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CFTC Capital and Liquidity Requirements

CFTC Reopens Comment Period on Proposed Rules Implementing Capital and Liquidity Requirements for Swap Dealers and Major Swap Participants

SUMMARY

On December 10, 2019, the Commodity Futures Trading Commission held an open meeting at which it voted (3-2, with Commissioners Rostin Behnam and Dan Berkovitz dissenting) to reopen the comment period and request additional comment on its 2016 re-proposed rule that would impose capital and liquidity requirements on swap dealers and major swap participants that are not subject to the capital requirements of a prudential regulator.

The release requests comments generally on the prior proposed rule and on a variety of specific topics, which are summarized generally below, including:

- The calibration of minimum capital requirements for swap dealers, including to take into account initial margin associated with derivatives positions;
- The regulatory approval process to use an internal model to calculate swap dealer market risk and credit risk capital charges;
- The application of liquidity requirements to swap dealers; and
- Financial reporting requirements for swap dealers.

Comments on the release are due on or prior to March 3, 2020.

BACKGROUND

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 Commodity Futures

Trading Commission (the "CFTC"), the Securities and Exchange Commission (the "SEC")[1] and the prudential regulators[2] (the "Prudential Regulators") to adopt rules establishing minimum initial margin, variation margin and capital requirements for swap dealers ("SDs"), major swap participants ("MSPs"), security-based swap dealers ("SBSDs") and major security-based swap participants (collectively, "Swap Participants"). Under Section 4s(e) of the CEA, the CFTC is required to adopt capital requirements for SDs and MSPs that are not subject to the capital rules of the Prudential Regulators ("Covered Swap Entities"), which include nonbank subsidiaries of bank holding companies.

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,[3] which occurred in December 2015.[4] 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 CFTC-registered futures commission merchants ("FCMs").[5]

Importantly, the Proposed Rule would provide several alternative approaches for calculating capital requirements applicable to Covered Swap Entities that are registered as SDs, in particular:

1. A bank-based approach derived generally from the Federal Reserve's regulatory capital requirements for bank holding companies (the "Federal Reserve Capital Rules"),[6] in which an SD would maintain a minimum level of common equity tier 1 capital ("CET1 Capital") as defined under the Federal Reserve Capital Rules[7] (the "Bank-Based Capital Approach");

2. A net liquid assets approach based generally on existing CFTC capital requirements applicable to FCMs and SEC capital requirements applicable to broker-dealers ("BDs") and SBSDs, in which an SD would maintain a minimum level of tentative net capital and net capital as calculated under the SEC's capital requirements applicable to an SBSD that is not subject to capital requirements of a Prudential Regulator[8] (the "Net Liquid Assets Capital Approach"); and

3. A tangible net worth approach available only for SDs predominantly engaged in non-financial activities, in which an SD would be required to meet a minimum level of tangible net worth[9] (the "Tangible Net Worth Approach").

In addition to satisfying minimum capital requirements, a Covered Swap Entity that is an SD electing either the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach would be required to meet, respectively, liquidity requirements that are consistent generally with the liquidity coverage ratio standard promulgated by the Federal Reserve (the "LCR")[10] or liquidity risk management standards proposed by the SEC for SBSDs.[11]

The Proposed Rule would also amend the FCM capital requirements to increase the minimum capital that must be held by an FCM dually registered as an SD from $1 million to $20 million. In addition, a dually registered SD-FCM would be required to include in its minimum capital requirements an amount that is intended to reflect uncollateralized exposures to swap counterparties and to satisfy minimum liquidity requirements.

The Proposed Rule further would impose financial reporting and recordkeeping requirements on SDs and MSPs, with certain limited exceptions for SDs and MSPs subject to prudential regulation.

OVERVIEW OF KEY AREAS FOR ADDITIONAL COMMENT

Below is a high-level overview of some of the specific areas on which the CFTC is requesting further comment on the Proposed Rule (the "Release"). Unless otherwise specified in this section, references to SDs are only to those SDs that are not subject to the capital rules of the Prudential Regulators.

A. 8 PERCENT RISK MARGIN AMOUNT

The Proposed Rule generally requires an SD to maintain capital in an amount equal to or greater than 8 percent of the sum of the SD's initial margin collected for its positions in all cleared and uncleared proprietary futures, foreign futures, swap and security-based swap positions (the "8 Percent Risk Margin Amount"). In light of comments stating that the 8 Percent Risk Margin Amount is over-inclusive and does not reflect actual risk, as well as the approach taken in the SEC Final SBSD Capital Rule, the CFTC is seeking comments on all aspects of the proposed 8 Percent Risk Margin Amount, including:

- The suitability of the 8 Percent Risk Margin Amount as a minimum capital requirement applicable to SDs and whether such margin amount is appropriate for each of the three approaches for calculating capital requirements under the Proposed Rule;
- The calibration of the risk margin percentage amount and whether a potential decrease would be appropriate, noting that the SEC Final SBSD Capital Rule uses initially a risk margin percentage amount of 2 percent that may be increased over a number of years based on the SEC's future experience with capital levels;
- The types of derivative positions included in the calculation of the 8 Percent Risk Margin Amount, including whether cleared transactions or any particular asset classes should be excluded; and
- The inclusion of a leverage ratio requirement in lieu of the 8 Percent Risk Margin Amount requirement.

