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May 12, 2017

Chris Kirkpatrick  
Secretary  
Commodity Futures Trading Commission  
1155 21st Street, NW  
Washington, DC 20581

Re: Capital Requirements for Swap Dealers and Major Swap Participants;  
RIN 3038-AD54

Dear Mr. Kirkpatrick:

Jefferies Group LLC (“Jefferies”) appreciates the opportunity to provide the Commodity Futures Trading Commission (the “Commission”) with comments on the Commission’s re-proposed capital and liquidity requirements, and related financial reporting and recordkeeping requirements proposal (the “Proposal”) for swap dealers (“SDs”) as provided for by Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).<sup>1</sup> We are aware that both the Securities Industry Financial Market Association and the Futures Industry Association have submitted comment letters on the Proposal, and we share the concerns expressed by each of those associations. However, we thought it important that we also submit an individual letter to emphasize the points that are most significant to Jefferies as a non-bank medium-size firm that is nonetheless an important participant in the swaps markets.

The adoption of Dodd-Frank, and particularly the Dodd-Frank clearing mandate, has allowed Jefferies to become a significant intermediary in cleared swaps, particularly cleared interest rate swaps. We believe that our participation in the swaps market has meaningfully increased competition, improved liquidity and benefitted end investors. Unfortunately, the Proposal as drafted could adversely impact the benefits of Dodd-Frank and, if it were to be adopted and made effective in its current form in the near future, diminish Jefferies’ participation in the swap markets.

Our most immediate concern is the adverse effect that the standardized market risk grids (the “Standardized Grid Approach”), as set forth in the Proposal, would have on our swap dealing business. Additionally, even if the Standardized Grid Approach were made workable, we are concerned that the Commission will implement the capital requirements without providing us with a reasonable opportunity to have capital models approved. The process of

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<sup>1</sup> 81 Fed. Reg. 91252 (Dec. 16, 2016); *see also* 76 Fed. Reg. 27802 (May 12, 2011) (Original Capital Proposal).

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switching from the Standardized Grid Approach to a models approach would subject Jefferies to material, and we think needless, expense.

We therefore request that the Commission allow a period of at least three years between adoption of a capital rule and final effectiveness (as we understand that this time period approximates the length of time required to have a model reviewed and approved by regulators). Further, the capital requirements should not become effective until the requirement to collect initial margin from all market participants becomes effective; otherwise, Jefferies will be required to take capital charges for failure to collect margin that the Commission has not required customers to provide us. Finally, we urge the Commission to grant automatic approval of models already approved by other regulators, including the Securities and Exchange Commission ("SEC"), so that we do not have to obtain approval from multiple regulators of the same model.

## About Jefferies

Jefferies is a global securities and investment-banking firm, which has served companies and their investors for over 50 years. We currently employ over 3,000 people in various countries throughout the world, and our 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 provides research and execution services in equity, fixed income, and foreign exchange markets, as well as a full range of investment banking services and other advisory services, with all businesses operating in the Americas, Europe and Asia.

Jefferies' swap dealing business in the United States consists of a broad, well-hedged portfolio, most of which revolves around interest rate hedging for customers. The vast majority of this U.S. activity is booked in two wholly owned entities, Jefferies Financial Services, Inc. ("JFSI") and Jefferies Financial Products, LLC ("JFP"), both of which are provisionally registered with the Commission. As a general matter, JFSI enters into non-security-based swap transactions (interest rate swaps, foreign exchange swaps and indexed based credit default swaps) while JFP enters into security-based swap transactions (total return swaps and single named credit default swaps). Our eventual intent is to book all U.S. swaps, securities-based swaps and their respective hedges in a single entity that is registered with and regulated by both the Commission and the SEC. Although Jefferies plans to operate using models to calculate capital requirements, if the capital requirements were to go into effect prior to us receiving model approval, we would be subject to the Standardized Grid Approach, while we obtain models approval.

## **I. The Market Risk Requirements Computed Using the Standardized Grid Approach Are Unreasonably High.**

### Market Risk Charges Under the Standardized Grid Approach

To illustrate our concerns, we think it useful to compare the effects of the Standardized Grid Approach with two alternative methods that the Commission might adopt. The chart below illustrates the capital requirements that would be imposed on a sample matched book composed

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of approximately \$250 billion of long interest rate swaps, all of which are hedged by an off-setting trade (the "Reference IRS Portfolio"). The chart below shows the capital requirements imposed on the Reference IRS Portfolio by each of (i) the Standardized Grid Approach set forth in the Proposal, (ii) the maintenance margin requirement ("MMR") required by the applicable clearing corporation consistent with current CFTC Regulation 1.17(c)(5)(x) and Appendix B of SEC Rule 15c3-1 for cleared futures contracts and OTC derivative positions for both a clearing member (Total MMR) and a non-clearing member (150% of MMR) and (iii) the Standardized Grid Approach, excluding the 1% minimum notional charge.

## Reference Interest Rate Swap Portfolio

Interest Rate Swap Portfolio (in millions)					Capital Approach as Proposed			Alternative Capital Approaches				
					Standardized Grid Charges Including the 1% Minimum			Charges Based on Clearing House Maintenance Margin Requirement (MMR)**		Standardized Grid Charges Excluding the 1% Minimum		
Maturity Category	Government Haircut*	Notional Value Long	Notional Value Short	Notional Value Net	1% Minimum of Matched Notional Long/Short Value	Charge on Unhedged Notional of Long/Short Position	Total	Total MMR	150% of MMR	Hedged	Unhedged	Total
Category 1	0% - 1%	\$151,000	\$(149,000)	\$2,000	\$1,490	\$20	\$1,510			-	\$11	\$11
Category 2	1.5% - 2%	38,000	(39,000)	(1,000)	380	33	413			-	33	33
Category 3	3% - 4%	60,000	(61,000)	(1,000)	600	29	629			-	29	29
Category 4	4.5% - 6%	4,000	(4,000)	-	40	0	40			-	0	0
Total		\$253,000	\$(253,000)	\$ -	\$2,510	\$82	\$2,592	\$18	\$27	-	\$73	\$73

\* Each maturity category within the U.S. Government haircut schedule has two or more subcategories. A blended haircut percentage was applied to categories 2 through 4.

