MEMORANDUM

TO: File

FROM: Leigh E. Bothe

RE: Meeting with the Securities Industry and Financial Markets Association

DATE: April 28, 2011

On April 15, 2011, Commission staff met with representatives from the Securities Industry and Financial Markets Association ("SIFMA") to discuss the implementation of Title VII of Dodd-Frank. The Commission staff met with the representatives in person. Other SIFMA members were able to listen in via a conference call, but could not participate in the discussion. The discussion included capital and margin requirements for swaps and security-based swaps under Title VII.

Commission representatives included: Robert Cook, John Ramsay, James Brigagliano, Greg Berman, Nathaniel Stankard, Mike Macchiaroli, Tom McGowan, Denise Landers, Mark Attar, Tim Fox, Rebekah Goshorn, Brian Bussey, Joe Furey, Haimera Workie, Marta Chaffee, Richard Grant, Jeff Dinwoodie, Jim Giles, Michelle Danis, Thiagarajah Maheswaran, Chul Park, and Leigh Bothe from the Division of Trading and Markets. Andrew Glickman represented the Office of General Counsel; James Burns represented the Office of the Chairman.

Tom Smith and Thelma Diaz represented the Commodity Futures Trading Commission. Sean Campbell represented the Federal Reserve Board. Grace Vogel and Bill Wollman represented FINRA. The SIFMA representatives at the meeting were: Anna Shender (Barclays Capital), Evan Picoult (Citigroup), Annette Nazareth and Bob Colby (Davis Polk & Wardwell LLP), Mark Holloway and Victor Ng (Goldman Sachs & Co.), David Russo and Anthony Cicia (Morgan Stanley), Ralph Mattone (Nomura Securities International, Inc.), and Kyle Brandon (SIFMA).

Security-Based Swap Dealer and Swap Dealer Capital Requirements under Title VII of the Dodd-Frank Act

Meeting With Securities and Exchange Commission, Commodity Futures Trading Commission and Federal Reserve Board
Friday, April 15, 2011 – Washington, D.C.

The Securities Industry and Financial Markets Association (SIFMA) prepared this illustrative material for discussion purposes only.

Swap Dealer Capital Requirements

Introduction

- Swap dealers should use risk-based methods, such as models, for computing capital requirements.
- Large global financial institutions use models and other risk-based methods to manage risk and determine appropriate levels of capital.
- Regulators in major financial centers around the world have incorporated model-based capital requirements into their regulations.
- If regulators in the U.S. and globally take different approaches to determining capital requirements, competitive advantages and disadvantages are likely to result.
- A grid-based approach would be inferior to a risk-based method for computing capital.

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Attributes of a Good Capital Regime: Grids vs. Models

Attributes of a Good Capital Regime

- Risk sensitive.
- Accurate at both trade and portfolio levels.
- Minimizes unintended consequences and bad behavior.
- Consistent with business risk-management processes.

Comparative Advantages of Models and Grids

- Grids: simpler to use
- Models: risk sensitive; recognize different risks within portfolios of many complex and different products; accurate at trade and portfolio levels; recognize diversification and concentration of risk; utilize back-testing and feedback loops; readily adjust capital requirements as risks are identified; minimize unintended consequences and bad behavior; consistent with business risk-management processes; consistent with global regulatory models

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Model Governance and Uses

VaR-Based Models are Subject to Rigorous Development and On-Going Validation

- Model governance includes model development and model validation conducted by separate teams with separate reporting lines; regulators subject models to rigorous approval processes.
- VaR models are back-tested daily and stressed tested regularly.
- Internal and external auditors provide independent review and oversight of models.
- Risks not adequately captured by VaR are identified and monitored separately.

VaR is an important tool in monitoring aggregate market risk exposures

- Important uses of VaR models include estimation of economic and regulatory capital, risk management and capital allocation, and public reporting.
- VaR numbers are produced daily and subject to a large number of control processes.
- VaR numbers and compliance with VaR limits are monitored daily.
- VaR numbers are reported to and well-understood by front office staff, senior management, and Boards of Directors.

Model Performance and Development

How Well Does VaR Perform in Measuring and Managing Risk?

- On the vast majority of trading days, VaR models perform well.
- During periods of market stress, VaR models can have lower predictability.
- VaR should not be the sole measure for determining economic capital because it does not take into account certain market factors such as illiquidity and extreme widening of credit spreads.
- Back-testing and feedback provide an accurate view of VaR models' shortcomings so that compensating steps can be taken.

Models Have Been Improved

- Regulators have introduced stressed VaR, incremental risk charges (IRC), and comprehensive risk measures (CRM).
- Firms have enhanced their own economic capital models to reflect levels of liquidity.

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Shortcomings of Grids

- Updated infrequently.
- Are product based and do not recognize cross-product hedging and other risk management techniques.
- Not internally consistent.
- Allow for recognition of a limited number of risk factors; fail to take others into account.
- Not used in managing financial businesses.
- At odds with global norms.
- Very difficult, and perhaps impossible, to make risk-sensitive and to align with other regulatory regimes.