

Jefferies

July 11, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Dear Mr. Stawick:

Jefferies & Company, Inc. (“Jefferies”) appreciates the opportunity to provide the Commodity Futures Trading Commission (the “Commission”) with comments on the Commission’s capital requirements proposal (the “Proposal”) for swap dealers and major swap participants (collectively, “Swap Entities”) as required under Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).

Jefferies is a wholly owned subsidiary of Jefferies Group, Inc. (“Jefferies Group”), a global securities and investment-banking firm, which has served companies and their investors for nearly 50 years. Jefferies Group is a publicly traded company with a market capitalization in excess of \$4 billion and net revenues for the 12 months ending May 31, 2011 of \$2.7 billion. We currently employ 3,650 people in more than 30 cities worldwide, and our approximately 1,200 sales and trading professionals transact business as a principal to, and on behalf of, thousands of institutional investors in most major markets in the world today.

Jefferies has been registered with the Securities and Exchange Commission (“SEC”) as a broker-dealer since 1969. Based on headcount, revenue and market capitalization, we are currently the largest U.S.-based full-service securities and investment-banking firm that is not affiliated with a bank holding company (“BHC”). Given the size and scope of Jefferies’ institutional sales-and-trading operations, we carefully examine all new business opportunities that enable us to better serve our clients and to better compete in the marketplace. To that end, Jefferies began to offer listed and over-the-counter equity, fixed income and commodities derivatives to our clients, either directly or through our affiliates, a number of years ago. Jefferies has recently registered with the Commission as a futures commission merchant (“FCM”) and expects to apply to become a clearing member of the major derivatives clearing organizations (“DCOs”). On July 1, 2011, we acquired Prudential Bache's Global Commodities Group, which offers brokerage and clearing services in listed derivatives on all major futures and options exchanges around the world and over-the-counter trading in foreign exchange, base and precious metals and energy and agricultural swap transactions.

However, like other non-BHC-affiliated firms, Jefferies’ efforts to become a major participant in the swaps markets have been hindered by traditional barriers to entry that have favored BHC and foreign bank subsidiaries and consequently allowed those entities to dominate the swaps markets. Jefferies hopes that Dodd-Frank will level the playing

field and enable Jefferies and other non-BHC affiliated firms to participate more actively in the swaps market by removing such traditional barriers.

Jefferies believes that the current Proposal does not do enough to help effect that level playing field. The Proposal unfairly differentiates between firms engaged in similar conduct but regulated by different regulators under disparate regulatory approaches. In particular, the Proposal treats differently BHC subsidiaries, SEC-regulated alternative net capital firms and SEC OTC Derivatives Dealers (“Model-Eligible Swap Entities”) on the one hand, and all other non-bank Swap Entities (“Non-Model-Eligible Swap Entities”) on the other. The Proposal only permits Model-Eligible Swap Entities to use risk-based models in capital calculations. This restriction limits the effective swaps markets participation of Non-Model-Eligible Swap Entities like Jefferies, whose services provide clients with expanded access to these markets to hedge commercial risks, supporting their broader activities in the financial markets. As discussed below, the inability of Non-Model-Eligible Swap Entities to use capital models would hamper their ability to provide these services, raising costs for their customers and increasing swaps market concentration in a way that is at odds with the goals of Dodd-Frank.

In this letter, we describe the competitive disadvantages that Jefferies and other Non-Model-Eligible Swap Entities would face under the Proposal and the harm these disadvantages would impose on those entities, their customers and competition in the swaps and related markets. In addition, we provide proposed solutions to these problems. First, we believe that the Commission should review and approve models for Non-Model-Eligible Swap Entities. At a minimum, the Commission should encourage and work with the SEC to develop a regime for SEC approval of Swap Entity models that will support the use of models for swap transactions by firms such as Jefferies. We also believe that the Commission should consider allowing Swap Entities to use approved DCO models for positions used to hedge uncleared swaps, though we believe that additional Commission oversight is necessary to make sure these models appropriately reflect swap risk. Finally, we believe that refinements should be made to the fallback capital grid for Swap Entities that cannot or choose not to use models.

The Proposal Subjects Non-Model-Eligible Swap Entities to a Competitive Disadvantage That Will Harm Competition in the Swaps and Related Markets and Hurt Customers.

The Proposal subjects Swap Entities that are not subject to capital requirements by prudential regulators to a CFTC-monitored capital regime. Under this regime, FCMs that are also Swap Entities would be required to hold the greater of \$20 million in adjusted net capital or the amount required under pre-existing FCM capital requirements. Non-FCM Swap Entities that are BHC subsidiaries would be required to hold the greater of \$20 million in Tier 1 capital or the minimum risk-based ratio requirements that would apply if the Swap Entity were a U.S. BHC. Finally, a residual category of Swap Entities that are not FCMs and not BHC subsidiaries would be required to hold \$20 million in tangible net equity plus an amount of capital corresponding to a “market risk exposure requirement” and an “over-the-counter derivatives credit risk requirement.”¹

¹ In addition, all Swap Entities would have to meet any capital requirements of a registered futures association of which it is a member.

