Morgan Stanley

May 15, 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**

Ladies and Gentlemen:

Morgan Stanley appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "**Commission**") in response to its notice of proposed rulemaking to establish capital requirements for Swap Dealers and Major Swap Participants (the "**Proposal**").[1]

Morgan Stanley is a global financial services firm that provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. We are registered as a bank holding company ("**BHC**") with the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), and are subject to the Federal Reserve's consolidated regulation and supervision, including regulatory capital and liquidity requirements that are based on standards developed by the Basel Committee. Morgan Stanley has multiple consolidated subsidiaries that are provisionally registered as Swap Dealers with the Commission.

Through the Proposal, the Commission has made substantial progress toward fulfilling its statutory obligation of imposing capital standards that are, "to the maximum extent practicable," comparable in relevant respects to capital standards imposed by the Securities and Exchange Commission (the "**SEC**") as well as the Federal Reserve, the Office of the Comptroller of the Currency ("**OCC**") and the Federal Deposit Insurance Corporation ("**FDIC**") (collectively, the "**Prudential Regulators**").[2] Permitting Swap Dealers to be governed by SEC- or Prudential Regulator-based standards promotes a practical, harmonized approach to capital and liquidity regulation, particularly in the case of Swap Dealers that are dual-registered with the SEC as Security-Based Swap Dealers ("**SBSDs**") or are consolidated subsidiaries of BHCs.

Our comments in this letter are focused on four areas of the Proposal: (i) the bank-based capital approach ("**Bank Approach**"); (ii) the net liquid assets capital approach, which is based on the SEC's proposed capital rules for SBSDs ("**Modified SBSD Approach**"); (iii) liquidity requirements; and (iv)

[1] 81 Fed. Reg. 91,252 (Dec. 16, 2016).
[2] 7 U.S.C. § 4s(e)(3)(D)(ii)(I).

the substituted compliance and internal capital model review processes. In addition, Annex A to this letter includes comments on the proposed reporting, disclosure and notification obligations.

In addition to our comments in this letter, we also support comments submitted to the Commission on the Proposal by the Securities Industry and Financial Markets Association.

**1. Bank Approach**

We support the Commission's decision to include the Bank Approach in the Proposal. We agree with the Commission that "proposing capital requirements using the Federal Reserve Board's capital framework is appropriate as the framework specifically reflects swaps and security-based swaps in the capital requirements, and the framework was developed to provide prudential standards to help ensure the safety and soundness of bank and bank holding companies."[3] While we agree with the general design of the Bank Approach, we have two comments.

First, we recommend that the Commission more closely align common equity tier 1 ("**CET1**") requirements in the Bank Approach with standards established by the Prudential Regulators. The Proposal applies an effective capital requirement of 9.6 percent CET1 in the Bank Approach, which results from application of the 120 percent Early Warning threshold to an 8 percent CET1 minimum requirement.[4] While we recognize the Commission's desire to include an Early Warning threshold in the Swap Dealer capital framework, the Proposal includes no explanation or rationale to support a *de facto* 9.6 percent CET1 requirement.[5] As an alternative, we recommend that the "Early Warning" threshold should be set at 6.5 percent CET1 with a "hard limit" regulatory minimum of 4.5 percent CET1, consistent with Prudential Regulators' "well capitalized" and "adequately capitalized" standards for banks.[6] Adopting the 6.5 percent CET1 "well capitalized" standard as the Early Warning threshold would more clearly advance the Commission's statutory duty to develop "comparable" capital requirements for bank and nonbank Swap Dealers, incorporate a robust post-crisis regulatory capital standard from the Prudential Regulators, and preserve the Commission's long-standing reliance on an Early Warning limit, which in this case would be set at more than 140 percent of the regulatory minimum.[7]

Second, we believe that Swap Dealers electing the Bank Approach should calculate risk-weighted assets ("**RWAs**") in accordance with Federal Reserve standards in Regulation Q. In its current form, the Proposal may result in confusion; while one section of the rule text directs Swap Dealers to calculate RWAs in accordance with Regulation Q, a separate section requires Swap Dealers to submit internal

[3] 81 Fed. Reg. at 91,256.

[4] While the 120 percent Early Warning threshold is grounded in futures commission merchant and broker-dealer regulatory capital principles, Proposal sections 104(c) and 105(c)(2) would apply it to all nonbank Swap Dealers regulated by the Commission.

