-quality, equity-based capital protects the safety and soundness of SDs, which, in turn, supports continuity of critical market functions, protects against contagion in the event of an SD failure or near-failure, and safeguards customer property.

The 2008 financial crisis demonstrated that U.S. regulators had for too long permitted financial intermediaries either to remain dramatically undercapitalized or to structure legal entities and/or activities to avoid effective application of capital requirements. Congress therefore[7] enacted CEA section 4s(e) to mandate that the CFTC impose capital requirements on SDs and major swap participants ("MSPs") without a prudential regulator.[8] CEA section 4s(e)(3) specifies that one statutory objective of imposing capital

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[4] See CFTC, Capital Requirements of Swap Dealers and Major Swap Participants, 81 Fed. Reg. 91252 (Dec. 16, 2016), available at https://www.govinfo.gov/content/pkg/FR-2016-12-16/pdf/2016-29368.pdf. The re-proposal solicits comment on potential regulatory language embedded in a small number of the total number of questions, but that language was not proposed as regulatory text within the release nor evaluated with respect statutorily required considerations or its deviation from the 2016 capital proposal. This is unusual, procedurally unsound, unlawful, and perhaps unprecedented for CFTC rulemakings since the adoption of the Dodd-Frank Act, as discussed below. See CFTC, Capital Requirements of Swap Dealers and Major Swap Participants, 84 Fed. Reg. 69664, 69666 (Dec. 19, 2019).

[5] 7 U.S.C. §1 et seq. See, in particular, 7 U.S.C. § 19(a), discussed in Section II below.

[6] 5 U.S.C. §551 et seq.

[7] See Statement of Sen. Christopher Dodd, Cong. Rec., Vol. 156, Issue 104, S5828, S5832 (July 14, 2010) ("Derivatives are vitally important if utilized properly in terms of wealth creation and growing an economy. But what was once a way for companies to hedge against sudden price shocks has become a profit center in and of itself, and it can be a dangerous one as well, when dealers and other large market participants don't hold enough capital to back up their risky bets and regulators don't have information about where the risks lie."), available at https://www.congress.gov/111/crec/2010/07/14/CREC-2010-07-14-pt1-PgS5828.pdf. See also Statement of Sen. Carl Levin, Id at S5842 ("[The Dodd-Frank Act] will bring new transparency and accountability to the shadowy market in derivatives . . . It empowers regulators to establish tough new capital requirements that make it harder for firms to become so big they endanger the stability of the system.").

[8] 7 U.S.C. § 6s(e)(2)(B)(i) (providing that "[t]he Commission shall adopt rules for [SDs] and [MSPs], with respect to their activities as a [SD] or [MSP], for which there is not a prudential regulator imposing—capital requirements"). See also 7 U.S.C. § 6s(e)(1)(B) (requiring SDs and MSPs to comply with such requirements). Because there are no MSPs at this time, our comments focus on the implications of the CFTC's proposal for the 54 SDs that would be subject to elements of the regulations, once finalized.

requirements is "[t]o offset the greater risk to the [SD] and [MSP] and the financial system arising from the use of swaps that are not cleared" and in this regard, requires capital levels that (1) "help to ensure the safety and soundness of the [SD] and [MSP];"[9] and (2) are "appropriate for the risk associated with the non-cleared swaps held as a [SD] or [MSP]."[10] Thus, the CFTC's capital regulations must give special attention to this statutory objective, while addressing other purposes of SD capital regulation, including mitigating risks associated with cleared swaps.[11]

The aims of the CFTC's SD capital regulations should be uncontroversial. To "help to ensure the safety and soundness" of SDs, the CFTC's capital requirements must protect SD legal entities as a going concern by requiring a minimum level of entity-level financial resiliency to ensure SDs can meet obligations to counterparties and creditors in most extreme but plausible market conditions, while accounting for risk mitigants (e.g., initial margin). These capital requirements must provide a loss absorbing buffer that is reasonably tailored to the residual risks *across* SD-related lines-of-business and that reasonably ensures, in actual effect, that SDs can perform on derivatives (and other contracts) and maintain critical functions in the event of a broad deterioration of the SD's assets. This, in turn, prevents disruptions to SD market-making, liquidity, and other functions, limits contagion that otherwise would be attendant to an SD's failure or near-failure, and protects funds and/or securities in the control or custody of the SD legal entity. These protective effects turn on the level of required high-quality equity capital reflected on the SD's balance sheet. But the methodology for discriminating between the capital treatment of certain categories of assets and positions in calculating net capital requirements also must be calibrated to create incentives that diminish the likelihood of financial distress.

For these purposes, the CFTC has been given an independent prudential mandate under the Dodd-Frank Act. As noted above, Congress recognized that capital regulation and related supervisory safeguards for financial institutions proved remarkably inadequate during the 2008 financial crisis, including with respect to investment banks and other non-bank financial intermediaries. Bank prudential regulators have since acknowledged that they failed to address capital inadequacies, contributing to the failure and near-failure (and hundreds of billions of dollars in U.S. taxpayer bailouts) of numerous banking entities, including Citigroup as one of many notable examples.[12] The problem was not merely technical; it was philosophical. For years, in the lead-up to the 2008 financial crisis, prominent bank regulators did not even agree that capital regulations should aim to mitigate systemic risk. Federal Reserve Chairman Alan Greenspan, for example, expressed a view that the "management of systemic risk is properly the job of the central banks" alone and that "banks should not be required to hold capital against the possibility of overall financial breakdown,"[13] presumably even if the banks' trading and other activities greatly increase the

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9 7 U.S.C. § 6s(e)(3)(A)(i).

10 7 U.S.C. § 6s(e)(3)(A)(ii).

11 There are competing purposes or rationales for capital regulation, with some differentiating between the following: (1) safety and soundness and systemic risk concerns relating to those involved primarily in principal trading (designed primarily to prevent failure); and (2) customer protection concerns relating to those involved in agency or customer-directed activities (designed to protect customer property in the event of failure). The CEA, in reality, contemplates both purposes. The specific statutory commands of CEA section 4s(e)(3) focus on the role of SD capital requirements with respect to the former, however: Protecting the safety and soundness of SDs and mitigating potential adverse effects from their uncleared swaps trading activities on the broader financial system.

12 For additional information, see Special Inspector General for the Troubled Asset Relief Program, Extraordinary Financial Assistance Provided to Citigroup, Inc. (SIGTARP 11-002) (Jan. 13, 2011), available at https://www.sigtarp.gov/Audit%20Reports/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf.

13 D. Sicilia, J. Cruikshank, The Greenspan Effect: Words that Move the World's Markets, pg. 202 (2001).

likelihood of that overall "breakdown" occurring. That view reflected prevailing group think. Daniel Tarullo, a post-crisis Federal Reserve Governor, has noted in this regard that "the extensive official Basel committee commentary on the Basel II process" did not cite "prevention of systemic risk as either a rationale for the existence of capital adequacy requirements or as a factor in setting them."[14]

Unsurprisingly, by 2010, Congress thoroughly disagreed with the Greenspan proposition and provided the CFTC a mandate to establish capital regulations not just to limit but "[t]o ***offset*** the greater risk to the [SD] . . . ***and the financial system*** arising from the use of swaps that are not cleared."[15] In other words, the Dodd-Frank Act not only discards the narrow conception of capital adequacy espoused prior to the financial crisis; it divides capital responsibilities between multiple regulators specifically to do the opposite: To protect SDs, as well as "the financial system," from risks associated with SD activities, most especially with respect to uncleared derivatives. **In the new framework, the CFTC has been provided a clear, independent, and unequivocal mandate to establish capital requirements reasonably designed to achieve systemic risk reduction and other public interest objectives, as informed by its unique understanding of the swaps markets and the residual risks in the SDs under its jurisdiction.** For this reason, the CFTC must responsibly implement capital requirements attentive to the risks posed and borne by SDs within its jurisdiction, not the capital requirements designed by other regulators, for other types of entities, and to address other types of risks.[16]

II. The CFTC's proposed framework in the 2016 capital proposal is conceptually rational. However, any final regulation arising from the present re-proposal would be unlawful and must be re-proposed with a basis to assess the actual application and effect of SD capital requirements.

The CFTC proposed to implement SD capital requirements in a conceptionally rational 2016 capital framework, albeit one too heavily reliant on existing capital frameworks applicable to BHCs regulated by the Board of Governors of the Federal Reserve System ("Federal Reserve"), broker-dealers ("BDs") regulated by the Securities and Exchange Commission ("SEC"), and futures commission merchants ("FCMs") regulated by the CFTC. The CFTC's re-proposal suggests that the commission may be considering potentially significant modifications to address SD concerns about elements of that conceptual framework. However, as noted above, the CFTC's re-proposed capital framework remains highly speculative with respect to the regulatory outcomes potentially contemplated by hundreds of questions and requests for comment and remains even more speculative in its actual application and effect, preventing not only meaningful public comment but meaningful assessment of the proposed capital framework by the CFTC itself.

