ALERT MEMORANDUM

CFTC Re-Proposes Capital Rules for Non-Bank Swap Dealers

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If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

New York

Edward J. Rosen
212 225 2820
erosen@cgsh.com

Colin D. Lloyd
212 225 2809
clloyd@cgsh.com

Igor Kleyman
212 225 2996
ikleyman@cgsh.com

Christina Obiajulu
212 225 2725
cobiajulu@cgsh.com

Truc Doan
212 225 2305
tdoan@cgsh.com

The Commodity Futures Trading Commission ("CFTC") has re-proposed capital, liquidity and financial recordkeeping and reporting rules (the "Proposed Rule")[1] for swap dealers ("SDs") and major swap participants ("MSPs") that are not subject to capital rules of a Prudential Regulator ("nonbank SDs and MSPs").[2] The Proposed Rule also would amend the CFTC's capital rules for futures commission merchants ("FCMs"), including to address SDs dually registered as FCMs. Under the Proposed Rule:

(1) a nonbank SD that is not an FCM could elect to apply a modified version of the risk-weighted capital requirements applied by the Board of Governors of the Federal Reserve System ("FRB") to U.S. bank holding companies;

(2) alternatively, a nonbank SD that is not an FCM could elect to apply a modified version of the capital requirements that the Securities and Exchange Commission ("SEC") has proposed to apply to a security-based swap dealer ("SBSD") that does not have a Prudential Regulator (a "nonbank SBSD") as part of its 2012 capital, margin and segregation proposal (the "SEC Proposal");[3]

(3) a non-financial SD could elect to apply a tangible net worth approach to capital requirements, under which market and credit risk charges would only apply to certain swap-related positions; and

(4) a dually registered SD/FCM would be subject to a modified version of the existing FCM net capital rule.

[1] 81 Fed. Reg. 91,252 (Dec. 16, 2016). The Proposed Rule is a re-proposal of capital rules initially proposed by the CFTC in May 2011. See 76 Fed. Reg. 27802 (May 12, 2011).

[2] The Proposed Rule also includes a limited range of financial recordkeeping and reporting requirements for SDs and MSPs that are subject to capital rules of a Prudential Regulator ("bank SDs and MSPs").

[3] 77 Fed. Reg. 70213 (Nov. 23, 2012).

By incorporating FRB and SEC requirements, the Proposed Rule could potentially provide relief for registrants subject to multiple prudential supervision regimes. Even so, the Proposed Rule raises a number of significant issues:

- 8 Percent IM Rule: Each of the approaches in the Proposed Rule would, to varying extents, establish minimum capital requirements based on 8 percent of the sum of an SD's initial margin for its positions in futures, cleared swaps, uncleared swaps, cleared security-based swaps and uncleared security-based swaps (the "8 Percent IM Rule"). This requirement, like parallel requirements in the existing FCM net capital rule and the SEC Proposal, is intended to ensure that the level of a registrant's capital increases with the risks of its exposures. However, because the sum of initial margin amounts for the relevant positions is not an accurate proxy for an SD's aggregate risk profile, the proposed 8 Percent IM Rule would require a registrant to maintain resources far in excess of the actual risks presented by its exposures;

- Standalone Liquidity Requirements: The Proposed Rule would apply standalone liquidity requirements to subsidiaries within a bank holding company group, which would constrain a bank holding company's ability to manage liquidity across entities and deploy resources as necessary in a stress scenario. In particular, the liquidity requirements applicable to a nonbank SD applying the SEC Proposal or a dually registered SD/FCM would inhibit group-wide liquidity management by restricting the intraday use of liquidity and limiting the range of assets eligible to satisfy liquidity requirements to unencumbered cash and U.S. government securities;

- Intersection of Capital and Margin Requirements: Unlike the margin rules in the SEC Proposal, the CFTC's margin rules require a registrant both to collect and post initial margin, require initial margin to be segregated with a third-party custodian, and incorporate a multi-year initial margin implementation schedule (with an accompanying increase in the extent of grandfathered legacy positions). To accommodate these differences, the Proposed Rule would modify certain aspects of the SEC Proposal and existing FCM net capital rule, such as eliminating 100 percent capital charges for initial margin that an SD posts when the margin is segregated at a third-party custodian. The Proposed Rule does not, however, clearly address certain other controversial elements of the SEC Proposal, such as capital charges for legacy accounts that are not subject to margin requirements and initial margin collected from a counterparty but segregated at a third-party custodian. If applied to swap positions covered by the CFTC's margin rules, these capital charges would be highly problematic due to the differences between the CFTC's and SEC's margin rules noted above.

