

Comment on the UK-PRA Swap Dealer Capital Comparability Determination

Introduction

The CFTC invited public comment on an application by petitioners representing UK-based swap dealers regulated by the UK Prudential Regulation Authority (PRA), to use the UK PRA's capital and financial reporting rules instead of the CFTC's rules, if the CFTC finds them comparable.

Substituted Compliance

The concept of substituted compliance is the concept of following an alternative set of rules that achieve the same regulatory objectives and outcomes as the original set of rules. The CFTC has a process called substituted compliance, which allows swap dealers to follow the rules of another jurisdiction instead of the CFTC's rules, if the CFTC determines that the other jurisdiction's rules are comparable or equivalent to the CFTC's rules. Substituted compliance can promote transactional simplification by establishing a reliable proxy.

Some everyday examples of substituted compliance are:

- Driving License Reciprocity: Drivers can use their valid licenses from one jurisdiction in another jurisdiction without getting a new license.
- Organic Products Certification: Products that meet the organic standards of one organization or authority can be sold as organic in another market without another certification process.
- Mutual Recognition of Professional Qualifications: Professionals who have obtained their qualifications in one jurisdiction can practice their profession in another jurisdiction without additional qualifications.

Examples of substituted compliance in financial areas include:

- Cross-border application of the US swap dealer registration and business conduct rules, part of the Dodd-Frank Act reforms for the derivatives market. The CFTC has issued several comparability determinations for various foreign jurisdictions, such as the European Union, Japan, Canada, Australia, and Switzerland, that allow swap dealers in those jurisdictions to comply with their local rules instead of the CFTC's rules, if the CFTC finds that the local rules are comparable or equivalent to the CFTC's rules in terms of achieving the same regulatory objectives and outcomes.

- Cross-border application of the US security-based swap dealer registration and business conduct rules, also part of the Dodd-Frank Act reforms for the derivatives market. The SEC has proposed a framework for substituted compliance for foreign security-based swap dealers, which would allow them to comply with their home country rules instead of the SEC's rules, if the SEC determines that the home country rules are comparable or equivalent to the SEC's rules in terms of achieving the same regulatory objectives and outcomes.
- Cross-border application of the EU data protection rules, part of the General Data Protection Regulation (GDPR) that governs the collection, processing, and transfer of personal data. The EU allows data transfers to third countries that have been recognized by the European Commission as providing an adequate level of data protection, which means that the third country's data protection rules are comparable or equivalent to the EU's rules in terms of ensuring the same level of protection for the rights and freedoms of data subjects. For example, the EU has granted adequacy decisions to countries such as Canada, Japan, and Switzerland, which allow data transfers between the EU and those countries without additional safeguards or authorizations.

The CFTC should find comparability between the UK PRA's rules and the CFTC's rules, if the UK PRA's rules are sufficiently similar to the CFTC's rules in terms of achieving the same regulatory objectives and outcomes of reducing risk and ensuring the resilience and stability of swap dealers and the swap market. The CFTC should also consider the potential advantages of allowing substituted compliance for UK PRA-designated non-bank swap dealers, such as: reducing regulatory burden, promoting global harmonization, enhancing market efficiency, and protecting the US financial system.

Operational Resilience Regime

A key area to be assessed in this comparability determination is the operational resilience regime, the set of rules and standards that aim to ensure that financial institutions and their critical third parties can withstand and recover from operational disruptions, such as cyber-attacks, IT failures, or natural disasters.

The UK PRA has recently proposed a new operational resilience regime for UK financial firms and their critical third parties, which would require them to identify their important business services, set impact tolerances, conduct scenario testing, and report incidents. The UK PRA's operational resilience regime is based on the principles and expectations set out by the Basel Committee on Banking Supervision, the Financial Stability Board, and the G20.

The CFTC may want to assess how the UK PRA's operational resilience regime compares to the CFTC's requirements on operational risk management, business continuity, and disaster recovery, in terms of achieving the same regulatory objectives and outcomes of enhancing the resilience and stability of swap dealers and the swap

market. The CFTC may also want to consider the potential costs and benefits of aligning or diverging from the UK PRA's operational resilience regime for cross-border swap dealers and their service providers.

Securitization Framework

Another specific area to consider in the CFTC comparability determination is the securitization framework, the set of rules and standards that govern the issuance, trading, and risk management of securitized products, such as asset-backed securities, mortgage-backed securities, or collateralized debt obligations.