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[14] Daniel K. Tarullo, Banking on Basel: The Future of International Financial Regulation, pg. 22 (2008). Then-Professor Tarullo rightly stated that "systemic [risk] concerns should perhaps not be dismissed so readily in framing capital adequacy requirements." Id.

[15] 7 U.S.C. § 6s(e)(2)(B) (emphasis added).

[16] This is not meant to suggest that the SEC, Federal Reserve, and alternative CFTC capital frameworks are not instructive or that the CFTC should conduct its SD capital rulemaking in a vacuum. The Dodd-Frank Act recognized that providing capital responsibilities to multiple regulators could present competitive and other concerns. CEA section 4s(e)(3)(D) therefore provides that the CFTC, SEC, and prudential regulators "shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements for SDs and MSPs." 7 U.S.C. § 4s(e). That which is not consistent with statutory standards and objectives cannot be "practicable," however, so the CFTC must not entertain a race to the bottom by following, for example, the SEC's inadequate phase-in risk margin capital approach instead of establishing prudent, considered, and lawful SD capital requirements appropriately tailored to CFTC SDs and suited to statutory purposes. See SEC, Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker- Dealers, 84 Fed. Reg. 43872 (Aug. 22, 2019). In addition, the CFTC's administrative record does not include comments responding to other rulemakings published by other agencies, though a number of common industry themes are apparent.

The CFTC's re-proposal violates fundamental CEA and APA procedural requirements intended to promote informed administrative decision-making through public participation in the rulemaking process. These clear statutory violations prevent any final rulemaking from being a logical outgrowth of the re-proposal. For example, the re-proposal contains no evaluation of CEA section 15(a)'s cost-benefit considerations. That statutory evaluation of specific considerations is a requirement designed to ensure that the public has essential information to understand and comment on the implications (literally, specified considerations relating to costs and benefits) of proposed regulations. The complete absence of CEA section 15(a) cost-benefit considerations, as here, fails to meet even the CEA's minimal procedural requirements for consideration of a proposed rulemaking and denies the public a meaningful opportunity to comment on the CFTC's consideration of costs and benefits.

In addition, the re-proposal is comprised of little more than 140 questions and requests for comment, with no specific rule text or accompanying explanations of such text. The questions and request present perhaps thousands of possible combinations of regulatory outcomes relating to more than a dozen categories of capital regulations, all of which arise from proposed regulations originating in a separate rulemaking. This exceptionally wide range of potential regulatory outcomes, along with the lack of proposed regulatory text and CEA section 15(a) considerations, makes the consequences of the re-proposal unknowable, denying the public fair notice of reasonably identifiable regulatory outcomes. Without fair notice, the public cannot meaningfully comment on the public interest consequences and mechanics of the re-proposal.

A. The CFTC's re-proposal fails to properly evaluate specified cost-benefit considerations, as required by CEA section 15(a).

The CFTC's re-proposal of the 2016 Capital Proposal appears intended to increase the potential scope of final regulations that might be considered a logical outgrowth of its previous rulemaking. However, it does so without evaluating the considerations required by CEA section 15(a) and therefore violates even the minimal CEA procedural requirements for valid proposed rulemaking. CEA section 15(a) requires the CFTC to consider the costs and benefits of its "proposed" actions in light of statutorily specified factors or "considerations."[17] That provision, instituted by the Commodity Futures Modernization Act of 2000 ("CFMA"),[18] requires the CFTC to consider its proposed rulemakings "in light of" the following: (1) the "protection of market participants and the public;"[19] (2) the "efficiency, competitiveness, and the financial integrity of futures markets;"[20] (3) "price discovery;"[21] (4) "sound risk management practices;"[22] and (5) "other public interest considerations."[23] Furthermore, CEA section 15(a)(1) instructs the CFTC to evaluate these considerations "[b]efore" a regulation is promulgated under the CEA.[24]

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17 7 U.S.C. § 19(a)(2).

18 Commodity Futures Modernization Act of 2000, H.R. 5660, 106th Cong. § 119.

19 7 U.S.C. § 19(a)(2)(A).

20 7 U.S.C. § 19(a)(2)(B).

21 7 U.S.C. § 19(a)(2)(C).

22 7 U.S.C. § 19(a)(2)(D).

23 7 U.S.C. § 19(a)(2)(E).

24 The statutory exclusions from the cost-benefit considerations requirement include only three specific types of commission actions, which do not include proposed rulemakings. See 7 U.S.C. § 19(a)(3)(A)-(C) (2012).

The CFTC's longstanding proposed rulemaking practices with respect to CEA section 15(a) are instructive. In the context of the CFMA's deregulation of over-the-counter ("OTC") derivatives, CEA section 15(a) was intended to ensure the CFTC evaluates a small number of specified considerations pursuant to a fairly minimal analytical rulemaking requirement.[25] The CFTC's first application of CEA section 15(a) was in a post-CFMA proposed rulemaking, which, unsurprisingly, contained little more than a few paragraphs on less than a single Federal Register page.[26] That is, notably, still more than the CFTC has provided in connection with the current re-proposal. **Without regard to the re-proposal's substance, the CFTC's failure to provide any statutorily required evaluation is per se a violation of CEA 15(a) and would merit judicial invalidation of any final regulations arising from the re-proposal under APA section 706(2)(D)**, which instructs a reviewing court to "hold unlawful and set aside agency action, findings, and conclusions found to be—without observation of procedure required by law."[27] Presumably, that is one reason that we are unable to identify any other proposed rulemaking that completely excised the CEA section 15(a) analysis in this manner.

In addition, soliciting feedback on whether a wide range of potential regulatory outcomes may have costs or benefits is not tantamount to conducting the statutorily required cost-benefit evaluation of a specific proposal. CEA section 15(a) instructs the CFTC to solicit feedback on ***its*** "evaluation" of identified factors,[28] providing the public an opportunity to comment on the CFTC's reasonably identifiable regulatory outcomes and analyses. That must be distinguished from the CFTC's request for the public to provide its own cost-benefit evaluation. Moreover, the CFTC's re-proposal contains no actual rule text or preamble explanations of that text, except as provided in a previous rulemaking, further impeding the public's ability to conduct a meaningful cost-benefit analysis on identifiable regulatory outcomes. This also is not a case where Congress' irrefutable mandate excuses the cost-benefit evaluation. The CEA section 15(a) concern is not *whether* the CFTC seeks to impose *some* regulatory minimum for capital—that much is clear—but whether the requirements it seeks in the re-proposal are consistent with the CEA's objectives and requirements and a product of a reasoned administrative decision-making. The re-proposal cannot meet these standards if the final regulations are not informed by public comment on the CFTC's evaluation of cost-benefit considerations.

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[25] It is well established that CEA section 15(a) does not require the CFTC to conduct a rigorous or quantitative cost-benefit analysis for its proposed rules. The D.C. Circuit has explained, for example, that "[w]here Congress has required 'rigorous, quantitative economic analysis,' it has made that requirement clear in the agency's statute, but [that] it imposed no such requirement [in the Commodity Exchange Act]." Inv. Co. Inst. v. Commodity Futures Trading Comm'n, 720 F. 3d 370, 379 (D.C. Cir. 2013). It is equally well established that an agency's duty to "consider" factors affords the agency wide discretion in how it approaches that task. The U.S. Supreme Court has explained, when statutorily mandated "considerations" are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion." Sec'y of Agriculture v. Cent. Roig Refining Co., 338 U.S. 604, 611-12 (1950). Nevertheless, Section 15(a) is a mandatory obligation, and it is an especially important one in that it requires the CFTC to evaluate proposed rules in light of factors or considerations that are highly relevant to the agency's public interest mandate.

[26] CFTC, A New Regulatory Framework for Trading Facilities, Intermediaries, and Clearing Organizations, 66 Fed. Reg. 14262, 14267 (Mar. 9, 2001), available at https://www.govinfo.gov/content/pkg/FR-2001-03-09/pdf/01-5618.pdf (noting that "[a]fter considering these [CFMA] factors, the Commission has determined to propose the revisions to its rules discussed above").

[27] 5 U.S.C. § 706(2)(D). The CFTC has issued internal guidance for CEA section 15(a)'s application to proposed and final regulations. See, e.g., CFTC, Guidance on and Template for Presenting Cost-Benefit Analyses for Commission Rulemakings (September 29, 2010); CFTC, Staff Guidance on Cost-Benefit Considerations for Final Rulemakings under the Dodd-Frank Act (May 13, 2011). Neither guidance document permits complete omission of CEA section 15(a) considerations in the context of a lengthy rulemaking proposing numerous alternatives with respect to capital regulations having the potential to seriously impact the financial stability of the U.S. financial system.

