ALERT MEMORANDUM

CFTC Finalizes Swap Dealer Capital and Financial Reporting Rules

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On July 22, 2020, by a 3-2 vote, the Commodity Futures Trading Commission (**CFTC**) adopted final rules establishing capital and financial reporting requirements for swap dealers (**SDs**) and major swap participants (**MSPs**) (the **Final Rules**). Under the Final Rules, SDs will be subject to capital requirements as follows:

- FCM-SDs: An SD dually registered as a futures commission merchant (**FCM**) will be subject to a modified version of the CFTC's existing FCM net capital rule;

- Standalone SDs: An SD that is neither dually registered as an FCM nor subject to the capital requirements of a Prudential Regulator[1] may elect one of the following three approaches:

  (1) Net Liquid Assets Approach: A standalone SD could elect to follow a modified version of the net capital requirements adopted by the Securities and Exchange Commission (**SEC**) for a security-based swap dealer (**SBSD**) that does not have a Prudential Regulator;

  (2) Bank-Based Approach: A standalone SD could elect to follow a modified version of the capital requirements adopted by the Federal Reserve Board for bank holding companies; or

  (3) Tangible Net Worth Approach: If it or its parent company is predominantly engaged in non-financial activities, a standalone SD could elect a capital requirement based on its tangible net worth;

- Foreign SDs: A standalone SD organized and domiciled in a non-U.S. jurisdiction for which the CFTC has issued a comparability determination may substitute compliance with its home country capital rules.

- Bank SDs: An SD subject to the capital requirements of a Prudential Regulator will follow that regulator's capital requirements instead of the CFTC's, but it will remain subject to certain CFTC financial reporting requirements.

[1] The Prudential Regulators include the Board of Governors of the Federal Reserve System (**Federal Reserve Board**), the Federal Deposit Insurance Corporation (**FDIC**), the Federal Housing Finance Agency, the Farm Credit Administration, and the Office of the Comptroller of the Currency (**OCC**).

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The Final Rules are the culmination of a process that began with a proposal in May 2011, a re-proposal in December 2016, and a re-opened comment period in December 2019. As one might expect from a rulemaking that took over nine years to complete, the Final Rules reflect a number of significant changes from prior proposals. The most notable changes are the following:

- Margin-Based Minimum Capital Requirements: The CFTC's 2016 proposal would have required FCM-SDs and standalone SDs to maintain capital equal to at least 8% of the SD's initial margin (**IM**) for its positions in futures, cleared swaps, uncleared swaps, cleared security-based swaps (**SBS**) and uncleared SBS. The Final Rule modified this requirement substantially by (a) lowering the multiplier from 8% down to 2% for FCM-SDs and standalone SDs that follow the Net Liquid Assets Approach; and (b) eliminating futures, cleared swaps, cleared SBS and uncleared SBS from the calculation.
- Bank-Based Approach: Under the 2016 proposal, the Bank-Based Approach would have required an SD to maintain common equity tier 1 (**CET1**) capital equal to the greater of 8% of its risk-weighted assets or 8% of the IM amount noted above. The Final Rules instead permit an SD to meet these requirements through a combination of CET1, additional tier 1 (**AT1**), and tier 2 capital, subject to a CET1 minimum set at 6.5% of risk-weighted assets. The Final Rule also clarified how SDs can compute their risk-weighted assets and deferred to the Federal Reserve Board's requirements for market and credit risk models.
- Tangible Net Worth Approach: The Final Rules expanded the availability of the Tangible Net Worth Approach to standalone SDs that themselves do not satisfy the "predominantly engaged in non-financial activities" test but which are wholly-owned subsidiaries of a parent company that satisfies that test.
- Provisional Model Approval: In recognition of the importance of using models to compute market and credit risk capital requirements and the supervisory resources needed to approve such models, the Final Rules permit SDs provisionally to use models approved by certain other regulators, although such SDs must still submit model approval applications and a certification regarding compliance with the CFTC's model requirements.
- Liquidity Requirements: Unlike the 2016 proposal, the Final Rules do not include any quantitative liquidity requirements for FCM-SDs or standalone SDs. Instead the CFTC will continue to rely on the qualitative liquidity requirements in its SD risk management rule.
- Financial Reporting: The Final Rules somewhat streamlined SD financial reporting requirements by eliminating weekly position and margin reporting rules, expanding the circumstances where SDs can rely on International Financial Reporting Standards (**IFRS**), and permitting SDs dually registered with the SEC instead to rely on certain SEC financial reports.

The Final Rules' compliance date will be October 6, 2021. In advance of that date, non-U.S. SDs, or their trade association or regulators, will need to apply to the CFTC for comparability determinations. In addition, standalone SDs will need to submit applications to use internal models, even if they intend to rely on the provisional model approval provisions noted above.

SCOPE OF THE FINAL RULES

The Final Rules' capital requirements apply to nonbank SDs and MSPs, including an FCM-SD or nonbank SD that is dually registered with the SEC as an SBSD. On the other hand, the Final Rules' capital requirements do not apply to a bank SD or MSP, although a bank SD or MSP will be subject to a limited set of financial reporting requirements.