The Proposal would allow Swap Entities that are BHC subsidiaries to use models reviewed and approved by the Federal Reserve. The Proposal would also allow Swap Entities that are security-based swap dealers or major security-based swap participants (“SBS Entities”) to use models reviewed and approved by the SEC. To date, the SEC only reviews and approves capital models for alternative net capital (“ANC”) broker-dealers, all of which are affiliated with BHCs, and OTC Derivatives Dealers, whose activities outside of eligible OTC derivatives are narrowly restricted under the “broker-dealer lite” regime. Swap Entities that are not BHC subsidiaries, ANC broker-dealers or OTC Derivatives Dealers – *i.e.*, Non-Model-Eligible Swap Entities – would not be allowed to use models to calculate capital. Instead, Non-Model-Eligible Swap Entities that are FCMs would be relegated to the standard deductions in Commission Rule 1.17, and those that are not FCMs would be relegated to the Proposal’s fallback grid capital calculations.

Jefferies believes that grid-based approaches to capital calculations are far less risk sensitive than model-based approaches and, as a result, subject those entities forced to use them to an unfair market disadvantage. As the Futures Industry Association, the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association have argued, “[g]rid-based approaches lack a number of attributes of a sound capital methodology.”² First, grids aggregate individual capital charges by product rather than viewing an entity’s risk across its full complement of investments and activities. As a result, grids are insufficiently risk sensitive, which penalizes well-hedged and well-risk-managed entities with higher than necessary capital requirements. Second, entities required to use standardized grids must calculate capital requirements without the ability to leverage the existing risk-management data, processes and systems upon which their internal risk models are based. As a result, grids do not align with the way in which the firm views and manages its own risk and require duplicative work. Third, grid-based approaches are inflexible and cannot easily accommodate frequent innovation and evolving trading strategies,³ which is likely to be particularly problematic in the constantly evolving swaps markets. Standardized grids incorporated into a government agency’s rules are even more difficult to change given rulemaking requirements in the Administrative Procedure Act, including proposal, notice and comment periods. As a result, regulators are likely to set grid-based capital requirements at a high level to protect against future changes in market behavior and activities. We thus agree with the Commission that “internal models ... can provide a more effective means of recognizing the potential economic risks or exposures from complex trading strategies involving OTC derivatives and other investment instruments.”⁴

² Letter from John M. Damgard, President, Futures Industry Association; Robert G. Pickel, Chief Executive Officer, International Swaps and Derivatives Association; Kenneth E. Bentsen, Jr., Executive Vice President, Securities Industry and Financial Markets Association to David A. Stawick, Secretary, Commodity Futures Trading Commission (July 7, 2011).

³ For example the SEC’s last update to its grid-based capital approach in Rule 15c3-1 was in 1998. *See* Exchange Act Release No. 40594 (Oct. 23, 1998), 63 Fed. Reg. 59,362 (Nov. 3, 1998).

⁴ 76 Fed. Reg. 27807 (May 12, 2011).

As a result, dividing Swap Entities into those that can use risk-based models and those that cannot provides the former group a marked advantage over the latter, hurting customers and stifling competition in the swaps and related markets. Forced to hold more capital against swap positions than their competitors, Non-Model-Eligible Swap Entities will be forced to increase spreads and will inevitably lose swap customers to Model-Eligible Swap Entities facing a less capital-intensive regulatory regime. As a result, Model-Eligible Swap Entities will grow and swaps market concentration will increase. Furthermore, the inability to use models would be a significant barrier to entry for would-be Swap Entities, further decreasing competition and concentrating swaps market power in a limited number of entities. Consequently, end users of swaps will suffer in a number of ways, including having to pay higher prices for swaps used to hedge interest, credit, commodity price and numerous other risks.

Moreover, harmful effects will not be limited to those participating in direct activities in the swap market. Financial entities enter into swaps to hedge risks of other customer transactions, including securities businesses. As a result, under the Proposal, Non-Model-Eligible Swap Entities would face higher costs for customer transactions related to, among other businesses, securities and investment banking which may (rather than swaps businesses) be their core competency. As in the direct swaps market, these indirect effects will increase concentration of market power in fewer participants and hurt the end users who rely on Non-Model-Eligible Swap Entities for a host of financial needs.

Model Use Should be Expanded to a Wider Range of Swaps Entities.