[28] 7 U.S.C. § 19(a)(1) (providing that "***the Commission shall consider the costs and benefits of [its]*** **actions**" and requiring such costs and benefits be evaluated in light of specified considerations).

The case law interpreting CEA section 15(a) is consistent with this view. In Investment Company Institute v. CFTC, for example, the D.C. Circuit upheld a CFTC rulemaking over a notice challenge relating to an alleged lack of sufficient cost-benefit analysis, in part because the proposed rulemaking "included a separate section entitled 'Cost-Benefit Analysis' that gave adequate notice to the CFTC's approach to the cost-benefit analysis by setting forth the factors that CFTC would consider and summarizing expected costs and benefits."[29] It is quite doubtful that the D.C. Circuit would have arrived at that conclusion in reviewing the record for final regulations arising from the present rulemaking, given the complete absence of that section and any identifiable cost-benefit evaluation. Indeed, as mentioned, the CFTC has not provided a single word addressing costs or benefits in concrete terms, much less set forth reasonably identifiable regulations.[30]

Thus, the CFTC has proposed a vast, and perhaps indeterminable, array of potential policy outcomes without a rulemaking section addressing statutory cost-benefit considerations. In doing so, it has deviated from longstanding administrative practice at the agency and failed to meet its minimal statutory obligation to "evaluate" the costs and benefits of its proposed rulemakings in light of statutorily specified "considerations." This is not a close call. The CFTC has provided literally no evaluation of the statutory factors set forth by Congress, much less an evaluation of SD safety and soundness and systemic risk implications arising from potentially dramatic changes to the previously proposed SD capital framework. The legal deficiency of the re-proposal is therefore hardly in need of lengthy exposition. Any final regulations arising from the re-proposal would be unlawful; therefore, the CFTC must properly re-propose its capital regulations with a CEA section 15(a) analysis relating to reasonably identifiable regulatory outcomes.

B. The CFTC's re-proposal fails to provide fair notice and a meaningful opportunity to comment on an identifiable regulatory outcome.

The CFTC's re-proposal fails to meet statutory requirements for informal rulemaking under APA section 553[31] and applicable case law. When engaging in informal[32] rulemaking, the CFTC must provide the public sufficient notice of statutorily specified information, including the "terms or substance" of proposed rulemakings or "a description of the subjects and issues involved."[33] This notice requirement is intended to ensure interested members of the public have an opportunity to meaningfully comment on proposed rulemakings.[34] The CFTC must judge the adequacy of notice on whether a proposed rulemaking

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29 Inv. Co. Inst. v. CFTC, 720 F.3d 370, 379 (D.C. Cir. 2013) (upholding a largely qualitative consideration of costs and benefits).

30 Judicial review of that statutory violation undoubtedly would lead reviewing courts to invalidate any final rulemaking. The U.S. Supreme Court case most cited to limit judicial review of allegedly improper rulemaking procedures, Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council Inc., for example, clearly contemplates exacting judicial review where courts endeavor to scrutinize whether agencies, like the CFTC, appropriately followed explicit statutory processes. In other words, the courts would have a duty to ensure that the CFTC considered costs and benefits and complied with the explicit and minimal procedural requirements of the CEA section 15(a) statutory mandate.

31 5 U.S.C. § 553.

32 For a brief but useful description of different APA rulemaking processes, see T. Garvey, A Brief Overview of Rulemaking and Judicial Review, Congressional Research Service (March 27, 2017), available at https://fas.org/sgp/crs/misc/R41546.pdf.

33 5 U.S.C. § 553(b)(3).

34 5 U.S.C. 551 et seq. The APA requires federal agencies to provide to the public notice and an opportunity to comment on regulatory proposals. 5 U.S.C. § 553(b). More specifically, it directs federal agencies to give interested persons an opportunity to participate in rulemakings through the submission of written data, views, or arguments to be considered in the agency's

provides information "sufficient to fairly apprise interested parties of the issues involved, so that they may present ***responsive data and argument*** relating thereto."[35] The Attorney General's Manual on the APA has for decades interpreted the APA's informal rulemaking provisions to require notice that is "sufficiently informative to assure interested persons an opportunity to participate intelligently in the rule making process."[36]

The courts have held that judicial examination of the sufficiency of notice must be informed by the APA's fundamental purposes: (1) to ensure regulations are tested via exposure to diverse public comment; (2) to ensure fairness to affected parties; and (3) to give affected parties an opportunity to develop evidence in the record to support their objections to the rule and thereby enhance the quality of judicial review.[37] Noting that good process can affect the quality of rulemaking outcomes, the courts also have been guided by the principle that a fair opportunity to comment requires agencies to maintain "a flexible and open-minded attitude towards [their] own rules" and seek requisite information to enable informed administrative decision-making.[38]

Hundreds of interrelated questions and requests for comment with the potential to impose an exceptionally wide range of SD capital requirements are not possible to meaningfully comment on. The SD capital requirements are among the most consequential derivatives reforms in Title VII of the Dodd-Frank Act, raising issues directly relevant to the CFTC's public interest mandate and the safety and soundness of SDs and the U.S. financial system.[39] For this reason, the APA commands more than the usual opportunity for public participation in the CFTC's re-proposal. The APA's legislative history makes clear that "[matters] of great importance, or those where the public submission of facts will be either useful to the agency or a protection to the public," as here, "should naturally be accorded more elaborate public procedures."[40] That principle supports the fundamental tenet that the public must be afforded a meaningful opportunity to participate in the rulemaking process, which improves administrative decision-making and judicial review.

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deliberative process. 5 U.S.C. § 553(c). Rulemakings must provide sufficient factual detail on the legal basis, rationale, and supporting evidence for regulatory provisions such that interested parties are "fairly apprised" of content, the reasoning of the agency implementing them, and the manner in which such regulations foreseeably may affect their interests. See, e.g., Mid Continent Nail Corporation v. United States, 846 F.3d 1364, 1373-1374 (Jan. 27, 2017); U.S. Telecom Ass'n v. F.C.C., 825 F.3d 674, 700 (June 14, 2016), citing Honeywell Int'l, Inc. v. E.P.A., 372 F.3d 441, 445 (June 29, 2004); Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 407 F.3d 1250, 1259-1260 (May 24, 2005); Am. Medical Ass'n v. Reno, 57 F.3d 1129, 1132-1133 (June 27, 1995); Florida Power & Light Co. v. U.S., 846 F.2d 765, 771 (May 13, 1988).

35 See S. Doc. No. 79-248, at 200 (1946) (emphasis added).

36 See U.S. Department of Justice, Attorney General's Manual on the Administrative Procedure Act 30 (1947), available at https://archive.org/details/AttorneyGeneralsManualOnTheAdministrativeProcedureActOf1947/page/n29.

37 See, e.g., Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 407 F.3d 1250, 1259 (D.C. Cir. 2005); see also, e.g., American Coke and Coal Chemicals Institute v. E.P.A., 452 F.3d 930, 938 (D.C. Cir. 2006); Envtl. Integrity Project v. E.P.A., 425 F.3d 992, 996 (D.C. Cir. 2005); Prometheus Radio Project v. F.C.C., 652 F.3d 431, 449 (3d Cir. 2011); Home Box Office, Inc. v. F.C.C., 567 F.2d 9, 35 (D.C. Cir. 1977) (stating that the APA's procedural requirements are intended to assist judicial review as well as to provide fair treatment for persons affected by a rule").

38 Fed. Express Corp. v. Mineta, 373 F.3d 112, 120 (D.C. Cir. 2004); McLouth Steel Products Corp. v. Thomas, 838 F.2d 1317, 1325 (D.C. Cir. 1988); see also, e.g., Rural Cellular Ass'n v. F.C.C., 588 F.3d 1095, 1101 (D.C. Cir. 2009) (stating that "[t]he opportunity for comment must be a meaningful opportunity" and that "to satisfy this requirement, an agency must . . . remain sufficiently open-minded").

39 7 U.S.C. § 6s(e)(3)(A)(i)-(ii).

40 See Administrative Procedure Act: Legislative History, S. Doc. No. 248, 259 (1946); See also C. Koch, 1 Administrative Law and Practice 329-30 (2010 ed.).

