January 16, 2024

Via Electronic Submission

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Board of Governors of the Federal Reserve System
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Office of the Comptroller of the Currency
400 7th St. SW
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Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity

Dear Sir/Madam:

Cboe Global Markets, Inc. ("Cboe") appreciates the opportunity to express our views on the notice of proposed rulemaking (the "Endgame Proposal" or "Proposal") issued by U.S. prudential bank regulators (collectively, the "Agencies").[1] The Proposal would implement the final components of the Basel III agreement, also known as Basel III endgame, and revise the approach used to calculate capital requirements for large banking organizations. Along with the associated notice of proposed rulemaking for U.S. global systemically important banking organizations or G-SIBs (the "Surcharge Proposal"), the proposed changes are expected to significantly raise the capital requirements for large banks.

Cboe, through its subsidiaries, is among other things a global leader in exchange-traded centrally cleared derivatives. Our U.S. derivatives markets collectively represent one of the largest risk transfer and hedging mechanisms in the world. In 2023, Cboe's S&P 500 Index Options ("SPX Options") alone traded over 2.9 million contracts per day, representing over $1 trillion in notional risk transfer per day.

In our experience, a well-tuned prudential framework is key to a well-functioning derivatives market. Fundamental to a well-tuned prudential framework is the support of client clearing, capital efficiencies, and the recognition of offsetting risk exposures. Over the years, reductions in client clearing services have been particularly impactful for centrally cleared exchange-traded options markets where options market makers are relied on to provide critical liquidity (e.g., in SPX Options the majority of contracts trade against a market maker). Options market makers clear positions through bank-affiliated clearing firms. Previous iterations of the capital rules caused bank-affiliated clearing firms to hold capital well in excess of the actual risk posed by these client positions. This led to reductions in liquidity, increased costs for customers, and increased potential for market dislocations as options market-makers faced insufficient clearing capacity. Although the transition to the more risk-sensitive SA-CCR methodology has been a positive development for options markets, this belies the fact that technical inefficiencies remain. These inefficiencies continue to require banks to hold capital in excess of the actual risk of supporting client clearing services.

[1] *See* Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve Board), and the Federal Deposit Insurance Corporation (FDIC), Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 FR 64028 (September 18, 2023), *available at*, https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant

Basel III reforms represent the goals of G20 leaders following the 2008 financial crisis. The policy objectives then were clear: (i) to strengthen regulatory frameworks, prevent excessive leverage and improve the quality and quantity of capital in the banking system; and (ii) to promote central clearing of standardized derivative contracts as part of mitigating systemic risk and making derivatives markets safer.[2] Regulatory frameworks around the world have indeed been strengthened over the years; however, insufficient attention has been paid to the market dynamics impacting the ability of market participants to support central clearing. In our view, G20 policy objectives cannot continue to be met without a strong marketplace for client clearing services.

To support the G20 policy objective of promoting central clearing, and to incentivize client clearing services and reduce knock-on effects from the significant increase in capital expected to result from the Endgame and G-SIB Surcharge, Cboe recommends the following:

- **Permit the exclusion of the derivatives exposures arising from client clearing from the credit valuation adjustment ("CVA") capital charge:** Excluding client cleared derivatives from the CVA framework supports client clearing as it will eliminate unnecessary and duplicative capital charges for client cleared positions as clearing member banks do not assume principal risk in these transactions and potential credit risk-related losses arising from client clearing are already captured through the counterparty credit risk default charge.

- **Permit the netting of economically offsetting client exposures**: Allowing settled-to-market contracts (futures) to net against collateralized-to-market contracts (equity options) will support client clearing and promote prudent hedging activity by reducing capital charges for hedged exposures between products with long standing, economically meaningful relationships.

- **Permit the decomposition of index options and options on ETFs:** Allowing banks to decompose an SPX Option and SPY Option into component pieces will aid client clearing by reducing capital charges associated with balanced long and short portfolios associated with options market-makers.

