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Robert de V. Frierson, Secretary
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Robert E. Feldman, Executive Secretary
Attention: Comments, Federal Deposit Insurance Corporation
550 17th Street NW.
Washington, DC 20429

By electronic submission (regs.comments@occ.treas.gov; regs.comments@federalreserve.gov; comments@fdic.gov)

Re: **Comment Letter on the Proposed Rule to Modify the Denominator of the U.S. Supplementary Leverage Ratio and the Enhanced Supplementary Leverage Ratio (Docket ID OCC–2014–0008; Docket No. R–1487 RIN AE–16; RIN 3064–AE12)**

Ladies and Gentlemen:

The Futures Industry Association ("FIA")[1] appreciates the opportunity to provide the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (the "Agencies"), with comments and recommendations on the Agencies' proposed rule, Regulatory Capital Rules: Regulatory Capital, Proposed Revisions to the Supplementary Leverage Ratio, 79 Fed. Reg. 24,596 (May 14, 2014) (the "Proposed Rule"). The Proposed Rule would modify the denominator of the supplementary leverage ratio and the enhanced supplementary leverage ratio (the "total leverage exposure") to more closely align with the international leverage ratio issued by the Basel Committee on Banking Supervision in 2010 (the "Basel III Leverage Ratio"), as recently revised (the "BCBS 2014 revisions"). In particular, the Proposed Rule would revise the treatment of certain on- and off-balance sheet exposures for purposes of calculating total leverage exposure.

Although FIA supports the implementation of a supplementary leverage ratio as a backstop to risk-based capital requirements, the Proposed Rule raises two significant issues for financial institutions active in the futures, options on futures, and over-the-counter cleared

[1] FIA is the leading trade organization for the futures, options, and over-the-counter cleared derivatives markets.

derivatives markets. In particular, for the reasons discussed below, we believe the Proposed Rule should be modified to (1) exclude from total leverage exposure cash segregated for clients in transactions cleared through central counterparties ("CCPs"), and (2) clarify that the exposure for written credit derivatives cleared for clients through CCPs should be based on the measure used for derivatives generally rather than the more stringent measure used for written credit derivatives not cleared through CCPs. Without such changes, we are concerned that the Proposed Rule would artificially inflate total leverage exposure and cause significant unintended consequences.

I. In Cleared Transactions, Cash Segregated for Clients Should Be Excluded from Total Leverage Exposure.

Under the Proposed Rule, a banking organization must follow prescribed calculation methodologies to determine its on-balance sheet assets and off-balance sheet exposure, both of which factor into the calculation of the banking organization's total leverage exposure. To calculate the on-balance sheet component of the total leverage exposure, the Proposed Rule would require a banking organization to include the full amount of its on-balance sheet assets, reduced only by certain amounts deducted from tier 1 capital under the Agencies' regulatory capital rules.[2] Although this approach may be appropriate for many categories of on-balance sheet assets, the factors discussed below support the exclusion from total leverage exposure of segregated cash for cleared derivatives transactions ("segregated cash"), notwithstanding its accounting treatment as an on-balance sheet asset under U.S. GAAP.

When an entity within a banking organization acts as a futures commission merchant clearing member of a CCP ("clearing member") and clears a cleared derivatives transaction on behalf of a client, initial margin is posted in the form of cash or securities collateral. The amount of such initial margin that is required by the CCP will be passed on to the CCP. Any excess required by the clearing member is retained by that clearing member and is subject to customer asset protection rules enforced by the Commodity Futures Trading Commission ("CFTC") and other prudential regulators. Any cash posted by a client to meet its initial margin obligation is generally reflected as an on-balance sheet asset of the clearing member, regardless of whether the cash is passed on to the CCP to meet its requirements or is retained by the clearing member; in both cases, the cash remains as an asset in the customer segregated pool. In contrast, any securities collateral posted by the client to meet its initial margin obligations is not treated as an asset of the clearing member; instead, such securities collateral is reflected only on the balance sheet of the client.

Under the customer asset protection rules issued by the CFTC, the clearing member may not use any segregated cash posted by the client to support the clearing member's own operations. Instead, such client cash must be used to satisfy the obligations of the client at the CCP, with any excess segregated cash deposited or invested by the clearing member according to the CFTC's customer asset protection rules. Moreover, such deposited or invested excess cash must remain in the client segregated pool.