[5] As noted by the SEC, an "'early warning' threshold acts as a de facto minimum" since regulated firms "seek to maintain sufficient levels of tentative net capital to avoid the necessity of providing this regulatory notice." 77 Fed. Reg. 70,214, 70,228 (Nov. 23, 2012).

[6] 12 C.F.R. §§ 6.4(c)(1)(iii), 6.4(c)(2)(iii) (OCC); 12 C.F.R. §§ 208.43(b)(1)(iii), 208.43(b)(2)(iii) (Federal Reserve); 12 C.F.R. § 324.403(b)(1)(iii) (FDIC).

[7] See CEA § 4s(e)(3)(D)(ii)(I); see also 78 Fed. Reg. 62,040-42 (Oct. 11, 2013) (describing the Prudential Regulators' "well capitalized" and "adequately capitalized" standards as developed in U.S. Basel III).

model RWA applications to the Commission pursuant to Commission-specific criteria rather than Regulation Q.[8] We believe that Swap Dealer RWA calculations should be based explicitly on Regulation Q, which would both ensure alignment with BHC parent company RWA calculations and eliminate the possibility that Swap Dealer examiners would interpret or apply RWA standards differently than the Federal Reserve. For Swap Dealers using internal capital models, Swap Dealers' credit risk RWAs would be calculated in accordance with Regulation Q, Subpart E, Sections 131-155, and market risk RWAs would be calculated in accordance with Regulation Q, Subpart F.

### 2. Modified SBSD Approach

We support the Commission's decision to incorporate by reference the SEC's Proposed Rule 18a-1, in modified form, as an alternative capital methodology to the Bank Approach.[9] Market participants frequently engage in both swap and security-based swap transactions, and the Modified SBSD Approach creates the possibility of a harmonized framework for Swap Dealers that are dual-registered as SBSDs.

The SEC has not yet finalized Proposed Rule 18a-1. As such, it is impossible to comment meaningfully on the Commission's proposed incorporation of, and modifications to, the SEC's proposal, since that would require making assumptions as to how the SEC will resolve the various technical issues raised during its notice and comment process.[10] As a practical matter, it appears that the SEC will need to finalize Proposed Rule 18a-1 before the Commission finalizes the Proposal, since the Proposal relies on Rule 18a-1 for the Modified SBSD Approach. We recommend that the Commission reopen the comment period on the Proposal after the SEC finalizes Rule 18a-1 to provide Swap Dealers with a meaningful opportunity to comment on the Commission's complete proposed capital framework.

As a preliminary matter, however, we support several of the Commission's modifications to Proposed Rule 18a-1, such as expanding the scope of counterparty relationships eligible for credit risk charges and clarifying that receivables from third-party custodians holding a Swap Dealer's initial margin are current assets.[11] We are unable to comment fully on the Commission's other proposed changes to Rule 18a-1, for the reasons described above.

### 3. Liquidity requirements

The Proposal includes two potential liquidity regimes: the Liquidity Coverage Ratio ("**LCR**") and, as an alternative, an internal liquidity stress test.[12] As with the capital framework, we support the Commission's approach of recognizing different liquidity standards, each of which are grounded in

---

[8] Compare Proposal § 101(a)(1)(i)(B) (referencing 12 CFR part 217) with Proposal § 102 and Appendix A (describing the technical standards to be met for internal model RWA approvals).
[9] See 77 Fed. Reg. 70,214 (Nov. 23, 2012).
[10] Morgan Stanley filed two comment letters with the SEC on Proposed Rule 18a-1, which are available at: https://www.sec.gov/comments/s7-08-12/s70812-32.pdf (Feb. 22, 2013); https://www.sec.gov/comments/s7-08-12/s70812-70.pdf (Oct. 29, 2014).
[11] Proposal § 101(a)(1)(ii)(A)(3)-(4).
[12] Proposal § 104(a)-(b).

existing regulatory frameworks. We believe, however, that the proposed liquidity framework can be improved in various ways.

*Liquidity framework optionality, similar to capital framework*

As a preliminary matter, we recommend that a Swap Dealer's liquidity requirements not be tied to its regulatory capital framework. A Swap Dealer subject to Bank Approach regulatory capital standards should be eligible for internal liquidity stress testing; similarly, a Swap Dealer governed by the Modified SBSD Approach should be able to elect the LCR. Each of the Commission's proposed liquidity regimes includes a contingency funding plan requirement, which is the foundation of liquidity risk management, and, depending on a specific Swap Dealer's particular business mix or activities, the LCR or an internal stress test may provide a more realistic assessment of a Swap Dealer's liquidity profile, regardless of the governing capital regime. As such, there is no inherent reason why the applicable liquidity framework must apply based on a Swap Dealer's capital framework.