Concerns regarding these issues were raised in comments on the SEC Proposal, but the Proposed Rule does not seek to address commenters' concerns or consider the alternative approaches they proposed. As the CFTC moves forward, it will be important for it to coordinate with the SEC in addressing these issues, as well as the many technical issues raised by the Proposed Rule. Otherwise, capital and liquidity requirements stand likely to introduce unwarranted competitive disparities, which would lead to further concentration and reduced liquidity within the swap and security-based swap markets.

This Memorandum provides an overview of the Proposed Rule and summarizes the key issues that it raises. Comments on the Proposed Rule are due by March 16, 2017.

Scope of the Proposed Rule

The Proposed Rule would apply to nonbank SDs and MSPs, including a nonbank SD that is dually registered with the CFTC as an FCM or that will register with the SEC as an SBSD. On the other hand, the Proposed Rule would not apply capital requirements to a bank SD or MSP, although a bank SD or MSP would remain subject to a limited range of financial recordkeeping and reporting requirements.[4]

A nonbank SD or MSP that is organized and domiciled outside the United States (a "Non-U.S. SD or MSP"), including one that is an affiliate of a person organized and domiciled in the United States, could satisfy the requirements of the Proposed Rule by substituting compliance with corollary home country requirements that the CFTC has affirmatively determined to be comparable to the CFTC's requirements.

SD Capital and Liquidity Requirements

As noted above the Proposed Rule contains four different approaches to calculating an SD's minimum capital requirements:

(1) a "Bank-Based Approach," which would incorporate certain aspects of the FRB's capital and liquidity requirements for U.S. bank holding companies;

(2) a "Net Liquid Assets Approach," which would incorporate certain aspects of the SEC Proposal's capital and liquidity requirements for nonbank SBSDs;

(3) a "Tangible Net Worth Approach," which would be available only to an SD that is predominantly engaged in non-financial activities (a "Non-Financial SD");[5] and

(4) an "FCM Approach," which would apply a modified version of the CFTC's existing FCM net capital requirements to all SDs that are dually registered as FCMs. A dually registered SD/FCM would also be required to satisfy the liquidity requirements applicable to a nonbank SD that elects the Net Liquid Assets Approach.

Any nonbank SD that is not dually registered as an FCM would be permitted to elect either the Bank-Based Approach or the Net Liquid Assets Approach, regardless of whether it is part of a U.S. bank holding company or dually registered as an SBSD.

On the other hand, even if a nonbank SD has access to internal risk models that have been approved by the FRB, the SEC or a foreign financial regulator, it would not be permitted to use those models to calculate its CFTC capital requirements unless it received separate approval from the CFTC or the National Futures Association ("NFA"). The CFTC has requested comment on measures that might mitigate the implementation burden associated with this duplicative model approval process, such as permitting an SD to use models on a provisional basis if another regulator has approved them.

The following comparison chart summarizes these different approaches, including the type of capital required to satisfy minimum capital requirements and the application of the 8 Percent IM Rule, market and credit risk charges, and liquidity requirements.

4 Under the Dodd-Frank Act, the FRB is the Prudential Regulator for an SD or MSP that is a foreign bank that does not operate an insured branch in the U.S. Accordingly, the FRB's 2015 margin and capital rulemaking covered such an SD or MSP. However, the FRB did not, as part of that rulemaking, adopt any capital rules for such an SD or MSP. The rule text proposed by the CFTC is not drafted in a manner that accounts for this aspect of the FRB's rulemaking, thus raising questions about how the CFTC would treat them.

5 An SD would qualify as a Non-Financial SD if: (1) its consolidated annual gross financial revenues in either of its two most recently completed fiscal years represent less than 15 percent of its consolidated gross revenue in that fiscal year; and (2) its 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 the fiscal years.