To avoid the negative consequences outlined above, the Commission should expand the allowable use of capital models. It is not reasonable to expect Non-Model-Eligible Swap Entities to become BHC subsidiaries in order to gain access to Federal Reserve model review and approval. It is also not feasible for many Non-Model-Eligible Swap Entities to become ANC broker-dealers, as doing so requires a minimum of \$5 billion in tentative net capital, nor is it a satisfactory solution that these entities all become OTC Derivatives Dealers, whose derivatives activities would be limited to certain eligible OTC derivatives instruments and whose securities and other activities are significantly circumscribed under the current rules.

Given the competitive disadvantages that Non-Model-Eligible Swap Entities would face under the Proposal, we believe it is important for the Commission to develop the necessary expertise to review and approve these entities' internal capital models. Otherwise, as described above, Non-Model-Eligible Swap Entities will face a significantly more difficult competitive landscape than their Model-Eligible counterparts.

If the Commission cannot or chooses not to review models, it should encourage and work together with the SEC to develop a workable regime through which Non-Model-Eligible Swap Entities can have their swap capital models approved. The SEC is well-positioned to review Swap Entity capital models for several reasons. First, the SEC currently reviews and approves capital model methodologies for ANC firms and OTC Derivatives Dealers and thereby has demonstrated the ability to review and approve models. Second, the SEC will regulate many Non-Model-Eligible Swap Entities as SBS Entities and, therefore, may already approve the entity's capital models in that capacity. Finally, the

SEC is already familiar with the businesses of many Non-Model-Eligible Swap Entities in their capacities as broker-dealers or otherwise in securities businesses.

We also believe that approved DCO margining models should be available for any Swap Entity to use when calculating capital charges for cleared swaps.⁵ However, we believe that additional Commission oversight is necessary to make sure these models appropriately reflect swap risk. In the cleared-swaps context, the Commission must ensure that the DCOs appropriately distribute risk among their members and provide fair access to the DCO, rather than simply acting for the benefit of DCO shareholders. As part of this process, it would be efficient to focus available resources on careful review of DCO models, as Commission approval would make the models available for participants in both the cleared and uncleared swaps markets. In addition, use of well-calibrated DCO models would allow for the alignment of capital rules, to the extent possible, with margin rules, making the regulatory structure more coherent. To the extent necessary, the Commission could add additional charges or multipliers to reflect the risks of hedging uncleared swaps.

The Fallback Grid Should be Refined in Order to Decrease the Competitive Disadvantage Faced by Swap Entities Forced to Use It.

Notwithstanding our strong preference for model-based approaches to capital calculations, we understand that a fallback grid is necessary for those non-BHC subsidiary, non-FCM entities that cannot or choose not to use models. However, we feel that the grid in the Proposal could be improved in a number of ways. Most importantly, we believe the proposed grid as a general matter does not give sufficient capital credit for positions in different classes of instruments that hedge or offset one another. As described above, sound capital regimes should look, to the extent possible, across individual products to the totality of a firm's risk in determining capital requirements.

In addition, we believe that a number of the provisions in the grid could be improved. In particular:

- the 15% capital charge for commodities positions is unnecessarily and unreasonably high and should be reduced to 8% of the market value of commodities swap position to align the requirement with the 8% risk margin capital charge for FCMs;
- capital charges for commodities should be decreased by the intercommodity margin spreads published by designated contract markets and DCOs, which provide established correlations between various commodities;
- the ability to only net bond positions with uncleared single-name CDS positions when maturity dates match is unnecessarily restrictive and does not adequately reflect the risk dynamics or common usage of the instruments; and
- capital charges for equity exposure at 8% general market risk plus 8% asset specific risk are unnecessarily and unreasonably high and should be reduced to

⁵ We understand the "market risk exposure requirement" and "OTC derivatives credit risk requirement" to be applicable to uncleared swaps and the instruments used to hedge those swaps, which may include cleared swaps.

8% plus 4% for equities (and 8% plus 0% for qualifying equity indices), as is used presently in international capital calculations.⁶

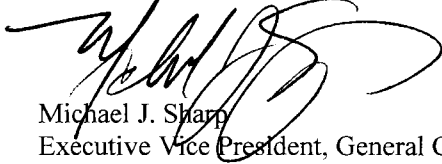
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Jefferies appreciates the opportunity to provide the Commission with comments regarding the Proposal. Please feel free to contact the undersigned at (212) 707-6409 with any questions.

Respectfully submitted,



Michael J. Sharp
Executive Vice President, General Counsel and Secretary
Jefferies & Company, Inc.

⁶ See BIPRU 7.3.30, FSA Handbook, available at <https://fsahandbook.info/FSA/print/handbook/BIPRU/7/3>.