Treatment of Foreign Bank SDs

The Final Rules' exception for bank SDs applies if the SD is "subject to minimum capital requirements established by the rules or regulations of a prudential regulator pursuant to section 4s(e) of [the Commodity Exchange Act]."

An SD that is a foreign bank without a U.S. branch is defined by the Dodd-Frank Act to have a Prudential Regulator, the Federal Reserve Board. Therefore, such an entity should generally not be subject to the Final Rules' capital requirements. However, the Federal Reserve Board did not require these entities to follow any of its capital rules. Therefore, it is not clear how such an entity should be treated under the Final Rules' exception for bank SDs. That said, in its cost-benefit analysis regarding which SDs will be subject to the Final Rules, the CFTC seems to have counted such entities as bank SDs eligible for this exception.

A nonbank SD or MSP that is organized and domiciled outside the United States, including one that is an affiliate of a person organized and domiciled in the United States, can satisfy the Final Rules' capital requirements by substituting compliance with corollary home country requirements that the CFTC has affirmatively determined to be comparable to the CFTC's requirements.

CAPITAL REQUIREMENTS

(1) FCM-SDs

Minimum Capital Requirements

Under the Final Rule, an FCM-SD is required to comply with an amended version of CFTC Regulation 1.17. As amended, Regulation 1.17 requires that an FCM-SD maintain adjusted net capital[2] at least equal to the greater of:

(i) $20 million;

(ii) The sum of (a) 8% of its risk margin requirement (generally speaking, the level of maintenance margin or performance bond required by the exchange or clearing organization for the customer or noncustomer cleared futures and swaps positions carried by the FCM) and (b) 2% of its "uncleared swap margin" (as defined below); and

(iii) The minimum net capital required by the National Futures Association (**NFA**).

Uncleared Swap Margin Requirement

The Final Rules replaced the "risk margin amount" concept in the CFTC's 2016 proposal with "uncleared swap margin." In the Final Rules, "uncleared swap margin" is defined to mean the aggregate amount of IM that the SD would be required to collect pursuant to the CFTC's margin rules from each counterparty for each outstanding swap position, calculated on a counterparty-by-counterparty basis.

An SD is required to include in the calculation swaps that are exempted or excluded from the scope of the CFTC's

[2] "Adjusted net capital" is the firm's net worth after adding back certain subordinated liabilities, subtracting for illiquid assets, and subtracting for market and credit risk charges. It is analogous to "net capital" under the SEC's capital rules for broker-dealers and nonbank SBSDs.

margin requirements (*e.g.*, swaps with commercial end users and legacy swaps) as well as exempt foreign exchange swaps and foreign exchange forwards. In addition, the uncleared swap margin amount must be calculated without regard to any minimum transfer amounts or thresholds. However, in response to industry comments, the CFTC eliminated from the uncleared swap margin calculation any SBS positions or cleared proprietary positions of the SD. The CFTC reasoned that including SBS positions would interfere with the SEC's regulatory sphere and that cleared positions do not present the same risks as uncleared swaps.

The CFTC's 2016 proposal also would have imposed an 8% IM requirement on all SDs. In the Final Rules, however, the CFTC reduced the requirement from 8% to 2% for FCM-SDs and standalone SDs that elect to follow the Net Liquid Assets Approach (though not for standalone SDs that elect the Bank-Based Approach or the Tangible Net Worth Approach).

The CFTC explained that this reduction would address industry concerns that requiring FCM-SDs and standalone SDs that elect the Net Liquid Assets Approach to hold an amount of capital based on IM would serve to double-count the risk of uncleared swaps and thereby create competitive disparities.[3]

The CFTC noted that it intended to review within five years the impact of the 2% multiplier on the minimum capital maintained by FCM-SDs and standalone SDs that follow the Net Liquid Assets Approach.

In addition, if the FCM-SD is approved to use models to compute its market and/or credit risk charges, it must maintain net capital of at least $100 million.[4] However, in practice all existing FCM-SDs are also registered with the SEC as broker-dealers and rely on the SEC's alternative net capital framework, which imposes a higher $5 billion requirement (as well as a $1 billion requirement instead of the $20 million requirement noted above).

Market Risk Charges

Under the Final Rules, an FCM-SD is required to calculate market risk charges using the standardized haircuts set forth in CFTC Regulation 1.17 or SEC Rule 15c3-1, unless the FCM-SD is approved to use models to compute such charges.

As revised, Regulation 1.17 now includes standardized market risk charges for uncleared swap positions. In response to industry comments, the CFTC made certain revisions to these charges in order to align them with the deductions set forth in the SEC's capital rules applicable to broker-dealers and SBSDs. In particular:

- The CFTC lowered the minimum required charge for uncleared interest rate swaps from 0.5% to 0.125% of the matched long interest rate swap positions against short interest rate swap positions with a maturity of three months or more;
- The CFTC adopted the same capital charges for credit default swaps (**CDS**) as set forth in the SEC's capital rules; and

[3] This double-counting arises because such transactions will serve to both increase the denominator of the ratio-based capital requirement (by increasing the uncleared swap margin amount) and by reducing the numerator (by resulting in market and credit risk charges).

[4] "Net capital" is the firm's net worth after adjustments for subordinated liabilities and illiquid assets, but before application of market and credit risk charges. It is analogous to "tentative net capital" under the SEC's capital rules for broker-dealers and nonbank SBSDs.