Comparison of Nonbank SD Capital Approaches				
Capital Approach	**Eligible Nonbank SDs**	**Type of Capital**	**Minimum Capital Requirement**	**Liquidity Requirements**
Bank-based Approach	Any nonbank SD that is <u>not</u> registered as an FCM	Common equity tier 1 capital	The <u>greater</u> of: (A) $20 million; (B) 8 percent of the SD's risk-weighted assets, computed as though the SD were itself a bank holding company subject to the FRB's consolidated capital requirements, with market and credit risk charges calculated using either: (i) standardized (a) credit risk charges in accordance with the FRB's requirements in subpart D of 12 C.F.R. part 217 and (b) market risk charges in accordance with the CFTC's FCM net capital rule, with those charges multiplied by a factor of 12.5 (so as to ensure that the SD maintains capital at least equal to the full market risk charge, after multiplying its risk-weighted assets by 8 percent); or (ii) CFTC/NFA-approved internal models; (C) the 8 Percent IM Rule; or (D) capital requirements established by the NFA	The FRB's Liquidity Coverage Ratio ("<u>LCR</u>") requirements for bank holding companies applied to the SD as though it were itself a bank holding company, subject to certain adjustments for cash deposited with banks and assets maintained by a Non-U.S. SD in its home country jurisdiction

Comparison of Nonbank SD Capital Approaches				
Capital Approach	**Eligible Nonbank SDs**	**Type of Capital**	**Minimum Capital Requirement**	**Liquidity Requirements**
Net Liquid Assets Approach	Any nonbank SD that is not registered as an FCM	Net capital, as though the SD were a nonbank SBSD subject to the SEC Proposal, but subject to certain adjustments in relation to market and credit risk charges and the treatment of initial margin posted with a third-party custodian	The greater of: (A) $20 million;[6] (B) the 8 Percent IM Rule; or (C) capital requirements established by the NFA	A liquidity stress test based on the stress test included in the SEC Proposal (the "Liquidity Stress Test")
Tangible Net Worth Approach	Only Non-Financial SDs	Tangible net worth, i.e., net worth under U.S. GAAP, excluding goodwill and other intangible assets, and marking long and short positions in swaps, security-based swaps and related positions to market	The greater of: (A) $20 million plus market and credit risk charges for the SD's swap and related hedge positions that are part of its swap dealing activities, computed using either the standardized charges in the CFTC's FCM net capital rule or using internal models approved by the CFTC or NFA; (B) the 8 Percent IM Rule; or (C) capital requirements established by the NFA	None
FCM Approach	Only Dually-Registered FCM/SDs	Adjusted net capital, as computed under the existing FCM net capital rule, subject to certain adjustments	The greater of: (A) $20 million; (B) the 8 Percent IM Rule; or (C) capital requirements established by the NFA	The Liquidity Stress Test

6 If an SD electing the Net Liquid Assets approach was approved to use internal models to compute its market and credit risk charges, then it would also be required to maintain tentative net capital (i.e., net capital before deductions for market and credit risk charges) of at least $100 million. Higher net capital and tentative net capital requirements would also apply under the SEC Proposal if the entity was registered as a broker-dealer.

8 Percent IM Rule

The 8 Percent IM Rule would set minimum capital requirements for an FCM or nonbank SD equal to 8 percent of the initial margin required for the SD's positions in futures, cleared swaps, uncleared swaps, cleared security-based swaps, and uncleared security-based swaps.

The 8 Percent IM Rule would build on the existing FCM net capital rule, which requires an FCM to maintain net capital in excess of 8 percent of the "risk margin requirement" for cleared swaps and futures positions carried by the FCM for customers and affiliates, and the SEC Proposal, which would require a nonbank SBSD to maintain net capital in excess of 8 percent of the "risk margin amount" for cleared security-based swaps carried by the SBSD for customers and uncleared security-based swaps entered into by the SBSD.

The Proposed Rule would, however, go further than these existing rules in several key respects:

- The 8 Percent IM Rule would apply to the sum of the initial margin requirements for all the relevant positions, rather than to the greater of the initial margin requirements for positions in CFTC-regulated instruments, on the one hand, and positions in SEC-regulated instruments, on the other hand.
- Unlike the existing FCM net capital rule, the 8 Percent IM Rule would cover initial margin for uncleared swaps, calculated on a counterparty-by-counterparty basis under the CFTC's margin rules.
    - This calculation would need to include initial margin for certain uncleared transactions that are not subject to initial margin requirements under the CFTC's margin rules, such as legacy uncleared swaps, exempt foreign exchange ("FX") swaps and exempt FX forwards, uncleared inter-affiliate swaps and uncleared swaps with non-financial end users.
    - This calculation would also include initial margin threshold amounts and minimum transfer amounts.
- The 8 Percent IM Rule would similarly cover initial margin for uncleared security-based swaps, without regard to any exemptions or exclusions adopted by the SEC.[7]
- Unlike both the existing FCM net capital rule and the SEC Proposal, the 8 Percent IM Rule would cover proprietary positions in cleared swaps and cleared security-based swaps.[8] Also, for nonbank SDs other than FCMs, the 8 Percent IM Rule would cover proprietary futures positions.[9]
    - SD/FCMs would also continue to need to include initial margin in respect of non-proprietary cleared swap positions, i.e., swap positions they clear for affiliates and customers.

