StoneX

StoneX Markets LLC
230 South LaSalle - Suite 10-500
Chicago, Illinois 60604 USA
www.stonex.com

September 29, 2021

Regulation 23.102

Amanda Olear, Acting Director
Market Participants Division
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Request for Temporary No-Action Relief Regarding Use of Internal Models to Calculate Market Risk-Weighted Assets

Dear Ms. Olear:

Pursuant to Regulation 140.99, StoneX Markets LLC ("SXM") (NFA ID: 0449652) is writing to respectfully request that the Market Participants Division (the "Division") of the Commodity Futures Trading Commission ("Commission") issue temporary no-action relief confirming that the Division will not recommend that the Commission commence enforcement action if, for purposes of the minimum risk-weighted asset capital requirement set forth in Regulation 23.101(a)(1)(i)(B), SXM calculates its market risk-weighted assets in accordance with prong (4) of the "BHC equivalent risk-weighted assets" definition in Regulation 23.100 using internal models that have not been approved by the Commission or a registered futures association (*i.e.*, the National Futures Association ("NFA")) pursuant to Regulation 23.102(d).[1] This relief would expire on January 6, 2022.

The purpose of this relief is to afford SXM a limited transition period so that, if NFA has not approved SXM's internal market risk capital models, SXM can restructure its swap dealer business so that it can instead calculate its market risk-weighted assets in accordance with the standardized approach reflected in prong (3) of the "BHC equivalent risk-weighted assets" definition without material disruption to its commercial end-user customer base.

I. Background on SXM

SXM is a wholly-owned subsidiary of StoneX Group Inc., which is a diversified global financial services organization providing execution, risk management, advisory, and clearing services across asset classes and markets. SXM has been provisionally registered as a swap dealer with the Commission since the inception of the swap dealer regime on December 31, 2012.

[1] The Division has determined to permit model approval by the NFA as an alternative means of compliance under Regulation 23.102. *See* Letter No. 21-03(Jan. 12, 2021).

A. SXM Predominantly Serves Commercial End-Users

SXM's core business is helping mid-sized commodity producers, processors, merchants, and end-users understand and mitigate commodity price risks by accessing derivatives markets. SXM's products are offered primarily to customers who seek to hedge their price risk exposure to grains, energy, softs, interest rates, metals, and other physical commodities. SXM's customer base consists predominantly of counterparties that are farmers, elevators, processors, merchants, and other commercial end-users of agricultural commodities.[2] Many of these customers are underserved by large, bank-affiliated swap dealers, who are not as active or specialized in the agricultural commodities markets.

B. SXM Does Not Present Systemic Risk

SXM's business does not present material interconnectedness to the broader financial markets or systemic risk. Relative to most other non-bank swap dealers, SXM has relatively lower trading volumes; indeed, the notional amount outstanding of its uncleared swaps positions falls materially below the $50 billion average aggregate notional amount that would have triggered initial margin requirements on September 1, 2021. Also, the non-financial and hedging nature of SXM's customer base insulates it from broader financial market risks.

SXM also imposes stringent limits on its market risk exposures,[3] which it manages by offsetting the risk of its customer-facing swaps through hedges with related trading in the listed futures and options and, to a lesser extent, over-the-counter swaps markets. Because of the commodity-centric nature of SXM's business,[4] the most liquid hedging market for SXM is the listed futures market.[5] Hedging in this manner also reduces SXM's credit risk and its overall systemic risk profile by ensuring that it is hedging through Commission-regulated futures commission merchants ("FCMs") and clearing organizations.

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[2] As of September 14, 2021, over 95% of SXM's active customers were commercial producers, processors, consumers, merchants, or other end-users mitigating their commodity, foreign exchange and/or interest rate risks using swaps, and roughly 80% of those customers were trading in agricultural or soft commodities.

[3] For instance, SXM has trading limits around its exposures to the Greek variables (Vega, Gamma, Delta and Theta). These include overall limits for the net of all these exposures, as well as specific limits for each individual commodity or foreign exchange pair. These limits minimize both the overall open market risk at any one time, and the amount of risk that is concentrated in any single product. In addition, SXM has established tenor limits that prevent its traders from having too many directional positions in any one asset class. These tenor limits reduce SXM's exposure to liquidity risk, making it more likely for it to be able to decrease risk should a position approach its Vega limits. Overall, these limits set fixed constraints around the amount of risk that SXM can take in its proprietary positions (*i.e.*, the difference between what is left on its books after hedging or closing out customer positions) that ensure the firm is financially capable of withstanding significant market movements.

