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CFTC Capital Requirements

CFTC Adopts Final Rule Implementing Capital Requirements for Swap Dealers and Major Swap Participants

SUMMARY

On July 22, 2020, the U.S. Commodity Futures Trading Commission ("CFTC" or the "Commission") voted 3-2 (with Commissioners Rostin Behnam and Dan Berkovitz dissenting) to adopt a final rule (the "Final Rule") that will impose capital requirements on swap dealers ("SDs") and major swap participants ("MSPs") that are not subject to the capital requirements of a Prudential Regulator (as defined below) (such entities, the "Covered Swap Entities"). The Final Rule allows SDs to choose from three potential alternative methods to be in compliance with the minimum capital requirements. Under the Final Rule, the CFTC also adopted financial reporting requirements for Covered Swap Entities and amended existing capital rules for CFTC-registered futures commission merchants ("FCMs" and those that are also SDs, "FCM-SDs") to provide explicit capital requirements for proprietary positions in swaps and security-based swaps that are not cleared by a clearing organization, in addition to other amendments to existing CFTC regulations.[1] Of the 108 SDs provisionally registered with the CFTC as of June 30, 2020, 56 will be subject to the Final Rule's capital requirements, while the remainder will remain subject to the capital requirements of their Prudential Regulators.[2]

BACKGROUND

A. DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") added a new Section 4s to the Commodity Exchange Act (the "CEA") and a new Section 15F to the Securities Exchange Act of 1934 (the "Exchange Act") that, together, require the CFTC, the SEC[3] and the Board of Governors of the Federal Reserve System (the ''Federal Reserve''), the Office of the Comptroller of the Currency ("OCC"),[4] the Federal Deposit Insurance Corporation, the Farm Credit Administration and

the Federal Housing Finance Agency (collectively, the "Prudential Regulators")[5] to adopt rules establishing minimum initial margin, variation margin and capital requirements for SDs, MSPs, security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs") (collectively, "Swap Participants"). Under Section 4s(e) of the CEA, the CFTC is required to adopt capital requirements for Covered Swap Entities, which include nonbank subsidiaries of bank holding companies, as well as swap dealers that are not affiliated with banking entities. Section 4s(f) of the CEA requires the CFTC to adopt financial reporting and recordkeeping requirements for SDs and MSPs.

B. PROCEDURAL HISTORY

On May 12, 2011, the CFTC initially proposed capital requirements and financial reporting rules for Covered Swap Entities, but elected to defer its consideration of final rules on these matters until the adoption of its margin rules for uncleared swaps,[6] which occurred in December 2015.[7] On December 2, 2016, the CFTC re-proposed rules (the "Proposed Rule") that would establish minimum capital and liquidity requirements and financial reporting rules for Covered Swap Entities, and amend existing capital requirements applicable to FCMs.[8] On December 10, 2019, the CFTC reopened the comment period on the Proposed Rule before moving forward with the Final Rule.[9]

THE FINAL RULE

A. MINIMUM CAPITAL REQUIREMENTS FOR FCMs AND FCM-SDs

The capital requirements for FCMs are set forth in CFTC regulation 1.17 and generally require each FCM to maintain a minimum level of "liquid assets" in excess of the firm's liabilities, in order to provide resources for the FCM to meet its financial obligations as a market intermediary in the regulated futures and cleared swaps markets.[10] There are two main components to the FCM capital requirements: (1) a minimum level of adjusted net capital that an FCM must satisfy at all times, and (2) an adjusted net capital amount that is based on the actual assets and liabilities of the FCM.[11]

Under the existing regulations,[12] the minimum level of adjusted net capital that an FCM must hold is the greater of: (i) $1 million; (ii) for an FCM that engages in off-exchange foreign currency transactions with retail forex customers, $20 million, plus 5% of the FCM's liabilities to retail forex customers that exceed $10 million; (iii) 8% of the sum of the risk margin[13] of futures, options on futures, foreign futures, and swap positions cleared by a clearing organization and carried by the FCM (the "Risk Margin Amount"); (iv) the amount of adjusted net capital required by the registered futures association ("RFA") of which the FCM is a member;[14] and (v) for an FCM that is also registered with the SEC as a broker dealer ("BD"), the amount of net capital required by the SEC.[15]

1. Minimum Fixed-Dollar Amount of Net Capital

Consistent with the Proposed Rule, the Final Rule increases the minimum fixed-dollar capital amount from $1 million to $20 million for FCM-SDs, but does not amend the required minimum fixed-dollar amount of adjusted net capital for stand-alone FCMs that may engage in swap activities at a level that does not require registration as an SD.[16] The CFTC stated that the Final Rule's increase is "necessary to ensure that FCMs meet their financial obligations" and "is also necessary to address the additional risk that is inherent in an SD's dealing activities."[17] In addition, the Final Rule adopts the Proposed Rule's amendment to CFTC Regulation 1.17(a)(1)(ii) to require an FCM-SD that uses internal market risk or credit risk models to maintain net capital of at least $100 million and adjusted net capital of at least $20 million.[18] The preamble to the Final Rule (the "Preamble") notes that such a minimum is appropriate given "potential model errors and tail risk and other factors that may not be fully or accurately captured in the models."[19]