B. SCOPE OF "CAPITAL" UNDER THE BANK-BASED CAPITAL APPROACH

SDs electing the Bank-Based Capital Approach under the Proposed Rule would calculate capital by reference to the definition of CET1 Capital under the Federal Reserve Capital Rules[12] and would be required to hold CET1 Capital equal to or greater than 8 percent of the SD's risk-weighted assets as calculated under the Federal Reserve Capital Rules.

The CFTC is seeking comment on, among other things, whether an SD should be permitted to recognize other instruments as capital for purposes of satisfying minimum capital requirements (including Additional Tier 1 capital or Tier 2 capital as defined under the Federal Reserve Capital Rules)[13] and whether SDs should be permitted to hold a minimum amount of CET1 Capital (e.g., 4.5 percent or 6.5 percent) with the remainder of the capital requirement to be satisfied by other instruments.

C. APPLICABILITY OF TANGIBLE NET WORTH APPROACH

Under the Proposed Rule, the Tangible Net Worth Approach—which would permit an SD to calculate minimum capital requirements based on its tangible net worth as opposed to CET1 or net capital—would be available only to an SD that is predominantly engaged in non-financial activities.[14] An SD would be considered to be "primarily engaged in non-financial activities" if (i) the SD's consolidated annual gross financial revenues in either of its two most recent fiscal years represents less than 15 percent of its consolidated gross revenue in that fiscal year; and (ii) the SD's consolidated total financial assets at the end of its two most recently completed fiscal years represent less than 15 percent of its consolidated total assets as of the end of that fiscal year. The Release notes that the CFTC included the Tangible Net Worth Approach in the Proposed Rule in recognition of the fact that some SDs are primarily commercial enterprises and, as a result, have materially different business activities and balance sheets than SDs predominantly engaged in financial activities.

The CFTC is requesting comment on whether to broaden the applicability of the Tangible Net Worth Approach, including to a subsidiary that belongs to a corporate group predominantly engaged in non-financial activities that would not itself qualify for the approach based on the subsidiary's own activities. The CFTC is also requesting comment on whether an SD subsidiary relying on a parent entity to qualify for the Tangible Net Worth Approach should obtain a parent guarantee or some other form of financial support in respect of its swaps obligations.

D. STANDARDIZED CAPITAL CHARGES AND INTERNAL MODEL APPROVAL PROCESS

The Proposed Rule generally would provide standardized market risk and credit risk capital charges in respect of uncleared swaps and security-based swaps for FCMs and SDs that do not have regulatory approval to use internal models.[15] However, upon the prior approval of the CFTC or a registered futures association ("RFA")[16] and subject to the satisfaction of certain quantitative and qualitative requirements, an SD may use an internal model to calculate market risk and credit risk capital charges in lieu of the standardized capital charges.[17]

With respect to the standardized market risk and credit risk capital charges, the CFTC is seeking comment on, among other things:

- The inclusion of netting provisions in respect of currency swaps and commodity swaps and modification of market risk capital charges in light of the standardized approach for market risk issued by the Basel Committee on Banking Supervision;[18] and
- The calibration of the standardized market risk capital charge for uncleared interest rate swaps and uncleared credit default swaps to harmonize with the SEC Final SBSD Capital Rule.

With respect to the internal model approval process, the CFTC is requesting comment on, among other things, whether to permit an SD to use an internal model that has been approved for the SD (or an affiliate of the SD) by the SEC, a Prudential Regulator or a non-U.S. regulator that has capital adequacy

requirements consistent with the Basel standards, and whether an SD should be permitted to request regulatory approval to use an internal model for either market risk or credit risk or if, alternatively, an SD must apply to use models for both types of exposures.

E. FCM MINIMUM CAPITAL REQUIREMENT

An FCM and a dually registered FCM/SD would be required to include 8 percent of its "uncleared swaps margin"[19] for uncleared swaps, 8 percent of the initial margin for uncleared security-based swaps for which the FCM or FCM/SD is a counterparty and 8 percent of the total initial margin required to be posted for all proprietary cleared swaps and security-based swaps in its minimum capital requirements under the Proposed Rule. In light of comments suggesting that these additional capital charges may be duplicative, as well as particularly burdensome for small dually registered SD-FCMs, the CFTC is requesting further comment on whether these proposed capital charges should be removed.

