Public Statements & Remarks

Dissenting Statement of Commissioner Rostin Behnam on Capital Requirements of Swap Dealers and Major Swap Participants

July 22, 2020

I respectfully dissent from the Commodity Futures Trading Commission's (the "Commission" or "CFTC") rulemaking today regarding Capital Requirements of Swap Dealers and Major Swap Participants (the "Final Capital Rule").

Ten Years of Dodd-Frank

Yesterday marked ten years since Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act[1]. Congress passed Dodd-Frank as a targeted legislative response to the 2008 financial crisis and the near obsolescence of the U.S. financial regulatory framework. The Great Recession wreaked havoc on Main Street Americans and the global economy. Undercapitalization was at the heart of the 2008 crisis, and the swift response to require financial institutions to hold additional capital mitigated both the blunt economic shock we endured this past March, and the substantial weight we continue to shoulder as a result of the Covid-19 pandemic.

Section 731 of the Dodd-Frank Act[2] requires the CFTC to establish capital rules for all registered Swap Dealers ("SDs") and Major Swap Participants ("MSPs") that are not banks, as well as associated financial recordkeeping and reporting requirements. The capital requirements in Section 731, which established Section 4s(e) of the Commodity Exchange Act ("the Act"), are clear: "…[t]o offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared," the Commission's capital requirements shall "help ensure the safety and soundness of the swap dealer or major swap participant" and "be appropriate to the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."[3] There can be no doubt that Congress intended to impose significant new requirements that would contribute to the protection from another financial crisis.

Congress's 2010 response largely incorporated the international financial reform initiatives for over-the-counter derivatives laid out at the 2009 G20 Pittsburgh Summit aimed at improving transparency, mitigating systemic risk, and protecting against market abuse.[4] One of the core initiatives in the G20 statement was the imposition of higher capital requirements. Paragraph 16 of the statement provides the purpose the G20 leaders agreed to aim for: "*To make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis.*"[5] Paragraph 17 then lays out what the G20 leaders agreed to do to rein in the excesses, and the first item is this: "We committed to act together to raise capital standards."[6] The G20 leaders said unequivocally that, for over-the-counter derivatives markets, "[n]on-centrally cleared contracts should be subject to higher capital requirements."[7] Congress had this same goal in mind when enacting the Dodd-Frank Act a decade ago.[8]

Three and a Half Years of the Capital Proposal

In 2016, the Commission issued a bipartisan proposal to implement capital requirements as directed by Congress through Section 731 of the Dodd-Frank Act.[9] The Commission now jumps from a proposal issued in 2016 to a significantly different final rule nearly four years later, without any intervening *reproposal* to provide interested market participants clear proposed capital requirements to meaningfully comment upon. In so doing, the Commission undermines the spirit of the Dodd-Frank Act and violates the letter of the Administrative Procedure Act ("APA").[10]

The preamble to the Final Capital Rule asserts that all of the actions taken today are a "logical outgrowth" from the 2016 Proposal.[11] The preamble even goes a step further, arguing that "modifications described in the *2019 Capital Reopening*, including a discussion and specific inclusion of potential rule language, were logical outgrowths" of the 2016 Proposal.[12] This simply cannot be true if the requirement that a final rule is a logical outgrowth of an agency's proposed rule is to have any meaning at all.[13]

The changes in the Final Capital Rule to the amount of capital that a futures commission merchant SD (FCM-SD) must maintain are illustrative of the point. The 2016 Proposal would have required an FCM-SD to maintain regulatory capital equal to or greater than 8% of the initial margin associated with the FCM-SD's proprietary cleared and uncleared futures, foreign futures, swap, and security-based swap positions. In 2019, the Commission reopened the comment period on the 2016 Proposal.[14] In the Federal Register release announcing the 2019 reopening, the Commission sought additional public input based on an initial review of comments received from the 2016 Proposal on myriad alternatives, seeking comment "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."[15] This, in many respects, is a blank check. Not only does it allow for any conceivable percentage of risk margin, it simultaneously opens up multiple combinations of inputs. The Commission now states that any of the possible outcomes along this sliding scale would have been a logical outgrowth. It is the equivalent of saying that the Final Capital Rule is a logical outgrowth because it imposes any capital requirements at all, and that simply cannot be the case under the legal intent and plain reading of the principle of logical outgrowth.