2. Minimum Capital Requirements Based on 8% Risk Margin Amount

The Final Rule also makes a number of changes to the calculation of the Risk Margin Amount. Under the Proposed Rule, an FCM-SD (but not stand-alone FCMs, which are not addressed in the Final Rule and which must continue to calculate the 8% Risk Margin Amount based upon the customer and noncustomer futures, foreign futures and cleared swap positions carried by the FCM) would have been required to include in its calculation of the risk margin amount each outstanding uncleared swap (calculated on the basis of maintenance margin, in accordance with § 1.17(b)(8)), including those not covered by the CFTC's uncleared swaps margin rules and any security-based swaps that the SEC excluded from its margin rules.[20] Section 1.17(b)(8) defines "risk margin" as the "level of maintenance margin or performance bond required for the customer . . . positions by the applicable exchanges or clearing organizations," but excludes the equity component of short or long option positions and may exclude the maintenance margin or performance bond requirement associated with a long option position "to the extent that the value of such long option position does not reduce the total risk maintenance or performance bond requirement." The Proposed Rule further required an FCM-SD to include the initial margin for all uncleared swaps that would otherwise fall below the $50 million initial margin threshold amount or the $500,000 minimum transfer amount, as defined in CFTC Regulation 23.151, for purposes of computing the uncleared swap margin amount.[21]

The Final Rule largely adopts as proposed the Proposed Rule, with a number of targeted exceptions. In particular, the Final Rule modifies the Proposed Rule to exclude cleared security-based swap and uncleared security-based swap positions from the Risk Margin Amount calculation.[22] The Preamble to the Final Rule notes that the CFTC "believes that the overall adequacy of the minimum capital requirement at an FCM-SD should be based upon the activities of the FCM-SD in CFTC-regulated markets," given the Commission's expertise and history in such products.[23]

In addition, in response to public comments on the Proposed Rule,[24] the Final Rule does not include proprietary futures, foreign futures, and cleared swaps in the Risk Margin Amount calculation.[25] The Preamble notes that the requirement for an FCM-SD to take a capital charge of 100% or 150% on its proprietary cleared positions "adequately accounts for the risk associated with those positions" and, as a result, "it is appropriate to exclude the proprietary cleared positions from the 8% risk margin amount calculation."[26]

Lastly, the Final Rule modifies the Proposed Rule to set the risk margin amount multiplier for uncleared swaps at 2% of the "uncleared swap margin"[27] required on such positions.[28] The Preamble notes that the 2% multiplier is appropriate in light of "the generally higher initial margin requirement imposed on such positions under the Commission's regulations relative to cleared positions."[29] Nonetheless, the CFTC will review the impact of the 2% risk margin amount on FCM-SDs' capital levels within five years to ensure that the regulations continue to achieve their goal of protecting the safety and soundness of FCM-SDs.[30]

3. Stand-alone FCM and FCM-SD Calculation of Net Capital and Adjusted Net Capital

Stand-Alone FCM and FCM-SD Standardized Market Risk Capital Charges

Under the second component of FCM and FCM-SD capital requirements, firms must maintain a certain level of adjusted net capital.[31] The Final Rule largely adopts the Proposed Rule's approach of more explicitly providing for specific standardized market risk capital charges for FCMs' and FCM-SDs' proprietary positions in uncleared swaps and security-based swaps, with certain limited changes. The standardized market risk charges adopted by the Final Rule are "generally based on [CFTC] and SEC standardized market risk charges for positions in foreign currencies, commodities, U.S. treasuries, equities and other instruments."[32] In response to comments pointing out that the standardized risk charges would generally result in higher capital requirements than internal market risk models, the Preamble noted that, while that is generally true, firms that utilize internal models are also subject to higher minimum capital requirements as a way of protecting against "potential model errors."[33]

Additionally, the Final Rule:

- In a departure from the Proposed Rule, reduces the minimum capital charge for a portfolio of interest rate swaps to align with the SEC's final capital requirements for BDs and SBSDs using standardized capital charges. Under the Final Rule, an FCM-SD or FCM must take a capital charge of at least 0.125% (compared to 0.5% in the Proposed Rule) of the matched long interest rate swap positions that are netted against short interest positions with a maturity of three months or more.[34]
- Provides that an FCM or FCM-SD may reduce market risk charges for uncleared swap positions (other than credit default swaps) to account for offsetting positions.[35]
- Retains the requirement that an FCM take capital charges equal to 150% of the margin for proprietary futures or cleared swap positions, despite some commenters calling on the CFTC to eliminate such requirement.[36]
- Makes certain technical amendments with regard to the "time to maturity grids" for credit default swaps to fully align with the SEC, and to avoid divergent regulatory requirements.[37]

FCM and FCM-SD Standardized Counterparty Credit Risk Capital Charges

The Final Rule also largely adopts the Proposed Rule's treatment of standardized counterparty credit risk capital charges for FCMs and FCM-SDs. The Final Rule permits FCMs and FCM-SDs to recognize margin posted with a third-party custodian for swap and security-based swap transactions as a current asset for purposes of calculating their adjusted net capital, so long as the margin is held in compliance with the rules of the CFTC, SEC, or, in a slight expansion from the Proposed Rule, Prudential Regulators or foreign jurisdictions that have received a Comparability Determination from the CFTC (as discussed below).[38]

The Final Rule also requires an FCM-SD to take a capital charge for undermargined uncleared swap positions in an amount necessary for a swap counterparty or a security-based swap counterparty to meet its respective CFTC margin requirement for uncleared swap positions and the SEC margin requirements for uncleared security-based swap transactions, though the FCM-SD may reduce the amount by any margin calls that are outstanding for a certain limited time.[39] The Final Rule further clarifies that the capital requirements for undermargined positions apply only to FCM-SDs, not stand-alone FCMs.[40] The Final Rule also requires an FCM-SD to take a capital charge for uncleared swaps and uncleared security-based swaps that are exempt from CFTC or SEC margin requirements (e.g., legacy swaps), and provides that the FCM-SD may reduce the amount of its undermargined capital charge by any funds deposited by the counterparty to margin its swaps or security-based swap positions.[41] In addition, although the Proposed Rule requested comment on whether to recognize non-cash collateral (e.g., lines of credit) for capital requirement purposes, the Final Rule does not modify the credit risk charges to recognize non-cash collateral.[42]