The CFTC's re-proposal does not meet the most essential APA requirements for a lawful proposed rulemaking, much less one that warrants public comment through "more elaborate" procedures. APA section 553(b), as mentioned, requires each proposed rulemaking to include "either the terms or substance of the proposed rule or a description of the subjects and issued involved."[41] That statutory notice requirement logically ensures the public knows at least the identifiable regulatory outcome it is being asked to comment on and understands the material subjects and issues involved. These elements of APA section 553(b), again, are informed by the administrative law principle that the public must be provided an opportunity for meaningful comment.

While the CFTC cursorily addresses a number of aspects of "the subjects and issued involved" in the re-proposal, it omits other material subjects and issues, including the most critical of all: whether and how the sweeping breadth of potential regulatory outcomes arising from the re-proposal would variously result in <u>actual</u> SD capital <u>levels</u> and incentives that address SD residual risks and statutory objectives (<u>i.e.,</u> the "avoidance of systemic risk"[42] and the "offset[ting] [of the] the greater risk to the [SD] . . . and the financial system arising from the use of [uncleared] swaps"[43]). In the absence of any non-conclusory explanation in this regard, the public is left to divine how a conceptual capital framework—proposed through a combination of multiple rulemakings over the course of multiple years and seeking public comment on multiple individual parts and multiple permutations of those parts—might satisfy the law and statutory policy objectives. That is not consistent with even the APA's minimum commands for proposed rulemakings.

For this reason alone, the re-proposal rightly might be treated as an action in the nature of an advanced notice of proposed rulemaking ("ANPR"). ANPRs, like the present re-proposal, usually set forth numerous complex questions and requests for comments on issues relevant to an agency's statutory responsibilities. They are designed, however, primarily to inform an agency's *future* proposed rulemakings and therefore, can meet a lower standard for sufficient notice and APA-required explanations and bases otherwise mandated for proposed regulations seeking public comment on specific, identifiable regulatory outcomes. In fact, at least one supporting CFTC commissioner appears to have viewed the re-proposal that way, "encourag[ing] commenters to **not limit their potential answers to the examples provided** but instead to **<u>view the request for comment as a non-exhaustive list of options</u>**."[44] That is entirely appropriate for an ANPR "rethinking" the CFTC's "approach to capital."[45] The same CFTC commissioner thoughtfully emphasized that the goal of the re-proposal must be to elicit information that is constructive

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41 5 U.S.C. §553(b).

42 <u>See, e.g.,</u> 7 U.S.C. § 5(b) (providing that one purpose of the CEA is "to ensure the financial integrity of all transactions subject to [the CEA] and the avoidance of systemic risk").

43 7 U.S.C. § 6s(e)(3)(A)(i)-(ii).

44 <u>See</u> CFTC Commissioner Dawn Stump, <u>Statement of Commissioner Dawn Stump for CFTC Open Meeting</u> (Dec. 10, 2019), available at <u>https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement121019</u>:

> I am supportive of the Commission again engaging with the public to receive more timely feedback from affected parties. Much has changed since the 2011 and 2016 proposals concerning capital. We need to solicit a more contemporary snapshot of the issues. The matter before us today provides us with an opportunity to **<u>rethink our approach to capital</u>** and allows us to be more consistent with what other regulators have accomplished. I agree with the need to re-open the comment period and also ask additional questions, but I do that with an open mind and am not presupposing the outcome. **<u>I encourage commenters to not limit their potential answers to the examples provided but instead view the request for comment as a non-exhaustive list of options.</u>**

45 <u>Id</u>.

to properly calibrating the CFTC's capital requirements, concluding that **"[t]he bottom line is that it is time to get this right—if we have to re-propose [the rulemaking], we have to re-propose it**."[46] We agree.

The CFTC's effort developing the re-proposal is not wasted if it is used to develop the administrative record and formulate a subsequent, better informed Notice of Proposed Rulemaking. Many agencies consider comments received in connection with ANPRs to be part of the "whole" administrative record[47] for subsequent proposed and final rulemakings. In any event, the re-proposal's procedural infirmities foreclose any other course of action. The CFTC's consideration of public comments and other information—which we highly recommend include capital-related financial reporting—must be used to develop a proposed framework with some level of CFTC confidence concerning the <u>actual</u> <u>application</u> and <u>effect</u> of proposed capital requirements on SDs. That is the logical, responsible, and only lawful course of action.

This view is reinforced by the fact that the CFTC's re-proposal does not include "the terms or substance of the proposed rule." As mentioned <u>above</u>, the re-proposal includes no specific regulatory text for public comment and omits all of the statutorily required analyses of that specific language and its potential or expected effects. The re-proposal does embed potential modified language in a few questions, on a few issues, scattered throughout the release; and the CFTC appears to solicit public comment on such potential regulatory language embedded in these small number of questions. However, that language is buried in the hundreds of other questions and not formally proposed as regulatory text in an identifiable, stand-alone section, which is a longstanding CFTC and general administrative best practice. Nor was any of that language specifically analyzed for its potential implications and costs and benefits with respect to statutory factors or the effect of its apparent deviation from the 2016 proposal. **These multiple irregularities are procedurally unsound, unlawful, and perhaps unprecedented for CFTC proposed rulemakings since the adoption of the Dodd-Frank Act**, as emphasized by both of the CFTC's dissenting commissioners.[48]

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46 <u>See</u> CFTC Open Meeting, Statement of Commissioner Dawn Stump, at 1:03:28 (Dec. 10, 2019), available at <u>https://www.youtube.com/watch?v=fE0pLs2BgJ0&feature=youtu.be</u>.

47 Generally speaking, judicial review of final regulations is based on the statutory requirement that a court "review the whole record or those parts of it cited by a party" created by the agency whose rulemaking decisions are being reviewed. <u>See</u> 5 U.S.C. § 706.

48 Consider, for example, CFTC Commissioner Rostin Behnam's statement explaining the procedural reasons for his dissent from the re-proposal:

> **<u>Today's action is a reopening of the comment period and a request for comment, rather than a true proposal</u>**, and thus the 2016 Capital Proposal remains the only concrete indicator to the public of the Commission's intentions. If the 2016 Capital Proposal is an extreme overshoot, the appropriate way to provide the public with an opportunity to comment is to issue a reproposal. **<u>Asking further questions, without a clear signal as to where the Commission is going, at the minimum risks further slowing this nearly ten-year effort to finalize a capital rule by adding an unnecessary step to the process in the form of a reproposal at some time in the future</u>**; and at the worst, incites the agency towards an exercise in creative reasoning outside the bounds of process . . .
>
> Too often over the last couple of years, I believe this agency has slowed its own progress by snaking outside clear Administrative Procedure Act ("APA") trajectories and adding unnecessary steps to the rulemaking process. In part, I fear that we are doing the same thing today. The competing threads throughout the Reopening make it harder for the public to discern what the Commission is proposing to do, and will make it more difficult to effectively comment on the existing proposal from 2016. This creates undue risk under the APA, and arguably poisons the well in regard to the reachable goals of this new request for comment . . . **<u>If the 2016 Capital Proposal is an extreme overshoot, and if there are alternative methodologies and</u>**

Because the re-proposal has provided inadequate notice of identifiable regulatory outcomes, it contravenes all of the APA's basic requirements and purposes and cannot provide a basis for a final rulemaking that is a logical outgrowth of the re-proposal. If the CFTC were to move immediately to a final regulation, the public would have been denied an opportunity to provide meaningful comment, preventing the content of such regulations from being tested through exposure to diverse perspectives, data, and analyses and sabotaging the development of an informative administrative record. In turn, that would diminish the quality of eventual judicial review, which requires a "thorough, probing, in-depth review" of the final rulemaking and the administrative record to determine "whether the [CFTC's] decision [in the final rulemaking] was based on a consideration of the relevant factors and whether there has been a clear error of judgment."[49] There is almost no doubt that a reviewing court engaging in that sort of thorough,

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> **concepts to consider because of new market data, the appropriate way to provide the public with an opportunity to comment is to issue a reproposal**.[48]

CFTC Commissioner Rostin Behnam, Statement of Dissent by Commissioner Rostin Behnam (Dec. 10, 2019), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement121019. Commissioner Behnam mirrored those written concerns with the following comment concerning his dissent during the CFTC's open meeting: "**[G]iven that fact that we are adding new questions, which are proposing new ideas, which require new data, and new different way of thinking about the capital rule writ large**, there's too much risk in my mind for going astray from what we are presenting to the public, which is just, at its core, [meant to be] a re-opening of the comment period." CFTC Open Meeting, Statement of Commissioner Rostin Behnam, at 1:03:28 (Dec. 10, 2019).

