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

September 30, 2011

**Re: Adjusted Net Capital Requirements for Futures Commission Merchants that Clear Swaps (RIN 3038-AD54)**

Dear Mr. Stawick:

UBS Securities LLC appreciates the opportunity to submit comments to the Commodity Futures Trading Commission (the "**Commission**") in response to the Commission's proposed rule on Capital Requirements for Swap Dealers and Major Swap Participants (the "**Proposed Capital Rule**")[1]. This letter is intended as a follow-up to the meetings conducted with Commission staff on July 7, 2011 and Chairman Gensler and Commissioner O'Malia on September 14, 2011 regarding the effects of the Proposed Capital Rule on futures commission merchant ("**FCM**") capital requirements.

The amount of adjusted net capital required to be maintained by an FCM registered with the Commission is determined by reference to the multi-prong test established by Regulation 1.17. One prong of this test reflects a risk-based approach: an FCM is required to maintain adjusted net capital equal to 8% of the total risk margin requirement for positions carried by the FCM in its customer and noncustomer accounts. This risk-based capital requirement is intended to provide a measure of the minimum amount of capital an FCM requires in order to provide protection for customer funds and maintain orderly markets.

The Proposed Capital Rule amends the definition of "cleared over the counter derivative positions" to include cleared swaps in the calculations required to be made by FCMs pursuant to Regulation 1.17. Given the broad scope of the regulatory changes to the swaps market resulting from the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), particularly the mandatory clearing requirement and the Commission's proposed rule on the Protection of Cleared Swaps Customer Contracts and Collateral (the "**Proposed Segregation Rule**")[2], the Proposed Capital Rule's inclusion of cleared swaps for purposes of Regulation 1.17 is far too significant to be treated as a mere conforming change. Our economic analysis of the impact of the Proposed Capital Rule on FCMs, which includes modeling the potential volume of the cleared swaps business and associated margin posting requirements by reference to a theoretical customer base, shows that an FCM acting as clearing broker for only a subset of active customers currently trading over-the-counter swaps could result in an additional US$3-5 billion of capital being required to be added to the FCM. We believe this enormous increase during a time of capital scarcity would negatively impact the economy as a whole by reducing the capital available to be deployed for other activities such as lending. In addition, FCMs will be forced to pass on many of the associated costs to customers, further adding to the increased economic burdens faced by end-users transacting in swaps.

The significant economic impact of applying the 8% risk-based capital requirement to cleared swaps, together with the other aspects of the regulatory regime for cleared swaps that are discussed below,

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[1] Capital Requirements for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27802 (May 12, 2011).

[2] Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33818 (June 9, 2011).

establish a strong policy rationale for modifying the application of the 8% risk-based capital requirement for cleared swaps instead of merely continuing the approach that was developed for futures and extended to "cleared over the counter derivative positions" prior to the enactment of the Dodd-Frank Act. As a result, we believe the Proposed Capital Rule's inclusion of cleared swaps for purposes of Regulation 1.17 should be accompanied by a comprehensive cost-benefit analysis from the Commission. In addition, we believe that other related rules proposed by the Commission, such as the Proposed Segregation Rule, should include an analysis of the increased capital costs for FCMs resulting from increased margin requirements, an element that currently appears to be absent from the "operational costs" and "risk costs" discussed in the Proposed Segregation Rule.[3] Under the Administrative Procedure Act, the Commission must examine relevant data and articulate a satisfactory explanation for its actions before promulgating a new rule.[4] In addition, the Commission has a statutory obligation under the Commodity Exchange Act to consider the costs and benefits of a proposed rule and specifically must examine such costs and benefits in light of, among other things, (a) the impact of the proposed rule on the efficiency, competitiveness and financial integrity of the relevant market and (b) sound risk management practices.[5] The Commission is required to assess the economic impact of a proposed rule, including quantifying the costs associated with the proposed rule where possible[6], and we believe that, in doing so, the Commission should remain cognizant of the direct linkages between capital and margin and the potential interaction between the extension of existing rules to cleared swaps and the various other rules proposed by the Commission.

Other aspects of the Commission's proposed regulatory regime for cleared swaps mitigate risks to customers, suggesting that the current capital requirements for FCMs should not be applied to cleared swaps and impacting the Commission's analysis of the efficiency, competitiveness and financial integrity of the swaps markets and the risk management practices of FCMs:

- Initial margins for cleared swaps are significantly higher than those for futures, in part due to the use of a five day close-out window for swaps versus a one day close-out window for futures.

