Shell Trading Risk Management, LLC

March 3, 2020

VIA ELECTRONIC SUBMISSION

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Proposed Rule; Reopening of Comment Period; Request for Additional Comment, *Capital Requirements of Swap Dealers and Major Swap Participants* (RIN 3038-AD54)

Dear Mr. Kirkpatrick:

I. INTRODUCTION

Shell Trading Risk Management, LLC ("**STRM**") appreciates the opportunity to provide additional comment on the U.S. Commodity Futures Trading Commission's ("**CFTC**" or "**Commission**") proposed rule regarding capital requirements of swap dealers and major swap participants (the "**Re-Proposal**")[1,2] as well as the CFTC's willingness to listen to the market and STRM's concerns with respect to the Re-Proposal. As a general matter, STRM is supportive of the Commission reexamining the matters raised in the questions set out in the Re-Proposal and moving forward with many of the changes implied by those questions. However, as set out below, STRM continues to have a number of concerns with respect to certain of the details of the CFTC's proposed capital rules for swap dealers.

II. THE RE-PROPOSAL'S SUGGESTED APPROACH TO THE TREATMENT OF NON-FINANCIAL SWAP DEALERS IS APPROPRIATE

The determination of whether a swap dealer is "predominantly engaged in non-financial activities" is properly conducted at the parent company level as non-financial companies may ring-fence

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[1] *See* Proposed Rule; Reopening of Comment Period; Request for Additional Comment, *Capital Requirements of Swap Dealers and Major Swap Participants*, 84 Fed. Reg. 69,664 (Dec. 19, 2019), https://www.cftc.gov/sites/default/files/2019/12/2019-27116a.pdf.

[2] *See* Notice of Proposed Rulemaking, *Capital Requirements of Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 91,252 (Dec. 16, 2016), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2016-29368a.pdf.

financial activities like swap dealing activity and treasury activity in standalone legal entities. Choosing to structure the business in this way does not negate the fact that the derivatives activity is typically one part of a much larger non-financial business. So, as previously noted by STRM,[3] conducting the "non-financial" analysis at the ultimate parent level would allow appropriate flexibility with respect to how a commercial swap dealer structures its business and not, de facto, dictate corporate structure by regulation.

In the alternative, if the Commission would like to apply the analysis of whether a swap dealer should be eligible for the Tangible Net Worth Capital Approach at an entity level, the CFTC could look to whether an entity is engaged predominantly in commodities-related swap dealing activity. Specifically, the CFTC could allow any swap dealer whose exempt or agricultural commodity-related swap dealing activity comprised 85% or more of their swap dealing activity to utilize the Tangible Net Worth Capital Approach.

III. RESPONSES TO THE COMMISSION'S QUESTIONS REGARDING THE TANIGIBLE NET WORTH CAPITAL APPROACH

Question 7-b: Should the Commission require an SD that relies on a parent entity to satisfy the "predominantly engaged in non-financial activities" criteria to elect the Tangible Net Worth Capital Approach to obtain parent guarantees, or some other form of financial support, for its swaps obligations?

A parental guarantee should not be required if a swap dealer is relying on its parent to qualify as non-financial. However, to the extent the Commission does require such a guarantee, the guarantee should be permitted to come from an affiliate with an appropriate credit rating – not just the ultimate parent of the swap dealer. Among other things, allowing this flexibility would permit swap dealers to rely on guarantees from a U.S. person rather than a non-U.S. person to the extent their ultimate parent is located outside the United States.

[3] *See, e.g.,* Shell Trading Risk Management, LLC Comments on Proposed Rule, *Capital Requirements of Swap Dealers and Major Swap Participants* (May 15, 2017), https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61221&SearchText=.

Question 7-c: Should the Commission require a higher minimum capital requirement for SDs that rely on its parent to meet the criteria to be eligible to use the Tangible Net Worth Capital Approach?

The Commission should not. The reliance on the character of a parent to qualify for the Tangible Net Worth Capital Approach should not cause a swap dealer to have a higher or different capital requirement as that fact does not affect the entity's creditworthiness or capitalization. In addition, if a swap dealer were to use the Tangible Net Worth Capital Approach and not use a capital model, they would already be subject to a higher capital requirement as the approach requires an entity to hold a minimum of $20 million plus the appropriate market and credit risk charges while the other two approaches set a floor of $20 million.

Question 7-d: Should the Commission consider any revisions to the 15% Asset Test and/or the 15% Revenue Test?