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7 The Proposed Rule does not address how an SD that is not dually registered as an SBSD, and thus would not have SEC approval to use risk-based models to compute its initial margin for uncleared security-based swaps, would make this calculation. For example, would such an SD be required to use a grid-based approach to making the calculation? Or could it look to the initial margin calculations performed by its registered SBSD counterparties?

8 For dually registered SD/FCMs (but not other SDs), these components of the 8 Percent IM Rule would include initial margin that the SD/FCM is required to post to a broker, in addition to the initial margin it is required to post to a clearing organization. Also, dually registered SD/FCMs and Net Liquid Assets SDs would perform this calculation based on the defined term "risk margin," which makes certain adjustments for options positions that would not apply under the Bank-Based or Tangible Net Worth Approaches.

9 For dually registered SD/FCMs, in contrast, the 8 Percent IM Rule would not cover proprietary positions in futures.

- o In addition, SD/FCMs would need to include initial margin in respect of non-proprietary cleared security-based swaps positions, i.e., security-based swap positions they clear for affiliates and customers.[10]

As proposed, the 8 Percent IM Rule would overstate the risk of derivatives activities in several notable respects:

- Because an SD would be required to perform the relevant calculations on a counterparty-by-counterparty basis, the 8 Percent IM Rule would not take into account the relatively common scenario where an SD has a well-hedged portfolio across multiple counterparties such that, even if they all default, counterparties with positions on one side of the market cannot owe money to the SD at the same time as counterparties with positions on the other side of the market. This aspect of the 8 Percent IM Rule could well induce SDs to limit the number of counterparties with whom they deal, increasing their counterparty concentration risk and reducing market competition.

- Although the CFTC has taken steps to promote portfolio margining through no-action and exemptive relief, in most instances the various categories of derivatives that would be covered by the 8 Percent IM Rule still must be margined separately, even if they exhibit offsetting risk profiles, and an SD may net the derivatives together upon a counterparty's default. By establishing a capital requirement that scales up with initial margin, not risk, the 8 Percent IM Rule would exacerbate the distortions created by this aspect of the U.S. margin regime.

- The 8 Percent IM Rule would not recognize segregated margin as an effective credit risk mitigant. This aspect of the 8 Percent Rule is particularly startling given the criticisms that the CFTC has leveled at the Basel Committee for making the same omission in connection with its supplemental leverage ratio.[11] There also is no indication in the Proposed Rule that the CFTC considers SDs collecting initial margin under the CFTC's margin rules to be exposed to residual counterparty credit risk that must be addressed through additional capital charges, outside of the context where the CFTC's margin rules do not require an SD to collect initial margin (e.g., in the case of initial margin thresholds or swaps with non-financial end users).

- For Net Liquid Assets Approach SDs and dually registered SD/FCMs permitted to use credit risk models, the 8 Percent IM Rule would have the effect of double-counting potential future credit exposure for uncleared swaps and uncleared security-based swaps because such SDs would already take into account their potential future credit exposure for those positions as part of credit risk charges to their net capital.

- By including proprietary positions in futures, cleared swaps, and cleared security-based swaps in the 8 Percent IM Rule calculation, the Proposed Rule would require significantly more capital to be held against clearing organization credit exposure than the level required for a bank in connection with its credit exposure to a qualifying central counterparty.

  - o As a result, the Proposed Rule would undercut efforts to use capital rules to

[10] This aspect of the Proposed Rule cross-references the defined terms for "customer" and "noncustomer" accounts. Read literally, these cross-references would have the effect of double-counting initial margin for cleared security-based swap positions portfolio margined with cleared swap positions in a cleared swap account.

[11] See, e.g., Remarks of Chairman Massad before the 3rd Annual Derivatives Summit North America, Sept. 29, 2015, available at, http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-28; Keynote Address by Chairman Massad before the Institute of International Bankers, Mar. 2, 2015, available at, http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-13.

encourage use of cleared derivatives relative to uncleared derivatives.

- In addition, as the Proposed Rule notes, the Commodity Exchange Act only cites the risk of uncleared swaps in setting standards for capital, which does not seem consistent with including proprietary positions in cleared transactions within the 8 Percent IM Rule.