- The CFTC provided that an FCM-SD may reduce market risk charges for uncleared swap positions other than CDS to account for offsetting positions in an identical fashion as the SEC has adopted for BDs and SBSDs.

However, the CFTC rejected comments from the industry to reduce the market risk charge for foreign exchange swaps referencing currencies other than euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs from 20% of the notional amount of swap to 6%, in line with the CFTC's standardized IM requirements. The CFTC also rejected comments to eliminate disparities in the capital charges for proprietary futures and cleared swaps as between self-clearing FCM-SDs (which is calibrated at 100% of the applicable maintenance margin requirement) and non-clearing member FCM-SDs (which is calibrated at 150%).

Credit Risk Charges

Under the Final Rules, an FCM-SD is also required to calculate credit risk deductions using the standardized charges set out in CFTC Regulation 1.17, unless the FCM-SD is approved to use internal models to compute such deductions. Such charges include dollar-for-dollar deductions for unsecured receivables, including any unsecured mark-to-market amounts owed under a swap or SBS.[5]

IM-Related Charges

In addition to the charges that currently apply to standalone FCMs, the CFTC revised Regulation 1.17 to require an FCM-SD to take a capital deduction for any IM that the SD would be required to collect under the CFTC's or SEC's margin rules but that the SD has elected not to collect due to an exception or exemption. The CFTC made clear that the uncollected IM charge for swaps only applies if the FCM is subject to those margin rules (*i.e.*, as a registered SD or SBSD).

However, the Final Rules do not require FCMs, including FCM-SDs, to take a capital charge for any IM posted by the FCM and held at a third-party custodian in accordance with CFTC, SEC, Prudential Regulator, or comparable non-U.S. margin rules.

Requirements for Standalone FCMs

The Final Rules did not change the minimum capital requirements applicable to standalone FCMs. However, the standardized market risk charges that the CFTC adopted for swaps and security-based swaps entered into by an SD and discussed above will apply to standalone FCMs.

(2) NET LIQUID ASSETS APPROACH

A standalone SD that elects the Net Liquid Assets Approach must maintain net capital (as defined by SEC Rule 18a-1) at least equal to the greater of:

(i) $20 million;

(ii) 2% of its "uncleared swap margin" (as defined above); and

(iii) The minimum net capital required by NFA.

In addition, if the standalone SD is approved to use models to compute its market and/or credit risk charges, it must maintain tentative net capital of at least $100 million.

An SD that follows the Net Liquid Assets Approach would calculate its net capital and tentative net capital using SEC Rule 18a-1, as if

[5] The CFTC rejected requests from the industry to recognized non-financial collateral for purposes of calculating credit risk charges. Members of the industry noted that commercial end users often post non-financial collateral to secure their derivatives, especially in the commodity swaps market. The CFTC, however, expressed concerns about the ability of SDs to liquidate non-financial collateral rapidly.

the SD were an SBSD, including calculating market and credit risk charges in accordance with SEC Rule 18a-1 and CFTC Regulation 1.17, unless the SD is approved to use internal models for such purposes. However, consistent with CFTC Regulation 1.17, the Final Rules do not require an SD to take a capital charge for any IM posted by the SD and held at a third-party custodian in accordance with CFTC, SEC, Prudential Regulator, or comparable non-U.S. margin rules.

Intersection with SEC Capital Rules

The Net Liquid Assets Approach is generally more conservative than the Bank-Based Approach (discussed below) because it requires 100% deductions for illiquid assets and it functionally requires an SD to double count the credit risk of its swaps by imposing the 2% uncleared swap margin net capital minimum on top of credit risk charges for uncleared swaps. As a result, presumably few or no standalone SDs will elect the Net Liquid Assets Approach unless they are already subject to SEC capital rules. In that regard, the Final Rules' recognition of IM posted by an SD and held at a third-party custodian is not shared by the SEC. In addition, SEC Rule 18a-1 requires an SBSD to maintain net capital at least equal to 2% of its IM for uncleared SBS (as well as any SBS cleared for customers),[6] meaning that a dually registered nonbank SD-SBSD following the Net Liquid Assets Approach will need to compare its IM requirements for swaps versus SBS to determine which will function as its binding capital constraint. Such an SD-SBSD will also need to satisfy both agencies' model approval requirements, although as noted below the CFTC will permit a standalone SBSD provisionally to use SEC-approved models.

(3) BANK-BASED APPROACH

A standalone SD that elects the Bank-Based Approach must satisfy the following capital requirements:

(i) CET1 of at least $20 million;

(ii) CET1 equal to at least 6.5% of its risk-weighted assets (**RWA**);

(iii) CET1, AT1, and tier 2 (collectively, **total capital**) equal to at least 8% of its RWA;[7]

(iv) Total capital equal to 8% of its uncleared swap margin; and

(v) The minimum capital required by NFA.

Total Capital

Under the CFTC's 2016 proposal, a standalone SD that elected to follow the Bank-Based Approach would have been required to maintain CET1 equal to the greater of 8% of its RWA or 8% of the IM amount. In response to industry concerns about the competitive disparities such requirements would generate, the CFTC revised the ratios in the Final Rules so that an SD need only maintain CET1 equal to 6.5% of RWA. This 6.5% multiplier corresponds to the amount of CET1 that a bank must maintain in order to be viewed as well-capitalized under the FDIC's Prompt Corrective Action framework.