*Federal Reserve Regulation YY as a potential third liquidity framework*

The Federal Reserve has two short-dated liquidity risk management standards for U.S. BHCs. The Proposal incorporates one of these standards, the LCR, but not the second, which imposes a comprehensive liquidity risk management program through the Federal Reserve's Regulation YY.[13] Similar to the Commission's proposed approach for regulatory capital, where Swap Dealers are permitted to conduct credit risk RWA calculations under either Subpart D or Subpart E of the Federal Reserve's Regulation Q, we recommend that the Commission recognize Regulation YY as an alternative liquidity risk management framework for Swap Dealers. As with regulatory capital rules, a Swap Dealer electing this approach would be required to comply with Regulation YY liquidity risk management standards, as if the Swap Dealer itself were a BHC, in lieu of either the LCR or an internal stress test.

Similar to the 30-day focus of the LCR, Regulation YY requires BHCs "to maintain a liquidity buffer that is sufficient to meet the projected net stressed cash-flow need [of the BHC] over the 30-day planning horizon."[14] Regulation YY is more comprehensive than the LCR, however, imposing liquidity risk management governance requirements on a firm's board of directors and senior management, mandating a range of liquidity stress testing practices from overnight to one-year scenarios, requiring the development and adoption of liquidity risk tolerance limits, and emphasizing the role of an independent review function.

Permitting Swap Dealers to elect Regulation YY-based liquidity risk management standards in lieu of the LCR or internal stress tests would also advance the Commission's policy goal of harmonizing, to the extent practicable, its standards with those of the Federal Reserve. Swap Dealer subsidiaries of BHCs would be required to demonstrate their independent adherence with Regulation YY standards, but could leverage existing Regulation YY-compliant practices of their parent companies. Where BHCs conduct "strategic analysis" of material subsidiaries' liquidity and funding needs for purposes of recovery

[13] See 12 C.F.R. §§ 252.34-35.
[14] 12 C.F.R. § 252.35(b)(1).

and resolution planning, including in the event of the BHC's material financial stress or failure, Swap Dealers' Regulation YY-based liquidity buffers could take into account such BHC support.[15] In most cases, a Regulation YY-based liquidity risk management program would more accurately reflect a Swap Dealer's actual liquidity needs than the LCR, since the LCR fails to reflect the Swap Dealer's role as a BHC subsidiary and otherwise excludes any analysis of the Swap Dealer's liquidity and funding needs in the event of stress or failure at a parent BHC.

*Technical comments on LCR standard*

Following the Commission's approach to initial margin requirements, we recommend that the Commission exclude inter-affiliate inflows and outflows from Swap Dealers' LCR calculations. As with initial margin requirements, imposing LCR charges for inter-affiliate transactions would result in "costly" frictions even where the transactions are only "shifting risks within the consolidated group."[16] In addition, to the extent that Swap Dealers are governed by the LCR for their liquidity requirements, we recommend that the Commission clarify that Swap Dealers meeting the applicable asset size thresholds, measured on a standalone basis, should be eligible for the modified LCR recognized by the Federal Reserve for certain BHCs.[17] Clarifying this point would better align the Commission's liquidity rules with the Bank Approach capital framework, where capital requirements apply "as if the swap dealer itself were a bank holding company," since Federal Reserve regulatory capital and liquidity standards are tailored for BHCs of different sizes.[18]

We support the Commission's approach of recognizing cash deposits at commercial banks as Level 1 assets; since nonbank Swap Dealers typically do not have central bank deposit access, this accommodation appropriately reflects Swap Dealers' liquidity management practices.[19] Finally, while we agree with the Commission that non-U.S. Swap Dealers should be permitted to include certain local jurisdiction assets in their eligible HQLA, we recommend that the Commission recognize a substituted compliance process for non-U.S. Swap Dealers' liquidity requirements, similar to the contemplated substituted compliance process for capital requirements.