Market and Credit Risk Charges

The Proposed Rule would, to varying extents, require a nonbank SD to hold capital against its market and credit risk exposures:

Bank-Based Approach. A nonbank SD following the Bank-Based Approach would take into account its market and credit risk exposures when calculating the prong of its minimum capital requirements corresponding to 8 percent of its risk-weighted assets.

- To make this calculation, the SD would use either (i) standardized (a) credit risk charges in accordance with the FRB's requirements in subpart D of 12 C.F.R. part 217 and (b) market risk charges in accordance with the CFTC's FCM net capital rule, with those charges multiplied by a factor of 12.5 (so as to ensure that the SD maintains capital at least equal to the full market risk charge, after multiplying its risk-weighted assets by 8 percent) or (ii) models approved by the CFTC or NFA.

- The Proposed Rule does not precisely address how its rules relating to the use of market and credit risk models are intended to interact with the parallel provisions of the FRB's rules that the Proposed Rule incorporates by reference, or whether or how the CFTC intends to apply other aspects of the FRB's advanced approaches to capital requirements (such as operational risk capital requirements). [12]

- Unlike under the Net Liquid Assets Approach or the FCM Approach, under the Bank-Based Approach the 8 Percent IM Rule would not apply cumulatively with these market and credit risk charges. Also, under the Bank-Based Approach, unsecured receivables and loans would not be subject to 100 percent capital charges like they would under the Net Liquid Assets Approach or the FCM Approach.

Net Liquid Assets Approach. An SD following the Net Liquid Assets Approach would take into account its market and credit risk exposures as charges to its net capital, based on the SEC Proposal.

- Unlike under the Bank-Based Approach, these charges would apply in addition to the 8 Percent IM Rule. Also, with the exception of receivables from third-party custodians for initial margin that the SD posts in accordance with the CFTC's margin rules or parallel SEC rules, an SD electing the Net Liquid Assets Approach would need to take 100 percent charges for unsecured receivables, loans and certain other illiquid assets, consistent with the SEC Proposal.

- The SD would calculate its market and credit risk deductions in accordance with the SEC Proposal,[13] subject to the following adjustments:[14]

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[12] It also is not clear whether the CFTC would defer to FRB interpretations of FRB rules or develop its own interpretations as questions arise (particularly if those questions arise in connection with supervising SDs that elect the Bank-Based Approach but are not subsidiaries of U.S. bank holding companies).

[13] As with the Bank-Based Approach, it is not clear whether the CFTC would defer to SEC interpretations of these requirements or develop its own interpretations as questions arise (particularly if those questions arise in connection with supervising SDs that elect the Net Liquid Assets Approach but are not registered as SBSDs).

[14] As drafted, the SEC Proposal's market and credit risk deductions would continue to apply to a dually registered SD/SBSD notwithstanding the adjustments in the Proposed Rule. If the SEC does not incorporate adjustments made by the CFTC's

- o If the SD has approval to use models to compute its market risk charges, then it would be required to calculate those charges as the sum of the value-at-risk ("VaR") measure, stressed VaR measure, specific risk measure, comprehensive risk measure and incremental risk measure, consistent with Basel 2.5 market risk requirements;
- o If the SD has approval to use models to compute its credit risk charges, it may use such models to compute charges for all its swap and security-based swap transactions, not just those with commercial end users;[15]
  - ▪ The Proposed Rule does not, however, address the SEC Proposal's requirement for a 100 percent capital charge in connection with legacy accounts that are not subject to margin requirements, even though that charge would not be consistent with the expanded ability to use models to compute credit risk charges.
  - ▪ A 100 percent charge for such legacy accounts would also be inconsistent with the CFTC's margin rules' grandfathering provisions, at least in connection with initial margin where the charge would not be necessary to offset an illiquid unsecured receivable.
- o As noted above, an SD may recognize as a current asset receivables from third-party custodians holding initial margin that the SD posts in accordance with the CFTC's margin rules or parallel SEC rules;
  - ▪ The Proposed Rule does not, however, address the SEC Proposal's requirement for a 100 percent capital charge in connection with counterparties that elect to hold their initial margin at a third-party custodian, even though such a charge would not be consistent with the proposed treatment of initial margin posted by an SD or the segregation requirements of the CFTC's margin rules (which are not mirrored in the SEC Proposal); and
- o An SD could not deduct the "margin difference" (as defined the SEC Proposal) in lieu of collecting margin for swap or security-based swap transactions.
  - ▪ While not entirely clear, it appears that this provision of the Proposed Rule would supersede a requirement in the SEC Proposal that a nonbank SBSD take a charge for the difference between (a) the market risk charges that the SBSD would incur for cleared security-based swap positions it carries for others if the SBSD instead owned those positions itself and (b) the margin value of collateral in the SBSD's

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capital rules, dually registered SDs/SBSDs would be subject to the stricter of both agencies' rules.