For the other ratios, an SD may count AT1 and tier 2 capital in addition to CET1. In

[6] After October 6, 2024, the SEC may increase this 2% multiplier to 4% and, if it does, then after October 6, 2026, it may increase the multiplier to 8%.

[7] Any subordinated debt included in the SD's capital for purposes of this requirement must qualify as conforming subordinated debt under the SEC's net capital rule.

addition, the CFTC clarified, an SD may count AT1 and tier 2 in determining whether it has breached the 120% early warning trigger discussed below.

A standalone SD that follows the Bank-Based Approach would generally calculate the components of its total capital as well as its RWA using the Federal Reserve Board's Part 217 regulations. The specific provisions of those regulations that the SD would apply will depend on whether it is approved to use internal models or not.

Non-Model-Approved SDs

A standalone SD that is not approved to use models to calculate market and credit risk would compute its RWA in accordance with Subpart D of the Federal Reserve Board's Part 217 regulations, which sets forth a standardized methodology for calculating the risk weights applicable to a bank holding company's assets. Subpart D sets out two different methodologies for calculating the credit risk associated with "OTC derivatives contracts": the current exposure methodology (**CEM**) and the standardized approach to counterparty credit risk (**SA-CCR**). Consistent with the provisions of Subpart D, the Final Rules permit a standalone SD that elects the Bank-Based Approach, and is not approved to use models to calculate credit risk, to apply either CEM or SA-CCR.

With respect to market risk, the Federal Reserve Board has not promulgated a standardized market risk framework. The Final Rules therefore provide that a standalone SD that elects the Bank-Based Approach, and is not approved to use internal models to calculate market risk, must employ the standardized charges set forth in CFTC Regulation 1.17 and SEC Rule 18a-1. Specifically, such an SD must multiply such charges by 12.5 and add the resulting product to its RWA.

Model-Approved SDs

A standalone SD that is approved to use models to calculate market and credit risk would compute its RWA in accordance with Subpart E of the Federal Reserve Board's Part 217 regulations, which sets forth a models-based methodology for calculating risk weights applicable to a bank holding company's assets. Similar to Subpart D, Subpart E allows a bank holding company subject to its provisions to elect to calculate the credit risk associated with OTC derivatives contracts using two different methodologies: SA-CCR or an internal models methodology (**IMM**). The Final Rules accordingly allow a standalone SD that elects the Bank-Based Approach, and is approved to use internal models to calculate credit risk, to apply SA-CCR or IMM.

With respect to market risk, the Final Rules provide that a standalone SD that elects the Bank-Based Approach, and is approved to use internal models to calculate market risk, shall calculate its market risk in accordance with Subpart F of the Federal Reserve Board's Part 217 regulations. That subpart sets forth rules governing the calculation of market risk using models.

Incorporating the Federal Reserve Board's Capital Rules

The CFTC's 2016 proposal left some ambiguity as to how a standalone SD that elected the Bank-Based Approach would calculate its RWA, especially if it were approved to use internal models. This is because proposal did not expressly state which provisions of the Federal Reserve Board's Part 217 regulations would apply and suggested that firms that had obtained market or credit risk approval would need to apply the CFTC's, rather than the Federal Reserve Board's, methodology for calculating market and credit risk charges.

In response to industry comments, the CFTC provided helpful clarity in this regard by expressly incorporating into the Final Rules the Federal Reserve Board's methodology for calculating credit and market risk as well as the Federal Reserve Board's model requirements. However, this straight incorporation also means that any changes to the Federal Reserve Board's part 217 regulations will automatically apply to an SD that elects the Bank-Based Approach.

(4) TANGIBLE NET WORTH APPROACH

Under the Final Rules, certain standalone SDs may elect to comply with simplified capital requirements tied to the tangible net worth of the SD. In order to be eligible to make this election, an SD must be "predominantly engaged in non-financial activities." The Final Rules provide that a standalone SD is "predominantly engaged in non-financial activities" if it meets the following two requirements:

(1) either its or, if it is a wholly-owned subsidiary, its parent organization'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) either its or, if it is a wholly-owned subsidiary, its parent organization's consolidated total financial assets 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.

Whether revenues or assets are "financial in nature" is determined by reference to the Federal Reserve Board's rules for determining whether a non-bank holding company is predominantly engaged in financial activities.[8] Financial activities for this purpose include lending, investing for others, safeguarding money or securities for others, providing financial or investment advisory services, underwriting or making markets in securities, providing securities brokerage services, and engaging as principal in investing and trading activities. However, the Final Rules clarify that an SD may exclude from its financial activities accounts receivable resulting from non-financial activities.

Predominantly Engaged in Non-Financial Activities

Under the CFTC's 2016 proposal, an SD could only elect the Tangible Net Worth Approach if the SD itself—not its parent company—satisfied the 15% tests noted above. In response to concerns that this would effectively exclude from eligibility commercial firms that house their swaps activities in designated subsidiaries, the CFTC expanded the eligibility criteria so that the tests can be applied at the parent organization level.