The UK PRA has adopted the EU securitization framework, which implements the Basel III standards and introduces a new category of simple, transparent, and standardized (STS) securitizations that benefit from lower capital requirements and preferential treatment. The UK PRA's securitization framework is aligned with the international standards and recommendations set out by the Basel Committee on Banking Supervision and the Financial Stability Board.

The CFTC may want to evaluate how the UK PRA's securitization framework compares to the CFTC's requirements on securitization activities, risk retention, disclosure, and due diligence, in terms of achieving the same regulatory objectives and outcomes of enhancing the transparency, quality, and stability of securitized products and the swap market. The CFTC may also want to consider the potential implications of granting or denying substituted compliance for cross-border swap dealers that are involved in securitization transactions.

Differences between UK PRA Rules and CFTC Rules

The UK PRA rules and the CFTC rules are different in some areas that affect how much capital swap dealers need to have and how they manage their risks. Differences include these areas:

- Market risk capital, which is the money that swap dealers need to have to cover the losses they may face from changes in the market prices of their swaps or other assets. The UK PRA rules and the CFTC rules use different methods, assumptions, and parameters to calculate how much market risk capital swap dealers need to have. For example, the UK PRA rules (aligned with Basel 3.1 standards) use a standardized approach that applies fixed weights to different types of swaps or assets, while the CFTC rules use a model-based approach that allows swap dealers to use their own models to estimate their market risk capital, subject to certain conditions and approval.
- Credit risk capital, which is the money that swap dealers need to have to cover the losses they may face from their counterparties not paying them back or defaulting on their swaps or other obligations. The UK PRA rules use a standardized

approach that applies fixed weights to different types of counterparties, while the CFTC rules use a model-based approach that allows swap dealers to use their own models to estimate their credit risk capital, subject to certain conditions and approval.

- Liquidity risk management, which is how swap dealers ensure that they have enough cash or liquid assets to meet their obligations and survive stress situations. The UK PRA rules and the CFTC rules have different requirements for how swap dealers measure and manage their liquidity risk. For example, the UK PRA rules require swap dealers to have a minimum amount of liquid assets that can cover their net cash outflows for 30 days, and a minimum amount of stable funding that can support their long-term assets for one year. The CFTC rules do not have these specific ratios, but require swap dealers to have a liquidity risk management program that includes policies, procedures, and stress testing. Both may get to essentially the same functional place via different methods.
- Capital planning and stress testing, which is how swap dealers plan for their future capital needs and test how they would cope with extreme scenarios. The UK PRA rules require swap dealers to submit their capital plans and stress test results to the UK PRA every year, and to use the scenarios and assumptions provided by the UK PRA. The CFTC rules do not have a specific frequency or format for the capital planning and stress testing, but require swap dealers to have a capital planning and stress testing program that includes policies, procedures, and reporting.

Definition of “Swap Dealer”

The proposed rule may be unclear or inconsistent on how to define “swap dealer” under the CFTC’s and the UK PRA’s rules. The CFTC defines a swap dealer as an entity that engages in various swap activities as a dealer or market maker. The UK PRA defines an investment firm as an entity that provides or performs various investment services or activities. The UK PRA’s definition is broader than the CFTC’s definition and may include entities that are not swap dealers by the CFTC’s standards. Therefore, it may be unclear or inconsistent which entities can use substituted compliance under the proposed rule, and whether they have to follow both the CFTC’s and the UK PRA’s rules for their swap activities.

Cross-Border Swap Transactions

The proposed rule may be unclear or inconsistent on how to apply and interpret the CFTC’s and the UK PRA’s rules to cross-border swap transactions with multiple jurisdictions and counterparties. For example, the CFTC’s rules focus on the location of the swap activities, while the UK PRA’s rules focus on the legal entity that is authorized and supervised by the UK PRA. Therefore, it may be unclear or inconsistent how the CFTC’s and the UK PRA’s rules apply and interact with each other in cross-border swap

transactions, and whether they create any gaps, overlaps, or conflicts that may affect the regulatory outcomes or expectations.

