



March 3, 2020

VIA ONLINE SUBMISSION
Chris Kirkpatrick, Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington, DC 2058

Re: Capital Requirements for Swap Dealers and Major Swap Participants, RIN 3038-AD54, 84 Fed. Reg. 69664 (Dec. 19, 2019)

Dear Mr. Kirkpatrick:

The National Corn Growers Association (“NCGA”) and the Natural Gas Supply Association (“NGSA”) submit the following comments in response to the Commodity Futures Trading Commission (“Commission” or “CFTC”) above-captioned release (the “December 2019 Release”) re-opening the comment period for the Commission’s December 2, 2016 Notice of Proposed Rulemaking for capital requirements of Swap Dealers and Major Swap Participants (the “2016 Proposal”) and re-proposing capital and financial reporting requirements for swap dealers and major swap participants and amended capital requirements for futures commission merchants (“FCMs”).¹

NCGA and] NGSA submitted comments in response to the “2016 Proposal” and offers the following additional comments for the Commission’s consideration in response to the December 2019 Release. References made herein to the Commodity Exchange Act (the “CEA”) refer to that statute as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act” or the “Act”).

The CFTC’s capital requirements rules must conform to the Dodd-Frank Act and to Congress’s intent in passing the Act. Further, the Act requires that the rules be risk-based—that

¹ Capital Requirements of [SDs] and [MSPs], 81 Fed. Reg. 91252 (Dec. 16, 2016). The 2016 Proposal was preceded by another proposal issued by the Commission in 2011. *See* Capital Requirements of [SDs] and [MSPs], 76 Fed. Reg. 27802 (May 12, 2011) (the “2011 Proposal”).

is, that they “help ensure the safety and soundness” of Swap Dealers (“SDs”) and Major Swap Participants (“MSPs”) (collectively, “Covered Swap Entities” or “CSEs”)² while being “appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.”³

Regulations implementing the Dodd-Frank Act’s capital requirements should be drafted consistent with the language of the statute and with congressional intent regarding mitigation of systemic risk and avoidance of unnecessarily diverting capital from beneficial forms of investment.

Overly conservative or poorly-sized capital requirements for non-bank CSEs unnecessarily sideline capital from productive uses. The re-direction of capital away from productive investment, such as investments made to produce a commodity, raises commodity costs for consumers. Regulatory-imposed capital requirements are akin to a clearing mandate in that they create a demand for capital and then sideline that capital from productive use. An unnecessary increase in capital requirements would come at the expense of increased investment in the economy and commodity production. Evidenced by the reopening of the 2016 Proposal comment period and the December 2019 release, the Commission’s diligence in assuring a sound approach is welcome.

Although very few NCGA members and no NCGA members are non-bank CSEs that would be directly affected by the Commission’s Proposal, the indirect impact of capital requirements on end users and commodity markets is significant. **Inappropriately sized capital requirements expose market participants to unforeseen risk if they are too low or they sideline capital away from productive investment and raise risk management costs as well as the cost of capital for *all* market participants if the capital requirements are too high.** Assuring the right approach to non-bank CSE capital requirements is of paramount importance to non-bank CSEs and end users.

The December 2019 Release raises many questions that must be answered to preserve the use of capital by non-bank CSEs and end users in energy, agriculture and other industries that drive and sustain our national economy. Diverse portfolios, robust counterparty credit evaluations and collateral requirements are integral to fiscal health.

Non-bank SDs and MSPs did not cause the financial crisis, are not supported by the federal treasury and thus do not pose a systemic risk. Therefore, **a primary policy consideration must also center on ensuring liquidity so that market participants have a choice in risk management counterparties.** Counterparty diversity is central to cost-effective hedging. Key to that is a process for appropriately sizing regulatory capital requirements for non-bank CSEs that recognizes the unique characteristics a non-bank CSE brings to the risk management market.

² Bank SDs and MSPs are covered swap entities with respect to the Prudential Regulators’ proposed rule. Non-bank SDs and MSPs are covered swap entities with respect to the CFTC’s proposed rules. These comments will refer to both groups interchangeably as “covered swap entities” or “CSEs,” which should be interpreted in context of the particular rule or rules being discussed.

³ See CEA § 4s(e)(3)(A).

NCGA and NGSAs recognize the dramatic improvements in the December 2016 Proposal since the Commission's initial capital requirements proposal nearly six years prior. The December 2019 Release includes additional important improvements suggesting that the Commission's work on Non-bank SD and MSP capital requirements is nearing the finish line. Nevertheless, **a few key important changes are still needed to align the Commission's non-bank CSE capital regulations with the unique underlying businesses of non-bank CSEs.**

The 2016 Proposal appears to assume that non-bank CSEs rely on elaborate, bank-like models to model risk. The December 2019 release importantly recognizes instead that bank risk models are not necessarily appropriate for non-bank CSEs. Companies in the physical commodity business are very different from banks. Non-bank CSEs generally have significant physical inventory and plant assets, and they generally *do not* hold deposits or make loans. As such, risk management practices are very different for a non-bank CSE, yet they are tried and true, allowing non-bank CSEs to effectively manage risk.