*Technical comments on internal stress test standard*

We support the general design of the internal stress test standard, which includes conservative assumptions designed to ensure that a Swap Dealer's liquidity profile is robust. We note in particular the Commission's requirement that a Swap Dealer justify any differences between its stress test assumptions and those of its parent BHC, which suggests that the two should generally be aligned.[20] Since parent BHC stress tests may require the BHC to maintain liquidity to support subsidiaries, including Swap Dealers, a Swap Dealer's stress test assumptions should logically reflect a consistent assumption. Finally, we recommend that the Commission expand the scope of qualifying liquidity reserves beyond cash and U.S.

[15] 12 C.F.R. § 243.4(c)(1)(iii).
[16] 81 Fed. Reg. 636, 688 (Jan. 6, 2016).
[17] See 12 C.F.R. § 249.63.
[18] Proposal § 101(a)(1)(i)(A), (B).
[19] Proposal § 104(a)(1).
[20] Proposal § 104(b)(2).

Treasury and Agency securities to include relevant foreign equivalents, as non-U.S. Swap Dealers will need to hold high-quality non-U.S. sovereign securities to meet local market liquidity requirements.[21]

**4. Substituted compliance and internal capital model review processes**

While technically distinct, the substituted compliance and internal capital model review processes are inherently interlinked. Swap Dealers seeking to use internal capital models will generally have affiliates or parent companies with existing regulator-approved internal capital models. In addition, existing internal capital models may be reviewed and approved by either U.S. or non-U.S. regulators. As such, the Commission will need a consistent approach for evaluating U.S. and non-U.S. Swap Dealers' internal capital models, taking into account existing U.S. and non-U.S. regulatory approvals.

The Commission noted in the Proposal the practical difficulties involved in reviewing and approving all Swap Dealers' capital models at a single moment when regulatory capital requirements take effect. The Commission also signaled its willingness to take into consideration relevant existing regulatory approvals.[22] We agree with the Commission that existing regulatory approvals and supervision programs should be strong considerations in the Commission's model review and substituted compliance processes.

We recommend that the Commission rely on a provisional approval process for internal capital models that have already been reviewed and approved by regulators. In particular, under this approach, the Commission might provide a two-year provisional approval for a Swap Dealer's internal capital models if:

- The Swap Dealer's internal capital models:
    - have been reviewed and approved, and are currently subject to supervision, by a prudential or foreign regulator whose regulatory capital framework has been reviewed by the Basel Committee for conformance with global capital standards;[23] or
    - are the same internal capital models used by an affiliated corporate banking group, and the affiliated corporate banking group's internal capital models have been reviewed and approved, and are currently subject to supervision, by a prudential or foreign regulator whose regulatory capital framework has been reviewed by the Basel Committee for conformance with global capital standards;

[21] Proposal § 104(b)(3)(i).
[22] 81 Fed. Reg. at 91269-70 & n. 88.
[23] As a practical matter, nonbank Swap Dealers subject to the Commission's capital jurisdiction would not have internal capital models reviewed and approved, and currently subject to supervision, by a Prudential Regulator, since the Prudential Regulators' capital jurisdiction is limited to banking entities. However, in many cases, we expect non-U.S. Swap Dealers to be subject to direct oversight by foreign regulators.

- The Swap Dealer has made available to the Commission and the NFA copies of underlying documentation, including regulatory approvals, evidencing review, approval and supervision of the internal capital models, to the extent permitted by applicable law;

- The Swap Dealer files an application for internal model approval with the Commission within 90 days of Swap Dealer capital requirements taking effect; and

- The Chief Financial Officer of the Swap Dealer provides the Commission with a written attestation on a quarterly basis that the Swap Dealer's regulatory capital calculation is measured in accordance with standards of the prudential or foreign regulator that has reviewed and approved, and currently supervises, the internal capital model, and makes available to the Commission regulatory capital reports prepared in accordance with prudential or foreign regulatory standards.

A provisional approval process along these lines would balance the Commission's interests in ensuring that Swap Dealers maintain rigorous levels of capital adequacy, on the one hand, with ensuring an orderly, practical implementation of the Commission's regulatory capital standards, on the other hand. At the conclusion of two years, the Commission could either finalize determinations of the adequacy of specific Swap Dealers' internal capital models, or recognize further one-year extensions of provisional treatment to the extent warranted by circumstances.