However, under the plain text of the Final Rules, the comparison is always against 15% of the SD's consolidated assets or revenue. This appears to be a mistake, as the preamble to the Final Rules indicates that by revising the rule the Commission was "allowing the ultimate consolidated parent entity to conduct the test."

Either way, the 15% tests would continue to exclude commodity dealing subsidiaries of financial firms. Also, for some commercial firms, it may not be possible to meet the 15% tests even at the consolidated parent company level.

[8] *See* 12 CFR § 242.3(d) and Appendix A to Part 242.

An SD that elects the Tangible Net Worth Approach must maintain:

(i) Tangible net worth of $20 million plus the market risk charges and credit risk charges set forth in CFTC Regulation 1.17 and SEC Rule 18a-1 for the SD's swap and related hedge positions that are part of its swap dealing activities;

(ii) Tangible net worth equal to 8% of uncleared swap margin; and

(iii) The minimum capital required by NFA.

Under the Final Rules, "tangible net worth" is defined as the net worth of the SD computed using generally accepted accounting principles, excluding goodwill and intangible assets.

(5) MAJOR SWAP PARTICIPANTS

Under the Final Rules, an MSP is required to maintain:

(i) Positive tangible net worth, and

(ii) The amount of capital required by NFA.

An MSP will not be subject to any kind of market or credit risk charges.

(6) MODEL REQUIREMENTS

Under the Final Rules, a standalone SD may apply to the CFTC or the NFA for approval to use internal models to compute market and credit risk.[9] The information that must be included in such an application (and thus the requirements the model must satisfy) differ depending on the SD's approach to calculating capital.

If the SD elects to use the Bank-Based Approach, it must:

(i) In order to use models to calculate market risk, provide the information required under Subpart F of the Federal Reserve Board's Part 217 regulations; and

(ii) In order to use models to calculate credit risk, provide the information required under Subpart E of the Federal Reserve Board's Part 217 regulations to calculate credit risk-weighted assets in accordance with sections 217.131 through 217.55 of that subpart.[10]

Other SDs must submit the information set forth in Appendix A to CFTC Regulation 23.102, which is broadly similar to the information required by the SEC in order to allow SBSDs to use models to calculate market and credit risk.[11]

Provisional Use of Models Approved by Other Regulators

A number of commenters, including NFA itself, expressed concern that it would take NFA substantial time to review all of the internal models submitted by SDs for review. Recognizing these concerns, the CFTC created a process whereby an SD may, on a provisional basis, use a model that has been approved by another regulator.

Specifically, the Final Rules provide that an SD may use a model on a provisional basis that the SEC, a Prudential Regulator, a

[9] As a technical matter, in order for an SD to apply to NFA for model approval, the CFTC must make a determination that NFA's model requirements and review process are comparable to those of the CFTC. However, as a practical matter, the CFTC has made clear that it anticipates most SDs will apply to NFA for model approval.

[10] These sections encompass calculations related to credit risk, but not operational risk.

[11] The 2016 Proposal did not squarely address whether SDs may use models to calculate only credit risk or only market risk. Although commenters requested clarification on this point, neither the Final Rules nor the CFTC's statements in the preamble thereto address the issue directly. However, certain language of the Final Rules suggests that the CFTC does anticipate SDs using models to calculate some charges and using standardized deductions to calculate others.

foreign regulator in a jurisdiction in respect of which the CFTC has made a comparability determination, or a foreign regulator whose capital requirements are consistent with those issued by the Basel Committee on Banking Supervision, has approved the SD or its affiliate to use. In order to utilize such a model, an SD must submit to the CFTC and NFA a certification, signed by the Chief Executive Officer, Chief Financial Officer, or other appropriate official with knowledge of the SD's capital requirements and the capital models, that the models are in substantial compliance with the CFTC's model requirements. The SD must also submit an application to the CFTC to use such models in accordance with the requirements above.

If the SD satisfies these requirements, it may use the model pending the CFTC's or NFA's review of the application. However, the SD must cease using the model if the regulatory authority that previously approved it withdraws its approval prior to the CFTC's approval.

Notably, however, these provisional model-use provisions do not appear to extend to IM models necessary to compute the "uncleared swap margin" amount, which might necessitate further NFA approval of IM models for, for example, legacy swaps.

LIQUIDITY REQUIREMENTS

In its 2016 proposal, the CFTC proposed liquidity requirements for SDs other than those eligible for the Tangible Net Worth Approach. Under the proposal, an SD electing the Bank-Based Capital Approach would have been required to meet the liquidity coverage ratio requirements set forth in the Federal Reserve Board's Part 249 regulations, and an SD electing the Net Liquid Assets Approach and an FCM-SD would have been required to satisfy a liquidity stress test requirement similar to that applicable to certain broker-dealers under the SEC's capital rules.

The CFTC ultimately decided not to adopt quantitative liquidity requirements in the Final Rules, reasoning that such were unnecessary in view of CFTC Regulation 23.600. That provision includes a series of qualitative requirements designed to ensure an SD maintains robust liquidity risk management policies. Moreover, the CFTC noted, quantitative liquidity requirements would not be appropriate considering the wide disparity in SDs' liquidity risk management policies. The CFTC noted, however, that it would continue to monitor nonbank SDs' liquidity and reassess the appropriateness of quantitative liquidity requirements.