In contrast with such derivatives transactions cleared through CCPs, when an entity within a banking organization transacts in the over-the-counter derivatives market, any

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[2] See 79 Fed. Reg. at 24,598 (col. 2-3).

cash margin collected or up-front premium received can be re-used by that banking organization for its daily operations. That is, the banking organization may lend that cash in exchange for securities or use the cash to purchase assets for its own portfolio. That is not the case with initial cash margin and excess cash margin received by a clearing member from a client in support of cleared derivatives activity. As previously described, such segregated cash collected for cleared transactions cannot be used to support the operations of the clearing member because the cash is legally segregated from the clearing member and is subject to the customer asset protection rules. In essence, such segregated cash really constitutes an asset of the client, not the clearing member. As a result, we believe that such segregated cash should be excluded from total leverage exposure.

Set forth below are both legal and policy reasons that flesh out and support this proposed exclusion.

A. Segregated Cash Is Not Treated as a Bank-Owned Asset in Bankruptcy.

Generally, cash owned by a banking organization is available to pay claims of creditors during the bankruptcy process, just like other unsecured assets owned by the bank and held on its balance sheet. Segregated cash held by a clearing member, however, is exempt from this general treatment. See, e.g., 11 U.S.C. § 766. Such treatment under fundamental bankruptcy principles is further evidence that segregated cash held for a client is really the client's asset, not the banking organization's, and therefore should be excluded from total leverage exposure.

B. CFTC Rules Strictly Limit the Ability to Reuse or Re-Hypothecate Segregated Cash.

Pursuant to CFTC rules, a clearing member may only invest segregated cash in a narrow range of financial instruments. See 17 C.F.R. § 1.25. These instruments include only safe and conservative investments (for example, obligations of the United States that are fully guaranteed as to principal and interest). The investment of segregated cash must be managed "with the objectives of preserving principal and maintaining liquidity. . . ." Id. § 1.25(b). Thus, a clearing member may not use segregated cash to fund its own operations or re-lend it to increase the banking organization's leverage. These investments are meant to increase the yield on excess client balances held by the clearing member, part of which may be remitted to the client.

Accordingly, the CFTC's rigorous limits on the ability of a clearing member to re-use or re-hypothecate segregated cash reinforces the conclusion that such assets belong to the customer, not the clearing member, and do not increase the banking organization's leverage or actual economic exposure.

C. Excluding Segregated Cash Would Incentivize Prudent Risk Management and Avoid Unintended Consequences.

The Proposed Rule could unintentionally result in greater systemic risk by both (1) creating strong incentives for clearing members to require clients to post securities as collateral, rather than cash, and (2) incenting such organizations to limit the amount of excess segregated cash a client should post, even though such excess cash benefits the clearing member and reduces systemic risk.

First, the Proposed Rule would incentivize clearing members to require clients to post securities, rather than cash, as collateral for derivatives transactions. U.S. accounting rules generally treat segregated cash held for clients significantly differently from segregated securities collateral held for clients, even though both mitigate risk associated with derivatives transactions. Specifically, segregated cash is generally treated as an on-balance sheet asset of a banking organization under U.S. GAAP, while segregated securities collateral is not. Because of this differential treatment of cash and securities, the Proposed Rule would penalize a clearing member for holding segregated cash by inflating the banking organization's total leverage exposure by the amount of such cash, while holding securities collateral would have no impact on the banking organization's total leverage exposure.

Such a stiff leverage capital penalty for holding segregated cash would create a powerful incentive for a clearing member to require clients to post collateral in the form of securities rather than cash – even though securities collateral presents greater risks to the organization. Unlike segregated cash, securities collateral is subject to price fluctuations and liquidity risk that may reduce the protection to the clearing member (even in light of any haircut required to the value of securities collateral), and over the long-term will require more frequent collateral calls. Both of these consequences increase risk to the clearing member and, when those risks are aggregated across the industry, to the financial system. Moreover, requiring the posting of securities rather than cash would significantly increase burden for clients: the costs associated with pledging securities as collateral are significantly greater than those associated with posting cash.

Second, the Proposed Rule would create a strong disincentive for clearing members to require clients to post excess segregated cash, even though such excess cash would reduce risk to the institution and to the financial system as a whole. For example, consider the simple example of a derivatives contract cleared through a clearing member under which its client has $1 of exposure to loss.

- Scenario A: In this scenario, the client posts $1 in segregated cash, the minimum amount required by the clearing member to cover its current risk. Under the Proposed Rule, the banking organization would have an additional $1 of on-balance sheet assets included in its total leverage exposure, but would be exposed to counterparty risk if the derivative declined in value.

- Scenario B: In this scenario, the client posts $10 of segregated cash with the clearing member, which is well in excess of the client's (and the clearing member's) current exposure to loss. As a result, the clearing member would have additional protection from loss if the value of the derivative declined, but the full value of that reduction in risk would be treated as an increase in risk through its inclusion in the banking organization's total leverage exposure under the Proposed Rule.