15 This provision of the Proposed Rule cross-references a provision of the SEC Proposal that sets forth the process for a nonbank SBSD to apply for approval from the SEC to use internal models. Given that a separate provision of the Proposed Rule appears to envision a separate model approval process administered by the CFTC and NFA, it is not clear whether the Proposed Rule was instead intended to cross-reference the provision of the SEC Proposal addressing when and how a nonbank SBSD approved to use internal models may calculate model-based credit risk charges.

That second provision of the SEC Proposal provides that, for purposes of calculating maximum potential exposure and current exposure, a nonbank SBSD can only take into account the value of collateral it receives if the SBSD "maintains physical possession or sole control of the collateral." It does not seem that this condition should apply to swaps, given that (a) the CFTC's margin rules require an SD to hold initial margin it collects at a third-party custodian and (b) as noted above, the Proposed Rule would, in the parallel context of initial margin posted by an SD, allow the SD to recognize as a current asset a receivable from a third-party custodian holding that margin in accordance with the CFTC Margin Rules.

account for the persons for whom it clears.

- It might also be the CFTC's intent to clarify that an SD must collect margin where it is required to do so, rather than taking a capital charge in lieu of margin. However, the "margin difference" provision of the SEC Proposal cross referenced by the Proposed Rule is inapposite to this principle, since the cross-referenced SEC provision addresses scenarios where the SEC Proposal would not require an SBSD to collect (or hold) margin.

Tangible Net Worth Approach. A Non-Financial SD following the Tangible Net Worth Approach would only need to hold capital against market and credit risk exposures associated with the SD's swap and related hedge positions that are part of the SD's swap dealing activities.

- In contrast, other assets, such as buildings or other fixed assets, could count as regulatory capital at their full U.S. GAAP value, even though the SD could not quickly liquidate those assets to cover losses associated with its swap dealing business. This approach is intended to avoid requiring Non-Financial SDs to restructure their swap dealing activity into a separate legal entity that does not hold such illiquid assets.

- In addition, like the Bank-Based Approach, but unlike the Net Liquid Assets Approach and the FCM Approach, the Tangible Net Worth Approach would not apply the 8 Percent IM Rule cumulatively with market and credit risk charges.

- As a result of these aspects of the Tangible Net Worth Approach, SDs following this approach are likely to have competitive advantages over SDs following the Net Liquid Assets Approach or the FCM Approach.

FCM Approach. An SD that is dually registered as an FCM would be required to apply the existing FCM net capital rule, with amendments expanding the 8 Percent IM Rule, as noted above.

In addition, the Proposed Rule would amend the FCM net capital rule to (i) incorporate standardized market risk charges for swaps and security-based swaps drawn from the SEC Proposal and (ii) permit an SD/FCM to apply for CFTC or NFA approval to use models to compute market and credit risk charges.

The Proposed Rule also would amend the FCM net capital rule to impose a charge for the amount of uncleared swap margin that the FCM has not collected from a swap counterparty, less any amounts owed by the FCM to the swap counterparty for uncleared swap transactions. Given that the term "uncleared swap margin" is defined to cover initial margin requirements for uncleared swaps (as described above in conjunction with the 8 Percent IM Rule), this amendment would appear to subject an FCM to capital charges in circumstances where the CFTC's margin rules do not require the FCM to collect margin, even if the failure to collect margin does not result in the FCM having an unsecured receivable.

With the exception of provisions permitting the use of approved models to compute market and credit risk charges, the amendments described above would also apply to an FCM that is not registered as an SD. [16]

Liquidity Requirements

Bank-Based Approach. A nonbank SD that follows the Bank-Based Approach would be required to comply with the FRB's LCR for bank holding companies as if the SD were a bank holding company, subject to limited modifications discussed below:

- Under the LCR, an institution is required to maintain high quality liquid assets ("HQLAs")[17]

[16] An FCM that is dually registered as a broker-dealer and eligible to use models under the SEC's alternative net capital rules would continue to be eligible to use SEC-approved models to compute its market and credit risk charges.