Access to the Tangible Net Worth Capital Approach

The 2016 Proposal provided three options for quantifying the capital requirements for a non-bank CSE. One of those options, the tangible net worth approach, is only available to entities that are "predominantly engaged in non-financial activities." While NCGA and NGSAs appreciate the Commission's acknowledgement that not all non-bank CSEs will be traditional financial firms and that the more flexible tangible net worth approach will be necessary, the proposed method for establishing the non-bank CSE's ability to use the tangible net worth approach does not work. More specifically, the proposed requirement that an entity have no more than 15% of consolidated assets or revenue related to or derived from "financial in nature" activities risks denying the availability of the more suitable non-bank model alternative, the tangible net worth approach, to non-bank CSEs. There is a better approach.

Commodity Exchange Act Section 2(h)(7)(C)(i)(VIII) defines "financial entity" as a "person predominately engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in Section 1843(k) of title 12." Further, under Title 1 of the Dodd-Frank Act, an entity that is "predominantly engaged" in activities that are financial in nature is one with at least 85% of consolidated assets or revenues related to, or derived from, "financial in nature" activities.⁴ In short, **a workable definition for "predominantly engaged in financial activities" already exists in CEA Section 2(h)(7)(C)(i)(VIII) and must be the method for which the ability to the use of the tangible net worth capital approach is determined.**

Importantly, the Commission appropriately recognized, "while these entities may engage in dealing activities, they are primarily commercial entities and differ from financial entities in various ways, including the composition of their balance sheet (e.g., the types of assets they hold), the types of transactions they enter into, and the types of market participants and swap

⁴ See Definitions of "Predominately Engaged in Financial Activities" and "significant" Nonbank Financial Company and Bank Holding Company, 78 Fed Reg. 20756 (Apr. 5, 2013).

counterparties that they deal with. Because of these differences, the Commission believes that application of the bank-based or net liquid assets capital approaches to these SDs could result in inappropriate capital requirements that would not be proportionate to the risk associated with them, and, therefore, these SDs should have the option to apply a tangible net worth approach.” Non-bank CSEs are fundamentally different than swap dealers that are bank subsidiaries. It is the nature of these differences, not an arbitrary 15% threshold, that must drive the ability for a non-bank CSE to make use of the tangible net worth capital approach.

Additionally, the limitation on the use of the tangible net worth capital approach must stem from the activities of the corporate parent in order to avoid the unintentional applicability to central hedging and treasury affiliates. Centralizing financial functions into a single subsidiary provides efficiencies for some holding companies that are primarily involved in non-financial businesses, such as energy production or agriculture. Thus, if an entity is a swap dealer and is embedded in a larger holding company that is not financial, the non-bank CSE entity should have the freedom to choose between the full range of means to establish its capital requirements and comply with the Commission’s capital requirements rules. **Non-bank CSE capital requirement rules should be corporate-structure neutral.** Accordingly, NCGA and NGSAs recommend that, when applying the “predominantly engaged in non-financial activities” criteria, the CFTC should consider the type of business activity (financial vs. physical) conducted by the ultimate parent of the swap dealer, not just the swap dealer itself.

Requirements and Approval Process for Internal Models

Equally important to the ability to use the tangible net worth approach is the option to use existing capital models. Although the December 2016 Proposal would have allowed a non-bank CSE to use existing internal models, the regulatory process proposed for CFTC approval of the company-specific model would have made this approach an arduous task, irrespective of the cost and time commitment involved. The proposed unworkable regulatory approval process would have likely caused non-bank CSEs to gravitate to an ill-fitting, standardized model that would not recognize important differences that non-bank CSEs bring to the market (i.e., end users looking to hedge risk). Differences such as physical inventory, plant assets and strong balance sheets are key characteristics that non-bank CSEs bring to the risk management market, thus creating counterparty diversification for end user hedging. Capital requirements for non-bank CSEs must be based on models that reflect the business risks of companies in the physical commodity business. Applying a bank capital model to a non-bank CSE is likely to overstate the non-bank CSE capital requirement because value of the assets and physical inventory would not be reflected. At a minimum, a bank model would result in an ill-fitting capital requirement that risks sidelining too much capital.

