

January 16, 2024

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Via email: regs.comments@federalreserve.gov

Re: Comment on Notice of Proposed Rulemaking, Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR-Y-15)
Docket No. R-1814; RIN 7100-AG65

Dear Ms. Misback:

Nodal Clear, LLC (“Nodal Clear” or “Nodal”) appreciates the opportunity to respond to the Notice of Proposed Rulemaking regarding the Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR-Y-15) (the “GSIB Surcharge Proposal”).¹ The GSIB Surcharge Proposal was issued in conjunction with another regulatory capital rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (the “Basel III Endgame Proposal”).² The GSIB Surcharge Proposal and the Basel III Endgame Proposal (collectively, the “Proposals”) were designed to finalize the implementation of the Basel III framework. We address both the GSIB Surcharge Proposal and the Basel III Endgame Proposal in this comment letter, which we have filed under both docket numbers.

As background, Nodal Clear is a registered derivatives clearing organization (“DCO”) with the Commodity Futures Trading Commission (“CFTC”) and the clearing house for Nodal Exchange, LLC (“Nodal Exchange”) and Coinbase Derivatives Exchange,³ which are both CFTC designated contract markets (“DCMs”). Nodal Clear is a wholly owned subsidiary of Nodal Exchange, itself ultimately wholly owned by the European Energy Exchange AG (“EEX”). Nodal Clear elected to comply with the requirements applicable to DCOs that have been designated systemically important (“SIDCOs”) by the Financial Stability Oversight Council.

¹ *Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)*, 88 Fed. Reg. 60,385 (Sept. 1, 2023).

² *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity*, 88 Fed. Reg. 64,028 (Sept. 18, 2023).

³ Coinbase Derivatives Exchange is a registered DCM under LMX Labs LLC.

Nodal Clear respectfully submits the following comments.

General Comments

Derivatives are a critical risk management tool employed by all types of businesses, allowing hedgers to redistribute risk from themselves to parties better positioned to hold such risk. For many, Banks provide access to these derivatives markets, such as those for futures, by acting as clearing members at DCOs, allowing their clients to hedge via exchange traded futures. Many of Nodal Clear's clearing members are affiliates of banks that would be subject to the proposed rules if adopted. Banks also use exchange traded derivatives to hedge their own risk. Such bank risk is often a result of bespoke over-the-counter ("OTC") derivatives traded directly with their clients.

This market access business is typically low risk. Clients must settle their profits and losses for their trading on Nodal Exchange at least twice daily through variation margin collection by Nodal Clear. In addition, clients must post additional collateral for their positions in the form of initial margin, which is sized to cover nearly all possible losses on their positions. A bank or its affiliate providing market access as a clearing member of Nodal Clear will only suffer a loss if the client defaults and their positions lose more than the value of the collateral posted before being closed out.

Policymakers have acknowledged the benefits of central clearing, which include the benefits noted above, as well as increased safety and stability of financial markets, mitigation of systemic and counterparty credit risk, improved risk management, increased operational efficiency, and many others. In response to the financial crisis of 2007-2008, policymakers mandated central clearing in the case of certain OTC derivatives through the Pittsburgh G20 commitments, which, in the United States, were enacted through the Dodd-Frank Wall Street Reform and Consumer Protection Act and implementing regulations.

A. The Proposals Will Increase Capital Requirements for Banks or Their Affiliates that Provide Access to Centrally Cleared Futures Exchanges

Several parts of the Proposals will, if finalized, substantially increase capital requirements for banks and bank affiliates that provide access to futures markets and central clearing.

1. GSIB Surcharge Proposal

In that regard, the agencies propose in the GSIB Surcharge Proposal to revise how capital add-ons for the eight largest U.S. banks — the GSIB Surcharges — are calculated. The changes will allocate a higher charge for the provision of client clearing services, which will significantly increase the contribution of client clearing to the surcharge.⁴ Specifically, the agencies propose including all client clearing of OTC derivatives into the interconnectedness and complexity indicators. They also propose adding OTC derivatives exposures into the cross-jurisdictional activity indicator.⁵

⁴ See 88 Fed Reg. at 60,392.

⁵ Id. at 60,394.

There are two models of client clearing: in the principal-to-principal model, the client faces the bank/clearing member, and the bank faces the clearing house, while in the agency model, the bank guarantees the client's performance at the clearing house. Principal-to-principal model clearing is already included in the GSIB calculation. Partly as a result, the vast majority of client clearing now takes place under the agency model, including for contracts traded on Nodal Exchange and cleared through Nodal Clear. The GSIB Surcharge Proposal would include agency model client clearing in the GSIB complexity and interconnectedness indicators, which would significantly increase the financial contribution of client clearing to the GSIB surcharge.⁶ Consequently, bank-affiliated clearing members capital requirements would increase. As such, this will in turn limit the willingness of bank-affiliated clearing members to offer clearing services, thereby restricting choices for hedgers and escalating costs for end-users.