[17] HQLAs are liquid assets that meet certain marketability criteria and are unencumbered by liens and other restrictions on the ability of the SD to transfer the assets. There are three categories of

at least equal to the institution's total net cash outflows over a prospective 30 calendar-day period. An institution's total net cash outflows represent its liquidity needs over a stressed 30-day horizon, determined in accordance with conservative inflow and outflow assumptions.

- Under the Proposed Rule, a nonbank SD that follows the Bank-Based Approach would be subject to the LCR, provided that: (i) any such nonbank SD would be allowed to include cash deposited with banks that is readily available for withdrawal as a level 1 HQLA and (ii) a Non-U.S. SD would be allowed to include HQLAs maintained in its home country jurisdiction in meeting its minimum LCR.

The Proposed Rule would require all nonbank SDs that follow the Bank-Based Approach to comply with the LCR on an entity level, even if the SD is a member of a holding company group that complies with the FRB's LCR on a consolidated basis. This approach could have the effect of restricting a bank holding company's ability to manage liquidity across entities and deploy resources as necessary in a stress scenario.

Net Liquid Assets Approach and FCM Approach. A nonbank SD that follows the Net Liquid Assets Approach or FCM Approach would be required to comply with a Liquidity Stress Test, under which the SD would be required to estimate cash and collateral needs over a period of time under specified stressed conditions.[18] The SD would then be required to maintain, at all times, liquidity reserves based on the results of the Liquidity Stress Test, in the form of unencumbered cash and U.S. government securities.

Features of the Liquidity Stress Test that raised concerns among commenters on the SEC Proposal are unchanged in the Proposed Rule. For example, the Liquidity Stress Test requires an SD to maintain minimum liquidity reserves "at all times." This aspect of the Liquidity Stress Test would limit the SD's ability to use excess liquidity intraday. In addition, the range of assets allowed to satisfy the Liquidity Stress Test is much narrower than the assets allowed to satisfy the LCR.

Tangible Net Worth Approach. A Non-Financial SD that follows the tangible net worth approach would not be subject to any liquidity requirements.

MSP CAPITAL REQUIREMENTS

The Proposed Rule would require an MSP that does not have a Prudential Regulator to maintain a positive tangible net worth, calculated in accordance with U.S. GAAP, and to maintain capital required by the NFA. As a result, the Proposed Rule would not subject an MSP to the 8 Percent IM Rule or any market or credit risk charges.

An MSP would not be subject to any liquidity requirements.

FINANCIAL RECORDKEEPING AND REPORTING REQUIREMENTS

The Proposed Rule would impose recordkeeping and reporting obligations on all SDs and MSPs, including, to a limited extent, bank SDs and MSPs.

HQLAs (level 1 and levels 2A and 2B), which are subject to haircuts and concentration limits.

18 These conditions would include, at a minimum: (1) a decline in creditworthiness of the SD severe enough to trigger contractual credit-related commitment provisions of counterparty agreements; (2) loss of all existing unsecured funding at the earlier of its maturity or put date and an inability to acquire a material amount of new unsecured funding; (3) the potential for a material net loss of secured funding; (4) the loss of the ability to procure repurchase agreement financing for less liquid assets; (5) the illiquidity of collateral required by and on deposit at clearing agencies or other entities which is not deducted from net worth or which is not funded by customer assets; (6) a material increase in collateral required to be maintained at registered clearing agencies of which it is a member; and (7) the potential for a material loss of liquidity caused by market participants exercising contractual rights and/or refusing to enter into transactions with respect to the various businesses, positions, and commitments of the SD.

Nonbank SDs and MSPs

Financial Records. The Proposed Rule would require a nonbank SD or MSP to keep current ledgers summarizing each transaction affecting its asset, liability, income, expense and capital accounts.

CFTC Reports and Notifications. A nonbank SD or MSP would be required to file the following reports with the CFTC:[19]

Frequency	Type of Report
Weekly	• All open uncleared swap positions, sorted by counterparty and asset class • For each counterparty with which the SD or MSP has an open uncleared swap position, the total initial margin posted by the SD or MSP, the total initial margin collected by the SD or MSP, and the net variation margin paid or collected by the SD or MSP over the previous week
Monthly	• Unaudited financial reports • Summary information regarding the SD's or MSP's positions and counterparty exposures • Information about the SD's or MSP's holdings and postings of margin, including information about third-party custodians • If the SD has approval to use internal market or credit risk models, additional information regarding the SD's risks, exposures, and Liquidity Stress Test results
Quarterly	• If the SD has approval to use internal market or credit risk models, information regarding daily trading losses in excess of daily VaR and backtesting information
Annually	• Audited financial reports

In certain instances, a nonbank SD or MSP dually registered as an FCM with the CFTC or as an SBSD with the SEC could instead submit reports prepared in accordance with FCM or SBSD financial reporting rules.