F. LIQUIDITY REQUIREMENTS

The Proposed Rule would impose liquidity requirements and equity withdrawal restrictions on SDs. An SD that elects the Bank-Based Capital Approach would be required to meet the Federal Reserve's liquidity coverage ratio test for bank holding companies[20] and, in particular, to maintain each day an amount of high-quality liquid assets ("HQLA") as defined under the LCR[21] with a value that is no less than 100 percent of the SD's total net cash outflows over a prospective 30-day period (the "HQLA Test"). Alternatively, an SD that selects the Net Liquid Assets Capital Approach would be required to perform monthly liquidity stress tests that take into account specified conditions over a 30-day period (the "Liquidity Stress Test").

In respect of the liquidity requirements in the Proposed Rule, the CFTC is requesting further comment on, among other things:

- Whether to permit an SD to elect either the HQLA Test or Liquidity Stress Test irrespective of the particular approach used by the SD to satisfy its minimum capital requirements;
- Whether to remove the Liquidity Stress Test, which was not adopted by the SEC in the SEC Final SBSD Capital Rule; and
- Whether to permit an SD that is a subsidiary of a bank holding company to rely on existing qualitative liquidity controls applicable to banking holding companies or whether specific quantitative liquidity requirements generally should not be imposed on SDs on the basis that CFTC regulations currently require an SD to maintain a comprehensive risk management program (including liquidity risk management).[22]

G. FINANCIAL REPORTING AND PUBLIC DISCLOSURE

The Proposed Rule generally would allow a Covered Swap Entity that is not organized under the laws of the United States to submit financial statements in accordance with the International Financial Reporting Standards ("IFRS") instead of U.S. GAAP if the SD is not otherwise required to prepare U.S. GAAP financial statements. The CFTC is seeking comment on whether a U.S.-domiciled Covered Swap Entity that is a

subsidiary of a non-U.S. entity also should be permitted to submit financial statements in accordance with IFRS.

Additionally, under the Proposed Rule, a Covered Swap Entity would be obligated to file an annual audited financial report no later than 60 days after the end of the fiscal year and post certain financial information on its website within 10 business days after filing such information with the CFTC. Given commenters' concerns regarding these timelines, the CFTC is requesting comment on whether certain Covered Swap Entities should be granted an exception that would allow for a 90-day timeline for the annual report and a 30-calendar-day timeline for the public disclosure requirement.

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ENDNOTES

1 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").

2 Section 1a(39) of the CEA defines "prudential regulator" to include the Board of Governors of the Federal Reserve System (the ''Federal Reserve''), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency.

3 Capital Requirements of Swap Dealers and Major Swap Participants, 84 Fed. Reg. 69,664, 69,665 nn. 7–8 (Dec. 19, 2019).

4 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, dated January 7, 2016, https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Margin_Requirements_for_Uncleared_Swaps.pdf.

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

6 12 C.F.R. Part 217.

7 12 C.F.R. § 217.20(b).

8 17 C.F.R. § 240.18a-1.

9 Under the Proposed Rule, tangible net worth would be defined generally as net worth as determined in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), excluding goodwill and other intangible assets.

10 12 C.F.R. Part 249.

11 Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70,214 (Nov. 23, 2012).

12 12 C.F.R. § 217.20(b).

13 12 C.F.R. §§ 217.20(c), 217.20(d).

14 The Proposed Rule would define "financial activities" in accordance with regulations issued by the Federal Reserve regarding whether a nonbank financial company predominantly engaged in financial activities should be designated by the Financial Stability Oversight Council for supervision by the Federal Reserve pursuant to Title I of the Dodd-Frank Act. *See* 12 C.F.R. Part 242, Appendix A.

15 With respect to the Bank-Based Capital Approach, the standardized credit risk capital charge would be based on the credit risk charges set forth in subpart D of the Federal Reserve Capital Rules, and the standardized market risk charge would be based on the market risk charges in CFTC Rule 1.17. The standardized capital charges for the Net Liquid Assets Capital Approach would be based on the SEC's standardized capital charges applicable to SBSDs.

16 The National Futures Association is currently the only RFA.

17 Among other requirements, an SD electing the Net Liquid Assets Capital Approach that has obtained approval to use internal capital models under the Proposed Rule would be required to maintain at least $100 million of tentative net capital and $20 million of net capital.

ENDNOTES (CONTINUED)

[18] Basel Committee on Banking Supervision, *Minimum capital requirements for market risk* (rev. Feb. 2019), *available at* https://www.bis.org/bcbs/publ/d457.pdf.

[19] Under the Proposed Rule, "uncleared swaps margin" would be defined as the amount of initial margin an SD is required to collect under the margin rules for uncleared swaps, with adjustments to include in the calculation initial margin in respect of swaps and security-based swaps that are exempt from the margin rules. See Proposed Rule § 23.100.

[20] 12 C.F.R. § 249.10.

[21] 12 C.F.R. § 249.20.

[22] 17 C.F.R. § 23.600.

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