2. Credit Valuation Adjustment

Another part of the Proposals that would impact central clearing is changes to the Credit Valuation Adjustment ("CVA"). While CCP exposures are exempted from the CVA charges, the Basel III Endgame Proposal would have bank affiliated clearing members hold CVA charges for activity undertaken by their clearing clients.⁷ Requiring CVA charges on client cleared activity is duplicative of the credit risk charges banks are already taking on these client exposures. In U.S. central clearing, clearing members do not assume principal risk, and they collect margin from their customers to mitigate credit risk related to their trades. Requiring CVA charges on top of margin when clearing members are only serving as agent would therefore further raise the costs of hedging for end users and dissuade them from using exchange-traded risk mitigating hedging instruments (to reduce costs). Such a requirement would also be in contrast to the approach taken on this topic in the Basel standards and adopted in other jurisdictions, such as the European Union and Japan, which do not impose CVA charges on client cleared transactions for the above-noted reasons. Client clearing should not have an associated CVA charge, to avoid these concerns.

3. SA-CCR Proposal

In addition, the Basel III Endgame Proposal requires the more widespread adoption of an indicator of counterparty credit risk — the standardized approach to counterparty credit risk, or SA-CCR.⁸ The SA-CCR approach to counterparty credit risk overstates counterparty credit risk compared to the already-prudent methods used by clearing houses, such as Nodal Clear, to manage risk, subject to regulatory oversight by the CFTC. Specifically, the largest banks are permitted, with regulatory approval, to use risk-sensitive approaches to counterparty credit risk. Smaller banks (Category III and IV banks, which are banks that have roughly \$100-250 billion in assets) use a standardized

⁶ See *id.* at 60,392.

⁷ 88 Fed. Reg. at 64,151 ("The proposed definition of a CVA risk covered position would include client-facing derivative transactions and would recognize the potential CVA risk of such exposures through the risk-based requirements for these exposures, as described in sections III.I.3.a and III.I.4 of this Supplementary Information.").

⁸ *Id.* at 64,056.

approach. The Basel III Endgame Proposal eliminates both of these approaches, replacing them with an expanded risk-based approach for the largest banks or SA-CCR, which would be required for Category III and IV banks. The safety of clearing houses relies on the prudence of their estimation of counterparty credit risk, and the CFTC carefully reviews the models that DCOs utilize for this purpose. The SA-CCR estimates of counterparty credit risk are significantly higher than those of clearing houses, indicating that SA-CCR may substantially overcharge for this risk.⁹

Moreover, the Basel III Endgame Proposal amends the current operational risk capital measure calculated under the expanded risk-based approach, switching it to SA-CCR. The SA-CCR approach includes a “services” component that includes clearing fees, exchange fees, and commission income on a gross basis, and not a net basis. This approach would disincentivize clearing via an unintentional tax in the form of additional operational risk capital. This will likely increase the pricing that banks will be required to charge, which would further increase gross revenues and consequently require even more operational risk capital. Nodal Clear agrees with the recommendation of CCP Global¹⁰ that, if the Basel III Endgame Proposal is finalized, fees and commission income paid for the central clearing of derivatives and relevant securities should not be included in the calculation of the business indicator component.

B. Impact of the Proposals

It is highly likely that banks will react to these proposals, if finalized, by 1) increasing fees for providing access to cleared derivatives, which would likely limit the amount of risk that the banks would allow clients to hedge through cleared derivatives, and 2) refusing to provide access at all to the banks’ least profitable clients. Banks actively manage their businesses to address constraints imposed by capital regulation. This management typically involves calculating the total contribution of each business line to the bank’s various capital requirements and comparing that contribution to the business lines’ profitability. Areas that do not provide a sufficient return on capital are often restructured or eliminated. As a result, through banks’ increasing their fees for clearing services and refusing to provide access to their least profitable clients, the Proposals may have a profoundly negative impact on the ability of businesses to hedge their risks in a safer clearing environment.

Specifically, it is expected that less hedging will occur, exposing companies to more risk and increasing the price volatility of goods and services offered by those companies. In turn, this could cause the exit of these end users from the cleared derivatives markets which may also cause the quality of price discovery on derivatives exchanges to deteriorate. This price discovery deterioration, in turn, will negatively impact the broader market because many commercial contracts in commodities are priced based off a reference to cleared derivatives market prices. Price discovery on futures markets provides greater efficiencies to the U.S. economy, as explained above. Undermining the price discovery function of futures markets would create greater inefficiencies and create significant negative impact on the U.S. economic output.

⁹ See M Roberson, CFTC Division of Clearing & Risk, *An Empirical Analysis of Initial Margin and the SA-CCR*.

¹⁰ See CCP Global Comment Letter at 4.

C. Need for these Proposals Has Not Been Demonstrated for Cleared Derivatives

The agencies' proposals do not demonstrate a need for higher minimum capital requirements and GSIB surcharges for cleared derivatives. The proposals do not provide any analysis to support the need for higher minimum capital requirements for derivatives intermediation. Before imposing any increases, the agencies should demonstrate that they are necessary and justified.

Pending the agencies' conducting such an analysis, Nodal Clear urges the agencies to withdraw the proposed changes to the GSIB surcharges, eliminate the CVA risk charges on client-cleared positions, and recalibrate SA-CCR.

* * * * *

Nodal Clear appreciates the opportunity to comment on the GSIB Surcharge Proposal. If you have any questions regarding these comments, please do not hesitate to contact the undersigned.

Respectfully submitted,

/s/ Ken McCracken

Ken McCracken
General Counsel

/s/ Cody Alvarez

Cody Alvarez
Chief Compliance Officer & Corporate
Counsel