Implementation and Enforcement

The proposed rule may be unclear or inconsistent on how to implement and enforce the CFTC's and the UK PRA's rules by the regulators and the swap dealers. The CFTC's and the UK PRA's rules may have different processes or standards for implementing and enforcing their rules, such as the reporting, recordkeeping, and disclosure requirements, or the examination, supervision, and enforcement actions. For example, the CFTC's rules require swap dealers to submit more frequent and detailed reports and records to the CFTC than the UK PRA's rules. Therefore, it may be unclear or inconsistent how the CFTC and the UK PRA implement and enforce their rules, and whether they provide enough and timely information and oversight to the regulators and the swap dealers.

Fourth-Party or Downstream Service Providers

The proposed rule may not clearly or consistently address how to treat fourth-party or downstream service providers, which are entities that provide services to the swap dealers' third-party service providers. For example, a swap dealer may use a third-party service provider for data processing, trade execution, clearing, or settlement, and the third-party service provider may use another entity for some or all of those services. The fourth-party or downstream service provider may pose risks to the swap dealer and its counterparties, if the swap dealer or the third-party service provider does not oversee or control them well. The proposed rule does not specify how the CFTC's rules or the UK PRA's rules, or both, would apply to the fourth-party or downstream service providers, depending on where they are and what they do. Therefore, the treatment of fourth-party or downstream service providers may be unclear or inconsistent, and may create gaps, overlaps, or conflicts that may affect the regulatory outcomes or expectations.

Differences among CFTC, SEC and FRB Rules

Another possible source of inconsistency or ambiguity in the proposed rule is the difference or conflict between the CFTC's rules and other regulators' rules, such as the Securities and Exchange Commission (SEC), the Federal Reserve Board (FRB), or foreign authorities, that may also apply to swap dealers or their service providers. For example, some swap dealers may also be registered or regulated as security-based swap dealers by the SEC, or as bank holding companies or foreign banking organizations by the FRB, or as investment firms or banks by foreign authorities. These regulators may have different or conflicting rules or standards for capital, liquidity, risk management, reporting, or other aspects of swap activities, that may not be fully aligned or consistent with the CFTC's rules or the UK PRA's rules. Therefore, there may be some inconsistency or ambiguity in the application or interpretation of the CFTC's rules and other regulators' rules, and whether they create any gaps, overlaps, or conflicts that may affect the regulatory outcomes or expectations.

Focusing on the Big Picture Goal

Given the CFTC's mission to promote the integrity, resilience, and vibrancy of the U.S. derivatives markets through sound regulation, CFTC should focus on (and not lose sight of) the big picture goal of the proposed rule: to reduce risk and ensure the resilience and stability of swap dealers and the swap market.

Conditional Substituted Compliance

The CFTC need not be limited to finding a binary yes or no answer to the comparability determination.

Rather, the CFTC has the flexibility to grant conditional substituted compliance. For instance, it could require extra certifications or specific conditions to address discrepancies. It could, for example:

- Provide additional information or reports to the CFTC, or make them accessible to the CFTC upon request, to complement or confirm the information or reports submitted to or obtained by the PRA, or to give the CFTC a more complete or timely view of the swap dealers' financial and risk positions.
- Follow additional rules or standards that the CFTC considers to be vital or crucial for the protection of the US financial system and markets, or to address any specific risks or issues that may arise from the swap dealers' cross-border activities, such as the operational resilience framework, the securitization framework, or the treatment of fourth-party or downstream service providers.
- Accept certain conditions or limitations that the CFTC imposes on the availability or scope of substituted compliance, such as the eligibility criteria, the notification or approval requirements, the compliance monitoring or verification procedures, or the revocation or suspension triggers.

I understand that the UK PRA's rules and the CFTC's rules may not be equally comparable in all areas or dimensions, and that the CFTC may have to adjust the scope and conditions of substituted compliance based on the interplay of various regulatory factors or considerations.

In my opinion, the CFTC should exercise its authority to make a flexible and nuanced decision, and strive to impose only the necessary conditions for approving the UK PRA rules as substitutes, to minimize the regulatory burden while achieving the necessary risk reduction.

Conclusion

In conclusion, the CFTC's decision will impact swap market stability. Balancing risk reduction and regulatory efficiency is crucial.

Rather than being limited to a binary yes/no decision, the CFTC could grant conditional substituted compliance by requiring additional specified certifications alongside the UK PRA's rules to address any gaps or conflicts.

Michael Ravnitzky
Silver Spring, Maryland