Model-Based Market Risk and Counterparty Risk Capital Charges

The Final Rule made two additional changes. First, the Final Rule retains the notice and filing process which permits alternative net capital firms[43] that register as FCMs or FCM-SDs to use the SEC-approved internal capital models in lieu of the standardized market risk and credit risk capital charges in calculating adjusted net capital requirements. Second, the Final Rule permits FCM-SDs that are not SEC-registered BDs to apply to the CFTC, or the RFA of which the FCM-SD is a member, for approval to use internal market risk models in lieu of standardized capital charges.[44] In the Proposed Rule, the Commission also proposed enhanced fixed-dollar minimum capital requirements as a condition for an FCM-SD to obtain capital model approval. Specifically, the Commission proposed that FCM-SDs must maintain net capital of no less than $100 million and adjusted net capital of no less than $20 million in order to use capital models;[45] and these changes were adopted in the Final Rule as proposed.[46]

B. CAPITAL REQUIREMENTS FOR SDs AND MSPs

Consistent with the Proposed Rule, the Final Rule allows SDs that are not registered FCMs to elect one of two possible capital alternatives in order to be in compliance with CFTC capital rules: (i) the Net Liquid Assets Capital Approach, which is based on the liquidity-based capital rules for FCMs in CFTC Regulation 1.17 and SEC requirements imposed on BDs and SBSDs,[47] or (ii) the Bank-Based Capital Approach, which

is based on capital requirements for bank holding companies established by the Federal Reserve.[48] In addition, the Final Rule permits SDs that are predominantly engaged in non-financial activities to elect the Tangible Net Worth Approach.[49] Each of these alternatives is discussed below.

1. Net Liquid Assets Capital Approach

The Net Liquid Assets Capital Approach has two prongs. The first requires the SD to calculate "the minimum amount of capital that the SD is required to hold at any given point in time."[50] The second requires the SD to "compute, based upon its balance sheet and certain adjustments including market risk and credit risk capital charges to its swaps, security-based swaps, and other proprietary positions, the actual amount of capital that the covered SD maintains."[51]

Under the first prong, the covered SD must maintain a minimum of the greater of two amounts. The first is $20 million of net capital and, if the covered SD uses internal models, $100 million of tentative net capital and $20 million of net capital. This requirement is unchanged from the Proposed Rule.[52] Under the Proposed Rule, the second amount would have been equal to 8% of the sum of: (i) the amount of uncleared swap margin for each uncleared swap position, calculated on a counterparty-by-counterparty basis; (ii) the amount of initial margin required for each uncleared swap or security-based swap position, computed on a counterparty-by-counterparty basis, without regard to any initial margin exemptions or exclusions; (iii) the amount of risk margin required by a clearing organization for the SD's futures, swaps, and foreign futures positions; and (iv) the amount of initial margin required by a clearing organization for security-based swaps.[53] The second amount received numerous comments from market participants, which resulted in the modification of its calculation in the Final Rule, as described below. One commenter noted, for example, that the 8% risk margin amount in the Proposed Rule was "computed on a counterparty-by-counterparty basis and not on the aggregate of all of the covered SD's positions across all counterparties, which may overstate the covered SD's risk by not taking into account offsetting positions across multiple counterparties, including hedging positions."[54] Other commenters noted that the Net Liquid Assets Capital Approach effectively double counted certain positions held by a covered SD, as a covered SD would have to hold net capital of at least 8% of the risk margin amount, while at the same time the covered SD is required to reduce the amount of capital it actually holds by the amount of market and credit risk charges associated with the covered SD's positions.[55]

The Final Rule makes a number of changes to the Proposed Rule regarding the calculations for the second amount:

- Removes cleared and uncleared security-based swap positions from the calculation;[56]
- Excludes proprietary futures, foreign futures, and cleared swap transactions;[57]
- Modifies the proposed 8% risk margin amount for covered SDs by setting the multiplier at 2%.[58]

Under the second prong (which is based on the SD's actual balance sheet), a covered SD electing the Net Liquid Assets Capital Approach must compute net capital by (i) determining its net worth under GAAP, (ii) adjusting its net worth by deducting certain assets and (iii) adding back certain qualifying subordinated liabilities."[59] The covered SD will then compute its "net capital" by deducting from "tentative net capital" prescribed capital charges based on the mark-to-market value of its proprietary swap, security-based swap, equities and commodities positions.[60]

In addition to the two prongs discussed above, the Final Rule also requires a covered SD to maintain net capital that is equal to or greater than the amount of net capital required by an RFA of which the covered SD is a member.[61]

2. Bank-Based Capital Approach

Covered SDs also have the option to elect the Bank-Based Capital Approach, which is based on the Federal Reserve's capital requirements for bank holding companies. Under the Proposed Rule, covered SDs would have had to maintain capital in excess of the greatest of: (i) $20 million of common equity tier 1 capital; (ii) common equity tier 1 capital equal to or greater than 8% of the SD's risk-weighted assets; (iii) common equity tier 1 capital equal to or greater than 8% of the sum of (a) the amount of uncleared swap margin on the SD's books, computed on a counterparty-by-counterparty basis, (b) the amount of initial margin that would be required for each uncleared security-based swap position, computed on a counterparty-by-counterparty basis, without regard to any initial margin exemptions, and (c) the amount of initial margin required by a clearing organization for cleared proprietary futures, foreign futures, swaps, and security-based swap positions; or (iv) the capital required by the RFA of which the SD is a member.[62]