[4] As of August 3, 2021, over 97% of the swaps for which SXM intends to use internal market risk capital models fell within the commodity asset class.

[5] For commodity swap positions that give rise to "delta-one" exposure to the underlying commodity or commodity futures contract, SXM typically buys or sells (as appropriate) a fully offsetting futures position. For other commodity swaps, SXM typically engages in dynamically managed "delta" hedging in the futures market.

II. SXM's Capital Requirements

SXM intends to follow the "bank-based" approach to compliance with the Commission's swap dealer capital rules, as reflected in Regulation 23.101(a)(1)(i). Under this approach, SXM will be required to maintain: (a) $20 million of common equity tier 1 capital; (b) an aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital equal to or greater than eight percent of SXM's BHC equivalent risk-weighted assets (subject to certain provisos); (c) an aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital equal to or greater than eight percent of SXM's uncleared swap margin (*i.e.*, the hypothetical margin for specified uncleared positions); and (d) the amount of capital required by NFA.

SXM's BHC equivalent risk-weighted assets will include both market and credit risk components. With regards to market risk, SXM must either (a) apply the standardized market risk charges set forth in 17 C.F.R. §§ 240.18a-1 and 1.17 to its proprietary positions, and multiply that amount by a factor of 12.5 or (b) calculate its market risk exposure requirement using Value-at-Risk ("VaR") and other models approved by the Commission or NFA.[6]

Under the standardized approach to market risk, the market risk charges for SXM's commodity swap positions would equal the notional amount of the positions times 20 percent of the market value of the amount of underlying commodities.[7] In addition, because SXM generally hedges those swaps in the listed futures and options market, instead of the swap market, SXM would not be permitted to net those swap positions against its offsetting futures and option hedges. Instead, SXM would be required to apply market risk charges separately to its commodity swaps and offsetting futures and option positions. In contrast, if SXM was permitted to use internal models to calculate its market risk-weighted assets, then its internal VaR and stressed VaR models would generally recognize offsets between SXM's commodity swaps and futures and option positions.

As a result of the fact that the standardized approach would not appropriately reflect the generally risk-neutral nature of SXM's portfolio by recognizing offsets between swaps and related futures and option positions, SXM estimates that its market risk-weighted assets under the standardized approach would be substantially more than an order of magnitude higher than if SXM was permitted to use internal models. At this level, it would not be economical for SXM to engage in its business, and it would likely need to exit the market, to the detriment of its commercial end-user customers.

III. SXM Application to Use Internal Market Risk Models

Following the July 22, 2020 adoption of the Commission's swap dealer capital rules, SXM engaged in an analysis of its business. Based on this analysis, and in light of the highly negative impact if SXM was required to apply standardized market risk capital charges, SXM

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[6] With regards to credit risk, SXM intends to follow the standardized approach reflected in prong (1) of the BHC equivalent risk-weighted assets definition (*i.e.*, either the current exposure method or the standardized approach for counterparty credit risk).

[7] *See* Regulation 1.17(c)(5)(iii)(C)(1)(*iii*).

initiated the internal model approval process with NFA on October 20, 2020 and submitted its response to NFA's "first-day" letter on December 14, 2020.

Since that time, SXM has engaged in extensive process to respond to NFA's feedback on its application. To assist it in this process, SXM has engaged multiple consulting firms, as well as legal advisers, and devoted significant internal resources. Over the course of the process, SXM has made material changes to quantitative and qualitative aspects of its market risk model framework, in order to respond to NFA's feedback. Notwithstanding these efforts and expenses, SXM understands that NFA considers certain key aspects of SXM's application to remain incomplete. Although SXM has been working, and continues to work, diligently to complete these aspects, SXM does not expect that it can do so sufficiently in advance of the October 6, 2021 capital rule compliance date to enable NFA to approve SXM to use its internal models by that date.