FINANCIAL REPORTING AND RECORDKEEPING REQUIREMENTS

The Final Rules contain a number of financial reporting, recordkeeping and notification requirements. We briefly summarize these requirements here and outline them in greater detail in Appendix A.

(1) Nonbank SDs and MSPs

Table 1: nonbank SD and MSP reporting requirements

Frequency	Type of Report
Weekly	No longer required
Monthly	For Net Liquid Assets and Bank-Based Approach SDs, unaudited financial report
	Swap and SBS position and margin information
	Model-related information, if using modes to calculate credit and/or market risk charges
Quarterly	Certain reports and the results of backtesting, if using models to calculate credit and/or market risk charges
	For Tangible Net Worth Approach SDs, unaudited financial report
Annually	Annual audited financial report

Financial Recordkeeping

A nonbank SD or MSP must prepare and keep current ledgers or other similar records which show or summarize each transaction affecting its asset, liability, income, expense, and capital accounts.

Expanded Ability to Use IFRS

Under the CFTC's 2016 proposal, only non-U.S. SDs would have been able to use IFRS in lieu of U.S. Generally Accepted Accounting Principles (**GAAP**) to satisfy the CFTC's reporting and recordkeeping requirements. Commenters expressed concerns that this exception was too narrow since it would not apply to U.S. SDs that are subsidiaries of non-U.S. companies that use IFRS on a consolidated basis. In responses to these concerns, the Final Rules permit any SD that is not otherwise required to prepare financial statements using GAAP to use IFRS to satisfy the CFTC's reporting and recordkeeping requirements.

Weekly Reporting Requirements

The CFTC's 2016 proposal would have required SDs to provide to the CFTC weekly reporting of position and margin information for purposes of conducting risk surveillance. However, in response to comments that such reports would have been unduly burdensome in view of the CFTC's Part 45 swap data recordkeeping and reporting requirements, the CFTC opted not to impose such weekly position requirements at this time.

Other Periodic Reporting Requirements

The Final Rules require nonbank SDs and MSPs to file with the CFTC and NFA: (1) an unaudited financial report on a monthly basis (or quarterly, for a Tangible Net Worth SD); (2) certain position, counterparty and margin information on a monthly basis;[12] and (3) if the

[12] The required information includes: (i) current net exposure by the top 15 counterparties, and all other counterparties combined; (ii) total exposure by the top 15 counterparties, and all others combined; (iii) the internal credit rating, gross replacement value, net replacement value, current net exposure, total exposure, and margin collected for the top 36 counterparties; (iv) current exposure and net exposure by country for the top 10 countries; and (v) information about custodians that hold margin for uncleared swaps and the aggregate amounts of margin held, as well as the aggregate amount required to be posted and collected pursuant to the CFTC's margin rules. The latter requirement contains references to custodians for both IM

SD is approved, either provisionally or permanently, to use internal models to calculate market and credit risk charges, certain information concerning those models, on a monthly basis.[13] SDs that are approved to use internal models must also file with the NFA and CFTC quarterly reports identifying the (i) number of business days for which the actual daily net trading loss exceeded the corresponding daily VaR and (ii) results of the backtesting of all internal models used to compute allowable capital, including VaR, and credit risk models, indicating the number of backtesting exceptions. Lastly, the Final Rules also require nonbank SDs and MSPs to file an annual audited financial report.

Alignment of Monthly, Quarterly and Annual Financial Reporting Requirements

In order to reduce the regulatory burden associated with filing regular financial reports, the Final Rules permit a nonbank SD that is also registered as a broker-dealer or SBSD to file with the CFTC and NFA the same reports that the SD files with the SEC in lieu of the monthly and annual financial reports required under the Final Rules. Similarly, an SD that is dually registered as an FCM may file with the CFTC and NFA Form 1-FR-FCM in lieu of the form required under the Final Rules.

Moreover, the CFTC aligned the content required to be included in the position, counterparty, margin and model reports with that required to be included in the analogous reports that the SEC requires SBSDs to provide. As a result, nonbank SDs that are dually registered as SBSDs should in many instances be able to use similar systems to satisfy both SEC and CFTC financial reporting requirements.

In view of the fact that SDs that follow the Tangible Net Worth Approach are less likely to be subject to routine reporting requirements and could require longer to prepare reports, the Final Rules impose somewhat more lenient reporting requirements on these firms. In particular, the Final Rules permit SDs that follow the Tangible Net Worth Approach to file unaudited financial statements on a quarterly (instead of monthly) basis and provide such firms with 90 days (rather than 60 days) after the entity's fiscal year-end to file audited financial reports. They must still, however, satisfy monthly position, margin, and model-related reporting requirements.

(2) Nonbank SD and MSP Notification Requirements

Nonbank SDs and MSPs are generally required to notify the CFTC and NFA if any of the following occur:

- The SD or MSP knows or should have known that its regulatory capital at any time is less than 120% of the minimum requirement;
- The SD or MSP fails to make or to keep current certain books and records;

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and variation margin, even though variation margin is not required to be segregated at a custodian.