- The complete legal segregation model contemplated by the Proposed Segregation Rule is expected to result in higher initial margin requirements by derivatives clearing organizations ("**DCOs**") to counteract the more limited recourse to customer margin in the event of a default. The Commission notes in the Proposed Segregation Rule that some commenters have estimated that DCOs will require approximately 70 percent more initial margin under the complete legal segregation model compared to other models.[7] This increase will translate directly into an increase in required FCM capital.

- The complete legal segregation model and the requirement that DCOs collect gross rather than net margin from FCMs in respect of swaps cleared for customers, both Commission proposals that represent a change from the current futures framework, should facilitate the transfer of customer positions and margin and reduce the risk of reliance on FCM capital when winding-down operations of an FCM.

- Absent further coordinated rulemaking from the Commission and the SEC permitting the portfolio margining of swaps and security-based swaps, margin requirements for cleared swaps, and therefore capital requirements for FCMs, will be based on calculations that do not accurately reflect the off-setting risks associated with certain positions cleared by an FCM that is also a registered

[3] See Proposed Segregation Rule at 33823.

[4] See 5 U.S.C. § 706(2)(A); Business Roundtable v. S.E.C., No. 10-1305, 2011 WL 2936808, at *2 (D.C. Cir. July 22, 2011).

[5] See 7 U.S.C. § 19(a).

[6] Although there are no cases addressing the scope of Section 15(a) of the Commodity Exchange Act, the D.C. Circuit has interpreted similar statutory requirements under the Securities and Exchange Act of 1934 and the Investment Company Act of 1940 as requiring the Securities and Exchange Commission (the "**SEC**") to rigorously examine the economic impact of rules promulgated under those statutes. See Business Roundtable, 2011 WL 2936808, at *5 (finding that the SEC's failure "to estimate and quantify the costs," combined with its failure to "claim estimating those costs was not possible," meant that it "neglected its statutory obligation to assess the economic consequences of its rule"); Chamber of Commerce of U.S. v. S.E.C., 412 F.3d 133, 142-44 (D.C. Cir. 2005) (observing that the SEC has the "statutory obligation to determine as best it can the economic implications of the rule it has proposed").

[7] See Proposed Segregation Rule at 33846.

broker-dealer or security-based swap dealer. For example, an FCM with two large transactions that largely offset each other may be required to hold twice as much capital as an FCM with only one of those transactions, even though the latter position has almost twice the risk.

The combination of the complete legal segregation model's proposed elimination of loss mutualization among non-defaulting customers of a defaulting FCM and the increased margins expected to be collected for cleared swaps compared to futures leads to the conclusion that a more tailored application of Regulation 1.17 is appropriate for FCMs clearing swaps. Imminent requirements for the mandatory clearing of swaps require that the Commission carefully consider the costs and benefits of the current capital requirements in light of the substantially different protections afforded to cleared swaps customers compared to customers clearing futures on a designated contract market. Uniformly applying the 8% risk-based capital requirement with respect to all of the initial margin required by DCOs for cleared swaps, as is proposed by the Proposed Capital Rule, appears to suffer from similar deficiencies as the 2009 Commission proposal to raise the risk-based capital requirement to 10%, which was later withdrawn by the Commission and described by commenters as an "indiscriminate, broad-brushed approach."[8]

Reasonable Alternatives

We urge the Commission to present proposals and seek public discussions on potential alternatives to the currently proposed application of Regulation 1.17's 8% risk-based capital requirement to FCMs that clear swaps. One such alternative could be a "sliding scale" that takes into account the diversification of risk that occurs as more products are cleared through an FCM, as an FCM broadens its client base and as more risk margin is collected from customers, as well as the total amount of adjusted net capital already held by such FCM. Such a "sliding scale" approach is more narrowly tailored to reflect the specific economic risks potentially applicable to an FCM, while still satisfying the key objectives of the capital requirements imposed by the Commission, such as ensuring that FCMs have a minimum level of liquid assets in excess of liabilities to meet their financial obligations and to wind-down their business in the event it is necessary to cease operating as an FCM.

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UBS is grateful for the open manner in which the Commission has addressed issues arising in connection with the implementation of the FCM capital requirements. We welcome the opportunity to provide additional information regarding our views on this topic, as well as any other issues related to the Dodd-Frank Act.

Respectfully submitted,

Eric Rosen
Managing Director

David Kelly
Managing Director

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[8] Revised Adjusted Net Capital Requirements for Futures Commission Merchants and Introducing Brokers, 74 Fed. Reg. 69279, 69281 (December 31, 2009).