A Final Capital Rule (and Five Years of Review)

Where did the Commission end up? The Commission decides today to set the multiplier for the uncleared swaps of FCM-SDs at 2%, rather than the 8% originally proposed. The Commission also is modifying the final rule from the proposal to *remove* security-based swaps, proprietary futures, foreign futures, and cleared swaps from the risk margin amount calculation. These are significant changes from the 2016 proposal, and they are just one of the possible outcomes suggested in the reopening of the comment period.

I am not sure if 2% is the appropriate landing spot to insulate our markets from outsize risk. And based on the preamble to this Final Capital Rule, I do not think the Commission is certain either. The preamble states that the Commission does not have the data to determine whether or not 2% is the optimal or even adequate percentage.[16] Instead, the Commission chooses 2% with the intent that "the Commission's decision to modify the final rule by removing cleared and uncleared security-based swaps, as well as proprietary futures, foreign futures, and cleared swaps positions from the risk margin amount calculation, and to set the multiplier at 2% should mitigate many of the commenters' concerns that the proposed 8% risk margin amount calculation was over inclusive of the types of positions included in the calculation and was set at a percentage that was too high."[17] Due to this lack of data, the Commission will need to conduct a *5-year* post implementation review "to assess whether the minimum capital requirements for FCM-SDs are adequately calibrated to ensure their safety and soundness."[18] And I applaud the Commission for including this critical regulatory component of the capital regime's implementation. However, this information is exactly the type of data that the Commission would have benefited from during the notice and comment process. By failing to issue a reproposal in 2019, allowing just a few additional months of concrete, data driven deliberation, which could have clearly stated a specific approach, we lost the opportunity to find out whether the minimum capital requirements that we selected are adequately calibrated to ensure safety and soundness.

Because of the lack of clarity in the reopening of the comment period, we again received more general comments that 8% was too high. In justifying the selection of 2%, the preamble states that "2% should mitigate many of the commenters' concerns that the proposed 8% risk margin amount calculation was over inclusive of the types of positions included in the calculation and was set at a percentage that was too high." [19] Because we did not provide a clear alternative, we again received comments on 8% rather than comments on 2%, or on some alternative.

Ultimately, this lack of information gathering impacts the CFTC and results in a Final Capital Rule that has not benefited from fulsome public comment. However, the impacts on our market participants are greater. They have been denied the ability to comment meaningfully. This is particularly true of the cost benefit analysis. Broadly asking stakeholders to comment on any variation results in a situation where no one had an opportunity to comment on anything approximating what the Commission has done in its Final Capital Rule. As a result, this rule ultimately derived from a process that is, in many respects, equivalent to not soliciting comments from the public and market participants at all.[20]

I note that, less than a month ago, the Commission voted to withdraw the Regulation Automated Trading proposal ("Regulation AT"),[21] the most recent iteration of which had been issued in November 2016, a couple of weeks before the 2016 Proposal.[22] At the same time that Regulation AT was withdrawn, the Commission issued a rebranded Electronic Trading Risk Principles proposal intended to *"accomplish a similar goal"* to the original Regulation AT.[23] Following the logic set forth today for the Final Capital Rule, the Commission could have simply issued a final rule for Electronic Trading Risk Principles last month, arguing that it was merely a *logical outgrowth* of the latest iteration of Regulation AT. While I disagreed with last month's policy decision, procedurally the Commission did the right thing under the APA. We should have followed the same procedure for capital, and issued a reproposal.[24] If we had done so last December, we could have received meaningful comments from market participants on a clearly stated reproposal, and we could well have been in position to finalize a stronger, more carefully considered Final Capital Rule today that addresses current market conditions in a manner that is more data driven.

Conclusion

Before I conclude, I would like to thank staff from the Division of Swap Dealer and Intermediary Oversight for their excellent work on this highly technical and complex rulemaking, and willingness to answer my questions and take feedback.

While I would have liked to stand with my fellow Commissioners today, I cannot justify it under these circumstances. I truly wish that I could support today's Commission action as we mark the tenth anniversary of the Dodd-Frank Act this week. To reiterate sentiments made in my first speech as a CFTC Commissioner,[25] capital is a cornerstone financial crisis reform[26] that is critical to protecting our financial institutions and our financial system as a whole from systemic risk and contagion. But it is also critical to protection from unintended consequences if capital (and margin) levels are applied and set without due regard to the uniqueness of our financial markets and market participants.