Consider also the public comments made by CFTC Commissioner Dan M. Berkovitz, who similarly dissented from the re-proposal:

> We received numerous public comments on . . . prior proposals. **The Document briefly discusses these comments, most of which were critical of the proposals, and then asks open-ended questions about various alternatives to the initial proposals. The discussion of the rationale behind the general alternatives posed in the questions is often superficial**.
>
> For the most part, the Document does not propose any new rule text or amendments to previously proposed rule text, but rather summarizes comments and asks for further comments, data, and analysis to support suggested alternatives to the previously proposed regulations. **In many cases, a wide range of alternatives are suggested**, such as capital levels ranging from 0 to 8% of risk margin. In a number of places, the Document asks commenters to propose new rule text for the Commission. The Document states "[t]he Commission notes that comments are of the greatest assistance to rulemaking initiatives when accompanied by supporting data and analysis, and, if appropriate, accompanied by alternative approaches and suggested rule text language." As an illustrative example, the Document asks commenters to, "Please provide data and analysis in support of any suggested modified percentage of the risk margin amount."
>
> **To the extent that some commenters provide significant new information or data that the Commission intends to rely upon in formulating or justifying a final rule, the public must be afforded notice of and an opportunity to comment on the new information. Under the APA it is not permissible for an agency to ask a wide range of questions about potential approaches, and then proceed to promulgate a final rule supported by new reasons and data sourced from the comments received. Data that is relied on by an agency to support its final rule and that is not merely supplemental or confirming data must be subjected to the notice and comment process.**
>
> Under the APA, an agency has a "duty to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules . . . An agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow meaningful commentary."

CFTC Commissioner Dan M. Berkovitz, Dissenting Statement of Commissioner Dan M. Berkovitz (Dec. 10, 2019), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatment121019b.

[49] Citizens to Pres. Overton Park, Inc. v. Volpe, 401 U.S. 402, 415–16 (1971). See also, e.g., Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 407 F.3d 1250, 1259 (D.C. Cir. 2005); see also, e.g., American Coke and Coal Chemicals Institute v. E.P.A., 452 F.3d 930, 938 (D.C. Cir. 2006); Envtl. Integrity Project v. E.P.A., 425 F.3d 992, 996 (D.C. Cir.

probing, and in-depth review would swiftly invalidate any final rule arising from the CFTC's re-proposal alone.

C. Any final rulemaking arising from the re-proposal would be invalidated as "arbitrary and capricious" and "without observance of procedure required by law."

For the above reasons, any final regulations arising solely from the CFTC's re-proposal undoubtedly would be judicially invalidated as "arbitrary" and "capricious," "otherwise not in accordance with law," and a product of a proposed rulemaking conducted "without observance of procedure required by law."[50] The re-proposal's multiple procedural infirmities would prejudice the CFTC's consideration of significant, pertinent information and data that otherwise would have been provided by the public. That, in turn, would impair the CFTC's deliberations and development of the administrative record, which must be informed by meaningful public comment.

Final regulations arising from the re-proposal alone therefore would present the following fairly obvious and legally fatal deficiencies:

(1) The CFTC would have failed to rationally inform the final rulemaking by data provided and tested by public comment and sufficient to rationally assess the application and effect of the capital framework.

and

(2) The CFTC would have failed to adequately consider whether its capital framework advances statutory objectives and adheres to statutory standards—with the benefit of public comment on identifiable regulatory outcomes—and yet, would have considered non-statutory factors that Congress did not intend it to address.

In these and other respects, final regulations arising from the CFTC's re-proposal could not survive hard-look review under the U.S. Supreme Court's explication of the "arbitrary and capricious" standard.[51] In fact, the Court has explained the "arbitrary and capricious" standard in terms that would be directly applicable to any final rulemaking arising from the re-proposal:

> [A]n agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[52]

2005); Prometheus Radio Project v. F.C.C., 652 F.3d 431, 449 (3d Cir. 2011); Home Box Office, Inc. v. F.C.C., 567 F.2d 9, 35 (D.C. Cir. 1977) (stating that the APA's procedural requirements are intended to assist judicial review as well as to provide fair treatment for persons affected by a rule").

50 5 U.S.C. § 706(2)(A), (D) (2006).

51 Motor Vehicle Manufacturers Association v. State Farm Auto Mutual Insurance Co., 463 U.S. 29, 42-44 (1983).

52 Id.

The Court further explained that it must invalidate agency actions that fail to "examine the relevant data and articulate a satisfactory explanation for [the] [administrative] action including a 'rational connection between the facts found and the choice made.'"[53]

Here, the CFTC recognizes its need for useful (any) data to inform the wide range of potential regulatory outcomes in the re-proposal and to determine the actual application and effect of capital regulations on applicable SDs. **In fact, the CFTC quite openly acknowledges that it must have that which it lacks and insufficiently solicits**. Consider the following exchange between one supporting CFTC commissioner and the CFTC division director responsible for presenting the re-proposal for CFTC approval and publication:[54]

> Commissioner Quintenz: "Director Sterling, do you agree that it is important to have data to finalize this rule?"
>
> Director Sterling: "Wholeheartedly, Mr. Commissioner."
>
> Commissioner Quintenz: "Do you feel as though we have that data currently?"
>
> Director Sterling: "No."

This is not a statement out of context. It is a CFTC commissioner and CFTC director laying bare the plain realities with respect to the re-proposal as follows:

(1) The CFTC has no evidentiary or data-based bases for the re-proposal's wide range of potential regulatory outcomes but rather, seeks to inform an ultimate approach through information provided in the procedurally flawed rulemaking process mentioned above; and

(2) Any final regulation arising from the re-proposal therefore would be based on information and data that was neither relied upon nor known by the CFTC at the time of publication and consequently, could be only an unforeseeable outgrowth of information not made available for public comment.[55]

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[53] Id at 43 (quoting Burlington Truck Lines v. United States, 371 U.S. 156, 168 (1962)).

[54] CFTC Open Meeting, Exchange between Brian Quintenz, CFTC Commissioner, and Joshua B. Sterling, Director of the Division of Swap Dealer and Intermediary Oversight, at 1:29:40 (Dec. 10, 2019).

[55] See CFTC Commissioner Brian Quintenz, Opening Statement of Commissioner Brian Quintenz before the Open Commission Meeting (Dec. 10, 2019), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement121019:

> I am pleased to support the re-opening and request for comment before us today. This document solicits comment on the key issues the [CFTC] **must** get right in the final rule to ensure that capital requirements are appropriate and commensurate to a firm's risk . . . I hope commenters use this opportunity to **provide the [CFTC] with *much needed* data and quantitative *analysis demonstrating the impact* that *various choices* contemplated in this proposal would have on a firm's minimum capital level** – and, by extension, on that firm's ability to participate in the market and adequately service clients. **Data will be vital to the [CFTC]'s *ability to evaluate various capital alternatives* and *identify those alternatives* that would render certain business lines or activities uneconomic**. **It will also be *vital to the [CFTC]'s assessment* that the capital requirements established ensure the safety and soundness of the firm**.[55]

We agree entirely with Commissioner Quintenz on this point. As noted above, data on the actual application and effect of the CFTC's proposed conceptual capital framework is "much-needed" and the CFTC must consider such "vital" data to "assess" and "understand the "impact that [the many] various choices contemplated" the re-proposal. That is why we recommend that the CFTC

These facts are not the touchstones of lawful proposed rulemaking. Undeniably, without the opportunity to submit data responsive to an identifiable regulatory outcome, the public cannot assist the CFTC in developing a record that permits a rational connection between lawfully ascertained facts and a data-based regulatory choice.

Reliable, pertinent data is necessary to assess the adequacy of the SD capital framework in achieving the CEA's objectives and mandates. **In the absence of such data, though, the CFTC is aiming in the dark at an unknown target.** The CFTC staff has acknowledged that it has no way of determining the amount or level of capital SDs would be required to maintain under the multiple potential permutations of the re-proposal. The CFTC's staff indicated at the open meeting, for example, that the re-proposal is merely "**asking the members of the public to provide [the CFTC] information sufficient for [the CFTC staff] to consider [] possibilities and recommend a choice that would be good**."[56] That is proper and sensible. Before finalizing a capital framework, however, the CFTC must arrive at and propose that particular good choice, so that the public has an opportunity to meaningfully comment on an identifiable regulatory outcome. As of now, the CFTC simply cannot reliably determine whether it has hit or missed a statutorily imposed capital standard for SDs, making any potential capital framework finalized in the absence of information requisite to an informed determination in that regard—almost by definition—arbitrary and capricious.