This problematic treatment of excess segregated cash is no mere hypothetical problem, because clearing members often require excess cash as a prudent risk management practice. As a result, the Proposed Rule would create a powerful and perverse incentive for clearing members not to require the posting of excess segregated cash — a result that would be plainly at odds with the fundamental risk-reducing purpose of the leverage ratio.

D. Exclusion of Segregated Cash Would Be Consistent with the Treatment of Segregated Cash Under the Liquidity Coverage Ratio.

Finally, under the proposed U.S. liquidity coverage ratio, segregated cash would not qualify as a high-quality liquid asset. Specifically, the proposed liquidity coverage ratio rules provide that high quality liquid assets must be "free of legal, regulatory, contractual, or other restrictions on the ability of the [clearing member] to monetize the asset."[3] The exclusion of segregated cash from the scope of "high-quality liquid assets" reflects the inability of a clearing member to use segregated cash to meet its liquidity needs.

The proposed liquidity coverage ratio rules recognize that segregated cash cannot be treated as an asset available to meet a banking organization's liquidity needs, even though cash is typically an optimal asset for providing liquidity. Similarly, a clearing member may not use segregated cash to increase leverage, due to the "legal, regulatory, [and] contractual" restrictions on the ability of such a clearing member to use such assets for its own purposes. Thus, the exclusion of segregated cash from the measurement of a banking organization's total leverage exposure would be consistent with the treatment of segregated cash under the proposed liquidity coverage ratio rules — which in turn is consistent with the basic concept that segregated cash for a client really does not belong to the clearing member, does not fund the clearing member's operations, and ought not be treated as an "exposure" of the banking organization.

II. The Treatment of Sold Client-Cleared Credit Protection Provided through Centralized Counterparties Should Be Clarified.

The Proposed Rule should clarify that, for purposes of a banking organization's total leverage exposure, sold credit protection cleared on behalf of a client through a CCP should not be measured at the effective notional amount, but should instead be measured in the same manner as derivatives generally. This clarification would be consistent with the text of the BCBS 2014 revisions to the Basel III leverage ratio, which provides that a performance guarantee in the context of a client-cleared transaction should be measured by reference to only the specific provisions of that document generally applicable to derivatives, with no reference to the specific provisions applicable to written credit derivatives.[4]

In addition to the textual rationale summarized above, we also note that the underlying logic and structure of the total leverage exposure denominator of the supplementary leverage ratio should result in excluding client-cleared credit protection from the notional exposure measurement. Total leverage exposure measures written credit protection on an effective notional basis, not on a notional basis. The total leverage exposure measure further recognizes that credit protection sold can be hedged by offsetting credit protection purchased, resulting in no effective notional protection sold. This is true in the case of a banking

[3] Prop. 12 C.F.R. § __.20(e)(1)(i), 78 Fed. Reg. 71,818, 71,861 (November 29, 2013).
[4] BCBS 2014 revisions, ¶ 28, at 5.

organization's own exposures, such as where the banking organization sells credit protection to one counterparty and buys offsetting credit protection as a hedge from another counterparty, and equally true where a clearing member facilitates client clearing activity. In the latter case, the clearing member stands in between the customer and the CCP. While the clearing member has credit risk to its customer in the event of customer default, the banking organization is market risk neutral on the cleared credit derivative, since any change in the market position of the contract will be covered by daily variation margin calls on the customer. Accordingly, client-cleared written credit derivatives are like any other class of client-cleared products: the clearing member is market risk-neutral and its credit exposure to its customer should be covered by margin requirements in the same way as with any other asset class.

Finally, FIA believes that such a clarification would be fully consistent with the Agencies' and international regulators' broader macroprudential support of initiatives designed to increase the volume of centrally cleared derivatives. CCPs are subject to rigorous regulatory oversight that requires clearing members to adhere to strict by-laws that cover initial margin, variation margin, and default fund contributions, thus reducing the need to include cleared CDS in the total leverage exposure measure at the effective notional amount.

Accordingly, the Proposed Rule should follow the same calculation methodology established in the BCBS 2014 revisions for the same subset of derivatives transactions. Specifically, a clearing member should calculate its exposure for client-cleared sold credit protection under the general rules applicable to derivatives, and not under the more stringent rules applicable to sold credit protection that is not cleared through a CCP. Such an outcome would conform the Final Rule to the BCBS 2014 revisions, and would properly recognize the benefits of client-clearing in the context of sold credit protection. This clarification would also provide greater incentives for banking organizations to clear written credit protection through CCPs.

If you have any questions, please contact Jacqueline Mesa, Senior Vice President and Director of International Relations and Strategy at 202-772-3040 or jmesa@fia.org.

Respectfully submitted,

Walt L. Lukken

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