[13] The required information includes: (i) a listing of each product category for which the SD does not use an internal model to compute market risk deductions, and the amount of the market risk deduction; (ii) a graph reflecting, for each business line, the daily intra-month VaR; (iii) the aggregate VaR for the SD; (iv) for each product for which the SD uses scenario analysis, the product category and the deduction for market risk; and (v) credit risk information on swap, mixed swap, and SBS exposures, including: (A) overall current exposure, (B) current exposure listed by counterparty; (C) the 10 largest commitments listed by counterparty, (D) the SD's maximum potential exposure listed by counterparty for the 15 largest exposures; (E) the SD's aggregate maximum potential exposure, (F) a summary report reflecting the SD's current and maximum potential exposures by credit rating category, and (G) a summary report reflecting the SD's current exposure for each of the top 10 countries to which the SD is exposed.

- The SD or MSP experiences a substantial reduction in capital;[14]
- The SD or MSP files a notice with the SEC under Rule 18a-8 or 17a-11; or
- The SD or MSP fails to post or collect margin required under the CFTC's or SEC's margin rules in excess of specified thresholds.[15]

(3) Nonbank SDs and MSPs Public Disclosure Requirements

The Final Rules also subject nonbank SDs and MSPs to certain public disclosure requirements. In particular, such an entity must make publicly available on its website:

(i) audited and unaudited statements of its financial condition; and

(ii) audited and unaudited statements disclosing its regulatory capital and minimum regulatory capital requirement.

(4) Bank SDs and MSPs

The Final Rules subject bank SDs and MSPs to substantially fewer reporting requirements in view of the fact that these SDs and MSPs are already subject to the comprehensive reporting requirements of the Prudential Regulators. Under the Final Rules, bank SDs and MSPs are only required to file with the CFTC and NFA unaudited financial reports containing substantially the same information required to be included in the "call reports" that banks regularly file with the banking regulators.

Timing for Bank SD Reports

In its 2016 proposal, the CFTC proposed to require bank SDs and MSPs to file quarterly financial reports within 17 days of the end of the firm's fiscal quarter. In response to concerns that this timing was inconsistent with the time periods that banks currently have to file call reports, the CFTC extended the period to 30 days. However, this 30-day period is still shorter than the 35 days that banks with foreign branches have to file call reports. The CFTC's quarterly reporting requirements accordingly could require bank SDs to make substantial changes to their reporting systems.

(5) Bank SD and MSP Notification Requirements

Bank SDs and MSPs are generally required to notify the CFTC and the NFA if any of the following occur:

- Its regulatory capital is less than the applicable minimum capital requirements of a Prudential Regulator or home country supervisor;
- There is a change to its reported capital category with a Prudential Regulator or home country supervisor; and
- The SD or MSP fails to make or to keep current the books and records required by the Final Rules.

The CFTC removed from the Final Rule the requirement to notify the CFTC of a material failure to post or collect IM for uncleared swap transactions or post or collect uncleared swap variation margin as required under the respective Prudential Regulators' rules.

[14] Such substantial reduction would be a 30% or more decrease in the amount of capital that the swap dealer or major swap participant holds in excess of its regulatory capital requirement.

[15] The requirement is triggered if the total amount that has not been exchanged is equal to or greater than: (1) 25% of the SD's or MSP's minimum required capital under the CFTC's capital rules calculated for a single counterparty or group of counterparties that are under common ownership or control; or (2) 50% of the SD's or MSP's required capital under the CFTC's capital rules calculated for all of the SD's counterparties.

Bank SD Public Disclosures

In its 2016 proposal, the CFTC proposed to require bank SDs and MSPs to make public disclosures similar to those applicable to nonbank SDs and MSPs. However, the CFTC ultimately removed such requirements from the Final Rules given that such bank SDs and MSPs are required to make public disclosures as part of the call report process.

SUBSTITUTED COMPLIANCE

The Final Rules permit a standalone SD or MSP that is organized and domiciled outside of the United States to comply with the CFTC's capital and reporting requirements through compliance with the capital and reporting requirements issued by a jurisdiction in respect of which the CFTC has made a comparability determination.

Eligibility for Substituted Compliance

The Final Rules do not permit an FCM-SD to rely on substituted compliance. In addition, even though the Final Rules subject bank SDs (including foreign banks) to certain financial reporting requirements as summarized above, the Final Rules' substituted compliance provisions do not address those requirements.

Under its 2016 proposal, the CFTC proposed to allow only SDs, MSPs, and foreign regulatory authorities to request a comparability determination. However, under the Final Rule, a trade association may also request such a determination on behalf of its members. In the Final Rules, the CFTC also eliminated previously proposed language suggesting that a comparability determination may depend on the extent to which a foreign regime was comparable to either the Basel capital standards or the SEC net capital rule. However, the CFTC rejected industry recommendations that a non-U.S. SD automatically qualify for substituted compliance if it is subject to Basel-compliant home country capital requirements administered by a regulatory authority in Australia, Canada, France, Germany, Japan, Singapore, Switzerland, or the United Kingdom.