The Final Rule largely adopted the Proposed Rule, with certain targeted changes in response to comments. In particular, under the Final Rule, covered SDs must maintain capital in excess of the greater of: (i) $20 million of common tier 1 equity capital (adopted as proposed);[63] (ii) common equity tier 1 capital equal to or greater than 6.5% of risk-weighted assets, with an additional 1.5% to be comprised of common equity tier 1 capital, additional tier 1 capital or tier 2 capital[64] (compared to the Proposed Rule, which required 8% common equity tier 1 capital);[65] (iii) common equity tier 1 capital, additional tier 1 capital, and tier 2 capital in an amount equal to or greater than 8% of the covered SD's uncleared swap margin (compared to only common equity tier 1 and initial margin in the Proposed Rule);[66] and (iv) the minimum capital required by the RFA of which the SD is a member (adopted as proposed).[67]

3. Tangible Net Worth Capital Approach

The Final Rule provides a further option for eligible SDs that are "predominantly engaged in non-financial activities" or are "part of a corporate parent entity that is predominantly engaged in non-financial activities."[68] Under the Final Rule, covered SDs electing this alternative must maintain tangible net worth, calculated according to U.S. generally accepted accounting principles ("U.S. GAAP"), equal to the greater of (i) $20

million, plus the market risk and credit risk exposures associated with its swap and related hedge positions that are part of the covered SD's swaps positions, (ii) 8% uncleared swap margin associated with the SD's swap positions, and (iii) the amount required by the RFA of which the SD is a member.[69]

In a change from the Proposed Rule, the Final Rule allows covered SDs that are subsidiaries of parent entities that are commercial enterprises to follow the Tangible Net Worth Approach, in order to take into account the fact that certain SDs are established as separate legal entities.[70] In effect, this allows SDs that may otherwise not qualify as "predominantly engaged in non-financial activities" to do so, as long as they are subsidiaries of commercial enterprises. The purpose of the amendment, according to the Preamble, is the Commission's recognition "that certain corporate entities that are predominantly engaged in nonfinancial activities establish separate legal entities to operate as financial affiliates to act on behalf of itself and the other affiliates of the corporate enterprise."[71] In addition, the Final Rule modifies the definition of "predominantly engaged in non-financial activities" to "extend the eligibility of the Tangible Net Worth Capital Approach to covered SDs that are subsidiaries of parent entities that are commercial enterprises." In particular, the Final Rule provides that an SD is predominantly engaged in non-financial activities if: (i) the SD's consolidated annual gross financial revenues, or if the swap dealer is a wholly owned subsidiary, then the swap dealer's consolidated parent's annual gross financial revenues, in either of its two most recently completed fiscal years represents less than 15 percent of the swap dealer's consolidated gross revenue in that fiscal year; and (ii) the consolidated total financial assets of the swap dealer, or if the swap dealer is wholly owned subsidiary, the consolidated total financial assets of the swap dealer's parent, at the end of its two most recently completed fiscal years represents less than 15 percent of the swap dealer's consolidated total assets as of the end of the fiscal year.[72] The application of these tests means that, as a practical matter, a non-financial entity that is part of a group of affiliated entities that are financial entities will likely not be eligible for the Tangible Net Worth Approach.

C. CAPITAL REQUIREMENTS FOR MSPs

The Final Rule adopts without modification the proposal under the Proposed Rule, which provided that a covered MSP must maintain the greater of (i) positive tangible net worth or (ii) the amount of capital required by the RFA of which the MSP is a member.[73] The Final Rule further requires a covered MSP to mark its swaps, security-based swaps and related positions to their market values in computing its tangible net worth and to include in its liabilities obligations of a subsidiary or affiliate that the covered MSP guarantees, endorses or assumes, either directly or indirectly, to ensure that the tangible net worth of the covered MSP reflects the extent of such potential financial obligations.[74] The Preamble further notes that there are no MSPs currently provisionally registered with the CFTC, and that only two firms have ever provisionally registered as MSPs. As a result, the Preamble states that the Commission has limited experience with MSPs and lacks reliable information. The CFTC plans, therefore, to "monitor any future developments with

MSPs and assess the appropriateness of the positive tangible net worth capital requirement to such firms to ensur[e] the safety and soundness of the MSPs."[75]

D. INTERNAL MODEL APPROVAL PROCESS

Upon the prior approval of the CFTC or an RFA[76] and subject to the satisfaction of certain quantitative and qualitative requirements,[77] an SD or FCM-SD may use an internal model to calculate market risk and credit risk capital charges in lieu of the standardized capital charges.[78]

To alleviate commenter concerns regarding the reliance on internal models, these quantitative and qualitative requirements have been made consistent with the standards established by the Basel Committee on Banking Supervision ("BCBS") and SEC for banking institutions and SEC-registered BDs, respectively.[79] Additionally, the CFTC expanded its model requirements so that they are identical to the Federal Reserve requirements by incorporating the Federal Reserve's rules by reference, which addressed concerns raised regarding the ongoing revisions to the rules as BCBS enhancements continue to be adopted and implemented in the U.S.[80] The CFTC will also work with the National Futures Association ("NFA") to establish a comprehensive ongoing examination program for the capital models used by SDs.[81]

Appendix A to the Final Rule, as proposed, lays out the information required for the internal model approval application process.[82] The CFTC or RFA may also require an SD or FCM-SD to supplement its application with additional information necessary for a proper evaluation.[83] An SD or FCM-SD also will be required to cease using the models if: (i) the models are altered or revised materially, or if the SD's or FCM-SD's internal risk management is materially changed, and such changes have not been submitted to the CFTC and RFA for approval; (ii) the CFTC or RFA determines that the models are no longer sufficient or adequate to compute market or credit risk charges; (iii) the SD or FCM-SD fails to comply with the regulations governing the use of models; or (iv) the CFTC by written order finds that permitting the SD or FCM-SD to continue to use the internal models is no longer appropriate.[84]