To facilitate the ability of a non-bank CSE to use internal capital models, the December 2019 Release suggested a modification that would allow a non-bank CSE to use an internal credit risk or internal market risk capital model *without* prior written approval of the Commission or a registered futures association if 1) the relevant model has been approved and currently is in use, either by the non-bank CSE or an affiliated entity under the supervision of the Securities and

Exchange Commission (the “SEC”), a prudential regulator or a foreign regulatory authority;⁵ and 2) the non-bank CSE has made available to the Commission any copies of underlying documentation (*e.g.* regulatory approvals, evidencing review, approval and supervision of the internal capital models), to the extent permitted by applicable law. NCGA and NGSA support this solution,⁶ as it leverages the existing Commission requirement to generate quarterly risk exposure reports, which presumably would be based on the same internal model that is underpinned by widely accepted and well understood risk management practices.⁷

Building on the important concept of the flexibility to use internal models, the non-bank CSE’s internal model must be recognized for both market risk and credit risk. While commonality among swap dealers is inevitable, risks are unique. The Dodd-Frank Act recognizes the importance of considering these differences and requires that the Commission’s capital requirements for swap dealers “be appropriate for the risk associated with the Swap Dealers’ non-cleared swaps.”⁸ Allowing for the efficient use of models based on widely accepted risk management practices in the agriculture and energy industries will align the capital requirements with market risks to ensure a level playing field for non-bank CSEs relative to financial entity swap dealers.⁹

Recognition of Alternative Forms of Capital

To conform to Congressional intent, **capital rules should protect the stability of the U.S. financial system but, at the same time, preserve the flexibility of market participants without unnecessarily directing capital away from productive uses** that drive and sustain the national economy. The lack of significant risk to the U.S. financial system attributable to the swaps activities of non-bank CSEs, and the capital-intensive nature of these businesses necessitate capital requirements rules that allow for flexibility and efficiency in the credit arrangements. For this reason, capital rules for non-bank CSEs must allow the use of unencumbered cash to be considered part of a non-bank CSE’s capital base even when the cash is swept up into a corporate omnibus account and held overnight at a financial institution. This is a common practice among commercial firms because the practice optimizes the returns on that cash and improves the utilization of capital.

⁵ The foreign regulatory authority must have capital adequacy requirements that are consistent with the Basel-based capital requirements for banking institutions.

⁶ With respect to the approval process for internal models, the Commission should, at a minimum, provisionally approve internal capital models submitted by the non-bank CSE to the National Futures Association (“NFA”) in good faith, subject to further review and final approval as appropriate. These models can be reviewed and evaluated by the Commission in an expeditious, cost-effective, and definitive manner through back-testing to demonstrate that the resulting capital requirements are appropriate. *See* Letter from the National Corn Growers Association and the Natural Gas Supply Association to the CFTC dated Jan. 12, 2012 (“NCGA/NGSA 2012 Letter”).

⁷ CFTC Rule 23.600(c)(2). *See also* NCGA/NGSA 2012 Letter (the VaR model approach used by many commercial companies is based on widely accepted and well understood risk management practices).

⁸ CEA Section 4s€(3)(A).

⁹ *See, e.g.*, NCGA/NGSA 2012 Letter.

In addition, the December 2019 Release asked if non-bank CSEs should be able to recognize alternative forms of collateral (*e.g.* letters of credit) provided by commercial end users in determining the non-bank CSE's counterparty credit risk charges for uncleared swap transactions. The short answer is yes. Alternative forms of non-cash collateral, such as parental guarantees and letters of credit, are vital means for satisfying credit requirements that are especially important in capital-intensive industries. Non-cash collateral allows for recognition of the value of the commercial market participant's assets making it an effective method for satisfying credit requirements without unnecessarily setting aside capital from a productive use. When a non-bank CSE is a counterparty to a commercial end user's swap that uses alternative forms of collateral, the non-bank CSE should be able to factor in the credit-risk-reducing characteristics of the commercial end user's alternative forms of collateral when determining the non-bank CSE's counterparty credit risk.

Frequency and Method for Financial Reporting

As the costs incurred by swap dealers are likely to be passed through to commercial hedgers and end users in one form or another, NCGA and NGSA members are interested in ensuring that any of the additional costs that the rule imposes on non-bank CSEs are offset by tangible benefits. Two parts of the proposed rule where benefits may not justify the costs to market participants and consumers are 1) the frequency of the production of financial statements, and 2) the requirements related to the use of U.S. Generally Accepted Accounting Principles (GAAP) to produce financial statements that are to be submitted to the Commission.