Yes, if the Commission retains the 15% tests, it should consider the assets and revenue derived from trading and investing in physical commodities to be non-financial in nature. In addition, all hedges of commercial risk should be considered non-financial in nature as that activity is more indicative of an entity being a commercial end-user rather than an entity engaged in activity that is financial in nature.

IV. REGISTERED SWAP DEALERS SHOULD BE PERMITTED TO USE IFRS

The CFTC asks whether U.S. person swap dealers with non-U.S. ultimate parents should be permitted to use IFRS when satisfying their financial reporting obligations, regardless of whether they are predominantly engaged in non-financial activity.[4] In short, they should. An entity like STRM that is a U.S. person, but has a non-U.S. ultimate parent, typically produces its financial statement in IFRS and requiring a conversion to GAAP would be a material cost and resources burden. Further, the CFTC asks for examples of relevant differences between IFRS and GAAP.[5] For the purposes of STRM's business, there would be no material difference between its financial statements if they were produced under IFRS or GAAP.

V. THE RE-PROPOSAL'S SUGGESTED CHANGES TO THE SWAP DEALER FINANCIAL REPORTING PARADIGM ARE PROPER

A. Audited Annual Report Submission

As set out in STRM's prior comment letter, the CFTC should permit a 90-day period for swap dealers that consolidate into parent entities that are not predominantly engaged in financial activities to provide

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[4] Re-Proposal at 69,679 (CFTC question 11-a).

[5] Re-Proposal at 69,679 (CFTC question 11-b).

their audited annual financial statements. As previously noted, this is consistent with large non-financial public company audit timelines. Adopting a 60-day submission period would be cost prohibitive as it likely would require STRM to have its own independent audit process outside of the larger Shell financial reporting process, which, among other things, would be duplicative.

B. Public Disclosures

The CFTC should modify the Re-Proposal by aligning the public disclosure requirements for swap dealers that are not affiliated with banks with those required by the U.S. Securities and Exchange Commission ("**SEC**") for stand-alone security-based swap dealers by replacing the quarterly public disclosure of financial information requirement with a bi-annual requirement. This modification should include changing the unaudited financial report posting requirement on the firm's website from a ten business day requirement to a thirty calendar day requirement following the date of the statements.

These proposed improvements to the rule raised in the Re-Proposal would significantly reduce the reporting burden on non-financial swap dealers, who would have to build new processes to address these requirements as they are not currently subject to similar obligations at the swap dealer level. Said another way, to the extent the Commission does not change the proposed reporting and disclosure timelines, non-financial swap dealers will have to dedicated new material resources to meet the tight timeframes set out in the Re-Proposal.

VI. NETTING OF COMMODITY POSITIONS FOR THE STANDARDIZED MARKET RISK CHARGE SHOULD BE PERMITTED

Consistent with Basel III, the CFTC should allow netting of commodity positions when determining capital requirements. Permitting netting would be consistent with prudent risk management practices and would allow certain swap dealers to be more responsive to customer needs. Under this netting paradigm, swap dealers should be permitted to consider the offsetting nature of physical commodity positions and related derivatives in addition to offsetting derivative positions. Further, to properly reflect the risk in their book, swap dealers should be permitted to net market-facing transactions with offsetting transactions entered into with affiliates.

VII. ALTERNATIVE FORMS OF COLLATERAL POSTED BY COMMERICAL END-USERS SHOULD BE ACCOUNTED FOR

As a number of other commenters have noted, Congress has stated on numerous occasions that commercial end-user transactions should not be subject to capital and margin requirements. While a complete exemption from capital requirements for transactions with commercial end-users may not be tenable, the Commission should follow the example

of the Prudential Regulators[6] and find a way to provide a reduced capital requirements with respect to transactions that qualify for the end-user exception from mandatory clearing.

One way the CFTC could provide some relief to those transactions would be to account for the credit risk migration provided by alternative forms of collateral. While alternative forms of collateral (*e.g.,* letters of credit, liens on physical assets, and parental guarantees) are not as liquid as certain other types of collateral, they are still a valuable credit risk mitigant. The Commission could acknowledge that fact by factoring in such collateral at an appropriate haircut when calculating a commercial end-user's counterparty credit risk charge.

VIII. THE POTENTIAL CHANGES TO VARIOUS QUANTITATIVE PROVISIONS OF THE CAPITAL REQUIREMENTS MERIT CLOSE CONSIDERATION

A. Risk Margin Amount

As a general matter, aspects of the Commission's capital requirements, including the Risk Margin Amount, should be tiered for the size and complexity of the swap dealer's business. The current proposed 8% level may be appropriate for the largest multi-asset class dealers, while a small single-asset class swap dealer that only engages in uncleared transactions might be subject to the 2% level adopted by the SEC, given the lower risk and simplicity of its business.