The CFTC will assess the sufficiency of the NFA's planned model review process and procedures to ensure that such processes and procedures are adequate for providing NFA with an appropriate basis for determining whether an FCM-SD's or an SD's capital models satisfy the NFA's model requirements.[85] Based on these assessments, the CFTC will issue a determination that the NFA's approval of an FCM-SD's or an SD's capital models may serve as an alternative means of complying with the CFTC's model approval requirement.[86]

To address concerns with completing the review of internal models by the CFTC and NFA before the compliance date, the Final Rule provided that an SD may use capital models that are pending approval by the CFTC or the NFA, provided that the SD submits a certification to the CFTC and to the NFA certifying that the models have been approved for use by the SD or an affiliate of the SD by the SEC, a Prudential Regulator, a foreign regulatory authority in a jurisdiction where the CFTC has found to be eligible for

substituted compliance, or a foreign regulatory authority whose capital adequacy requirements are consistent with the BCBS bank capital requirements.[87] However, FCM-SDs must have approval prior to using such models to compute their adjusted net capital.[88]

E. LIQUIDITY REQUIREMENTS

The Proposed Rule included a liquidity coverage ratio that required the SD to maintain each day an amount of high quality liquid assets ("HQLAs") that is no less than 100 percent of the SD's total net cash outflows over a prospective 30 calendar-day period.[89] The Proposed Rule also required covered SDs electing the Net Liquid Assets Capital Approach and FCM-SDs to adopt a liquidity stress test requirement that addressed the types of liquidity outflows experienced by SEC-registered BDs that are ANC firms in times of stress (the "LST Proposal").[90] Under the LST Proposal, an SD or FCM-SD would be required to perform a liquidity stress test at least monthly and to take into account certain assumed conditions lasting for 30 consecutive days.[91]

While the Proposed Rule set liquidity requirements for SDs, the CFTC has decided to defer the adoption of detailed quantitative liquidity requirements.[92] Given the diversity of the provisionally registered SDs, the CFTC believes that it is not advisable to impose a single, mandated method of measuring liquidity needs at an SD, and will reassess the appropriateness of modifying or supplementing the current liquidity risk management requirements.[93]

F. EQUITY WITHDRAWAL RESTRICTIONS

The Final Rule, consistent with the Proposed Rule, prohibits certain withdrawals of equity capital from SDs.[94] Generally, an SD, or any subsidiary or affiliate of the SD that has any of its liabilities or obligations guaranteed by the SD, may not withdraw its capital by action of the SD or by its equity holders if the withdrawal, and any other similar transactions scheduled to occur within the succeeding six months, would result in the SD holding less than 120 percent of the minimum regulatory capital that the SD is required to hold, with an exception permitting the SD to pay required tax payments and reasonable compensation to equity holders of the SD.[95] These equity withdrawal restrictions are consistent with existing equity withdrawal restrictions imposed on FCMs and BDs, and with equity withdrawal restrictions adopted by the SEC for SBSDs.[96]

G. LEVERAGE RATIO REQUIREMENTS

The CFTC considered whether it would be appropriate for the CFTC, at a future date after notice and comment, to revise the SD capital requirements by adopting a leverage ratio for SDs in lieu of the percentage of the risk margin amount.[97] Commenters generally opposed the adoption of a leverage ratio. The CFTC did not adopt a leverage ratio in the Final Rule.[98]

H. FINANCIAL REPORTING, NOTICE FILING AND PUBLIC DISCLOSURE REQUIREMENTS

Consistent with section 4s(f) of the CEA, which requires Covered Swap Entities to comply with certain reporting requirements adopted by the CFTC, the Final Rule requires Covered Swap Entities to satisfy current books and records requirements, "early warning" and other notification filing requirements, and periodic and annual financial report filing requirements with the CFTC and with any RFA of which the Covered Swap Entities are members.[99] The Final Rule adopts the following financial reporting, notice filing and public disclosure requirements as proposed with certain modifications.

The Final Rule requires a Covered Swap Entity to submit financial statements in accordance with U.S. GAAP, unless the Covered Swap Entity is not otherwise required to prepare financial statements in accordance with U.S. GAAP and, therefore, may satisfy the requirements using the International Financial Reporting Standards ("IFRS") instead of U.S. GAAP, regardless of whether the Covered Swap Entity is domiciled outside the U.S.[100] Foreign-domiciled Covered Swap Entities may also apply for a Capital Comparability Determination, and such a determination could consider different, yet comparable, financial reporting requirements, including the use of a local accounting standard other than U.S. GAAP and IFRS.[101] All Covered Swap Entities that are also registered as FCMs or BDs must continue to prepare their financial statements in accordance with U.S. GAAP and are not eligible to use IFRS.[102]