Fortunately, that highly relevant, baseline information could be readily ascertained with an appropriate capital reporting framework. That is why we encourage the CFTC to adopt financial reporting regulations before finalizing remaining pieces of its capital framework that rightly should be informed by such reporting. **In the present re-proposal, however, the CFTC merely requests data from the public that it knows is uniquely in the control of SDs and therefore is uniquely in need of validation *at least* through a subsequent proposed rulemaking with identifiable regulatory outcomes and a meaningful public comment process.**[57]

Finally, the CFTC's re-proposal appears to account for factors that Congress has not intended it to consider and to insufficiently consider important aspects of the problem that Congress did intend it to consider. In several places, the CFTC appears particularly interested in the operational complexities and compliance costs of potential capital requirements.[58] While the CFTC must ensure its regulations are

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first implement appropriate capital reporting regulations that would require SDs to reliably provide that information under penalty of law.

56 CFTC Open Meeting, Statement of Joshua B. Sterling, Director of the Division of Swap Dealer and Intermediary Oversight, at 53:32 (Dec. 10, 2019).

57 The CFTC staff explained in the open meeting that "[i]n fairness, I believe, [for] a lot of the information that would be required to be provided to articulate what [SDs] believe the acceptable standard would be, there are significant privacy interests in retention of that information. So we are trying to design a process where we can have conversations about that, or receive information about that information from the public, by giving them specific choices to look at, within a range . . . ." CFTC Open Meeting, Statement of Joshua B. Sterling, Director of the Division of Swap Dealer and Intermediary Oversight, at 53:32 (Dec. 10, 2019). However, if the CFTC were to receive information in the course of the comment period for the present re-proposal and use it to form the basis for an identifiable regulatory outcome, the CFTC would be required to propose that specific outcome in a properly conducted proposed rulemaking subject to notice and public comment.

58 See, e.g., CFTC, Capital Requirements of Swap Dealers and Major Swap Participants, 84 Fed. Reg. 69664, 69673 (Dec. 19, 2019) ("The Commission and SEC have a long history of harmonizing CFTC and SEC capital requirements ***in order to reduce costs that would otherwise be imposed on dually-regulated entities, including dually-registered FCM/BDs, from having to comply with two different regulatory requirements***. This approach to a uniform capital rule reduces costs to registrants and encourages entities to engage in activities that require registration with both the CFTC and SEC, while also providing appropriate

reasonable and practicable, the CFTC must, first and foremost, follow statutory commands to protect the safety and soundness of SDs and the U.S. financial system[59] and ensure the "avoidance of systemic risk."[60] Those specifically identified capital standards, along with others in the CEA, must motivate the CFTC's assessment of the adequacy of capital approaches. Among the wide array of speculative outcomes from the release, however, could be minimal capital requirements that violate these directives, while achieving non-statutory objectives (e.g., reducing certain costs), though the apparent number of capital alternatives and the lack of information on the actual application and effect of proposed alternatives make informed public comment impossible.

The re-proposal also inadequately considers other relevant statutory concerns with respect to capital requirements—for example, the protection of market integrity and customer funds. The CFTC's capital regulations apply to approximately half of all SDs, with significant collective market presence, counterparty exposures, and in some cases, custody or control of hundreds of millions of dollars in customer assets as SD legal entities registered as SEC BDs, FCMs, or both. The CFTC's re-proposal makes little more than passing references to advancing these critical statutory objectives for at least some SDs subject to capital requirements, like deterring disruptions to market integrity and deterring the misuse or loss of customer funds and/or securities held by an SD legal entity.[61]

III. The CFTC explores an extremely wide range of potential regulatory outcomes for the risk margin-based component of multiple capital approaches, which is just one example of the breadth of the re-proposal.

Among the wide range of potential regulatory outcomes from the re-proposal, those relating to the risk-margin component proposed to serve as a floor in primary capital approaches may be the most critical. That particular capital component presents a useful illustration of the re-proposal's breadth. The re-proposal appears to contemplate a ratio that could range anywhere from zero percent to eight percent of common equity tier 1 ("CET1")[62] to total IM on specified derivatives portfolios.[63] That in itself is a

regulatory requirements."). Id at 69679 ("Further, timely financial reporting ensures that the [CFTC] and its oversight functions can assess equally across all firms compliance with its capital rule, as well as, promote a culture of compliance at the firm and with its auditor that is at least as stringent as other similarly situated registrants. However, the [CFTC] recognizes that not all SDs may be subjected to the same operational burdens and is ***cognizant that imposing an accelerated reporting cycle on certain SDs may unnecessarily increase costs of compliance without much added benefit*** . . . 12–d. ***How much additional cost will a SD save if they are permitted to file*** their audited financial statements within a ninety day period as opposed to a sixty day period?").

59 7 U.S.C. § 6s(e)(3)(A).

60 See, e.g., 7 U.S.C. § 5(b) (providing that one purpose of the CEA is "to ensure the financial integrity of all transactions subject to [the CEA] and the avoidance of systemic risk"). See also 7 U.S.C. § 6s.

61 See 7 U.S.C. § 5(b) (providing that the CEA is intended "to deter disruptions to market integrity . . . [and] protect all market participants from . . . misuses of customer assets").

62 CET1 Capital is defined in 12 C.F.R. § 217.20, and essentially represents the sum of a BHC's common stock value and any related surpluses, retained earnings, and accumulated other comprehensive income.

63 The 2016 capital proposal set forth a framework would have would require SDs to comply with one of three conditional capital approaches:

(1) Bank-Based Capital Approach: An approach that would permit SDs that are not dually registered as FCMs to elect a minimum capital requirement that is based on a modified version of BHC capital rules adopted by the Federal Reserve.

sweeping range of potential regulatory outcomes with significant consequences for the safety and soundness of SDs and the U.S. financial system. **However, the re-proposal also appears to contemplate numerous potential changes to the ratio's *constituents* in ways that are material to consideration of each other and to the actual application and effect of the minimum percentage itself.** Thus, the re-proposal asks the public to provide meaningful public comment on potential outcomes that include everything from complete elimination of the probable ***binding capital constraint*** for most SDs to the maintenance of the methodology in the 2016 proposed framework.

That simply asks too much. It is impossible to comment on such a wide range of possible outcomes in just a single area of the framework, which cannot be thoughtfully considered in isolation, especially without data on the actual application and effect of the presented choices, and without an explanation of the interdependencies with multiple other aspects of the SD capital requirements and Federal Reserve, SEC, and CFTC capital requirements applicable to other types of financial intermediaries (i.e., BHCs, BDs, and FCMs).

A. The extremely wide range of potential regulatory outcomes for the risk-margin-based component opens the door to dramatically reduced capital requirements, because the re-proposal contemplates multiple potential (simultaneous) changes to all constituents of the risk margin-based ratio.

The CFTC's re-proposal opens the door to a vast array of potential regulatory outcomes for capital requirements, including the explicit or de facto elimination of the binding capital constraint arising from the risk-margin-based ratio component. In fact, the actual application and effect of SD capital requirements could be affected **dramatically** relative to the 2016 capital proposal, with extreme variation in potential regulatory outcomes, including through dozens of possible changes to the numerator, the denominator, and the minimum percentage relevant to the risk-margin-based ratio, or all three. There can be little doubt that SDs and their trade associations will seek to reduce, if not eliminate, required capital arising from the risk-margin-based component specifically, and without so much as a public comment period to reveal the consequences.

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(2) Net Liquid Assets Capital Approach: An approach that would permit SDs to elect a minimum capital requirement that is based on a modified version of the CFTC's FCM capital regulations, the SEC's BD capital regulations, and the SEC's security-based swap dealer capital regulations.

(3) Tangible Net Worth Capital Approach: An approach that would permit SDs that are predominantly engaged in nonfinancial activities to compute minimum regulatory capital based upon the firms' tangible net worth.

Under Proposed § 23.101(a)(1)(i) in the 2016 capital proposal, SDs eligible to elect the Bank-Based Capital Approach would be required to maintain regulatory capital equal to or in excess of the highest of four capital components: (1) a common CET1 capital floor of $20 million; (2) CET1 capital equal to or greater than 8% of the SD's risk-weighted assets; **(3) CET1 capital equal to or greater than 8% of the sum of (a) uncleared swap IM, computed on a counterparty-by-counterparty basis in accordance with § 23.154; (b) proprietary uncleared SBS IM, computed pursuant to similar SEC Rule § 18a–3(c)(1)(i)(B), 17 C.F.R. § 240.18a– 3(c)(1)(i)(B), without regard to exemptions or exclusions; and (c) cleared proprietary futures, foreign futures, swaps, and SBS IM required by clearing organizations or agencies (collectively, under component (3), the "Risk Margin Amount")**; or, (4) The amount of capital required by a registered futures association (i.e., the National Futures Association). Under Proposed § 23.101(a)(1)(ii) in the 2016 capital proposal, SDs eligible to elect the Net Liquid Assets Capital Approach would be required to maintain regulatory net capital equal to or in excess of the highest of three similar categories: (1) $20 million, with a $100 million minimum tentative net capital and $20 million minimum net capital for SDs approved to use internal capital models; **(2) Eight percent of the sum of a similar Risk Margin Amount, modified, in part, to include a calculation of the "risk margin" applicable to proprietary futures, swaps, and foreign futures under CFTC § 1.17(b)(8)**; and (3) The amount of capital required by a registered futures association. FCMs and dually registered SD-FCMs would comply with a further modified version of the above Risk Margin Amount calculation. The CFTC contemplates multiple revisions of these proposed capital components. See CFTC, Capital Requirements of Swap Dealers and Major Swap Participants, 84 Fed. Reg. 69664, 69666-67 (Dec. 19, 2019).