Such an approach is particularly compelling in the case of Swap Dealers based in major foreign markets with robust regulatory regimes, such as the European Union and Japan. Any failure to recognize substituted compliance, even if such recognition is only on a provisional basis for a short period, would result in major disruptions to the Swap Dealer's existing regulatory capital practices administered by host country regulators. While the Commission could require regulatory capital information to be submitted to appropriately monitor such Swap Dealer's capital levels and risk profiles, there should be a well-defined process for incorporating non-U.S. regulators' existing supervisory programs.

Finally, the Proposal does not appear to include a substituted compliance process for liquidity requirements. Regulatory capital and liquidity standards raise many of the same considerations, and we believe that the Commission's final rule should include an equivalent process for recognizing substituted compliance for non-U.S. Swap Dealers' liquidity requirements.

**Conclusion**

We appreciate the opportunity to comment on the Proposal. We would welcome an opportunity to discuss any of the points raised in this comment letter.

Respectfully submitted,

Sebastian Crapanzano
Managing Director

Soo-Mi Lee
Managing Director

cc: Hon. J. Christopher Giancarlo, Acting Chair

Hon. Sharon Bowen, Commissioner

Eileen T. Flaherty, Director, Division of Swap Dealer and Intermediary Oversight

Thomas Smith, Deputy Director, Division of Swap Dealer and Intermediary Oversight

Annex A: Comments on proposed reporting, disclosure and notification obligations

| Proposed Rule | Comment |
|---|---|
| 105(b), (e)(3) | The Proposal would permit a Swap Dealer prepare and maintain its financial records, and to file audited financial statements, in either U.S. GAAP or International Financial Reporting Standards (IFRS). We recommend that non-U.S. Swap Dealers be permitted to file audited financial statements under any locally applicable accounting regime (e.g., Japanese GAAP), or at a minimum that a non-U.S. Swap Dealer be permitted to apply to the Commission for permission to use a locally applicable accounting regime other than U.S. GAAP or IFRS. |
| 105(d)(2) | Existing accounting and regulatory standards do not require preparation of a monthly statement of cash flows. We recommend that the monthly cash flow reporting requirement be eliminated. |
| 105(d)(3), (e)(5) | We support the Commission's efforts to harmonize reporting obligations for dual-registered Swap Dealer-SBSDs. When the SEC finalizes its SBSD capital rule, we recommend that the Commission consider other areas where alignment of reporting obligations for dual-registered Swap Dealer-SBSDs may be appropriate. |
| 105(f), (p)(5) | The Proposal would impose a personal attestation requirement with respect to every "filing" made pursuant to Section 105. Section 105 imposing a wide range of reporting and notification obligations on Swap Dealers, and Swap Dealers will need to implement control processes to support any personal attestation requirement. We request that the Commission clarify and limit the scope of the personal attestation requirement to financial statement filings to avoid the need for Swap Dealers to create personal attestation control processes for day-to-day communications with the Commission that may be viewed as extending from the requirements of Section 105. |
| 105(k)(1)(v) | Section 105(k)(1)(v) would require a Swap Dealer to report to the Commission, on a monthly basis, "credit risk information on swap, mixed swap and security-based swap exposures." Swap Dealers generally manage credit risk exposures at the netting set level; as such, we recommend that the Commission clarify that any credit risk reporting obligations apply with respect to netting sets and not to individual swap, mixed swap, or security-based swap products within netting sets. |
| 105(l), Appendix A | We request that the Commission clarify whether the "margin collected" reporting field is intended to include initial margin, variation margin or both. In addition, we believe that instructions governing Appendix A should clarify whether notional or market values apply in each reporting field and whether reporting field amounts should reflect applicable netting arrangements. These comments are particularly relevant for lines 12-14 of Schedule 1. |
| 105(p)(2), Appendix B | We recommend that Appendix B be eliminated. The Commission should rely on comparable information prepared by Swap Dealers for prudential regulators rather than require the same information to be submitted in a different format. |
| 105(p)(7) | Public disclosure requirements for Swap Dealers subject to the capital requirements of a prudential regulator should be aligned with existing public disclosure requirements imposed by prudential regulators (i.e., the disclosures required by 12 C.F.R. §§ 3.61-63). The Commission should impose no incremental or additional public disclosure obligations on prudentially regulated Swap Dealers. |
| 105(q) | The weekly position and margin reporting requirements imposed by Section 105(q) should be rationalized with existing reporting requirements imposed by Part 45 of the Commission's rules. The Proposal does not discuss the interplay of Section 105(q) with the reporting obligations of Part 45. |