Under the Final Rule, consistent with the Proposed Rule, a Covered Swap Entity will generally be obligated to file an annual audited financial report no later than 60 days after the end of the fiscal year and a monthly unaudited financial report.[103] The CFTC extended the timeline for the annual report to 90 days (from 60 days) and modified the monthly unaudited requirement to a quarterly requirement for SDs that elect the Tangible Net Worth Capital Approach.[104] Nevertheless, Covered Swap Entities eligible to file financial information on a quarterly basis may be required by the CFTC or RFA to furnish such information on a monthly or more frequent basis.[105] Compliance with the CFTC's capital rule is an "at all times" requirement, and the Final Rule requires SDs to routinely monitor their capital position and notify the CFTC and its RFA of material changes.[106] Consistent with the Proposed Rule, among other notice requirements, the Final Rule requires a Covered Swap Entity to provide immediate written notice to the CFTC and RFA when it: (i) is undercapitalized; (ii) fails to maintain capital at a level that is in excess of the "early warning" level of 120 percent of its minimum capital requirement; or (iii) fails to maintain current books and records.[107] The Final Rule, as proposed, requires a Covered Swap Entity to provide the CFTC and an RFA with a minimum two days' advance notice of an intention to withdraw capital by an equity holder that would exceed 30 percent of the Covered Swap Entity's excess regulatory capital.[108] An SBSD or MSBSP is required to file with the CFTC and with its RFA a copy of any notice that the SBSD or MSBSP is required to file with the SEC under its notification requirement rules.[109]

Reporting requirements for Covered Swap Entities that use internal capital models are identical to those finalized by the SEC for SBSDs and MSBSPs who have been approved to use models to calculate their

market and credit risk charges under the SEC's rules.[110] The CFTC also harmonized reporting requirements for Covered Swap Entities subject to the margin and capital requirements of a Prudential Regulator, including adopting: (i) a 30-calendar-day reporting timeline comparable to that required of SBSDs subject to the capital rules of a Prudential Regulator; and (ii) the notification requirements relating to the notices of change in the capital category or falling below their minimum capital requirement with a Prudential Regulator.[111] As proposed, the Final Rule requires each Covered Swap Entity to file monthly swap and security-based swap position information with the CFTC and with its RFA.[112]

To harmonize the public disclosure requirements with those required of the stand-alone SBSDs, the Final Rule requires Covered Swap Entities to bi-annually make available on its website basic financial information 30 calendar days following when such information is filed with the CFTC.[113] The CFTC did not adopt proposed public disclosures requirements for bank SDs and bank MSPs.[114]

I. COMPARABILITY DETERMINATIONS

Under the Final Rules, consistent with the Proposed Rules, the CFTC may permit a Covered Swap Entity organized and domiciled in a foreign jurisdiction to comply with a substituted compliance framework in lieu of meeting all or parts of the CFTC's capital adequacy and financial reporting requirements.[115] A Covered Swap Entity, a foreign regulatory authority that has direct supervisory authority over at least one eligible Covered Swap Entity or a trade association or other similar group can submit information that demonstrates how the foreign regulatory requirements achieve outcomes comparable to the CFTC's requirements.[116] The CFTC's approach to evaluating substituted compliance is a principles-based, holistic approach that focuses on whether the foreign regulations are designed with the objective of ensuring the overall safety and soundness of the non-U.S. Covered Swap Entities in a manner that is comparable with the CFTC's overall capital and financial reporting requirements.[117] Specifically, the CFTC would consider certain key factors in making a Capital Comparability Determination, including: (i) the scope and objectives of the relevant foreign jurisdiction's capital requirements; (ii) how and whether the relevant foreign jurisdiction's capital adequacy requirements compare to international BCBS capital standards for banking institutions or to other standards such as those used for securities brokers or dealers; (iii) whether the relevant foreign jurisdiction's capital requirements achieve outcomes comparable to the CFTC's corresponding capital requirements; (iv) the ability of the relevant regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's capital adequacy and financial reporting requirements; and (v) any other facts or circumstances the CFTC deems relevant.[118]

J. OTHER AMENDMENTS

The CFTC also made certain amendments to existing regulations, including:

- Financial reporting requirements for FCMs or introducing brokers ("IBs") that are also registered SBSDs, which include requirements relating to the filing of certain financial reports with a designated self-regulatory organization ("DSRO"), the CFTC or NFA;[119]

- Amendments to the FCM and IB notice provisions, which require an FCM or IB to file a notice with the CFTC and with the registrant's DSRO when certain prescribed events occur;[120]
- Amendments to allow both FCMs and IBs to recognize (i) unsecured commissions receivable resulting from swap transactions in computing their net capital, provided that the unsecured receivables are not outstanding more than 60 days from the month-end accrual date and the commissions are billed promptly after the close of the month; and (ii) dividends receivable that are not outstanding more than 30 days;[121]
- Amendments to FCM and IB notice and disclosure requirements for bulk transfers relating to timing and filing requirements;[122] and
- Conforming amendments to delegate to the Director of the Division of Swap Dealer and Intermediary Oversight, or the Director's designee, the authority reserved to the CFTC under certain adopted rules.[123]

K. EFFECTIVE DATE

The Final Rule is effective 60 days after publication in the Federal Register.[124] Market participants must be compliant by October 6, 2021.[125]

* * *

ENDNOTES

1 Additionally, the Final Rule amends certain other existing CFTC regulations, including by (i) permitting certain entities dually registered with the CFTC and the U.S. Securities and Exchange Commission ("SEC") to file an SEC Financial and Operational Combined Uniform Single Report in lieu of CFTC financial reports; (ii) requiring certain registrants to file notices of certain defined events; and (iii) requiring notices of bulk transfers to be filed with the CFTC electronically and within a defined period of time. Capital Requirements of Swap Dealers and Major Swap Participants, RIN 3038 – AD54 (hereinafter, the "Preamble"), at 5 (July 22, 2020), *available at* https://www.cftc.gov/PressRoom/PressReleases/8210-20.

2 Preamble at 20.

3 Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 84 Fed. Reg. 43,872 (Aug. 22, 2019) (the "SEC Final SBSD Capital Rule").

4 Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013) (where the Federal Reserve and OCC adopted revised capital rules to incorporate Basel III capital adequacy requirements).