In addition, a nonbank SD or MSP would be required to provide notice to the CFTC upon the occurrence of specified events, including noncompliance with capital and liquidity requirements and noncompliance with margin requirements above certain thresholds.

Public Disclosures. A nonbank SD or MSP would be required to make publicly available on its website: (i) at least quarterly, a statement of the SD's or MSP's financial condition, its regulatory capital as of the end of the quarter, and the amount of its minimum regulatory capital requirement; and (ii) at least annually, a statement of financial condition from the SD's or MSP's audited financial statements and a statement disclosing the SD's or MSP's minimum regulatory capital.

Use of U.S. GAAP. A nonbank SD or MSP would generally be required to prepare its ledgers and financial reports in accordance with U.S. GAAP, except that a Non-U.S. SD or MSP would be allowed to prepare these ledgers and statements in accordance with International Financial Reporting Standards ("IFRS") if it does not otherwise prepare statements under U.S. GAAP. A Non-U.S. SD or MSP would not be eligible to use IFRS if it prepares U.S. GAAP financial statements as part of consolidation into a U.S. parent company.

Bank SDs and MSPs

Bank SDs and MSPs would be required to file the following reports with the CFTC:[20]

19 In addition to the requirements below, the CFTC may, by written notice, require a nonbank SD or MSP to file financial information on a daily basis or at such other times as may be specified by the CFTC.

20 In addition to the requirements below, the Commission may, by written notice, require a bank SD or MSP to file financial information on a daily basis or at such other times as may be specified by the CFTC.

Frequency	Type of Report
Weekly	• All open uncleared swap positions, sorted by counterparty and asset class • For each counterparty with which the SD or MSP has an open uncleared swap position, the total initial margin posted by the SD or MSP, the total initial margin collected by the SD or MSP, and the net variation margin paid or collected by the SD or MSP over the previous week
Quarterly	• Financial reports and position information

A bank SD or MSP would also be required to provide notice to the CFTC upon the occurrence of specified events, including noncompliance with capital requirements or noncompliance with margin requirements above certain thresholds.

Public Disclosures. A bank SD or MSB would be required to make publicly available on its website at least quarterly a statement of the SD's or MSP's financial condition and a statement disclosing the amount of the SD's or MSP's regulatory capital as of the end of the quarter and the amount of its minimum regulatory capital requirement.

Substituted Compliance. In what might be an oversight, a bank SD or MSP organized and domiciled outside the United States would not appear to be eligible for the substituted compliance regime described below in connection with the financial reporting requirements described above.

SUBSTITUTED COMPLIANCE

The Proposed Rule would permit a Non-U.S. SD or MSP to comply with the Proposed Rule by substituting compliance with the corollary requirements of its home country jurisdiction. Substituted compliance would only be available if the CFTC issues a determination that the Non-U.S. SD's or MSP's home country requirements are comparable to the CFTC's. The Proposed Rule would establish a process pursuant to which a Non-U.S. SD or MSP or its home-country regulator could apply to the CFTC for such a determination by submitting documentation and information about the non-U.S. requirements.

The CFTC would issue comparability determinations on a jurisdiction-by-jurisdiction basis, based on consideration of: (i) the scope and objectives of a non-U.S. jurisdiction's capital requirements; (ii) how such capital requirements compare to the international Basel capital standards; (iii) whether a non-U.S. jurisdiction's capital adequacy and financial reporting requirements achieve comparable outcomes to the CFTC's corresponding requirements; (iv) the ability of the relevant non-U.S. regulatory authority to supervise and enforce compliance; and (v) any other facts or circumstances the CFTC deems relevant.

If the CFTC has made a comparability determination for a Non-U.S. SD's or MSP's home country jurisdiction, the Non-U.S. SD or MSP would be required to file a notice of its intent to comply with its home country capital adequacy and financial reporting requirements with the NFA. Before it could rely on substituted compliance, the Non-U.S. SD or MSP would be required to obtain a confirmation from the NFA. This final step is an additional administrative requirement not currently required for other CFTC rules, and it is not clear what additional information the NFA might require a Non-U.S. SD or MSP to submit.

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