First, the frequency of the production of financial statements provided to the Commission should be commensurate to the non-bank CSE's risk, which in the case of non-bank CSE's is low. NGSA and NCGA support that -- 1) the requirement for monthly financial statements be eliminated all together for non-bank CSEs, 2) the disclosure deadline for quarterly financial information be extended from 10 to 15 days, and 3) annual audited financial statements should not be required until 90 days after the end of the fiscal year. This aligns the CFTC requirements with standard practices for non-financial companies and Securities and Exchange Commission requirements. Importantly, to the extent that the non-bank CSE's audited financial statements are non-public and separate from the parent company's financial statements, the parent company's audited annual financial statements should satisfy the reporting requirement or, at a minimum, non-public non-bank CSE financial statements must not be made public. The release of non-public financial statements will harm the efficiency of the market.

Second, the requirement that all CSEs file financial reports using GAAP does not account for the fact that while some CSEs are domiciled in the U.S., they may be a part of an international holding company that uses International Financial Reporting Standards ("IFRS") to produce financial statements. The December 2019 Release requests comments as to whether the 2016 Proposal should be modified to permit U.S. domiciled non-bank CSEs that are subsidiaries of foreign parent entities or holding companies to submit required IFRS financial statements in lieu of GAAP financial statements. The December 2019 Release further asks if this modification should be limited to U.S. non-bank CSEs that are consolidated into foreign entities that are predominantly engaged in non-financial activities.

U.S. domiciled non-bank CSEs that are subsidiaries of foreign parent entities or holding companies *should be* permitted to meet the CFTC report obligations using IFRS financial statements. However, the modification to allow for the use of IFRS financial statements to satisfy the reporting obligations *should not be limited* to only those entities predominately engaged in non-financial activities. Rather, the use of IFRS in lieu of GAAP financial statements to satisfy reporting requirements should hinge only on the parent company or non-bank CSE accounting system, not the lack of engagement in financial activities.

In short, the CFTC should permit CSEs that have an ultimate parent that prepares its financial statements under IFRS to meet their CFTC reporting obligations using IFRS. In addition to internationally-held CSEs, privately-held CSEs may not use GAAP. Thus, the Commission should allow privately-held, **non-bank CSEs to submit financial statements prepared in accordance with other recognized accounting standards with a public disclosure of the accounting method used.** Importantly, the financial statement submission requirements should evolve as global financial reporting standards emerge and must reflect the size, location, operating characteristics and global presence of the non-bank CSEs. **Reporting requirements must not become a barrier to entry into the market for non-bank CSEs.**

Conclusion

Although the 2016 Proposal and the December 2019 Release contemplate capital requirements for CSEs, end users and consumers are profoundly impacted by changes in the level of working capital in the economy and market liquidity. **The unnecessary sidelining of capital away from productive use in the economy raises commodity costs for consumers in three ways -- 1) diverting capital that could otherwise be invested in the production of the commodity, 2) increasing the cost of hedging and risk management, and 3) decreasing market liquidity by raising the cost of participation in the market.** Capital requirements that are out-of-step with the risk they seek to mitigate undermine liquidity by elevating a barrier to entry and concentrating risk over a smaller number of market participants. Getting capital requirements right is vital to consumers.

Industries with physical assets must retain their ability to cost-effectively trade derivatives. Non-bank CSEs offer important counterparty diversity in the market. End users benefit from a variety of choices when selecting a counterparty for risk management transactions. **A robust market with diversity among potential counterparties is the most cost-effective way to mitigate systemic risk.** The Commission's rules must allow efficiency in risk management markets. With the important changes suggested above and the modifications contemplated in the December 2019 Release, the Commission can bring nearly a decade of uncertainty surrounding non-bank CSE capital requirements rules to a close.

Founded in 1957, the National Corn Growers Association represents more than 40,000 dues-paying corn farmers nationwide and the interests of more than 300,000 growers who contribute through corn checkoff programs in their states. NCGA and its 50 affiliated state organizations work together to create and increase opportunities for corn growers.

Established in 1965, NGSA represents integrated and independent companies that produce and market natural gas consumed in the United States. NGSA encourages the use of natural gas within a balanced national energy policy and advocates for well-functioning markets that foster a growing, competitive market for natural gas. NGSA is dedicated to achieving a cleaner future through strong partnerships with renewables and supporting innovative technologies and market solutions that reduce emissions.

Because of the potential for regulations implementing the Dodd-Frank Act to unnecessarily limit the hedging tools available to corn producers and participants in the natural gas industry and the potential for the regulations to impede what is and has been a healthy, competitive, and resilient natural gas market, NCGA and NGSA played an active role in the shaping of the Act during its passage and wish to continue this role in ensuring the Act's successful implementation.

NCGA and NGSA appreciate the opportunity to provide these comments. Should you require further information, please do not hesitate to contact NCGA's Wayne Stoskopf at 202-628-7001 or NGSA's Jenny Fordham at 202-326-9317. We look forward to working with you.

Sincerely,

National Corn Growers Association
Natural Gas Supply Association