The ultimate application and effect of the risk-margin-based capital component could be manipulated most directly through one of three mechanisms:

- First, SDs could seek to diminish SD resiliency by changing the numerator (CET1 capital) to include non-common-equity and lower tier funding instruments that are less permanent[64] and more sensitive to market distress.

- Second, SDs could seek to decrease the ultimate capital requirement by changing the Risk Margin Amount in the denominator to exclude certain types or classes of products (e.g., cleared swaps, or exchange-traded derivatives) or to haircut total relevant margin for purposes of inflating the ratio calculation.

- Third, SDs could seek to decrease the ultimate capital requirement by requiring that the ratio meet or exceed a much lower percentage standard (e.g., 4% or 2%) than previously proposed.

We discuss the potential implications of these changes below.

1. The Numerator: The re-proposal's wide range of potential regulatory outcomes could include changes to multiple capital components that would permit SDs to recognize, for capital calculation purposes, non-common-equity and lower tier funding instruments that are more susceptible to market distress.

The CFTC asks numerous questions about and generally requests comment on the 2016 capital framework's restrictions on qualifying capital instruments, which would affect SD financial resiliency through multiple capital components. The CFTC's re-proposal in this regard appears to open the door to substantial revisions, which, again, widely range from permitting SDs to recognize additional categories of non-common-equity instruments to permitting SDs to recognize subordinated debt for capital purposes. However, the CFTC neither states specifically *how* it proposes to "adjust" the CET1 capital limitation, nor how that adjustment would or could affect the permanence of capital and the SD's reliance on and susceptibility to debt and other funding instruments. In other words, the CFTC proposes a wide range of potential changes to capital quality standards that would be extremely consequential to the safety and soundness of SDs and the financial stability of the U.S. financial system, without presenting an identifiable regulatory outcome for public comment.

In addition, while apparently considering multiple changes to the *types of qualifying capital* that might supplement CET1 in multiple components of the Bank-Based Capital Approach (e.g., additional tier 1 capital or tier 2 "capital"), the CFTC provides no discussion, analysis, or specific proposal with respect to the financial instruments within the new potential qualifying capital classifications that would be recognized. That is a concerning deficiency. For policy and legal reasons, any expansion of qualifying capital must at least identify the instruments being contemplated. Each has different potential implications for SD and financial system resiliency, and each is differently susceptible to market distress and changes in risk tolerances. That is why lawful, considered analyses of the likely implications of such changes (and not just open-ended questions) are so critical. A retreat from recognition solely of CET1 capital could significantly diminish SD resiliency, making both SDs and the U.S. financial system more vulnerable to financial distresses.

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64 See, e.g., CFTC, Capital Requirements of Swap Dealers and Major Swap Participants, 84 Fed. Reg. 69664, 69670 (Dec. 19, 2019) ("As noted in the 2016 Capital Proposal, the [CFTC] proposed to limit the forms of capital that a SD electing the Bank-Based Capital Approach could recognize to CET1 capital as such capital is a more conservative form of capital than Additional Tier 1 capital or Tier 2 capital, particularly as it relates to the permanence of the capital and its availability to absorb unexpected losses.").

This and other potential changes in the re-proposal raise a host of critical questions for the public and should affect analyses of all other elements of the CFTC's 2016 proposed capital framework. For example, potential recognition of lower tier instruments, like subordinated debt, in SD capital calculations might demand a higher minimum percentage for the risk-margin-based ratio; or such potential changes could warrant additional changes to other constituents of that ratio, like the total IM included in the denominator. Moreover, the proposed 2016 capital regulations do not account for capital charge add-ons, like a capital conservation buffer and a countercyclical capital buffer,[65] each of which could make less urgent limiting <u>all</u> CFTC capital to CET1 in some components of the Bank-Based Capital Approach. These issues alone demonstrate why it is impossible for the public to meaningfully comment on a re-proposal that contemplates a wide range of potential changes to multiple interconnected constituents of a single capital calculation.

The re-proposal, in this and many related respects, is simply too short on critical details. The public cannot provide meaningful comment on potential changes to capital quality standards without some specific, identifiable regulatory outcomes to address. That is what is required for nuanced public analysis of interdependent elements of a proposed capital framework; and that is what informed administrative decision-making demands.

2. <u>The</u> <u>Denominator</u>: The re-proposal's wide range of potential regulatory outcomes could include substantial changes to the Risk Margin Amount relevant to multiple risk-margin-based capital components, potentially limiting the types and classes of derivatives included in capital calculations.

The CFTC asks numerous questions about and generally requests comment on whether to exclude various types or classes of derivatives from the risk-margin-based capital ratio. Like potential changes to the CET1 restriction, the re-proposal's wide range of potential revisions could **<u>dramatically</u>** change the scope of SD residual risks addressed by—and even the relevance of—the risk-margin-based capital component. The CFTC's own rationale for a broad scope of derivatives to be included in the risk-margin-based ratio's denominator best explains why such potential changes are concerning:

> [C]apital serves as an overall financial resource for the SD and is intended to cover potential risks that are not adequately covered by other risk management programs (*i.e.,* "residual risk") including margin on uncleared swaps. Therefore, the *Proposal* expanded the types of financial instruments included in the computation of the risk margin amount to include an SD's futures, foreign futures, swaps, and SBS positions, which is a more expansive list than the SEC imposed on SBSDs, as **the [CFTC] believed that it was appropriate for SDs to maintain a minimum level of capital that reflects the extent of the risks and activities posed by the full, broad range of the SD's proprietary positions**.[66]

Better Markets agrees with the CFTC's 2016 reasoning. **By their entity-level and cross sub-line-of-business nature, SD residual risks are very likely to increase with any increase in the scope of derivatives activities.**

Nevertheless, the CFTC's re-proposal asks numerous questions and requests comment on multiple accommodations sought by industry commenters. For example, the CFTC notes that several commenters

65 <u>Id</u> at 69670.

66 <u>Id</u> at 69668.

previously asserted that the 8% risk margin calculation was "over-inclusive of the various types of business activities engaged in by SDs."[67] That criticism from SDs and their trade associations should be expected. One obvious means for SDs to inflate the risk-margin-based capital ratio calculation would be to recommend that the CFTC either exclude or substantially haircut certain types or classes of products proposed in 2016 to be included in the Risk Margin Amount (e.g., excluding cleared swaps or exchange-traded derivatives).

Differentiating between types or classes of derivatives for capital purposes could conceivably be rational from a residual risk perspective. However, without re-proposing a specific alternative to the 2016 proposal, the CFTC simply "invites [more] comments on **all aspects** of the proposed risk margin amount, including comments regarding the **possible increase or decrease** of the risk margin percentage in coordination with the **inclusion or exclusion of certain products** in order to establish the most optimal capital requirement."[68] In this regard, like others, the re-proposal essentially seeks comment on what to do rather than what it seeks to do.

The re-proposal, in other words, does not present identifiable regulatory outcomes amenable to meaningful public comment. The CFTC neither states *how* it intends to adjust the Risk Margin Amount calculation nor how various potential exclusions would affect statutory objectives and mandates that motivated construction of the 2016 proposed Risk Margin Amount in first instance. Instead, the CFTC opens the door to comment on a wide range of potential changes that it acknowledges could *reduce* or *increase* the Risk Margin Amount, providing limited, if any, discussion, analysis, or specific proposal with respect to that range of potential changes and others that may affect it.

For policy and legal reasons, material changes to constituents of the probable binding capital constraint for most subject SDs must identify the specific exclusions or inclusions contemplated for the Risk Margin Amount. The re-proposal fails that minimal standard.

3. The Ratio: The re-proposal's wide range of potential regulatory outcomes could include changes that require that the risk-margin-based ratio meet a lower percentage standard (e.g., 4% or 2%).