- **Permit the exclusion of client cleared transactions from minimum haircut floors related to securities financing transactions ("SFTs"):** To the extent the Agencies adopt minimum haircut floors for securities financing transactions, we are supportive of the exemption for cleared transactions as this incentivizes central clearing. Extending the clearing exemption to client cleared transactions will support the ability of banking organizations to support the clearing of SFTs.

These recommendations are described in greater detail below.

1) Permit the exclusion of the derivatives exposures arising from client clearing from the credit valuation adjustment capital charge

The proposed CVA capital charge arose in response to the 2008 financial crisis. During the crisis proprietary bank exposures were devalued, but capital rules at the time did not adequately account for the credit risk losses associated with these fair value adjustments (i.e., credit valuation adjustments). The Proposal now seeks to adopt a CVA capital charge; however, as proposed, the CVA capital charge would be applied to client cleared transactions in addition to proprietary positions. We believe this is an unnecessary and duplicative surcharge when applied to cleared transactions and will once again hinder the ability of banks to support client clearing services.

As other commenters have stated,[3] banking organizations do not account for client cleared transactions on their balance sheets. This means that there will be no credit valuation adjustment associated with these client cleared transactions; thus, no need for a specific CVA charge for client cleared transactions. Importantly, this does not mean that risk from client cleared business is not appropriately accounted for. In the client clearing business, the risk to the bank is client default risk. Since this risk is already accounted for through the existing counterparty credit risk default charge, any CVA capital charge applied to client cleared transactions would be unnecessarily and harmfully duplicative.[4]

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[2] BCBS, Consultative Document, Leverage Ratio Treatment of Client Cleared Derivatives, October 2018, available at, https://www.bis.org/bcbs/publ/d451.htm.

[3] See ISDA and SIFMA presentation, November 2, 2023, available at, https://downloads.regulations.gov/OCC-2023-0008-0053/content.pdf.

[4] See EU Capital Requirements Regulation (CRR), Art. 382(3), available at, https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/1568 ("Transactions with a qualifying central counterparty and a client's transactions with a clearing member, when the clearing member is acting as an intermediary between the client and a qualifying central counterparty and the transactions give rise to a trade exposure of the clearing member to the qualifying central counterparty, are excluded from the own funds requirements for CVA risk").

2) Permit the netting of economically offsetting client exposures

As it stands, existing prudential requirements may prevent banks from netting client exposures of centrally cleared exchange-traded equity options, such as SPX Options, against economically offsetting positions in centrally cleared exchange-traded equity futures, such as futures on the S&P 500 Index ("S&P Futures"). This is because under existing rules, settled-to-market contracts (i.e., futures) are not allowed to be in the same netting set as collateralized-to-market contracts (i.e., equity options).

This is a perverse outcome. SPX Options and S&P Futures track the same underlying index, and S&P Futures are a natural hedge for SPX Options positions that have long been used by SPX Options market makers to reduce risk. Moreover, SPX Options and S&P Futures are two of the largest hedging products in U.S. capital markets. In 2023, SPX Options traded over 2.9 million contracts per day and S&P 500 e-mini futures traded over 1.8 million contracts per day. Banks naturally support clearing of both products; thus, by preventing these banks from netting SPX Options and S&P Futures positions, hedged positions with reduced market risk have unnecessarily high capital charges. This is problematic treatment that disincentivizes client clearing and penalizes prudent hedging activity. In our view, this is exactly the kind of outcome prudential requirements should seek to avoid.

This treatment is made more perverse by the fact that if SPX Options and S&P Futures were held proprietarily by banks, as opposed to on an agency basis in support of client clearing, the banks would theoretically be allowed to net such positions. Similarly, if a counterparty were to default, a banking organization would also be able to net such positions.

The inability to net exchange-traded options and exchange-traded futures unnecessarily impacts a natural, longstanding hedging relationship. Cboe respectfully requests that the banking Agencies recognize these important relationships by allowing centrally cleared exchange-listed equity index futures to fully net with centrally cleared exchange-listed equity index options.