5 Commodity Exchange Act, § 1a(39).

6 Capital Requirements of Swap Dealers and Major Swap Participants, RIN 3038 – AD54, at 14 (July 22, 2020), *available at* https://www.cftc.gov/PressRoom/PressReleases/8210-20.

7 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016). As required by the Dodd-Frank Act, the Prudential Regulators have also promulgated margin rules for uncleared swaps applicable to Swap Participants that are subject to the jurisdiction of one of the Prudential Regulators. Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (Nov. 30, 2015). For further information, see our Client Memorandum, Margin Rules for Uncleared Swaps: CFTC and Prudential Regulators Finalize Rules Imposing Minimum Margin and Capital Requirements on Covered Swap Entities (Jan. 7, 2016), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Margin_Requirements_for_Uncleared_Swaps.pdf. In May 2016, the CFTC amended the margin rules to add CFTC regulation § 23.160, providing rules on the cross-border application of the margin rules. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,818 (May 31, 2016). Recently, the CFTC unanimously approved a final rule codifying CFTC No-Action Letter 19-22, which provided that no enforcement actions would be recommended against a registered SD that does not follow the uncleared margin rules with respect to swaps entered into with the European Stability Mechanism. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 Fed. Reg. 27,674 (May 11, 2020).

8 Capital Requirements of Swap Dealers, 81 Fed. Reg. 91,252 (Dec. 16, 2016).

9 Capital Requirements of Swap Dealers and Major Swap Participants, 84 Fed. Reg. 69,664 (Dec. 19, 2019). For further information, see our Client Memorandum, CFTC Capital and Liquidity Requirements (Jan. 7, 2020), *available at* https://www.sullcrom.com/files/upload/SC-Publication-CFTC-Capital-and-Liquidity-Requirements.pdf.

10 Preamble at 22.

11 Preamble at 23.

12 CFTC Regulation 1.17(a)(1)(i).

ENDNOTES (CONTINUED)

13 "Risk margin" is "the level of maintenance margin or performance bond required for the customer or noncustomer positions by the applicable exchanges or clearing organizations, and, where margin or performance bond is required only for accounts at the clearing organization, for purposes of the FCM's risk-based capital calculations applying the same margin or performance bond requirements to customer and noncustomer positions in accounts carried by the FCM, subject to the following: (i) risk margin does not include the equity component of short or long option positions maintained in an account; (ii) the maintenance margin or performance bond requirement associated with a long option position may be excluded from risk margin to the extent that the value of such long option position does not reduce the total risk maintenance or performance bond requirement of the account that holds the long option position; (iii) the risk margin for an account carried by an FCM which is not a member of the exchange or the clearing organization that requires collection of such margin should be calculated as if the FCM were such a member; and (iv) if an FCM does not possess sufficient information to determine what portion of an account's total margin requirement represents risk margin, all of the margin required by the exchange or the clearing organization that requires collection of such margin for that account, shall be treated as risk margin." Preamble at 25-6. *See also* CFTC Regulation 1.17(b)(8).

14 As the Preamble notes, the National Futures Association ("NFA") is the only RFA. Preamble at 101.

15 Preamble at 24-5.

16 Preamble at 26.

17 Preamble at 29.

18 Preamble at 27-8.

19 Preamble at 29.

20 Preamble at 31-32. Specifically, the Proposed Rule provided that an FCM-SD must include in its computation of the risk margin amount each outstanding uncleared swap, including swaps exempt from the scope of the Commission's uncleared swaps margin rules by regulation 23.150 ("TRIPRA Exemption"), legacy swaps, foreign exchange swaps as the term is defined in regulation 23.151, or netting set of swaps or foreign exchange swaps, for each counterparty, as if the counterparty were an unaffiliated SD.

21 Preamble at 32.

22 Preamble at 34.

23 Preamble at 34.

24 For example, the Preamble notes that one commenter "stated that including margin associated with proprietary cleared swaps in the 8% risk margin amount was not necessary as proprietary cleared positions present minimal credit risk to an FCM-SD as the only credit exposure is to a clearing organization or broker." Preamble at 36.

25 Preamble at 36.

26 Preamble at 36-7.

27 "The term 'uncleared swap margin' is defined in CFTC Regulation 1.17(b)(11) to mean the amount of initial margin that the FCM-SD would compute on each uncleared swap position pursuant to the calculation requirements of regulation 23.154. The FCM-SD must include all uncleared swap positions in the calculation of the uncleared swap margin amount, including uncleared swaps that are exempt from the scope of the Commission's margin regulations for uncleared swaps pursuant to regulation 23.150, exempt foreign exchange swaps or foreign exchange forwards, or netting set of swaps or foreign exchange swaps, for each counterparty, as if the counterparty was an unaffiliated swap dealer. Furthermore, in computing the uncleared swap margin amount, an FCM-

SD may not reduce the uncleared swap margin amount to reflect the initial margin threshold amount or the minimum transfer amount as such terms are defined in regulation 23.151." Preamble at 38.

28 Preamble at 37-8.

29 Preamble at 39.

30 Preamble at 40-1.

31 "Regulation 1.17(c)(5) defines the term 'adjusted net capital' as an FCM's 'current assets' (i.e., current, liquid assets excluding, however, most unsecured receivables), less all of the FCM's liabilities (except certain qualifying subordinated debt)." Preamble at 51.

32 Preamble at 50.

33 Preamble at 50-1.

34 Preamble at 51-2. The CFTC notes that it "believes that in making this change, the overall effect on the amount of capital held by an FCM or an FCM-SD will not have a substantial adverse impact on the safety and soundness of these entities," but that it will "monitor the standardized capital charges and refine the percentages as it obtains experience with the level of interest rate swaps transactions entered into by stand-alone FCMs and FCM." *Id.* at 52.