IV. <u>Proposed Transition Plan</u>

SXM expects that it can materially complete its market risk model approval application to NFA by October 6, 2021. In the meantime, SXM is taking steps to restructure its swap dealing business in a manner designed to enable it to conduct that business while subject to standardized market risk capital charges. Specifically, instead of hedging its customer-facing commodity swaps predominantly by trading directly in the listed futures and option markets, SXM would enter into offsetting, "back-to-back" uncleared commodity swaps with an affiliate domiciled in Bermuda, and that affiliate would in turn hedge those inter-affiliate swaps predominantly by trading in the listed futures and option markets. Restructured in this manner, SXM's commodity swaps and related hedges would be eligible for netting treatment under the Commission's standardized market risk rules.[8]

Several significant commercial, legal, and operational changes would be necessary for SXM to effect this restructuring without the potential for undue risk. For example, SXM would need to transfer its futures and option positions and related FCM clearing relationships to its Bermudan affiliate. SXM would also need to ensure that appropriately expert traders are able to transact for that affiliate. Various trading accounts and other operational infrastructure would need to be established by both SXM and the affiliate. SXM would also need to update its risk management program. Various tax and accounting considerations would also need to be addressed.

Given the extent of these changes, attempting to complete the restructuring before the October 6, 2021 capital rule compliance date would create significant risk of a disruption to SXM's operations and, accordingly, to its customers' commodity risk hedging activities. Rather, SXM would propose to continue its restructuring work during the period it is also completing work on its model application. Then, if NFA declines to approve SXM's application, SXM would pivot to completing the restructuring by January 6, 2022, *i.e.*, the expiration of the no-action relief sought in this letter.

V. <u>Request for Relief</u>

[8] *See* Regulation 1.17(c)(5)(iii)(D).

In order to afford SXM additional time to execute the transition plan described above, so that it does not become subject to disproportionately large capital charges that would force it to exit the market and disrupt access to hedging by its commercial end-user customers, we respectfully request that the Division grant no-action relief confirming it will not recommend that the Commission commence enforcement action if, for purposes of the minimum risk-weighted asset capital requirement set forth in Regulation 23.101(a)(1)(i)(B), SXM calculates its market risk-weighted assets in accordance with prong (4) of the "BHC equivalent risk-weighted assets" definition in Regulation 23.100 using internal models that have not been approved by the Commission or a NFA pursuant to Regulation 23.102(d).

This relief would be subject to the following conditions, which are intended to ensure that SXM operates with a material capital buffer during the transitional period:

1. In calculating its market risk-weighted assets in accordance with prong (4) of the "BHC equivalent risk-weighted assets" definition in Regulation 23.100, SXM would multiply the amount calculated using subpart F of 12 C.F.R. part 217 times two, *i.e.*, it would maintain capital based on two-times the market risk-weighted assets calculated by its internal models; and

2. In lieu of the $20 million of common equity tier 1 capital required by Regulation 23.101(a)(1)(i)(A), SXM would maintain $100 million of common equity tier 1 capital.

In addition, the requested relief would expire on January 6, 2022.

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Thank you for your attention to this request. Please do not hesitate to contact Colin Lloyd, our counsel at Cleary Gottlieb Steen & Hamilton LLP, at (212) 225-2809 for any further information the Commission or its staff may require in connection with this request. Pursuant to Regulation 140.99(c)(3)(ii), SXM hereby undertakes that, if at any time prior to the issuance of a no-action letter, any material representation made in this letter ceases to be true and complete, it will promptly inform the Commission staff in writing of all materially changed facts and circumstances.

Respectfully submitted,

DocuSigned by:
Scott Colburn
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Scott Colburn
President and Chief Executive Officer

cc: Thomas Smith, Deputy Director
Joshua Beale, Associate Director
Rafael Martinez, Senior Financial Risk Analyst

Certification

(Pursuant to Commission Rule 140.99(c)(3)(i))

The undersigned hereby certifies that the material facts set forth in the attached letter, dated September 29, 2021, are true and complete to the best of his or her knowledge.

By: DocuSigned by: Scott Colburn
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Name: Scott Colburn

Title: President and Chief Executive Officer