3) Permit the decomposition of index options and options on ETFs

As stated in the Proposal, banks are generally permitted to decompose derivatives on indices into the underlying components for purposes of calculating exposures. The Proposal, however, seeks to clarify that decomposition is not allowed in the case of "non-linear indices" (e.g., equity index options, as well as options on certain ETFs). The Agencies posit that it is not appropriate to decompose non-linear products because "it is not mathematically possible to calculate the supervisory delta for an underlying component, as the delta associated with the non-linear index applies at the instrument level."[5]

The inability to decompose non-linear products directly increases capital charges for an important segment of exchange-traded derivatives markets – options market makers. This is to the detriment of client clearing and to exchange-traded derivatives markets. For example, SPX Options and options on an ETF that tracks the S&P 500 (e.g., SPDR S&P ETF or "SPY Options") are two of the most active and liquid exchange-traded options in the U.S. The underlying component exposure is the same broad-based, diversified index, and options market makers supply significant liquidity across both products. In 2023, over 50% of SPX Options and SPY Options contracts traded against market makers. This market-making activity generally leads to balanced long and short portfolios across SPX Options and SPY Options, and the positions are cleared at bank-affiliated clearing firms.

If banks are not allowed to decompose these market maker portfolios, it is our general expectation that certain aspects of the capital calculation will be 4x higher than they otherwise would be with decomposition. We also understand that the benefits of decomposition would accrue to balanced long and short portfolios – exactly the kind of portfolios market makers generally maintain – rather than more directional portfolios. This not only makes decomposition a naturally more risk-sensitive methodology, but it also represents a targeted solution that directly enhances client clearing capacity for clients that are most responsible for liquidity provision in options markets.

Importantly, the inability to calculate the delta for each underlying component should not serve as a basis for prohibiting decomposition. If banking organizations were allowed to apply the delta applicable to the index itself to each individual component this would be an adequate proxy for broad-based indices. We acknowledge that this is a simplification, but SA-CCR itself is a simplified approach to measure exposures.

Given the size of the SPX Options and SPY Options markets and the importance of the liquidity supplied by options market makers, we believe allowing decomposition for non-linear indices will be meaningfully beneficial. The collective policy objective should be to support and incentivize client clearing in an effort to maintain highly liquid and resilient, exchange-traded centrally cleared markets for the benefit of all investors. Otherwise, the risk is less liquidity and higher costs for investors, if not more problematic outcomes.

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[5] See Proposal at 64058.

4) **Permit the exclusion of client cleared transactions from minimum haircut floors related to securities financing transactions**

The Proposal seeks to adopt a minimum haircut floor for non-centrally cleared securities financing transactions. Without opining on the relative merits of the minimum haircuts related to SFTs, we support the proposed exemption for cleared SFTs. Central clearing is an important method for reducing systemic and counterparty credit risk. Our understanding is that this proposed exemption would apply to a bank's proprietary SFT exposures that are subsequently cleared. In order to fully support the clearing system and incentivize client clearing, we recommend that the clearing exemption be extended to include client cleared SFT transactions. This will enable bank-affiliated clearing firms to more fully support SFT clearing.

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Cboe greatly appreciates the opportunity to provide views on the proposed U.S. bank capital rules. We echo the concerns raised by many others in the industry about the magnitude of these changes and the significant additional capital necessary to satisfy the requirements. Given the increasingly smaller universe of clearing members coupled with higher demand for clearing, the Agencies must ensure the methodologies used to calculate bank capital requirements not only appropriately measure risk exposures but strike a balance that allows for recognition of capital efficiencies to be maximized and, as a result, foster robust clearing capacity in the economy.

We encourage the Agencies to consider these recommendations, as well as all of the recommendations made by the industry. Enabling capital efficiencies through the recognition of offsetting risk exposures is a critical way to incentivize central clearing, and we urge regulators to find ways to fine-tune the proposed framework to accurately reflect actual risk and support the ability of markets to absorb these changes.

Sincerely,

Angelo Evangelou
Chief Policy Officer
Cboe Global Markets