Requirement for CFTC Confirmation to Rely on Substituted Compliance

Unlike the CFTC margin rules, in order to use substituted compliance, a non-U.S. SD or MSP must file with the CFTC a notice of its intent to use substituted compliance and must receive confirmation from the CFTC. The CFTC indicated that it needed this requirement to assess whether a particular non-U.S. SD or MSP satisfies any conditions set forth in the relevant CFTC comparability determination. It explained that, upon receipt of a notice, the CFTC staff will engage with the SD or MSP to determine the extent to which the foreign regulation to which it is subject is consistent with the comparability determination. The adoption of this further review process underscores the urgency for non-U.S. SDs, their trade associations, or their regulators to apply for comparability determinations.

COMPLIANCE DATE

The compliance date for the Final Rules is October 6, 2021, the same as the SEC's capital, margin, segregation, and financial reporting obligations for SBSDs.

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APPENDIX A

NONBANK SD AND MSP REPORTING REQUIREMENTS

Section	**Requirement**	**Timing**
23.105(h)	The CFTC or NFA may, by written notice, require an SD MSP to file financial or operational information	General Requirement
23.105(d)	File an unaudited financial report	Monthly (no later than 17 business days after the close of business each month) for MSPs and SDs that elect the Net Liquid Assets Approach or Bank-Based Approach Quarterly (no later than 17 business days after the close of business) for SDs that elect the Tangible Net Worth Approach
23.105 (l) & (m)	File swap and SBS position and margin information	Monthly for position information Monthly (within 17 business days of the end of each month) for model information
23.105(k)	Model information if using a model that has received approval or was filed in an application for provisional approval under § 23.102(d)	Monthly (within 17 days of the end of each month)
23.105(k)	Reports related to model information and the results of backtesting if using a model that has received approval or was filed in an application for provisional approval under § 23.102(d)	Quarterly (within 17 business days of the end of each calendar quarter)
23.105(e)	File an annual audited financial report	Annually (no later than 60 days after fiscal year-end) for MSPs and SDs that elect the Net Liquid Assets Approach or Bank-Based Approach Annually (no later than 90 days after fiscal year-end) for SDs that elect the Tangible Net Worth Approach

NONBANK SD AND MSP NOTIFICATION REQUIREMENTS

Section	Trigger	Notification Requirement	Timing
23.105(c)(1)	Knows or should have known that its regulatory capital at any time is less than the minimum	Written notice containing documentation to adequately reflect its regulatory capital condition as of any date its regulatory capital was less than the minimum Other information as required	Immediate
23.105(c)(2)	Knows or should have known that its regulatory capital at any time is less than 120 percent of its minimum	Written notice	Within 24 hours
23.105(c)(3)	Fails to make or to keep current required ledgers and other financial books and records	Written notice specifying the books and records which have not been made or which are not current Follow up with report about what steps have been and are being taken to correct the situation.	Same day Follow up within 48 hours after giving the notice
23.105(c)(4)	Experiences a 30% or more decrease in the amount of capital that it holds in excess of its regulatory capital requirement	Written notice	Unspecified
23.105(c)(5)	Withdrawal of capital that exceeds 30 percent of excess required capital by action of the equity holders	Written notice	Two business days prior to the withdrawal of capital
23.105(c)(6)	SBSD or major SBS participant files a notice with the SEC under Rule 18a-8 or 17a-11	File a copy of such notice with the CFTC and NFA	At the time it files with the SEC
23.105(c)(7)	Failure to post or collect margin in excess of specified thresholds	Written notice	Within 24 hours of the occurrence of the relevant event

NONBANK SD AND MSP PUBLIC DISCLOSURE REQUIREMENTS

Section	**Notification Requirement**	**Timing**
23.105(i)(1)	Make publicly available on its website unaudited (i) statement of financial condition; (ii) statement disclosing the amount of its minimum regulatory capital requirement; and (iii) statement disclosing the amount of regulatory capital as of the end of the quarter	No less than six months after the date of the most recent annual audited financial report and within 30 days of the date the statements are required under paragraph (d)(1)
23.105(i)(2)	Make publicly available on its website audited (i) statement of financial condition; (ii) statement disclosing the amount of its minimum regulatory capital requirement; and (iii) statement disclosing the amount of regulatory capital as of the end of the quarter	Annually and within 10 business days of filing the reports required under paragraph (e)(1)

BANK SD AND MSP REPORTING REQUIREMENT

Section	**Requirement**	**Timing**
23.105(p)(2)	Unaudited financial reports (as set forth in Appendix B)	Quarterly (within 30 days of end of fiscal quarter)

BANK SD AND MSP NOTIFICATION REQUIREMENTS

Section	**Trigger Requirement**	**Notification Requirement**	**Timing**
23.105 (p)(3)(i)	Files a notice of adjustment of its reported capital category with the Federal Reserve Board, the OCC, the FDIC or with a home country supervisor	Transmit to the CFTC and NFA a copy of the notice of the adjustment of reported capital category, or the similar notice provided to its home country supervisor(s)	Same day
23.105 (p)(3)(ii)	Regulatory capital is less than the applicable minimum capital requirements with a Prudential Regulator or with its home country supervisor	Written notice	Immediate
23.105 (p)(3)(iii)	Fails to make or to keep current the books and records necessary to produce financial reports	Written notice specifying the books and records which have not been made or which are not current Follow up with report about what steps have been and are being taken to correct the situation.	Same day Follow up within 48 hours