35 Preamble at 52-3.

36 Preamble at 54. Some commenters requested that the CFTC eliminate the requirement. One commenter argued, for example, "that there is no justification for a higher capital charge as market risk is independent of whether the firm is or is not a clearing firm." Preamble at 54.

37 Preamble at 52.

38 Preamble at 58-9.

39 Preamble at 59-60. The final regulation would apply only to uncleared swaps and uncleared security-based swaps that are subject to the Commission's or SECs' margin requirements under applicable regulations. *Id.* at 60.

40 Preamble at 51.

41 Preamble at 61.

42 Preamble at 62-3.

43 The Preamble defines "Alternative Net Capital Firms" as "dually-registered FCM-BDs." Preamble at 42.

44 Preamble at 65, 66.

45 Preamble at 67.

46 Preamble at 68-9.

47 Preamble at 70.

48 Preamble at 70.

49 Preamble at 70.

50 Preamble at 72.

51 Preamble at 72.

52 Preamble at 74.

53 Preamble at 76.

54 Preamble at 78.

ENDNOTES (CONTINUED)

55 Preamble at 79.

56 Preamble at 91.

57 Preamble at 92.

58 Preamble at 93. The Preamble notes that the CFTC will monitor the impact of the 2% risk margin amount to determine if any amendments (*i.e.*, either increasing or decreasing the multiplier) would be beneficial. Preamble at 98-99.

59 Preamble at 104.

60 Preamble at 105.

61 Preamble at 100-02.

62 Preamble at 113-14.

63 Preamble at 115. Common equity tier 1 capital is defined under the bank holding company regulations in 12 CFR 217.20(b).

64 Additional tier 1 and tier 2 capital are defined in 12 CFR 217.20(c) and (d), respectively.

65 Preamble at 123.

66 Preamble at 132.

67 Preamble at 135, 137.

68 Preamble at 71. The Final Rule provides that an SD is "predominantly engaged in non-financial activities" if (1) the SD's consolidated annual gross financial revenues, or if the SD is a wholly owned subsidiary, then the SD's consolidated parent's consolidated annual gross financial revenues, in either of its two most recently completed fiscal years represents less than 15% of the SD's consolidated gross revenue in that fiscal year; and (2) the consolidated total financial assets of the SD, or if the SD is a wholly owned subsidiary, the consolidated total financial assets of the SD's parent, at the end of its two most recently completed fiscal years, represents less than 15% of the SD's consolidated total assets as of the end of the fiscal year. Preamble at 150.

69 Preamble at 71.

70 Preamble at 150.

71 Preamble at 150-51.

72 Preamble at 150.

73 Preamble at 154.

74 Preamble at 155-56.

75 Preamble at 156.

76 The National Futures Association is currently the only RFA. Capital Requirements of Swap Dealers and Major Swap Participants, RIN 3038 – AD54, at 10 n.19 (July 22, 2020), *available at* https://www.cftc.gov/PressRoom/PressReleases/8210-20.

77 The Final Rule provides further specifications on the market risk and credit risk model requirements, including value at risk ("VaR") models, stressed VaR models, specific risk models, incremental risk models, comprehensive risk models and credit risk models. Preamble at 3, 158-72.

78 Preamble at 169.

79 Preamble at 169.

80 Preamble at 171-72.

81 Preamble at 169.

ENDNOTES (CONTINUED)

82 Appendix A requires the application for model approval to include: (i) a list of categories of positions that the SD or FCM-SD holds in its proprietary accounts and a brief description of the methods the SD or FCM-SD would use to calculate market risk and credit risk charges; (ii) a description of the mathematical models to be used to price positions and to compute market risk and credit risk; (iii) a description of how the SD or FCM-SD would calculate current exposure and potential future exposure for its credit risk charges; and (iv) a description of how the SD or FCM-SD would determine internal credit risk-weights of counterparties, if applicable. Preamble at 172.

83 Preamble at 172.

84 Preamble at 173.

85 Preamble at 180-81.

86 Preamble at 180-81.

87 Preamble at 182.

88 Currently, the only FCM-SDs provisionally registered with the CFTC are four alternative net capital ("ANC") firms that have existing approvals to use capital models and may continue to use such models after the compliance date of these rules. Preamble at 183-84.

89 Preamble at 185.

90 Preamble at 185-86.

91 Preamble at 185-86.

92 Preamble at 190.

93 Preamble at 190-91.

94 Preamble at 191-92.

95 Preamble at 191-92.

96 Preamble at 192.

97 Preamble at 193.

98 Preamble at 193-94.

99 Preamble at 194.

100 Preamble at 200.

101 Preamble at 200.

102 Preamble at 200.

103 Preamble at 202.

104 Nevertheless, the CFTC or RFA may still require any such Covered Swap Entities to furnish such information on a monthly or more frequent basis. Preamble at 202-03.

105 Preamble at 203.

106 Preamble at 203.

107 Preamble at 206.

108 Preamble at 207.

109 Preamble at 207.

110 Preamble at 220.

111 Preamble at 211.

ENDNOTES (CONTINUED)

112 The CFTC did not adopt proposed position and margin information weekly reporting requirements because it was duplicative of other CFTC efforts. Preamble at 216, 221.

113 Preamble at 213.

114 Preamble at 214.

115 Preamble at 222.

116 Preamble at 228.

117 Preamble at 229.

118 Preamble at 224.

119 Preamble at 231.

120 Preamble at 234.

121 Preamble at 236.

122 Preamble at 236.

123 Preamble at 239.

124 Preamble at 241.

125 Consistent with the compliance date for the SEC Final SBSD Capital Rule. Preamble at 242.

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