B. Risk-Weighted Assets Capital Ratio Requirement

As with the Risk Margin Amount percentage, the composition of the Risk-Weighted Assets Capital Ratio requirement in the Bank-Based Capital Approach should be tiered based on the size and complexity of the swap dealer's business.

For a simpler and smaller swap dealer, permitting the use of a 4.5% level of Tier One Capital and 3.5% Tier Two Capital would be proper. In fact, these levels would be consistent with, and arguably more stringent than, the Federal Reserve's minimum capital requirements for bank holding companies.[7]

In addition, the CFTC also asks whether certain types of assets should be permitted to comprise Tier One and Two Capital, including subordinated debt.[8] STRM would support the Commission mirroring the

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[6] *See* Final Rule, *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 85 Fed. Reg. 4,362, https://www.fdic.gov/news/board/2019/2019-11-19-notice-dis-a-fr.pdf.

[7] *See* 12 C.F.R. § 217.10.

[8] Re-Proposal at 69,671 (CFTC question 3-d).

Prudential Regulators and including instruments like subordinated debt as Tier Two capital.[9]

C. Additional Liquidity Requirements

In question 10-f, the CFTC asks whether it should consider eliminating the specific quantitative liquidity requirements for swap dealers electing either the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach, in consideration of the requirement of all swap dealers to have comprehensive risk management programs, including liquidity risk.[10] STRM would support the removal of those additional liquidity requirements. The combination of the base-level capital requirements and a swap dealer's obligation to have a comprehensive risk management program in place should be sufficient to insure swap dealers are adequately capitalized.

IX. SWAP DEALERS NOT CURRENTLY SUBJECT TO CAPITAL REQUIREMENTS SHOULD BE PROVIDED AN EXTENDED COMPLIANCE PERIOD

For swap dealers that are not currently subject to capital requirements, the transition to being fully subject to regulatory capital requirements could be quite disruptive to such swap dealers and their customers. In addition, in markets like the commodity swaps markets that are served by non-financial swap dealers like STRM, a sudden imposition of capital requirements could cause material price increases.

To address this issue, the CFTC should provide a longer period for non-financial swap dealers to come into compliance and should consider phasing in the requirements over time. For example, the CFTC could permit a non-financial swap dealer to comply with 25% of its capital requirement in Year 1, 50% in Year 2, 75% in Year 3, and 100% in Year 4.

X. THE NFA'S CAPITAL REQUIREMENTS SHOULD CLOSELY MIRROR THOSE ADOPTED BY THE CFTC

While STRM appreciates the opportunity to comment on the Re-Proposal, its comments on the implications or practicality of the proposed capital requirements are not fully informed as the National Futures Association ("**NFA**") has yet to propose its capital requirements for swap dealers. Said another way, because the CFTC's three proposed approaches to capital requirements each require a registered swap dealer to satisfy the higher of a number of different requirements, including "the amount of capital required by a

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[9] *See* 12 C.F.R. § 217.20.

[10] Re-Proposal at 69,678 (CFTC question 10-f).

registered futures association of which the [swap dealer] is a member,"[11] STRM cannot fully evaluate such capital requirements.

If the NFA, which is the one registered futures association, issues capital requirement that are not put through a rigorous notice and comment process and ends up differing materially from those adopted by the Commission, then much of the CFTC's careful work incorporating public feedback may be nullified. Therefore, STRM requests that the CFTC require the NFA to closely mirror the CFTC's final capital rules, or, at the very least, require the NFA to conduct a rigorous notice and comment process prior to finalizing its capital rules.

XI. CONCLUSION

STRM believes that by raising questions with respect to and addressing the issues set out in the Re-Proposal, the CFTC has created a framework for materially improving its 2016 capital proposal. With the inclusion of the suggestions made herein, the Commission's final rule on swap dealer capital requirements would provide the flexibility necessary to make such requirements workable for non-financial swap dealers like STRM.

We appreciate the opportunity to submit comments regarding the Re-Proposal and look forward to working with the Commission to improve upon its 2016 capital proposal as it moves to finalize the proposed requirements.

Respectfully submitted,

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Scott Earnest
Chief Compliance Officer
Shell Trading Risk Management, LLC

[11] Re-Proposal at 69,666.