\*\* MMR is provided by the clearing corporation.

## Capital Requirements Under the Standardized Grid Approach

As illustrated by the above chart, the Standardized Grid in the Proposal would require a firm to maintain almost \$2.6 billion in capital for the Reference IRS Portfolio. By contrast, using the Standardized Grid without a minimum charge based on notional would result in a capital requirement of approximately \$73 million. Applying the MMR of the clearing corporations (consistent with the regulatory capital treatment for cleared futures transactions), the capital requirement would be only \$27 million, even after multiplying the MMR by 150% for a non-clearing member firm. The MMR is intended to reflect the risk of these positions as determined by the clearing corporations. While our VaR model has not been approved by a regulator, the VaR associated with the above sample interest rate swap portfolio is consistent with the MMR. The result of the Proposal is almost **144x higher** than an alternative measure of

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risk (Total MMR) that is actually used by the clearing houses.<sup>2</sup> In short, the proposed Standardized Grid Approach is simply not feasible for a swap dealer to remain in business.

The primary reason that the Standardized Grid does not produce a reasonable result is that it does not provide sufficient recognition for positions that are hedged or offset one another. Beyond the problematic numbers generated by the Standardized Grid, Jefferies also notes that the grid is operationally difficult to use. Because the grid does not actually measure risk in any meaningful way, firms required to use the standardized grid would have to calculate capital requirements without the ability to leverage the existing risk-management data, processes and systems upon which their internal risk models are based.

## Alternative Capital Requirements are Better Suited for Interest Rate Swaps

As to cleared interest rate swaps and security-based swaps, we recommend that Commission apply the capital requirements applicable to cleared futures contracts under CFTC Regulation 1.17(c)(5)(x) and Appendix B of SEC Rule 15c3-1, using the maintenance margin requirement as determined by the clearing corporation.<sup>3</sup>

As for uncleared interest rate swaps, we recommend using the SEC's Government Securities haircut grid without the 1% minimum charge that otherwise applies to the notional value of the hedged portion of the positions. The 1% minimum haircut is designed to account for potential differences between the movements of interest rates upon which swap payments are based. However, if a position is fully hedged, interest rate fluctuation is already addressed.

## **II. Time Required to Go Effective**

### After Effectiveness of Margin Requirements

Jefferies request that the Commission implement the capital rule after the margin regulations are fully implemented. By waiting until after the margin regulations are effective, the Commission will avoid punishing a firm by imposing capital charges for failing to collect margin it is not yet required to collect.

### Time for Approval

Jefferies request that the Commission implement the capital rule after all firms who are interested have been given the opportunity to have its internal models approved. No firm can sustain its business if it is to be subject to a capital charge that is 100x higher than a meaningful measurement of risk would require.

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<sup>2</sup> One question that the Commission might reasonably ask is how the grid capital charge could have been used by the SEC if it produced such an unreasonable result. The short answer to that question is that firms did not book any material amount of interest rate swap transactions into an SEC-registered broker-dealer subject to the grid charges. Firms booked these transactions into a bank or into an unregulated swaps vehicle. As a result, the grid charges essentially worked not to regulate swaps, but to prevent them from being booked into a broker-dealer.

<sup>3</sup> 17 CFR 240.15c3-1b(a)(3)(xiv)(B).

## Automatic Approval

Jefferies recommends that the Commission automatically recognize and accept models previously approved by the SEC and the other prudential regulators. Automatic approval will decrease the Commission's review burden and will allow firms such as Jefferies to operate without submitting the same models to multiple regulators. Proposed Regulation 1.17(c)(6)(i) allows Futures Commission Merchants ("FCMs") that are dually registered with the SEC to use alternative capital deductions approved by the SEC. Such a regime should also be in place for swap dealers subject to proposed Regulation 23.101 with respect to both SEC and Prudential Regulator approved models.

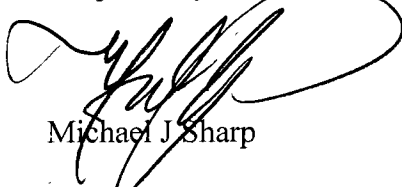
### **III. Need for Competitive Markets**

The Commission has recognized and even emphasized the importance of firms like Jefferies to the swap dealing market. When adopting its "Derivatives Clearing Organization General Provisions and Core Principles,"<sup>4</sup> the Commission specifically required clearing agencies registered with the Commission to implement a lower minimum net capital requirement on the basis of the Commission's determination that midsize firms "will make markets more competitive, increase liquidity, reduce concentration, and reduce systemic risk."<sup>5</sup> If this Proposal is adopted, many of these same firms that the Commission expressed concern over will be forced to exit the market.

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We appreciate the Commission's consideration of our comments on the Proposal. We would be pleased to provide further information at the request of the Commission or its staff. If you have any questions or comments, please do not hesitate to contact the undersigned, or Steven Lofchie (212-504-6700) of Cadwalader, Wickersham & Taft LLP, outside counsel to Jefferies in this matter.

Respectfully submitted,



Michael J. Sharp

EVP, General Counsel

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<sup>4</sup> 76 Fed Reg. 69334 (Nov. 8, 2011).

<sup>5</sup> *Id.* at 69355-6 (Nov. 8, 2011).