I appreciate that in moving forward, we must fulfill our directive to establish capital standards appropriately, and in consideration of other activities engaged in by SDs and MSPs such that we ensure that we do not penalize commercial end-users who need choices and benefit from competition in our markets. At the same time, we must heed Congressional intent without any compromise, regardless of what *we* think is best, remaining cognizant of the impact that capital requirements have on market stability, and follow APA rulemaking requirements when we do so.

Shortly before the Commission voted on the reopening in December, 2019, Chairman Tarbert gave remarks about *transparency[27]*, making many very powerful and important points about the incredible importance of being mindful – as regulators – of "…not only what we do, but how we do it."[28] The Chairman ended that particular statement with a wonderful quote from Aristotle. Among many profound lessons from the Greek philosopher, he is also sometimes credited with the statement that "[p]atience is bitter, but its fruit is sweet." In that vein, I simply wish the Commission had devoted a little bit more time to how we fulfill this foundational Dodd-Frank requirement.

The road has been long, far too long in many respects. But, unsure of what deadlines we are racing to meet at this point, or targets we are aiming to hit, I feel strongly the Commission and our markets, would have stood on sturdier ground, and perhaps even have landed at the same conclusion voted on today, if we had practiced a little patience.

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[1] *See* The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203), 124 Stat. 1376 (2010) (the "Dodd-Frank Act").

[2] *Id.*at § 731(e), 124 Stat. at 1704-6.

[3] Section 4s(e)(3) of the Commodity Exchange Act ("the Act"), 7 U.S.C. § 6s(e)(3).

[4] G20, *Leaders' Statement, The Pittsburgh Summit* (Sept. 24-25, 2009), *available at* https://www.oecd.org/g20/summits/pittsburgh/.

[5] *Id.* at 2.

[6] *Id.*

[7] *Id.* at 9.

[8] *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.").

[9] Capital Requirements of Swap Dealers and Major Swap Participants, 81 FR 91252 (proposed Dec. 16, 2016) (the "2016 Proposal").

[10] 5 U.S.C. § 551 *et seq*.

[11] Final Capital Rule at 1.B.

[12] *Id.*; Capital Requirements for Swap Dealers and Major Swap Participants, 84 FR 69664 (Dec. 19, 2019).

[13] *See Small Refiner Lead Phase-Down Task Force v. United States Envtl. Prot. Agency*, 705 F.2d 506, 548-49 (D.C. Cir. 1983) ("Agency notice must describe the range of alternatives being considered with reasonable specificity. Otherwise, interested parties will not know what to comment on, and notice will not lead to better-informed agency decisionmaking.").

[14] 84 FR 69664.

[15] *Id.* at 69668.

[16] Final Capital Rule at II.B.2.b. ("The Commission does not have the benefit of . . . comprehensive data regarding the multiplier for the uncleared swaps risk margin amount at this time.")

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *See Texas v. United States EPA*, 389 F.Supp. 3d. 497, 505 (S.D. Tex. 2019) ("The APA does not envision requiring interested parties to parse through such vague references like tea leaves to discern an agency's regulatory intent regarding such significant changes to a final rule").

[21] Press Release Number 8188-20, CFTC, CFTC Approves Two Final Rules and Two Proposed Rules at June 25 Open Meeting (June 25, 2020), https://www.cftc.gov/PressRoom/PressReleases/8188-20.

[22] Regulation Automated Trading, 81 FR 85333 (proposed Nov. 25, 2016).

[23] Electronic Trading Risk Principles (proposed Jun. 25, 2020), at I.B.

[24] Statement of Dissent of Commissioner Rostin Behnam, Capital Requirements of Swap Dealers and Major Swap Participants (Dec. 10, 2019), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement121019.

[25] *See* Rostin Behnam, Commissioner, CFTC, The Dodd-Frank Inflection Point: Building on Derivatives Reform, Remarks of CFTC Commissioner Rostin Behnam at the Georgetown Center for Financial Markets and Policy (Nov. 14, 2017), https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam.

[26] G20, Leaders' Statement, Framework for Strong, Sustainable and Balanced Growth, The Pittsburgh Summit (September 24-25 2009), http://www.g20.utoronto.ca/2009/2009communique0925.html ("We committed to act together to raise capital standards…").

[27] Heath P. Tarbert, Chairman, CFTC, Statement of Chairman Heath P. Tarbert Before the December 10, 2019 Open Meeting (Dec. 10, 2019), https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement121019.

[28] *Id.*

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