The CFTC asks numerous questions about whether to lower the proposed percentage (8%) applicable to the risk-margin-based capital ratio. While exploring the possibility of lowering that percentage to multiple alternatives (e.g., 2% or 4%, or "a different level"),[69] the CFTC also requests comment on whether it should adopt "future" capital measures—for example, a leverage ratio—"***in lieu of*** the proposed percentage of the risk margin amount."[70] The re-proposal therefore asks, yet again, numerous questions on a wide range of interconnected potential regulatory outcomes that can vary from eliminating the risk-margin-based capital ratio altogether to adopting the 2016 proposed capital framework.[71] In addition, in doing so, the re-proposal introduces a number of new considerations or regulatory approaches

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67 Id at 69667.

68 Id at 69668.

69 Id at 69669.

70 Id (emphasis added).

71 In addition, the CFTC again seeks comment on an issue not considered in connection with the 2016 capital proposal: whether it should harmonize with the SBSD capital requirements by defaulting to a 2% threshold and permitting requirements by order over time. Id at 69668.

(e.g., the SEC's final capital regulations, the leverage ratio) that were not mentioned in the 2016 capital proposal.[72]

B. The re-proposal's wide range of potential regulatory outcomes prevent meaningful public comment on specific terms and substance, while also providing cursory or no descriptions of the material subjects and issues involved.

Because of the procedural infirmities of the re-proposal, it is impossible to determine whether we support or oppose (or something in between) any individual element of the re-proposal's framework. That is true, for example, with respect to the wide range of alternatives presented for the risk-margin-based ratio itself, its constituent calculations, and its level, all of which leave the public guessing as to the CFTC's proposed regulatory outcomes and their actual application and effect on SDs and incentives to trade in particular markets.

The re-proposal neglects important conceptual issues that would benefit from meaningful public comment as well. For example, the CFTC explains that the risk-margin-based ratio percentage was initially considered a logical extension of the risk-based capital requirements applicable to FCMs.[73] But CFTC does not discuss the fact that the 8% FCM minimum has its CFTC origins (more or less) in a 1978 rulemaking focused exclusively on FCM customer protection concerns in the cleared futures markets.[74] In that context, it was reasonable to adopt IM-based capital requirements, because IM served as a measure inextricably tied to customer collateral in possession or control of the FCM. However, the extension of that approach to SDs presents complex issues that warrant public deliberation. IM-based capital measures could considerably underestimate SD residual risks in very large **un**cleared derivatives portfolios, the statutorily commanded focus of SD capital requirements. On the other hand, whereas the proposed 8% threshold at least was informed by the CFTC's experience overseeing FCMs and cleared derivatives markets, the re-proposal's various percentages (as one example) seem to amount to little more than a guess as to what might be adequate for SD capital purposes.

Even more fundamentally, the CFTC neglects to ask questions about or request comment on the conceptual distinction between the following: (1) credit risks mitigated by counterparty and portfolio-specific IM—intended to address a measure of potential future exposure; and (2) residual risks *across* SD counterparties and portfolios on a legal entity basis. The CFTC's use of a counterparty credit risk measure, though not conceptually pure, could be reasonable in this context. Although the risk-margin-based ratio's methodology is a function of a particular credit risk measurement and not *necessarily* indicative of residual risks, the CFTC could view such a measure as likely to be reasonably commensurate with residual risks across the SD's business lines. However, as the CFTC would likely acknowledge, it is an imprecise residual risk proxy at best, which conceivably could demand a higher percentage minimum for the risk-margin-based capital component.

The APA directs the CFTC to elicit public comment through a reasonable description of such subjects and issues. The re-proposal simply does not provide that. In fact, the only percentages specifically mentioned in the re-proposal are *lower*; there is no discussion of the above proxy issue, or other conceptual issues, that might warrant a higher, or conceptually different, capital component. In addition, as mentioned

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72 See, e.g., id ("How would [the 8% risk margin requirement, for example,] compare with the amounts of capital required of SBSDs under the *SEC Final Capital Rule*?").

73 Id at 69667 (stating that "[t]he proposed minimum capital requirement was drawn from the [CFTC]'s experience with the 'risk-based' capital requirements currently imposed on FCMs").

74 See CFTC, Part 1—General Regulations under the Commodity Exchange Act, 43 Fed. Reg. 39956 (Sept. 8, 1978), available at https://www.govinfo.gov/content/pkg/FR-1978-09-08/pdf/FR-1978-09-08.pdf#page=32.

above, the CFTC does not have sufficient SD financial reporting to determine the actual application and effect of the wide range of potential regulatory outcomes contemplated by the re-proposed capital requirements, preventing informed public comment on the implications of any conceptual framework's fitness to advance statutory objectives and mandates.

There are many other issues warranting public consideration. The re-proposal should have examined whether IM-based capital constraints could affect the behavior of market participants, as we are concerned about the potential for SDs to seek to exchange less IM (and to seek to influence regulators and market infrastructure firms to require less IM) over time. The capital calculation also could be variable and perhaps pro-cyclical, potentially reducing the binding capital constraint on SDs during the very market conditions most likely to lead to a default or wind-down of SD derivatives activities. These issues, again, conceivably rationalize a higher percentage baseline for the risk-margin-based capital ratio and yet, the re-proposal remains largely silent in these and other respects.

These issues ignore still numerous other issues in need of public consideration, in particular the nature of the higher residual risks in OTC portfolios, issues relating to reliance on internal models in related components of the capital approaches, and the risk-reducing clearing incentives that would be attendant to a capital differential on different derivatives. For present purposes, though, we hope that we have adequately illustrated the essential point that the CFTC must properly issue a Notice of Proposed Rulemaking comprehensively addressing material subjects and issues relevant to a proposed capital framework with identifiable regulatory outcomes. Otherwise, informed public comment is impossible, and the public comment process is a charade.

IV. Conclusion

The re-proposal's expansive range of interconnected potential regulatory outcomes make meaningful public comment on the CFTC's capital framework impossible. The solution is quite simple:

- The CFTC must re-propose specific, identifiable capital requirements with the benefit of the administrative records for the present release and the 2016 capital proposal and must conduct all statutorily required analyses in connection with the regulatory approach and text specifically proposed in that release.

- This re-proposal must be developed with the benefit of capital-related SD financial reporting, which therefore must precede the re-proposal by a short but reasonable period of time.

As we noted above, financial reporting is the only practical way for the CFTC to assess critical capital-related information with respect to subject SDs (information which the CFTC acknowledges it does not have) without relying on unvalidated SD assertions and claims.[75] **Indeed, the CFTC can be confident**

[75] For example, the CFTC could propose and finalize a stand-alone SD financial reporting rulemaking includes hypothetical capital calculations based on select variations of the 2016 capital framework. The CFTC might consider a quarterly capital report that includes hypothetical capital calculations relevant to different elements of the Bank-Based Capital Approach and the Net Liquid Assets Approach. This would assist the CFTC in definitely identifying whether the 8% threshold component, for example, is a binding capital constraint for classes of SDs and if so, by how much. The CFTC notes that "commenters stated that the proposed minimum capital requirement of CET1 Capital equal to or greater than 8% of risk-weighted assets would impose a capital requirement on SDs that is materially higher and more restrictive than the prudential regulators' capital requirement for banks and [BHCs]." CFTC, Capital Requirements of Swap Dealers and Major Swap Participants, 84 Fed. Reg. 69664, 69670 (Dec. 19, 2019). The CFTC's hypothetical reporting would validate that assertion. It could similarly require capital reporting that includes hypothetical leverage ratio calculations, providing the CFTC necessary information to inform how such a requirement might affect SD capital positions. In the second phase, the CFTC could propose and then finalize a regulation generally arising from 2016 proposed capital framework, with reasoned, validated adjustments based on the CFTC's known implications of capital requirements on specific SDs.

that capital requirements are attentive to statutory objectives only if the actual application and effect of capital requirements can be assessed through pertinent financial reporting provided under penalty of law.

SD capital requirements are too consequential to get wrong, and the CFTC simply does not have sufficient information at this time to be confident that it is getting them right (or even not grossly wrong). **Financial reporting can and must solve that. It also can be narrowly proposed and finalized in the next 4-5 months if given priority, as it should be.**

In exploring SD financial reporting, we encourage the CFTC to consider requiring information that would be helpful in assessing whether and how CFTC-imposed capital requirements and prudential regulator-imposed capital requirements may affect competition between SDs. We share the CEA and CFTC's concerns about fair derivatives market access and competition—as well as the degree of risk concentration in a handful of BHCs with SDs—but we note that capital requirements have had little causal influence on that reality to date (indeed, market concentration has persisted without any application of SD capital requirements at all). Yet, the competition concern, which is statutorily valid for the CFTC to consider, is likely to arise in the future, again based on unvalidated SD assertions, even if the industry sought capital "flexibilities" would be unlikely to change that reality or exacerbate competitive dynamics driven by other factors.

Sincerely,

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