COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 23, and 140

RIN 3038–AD54

Capital Requirements of Swap Dealers and Major Swap Participants

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (''Commission'' or ''CFTC'') is adopting new regulations imposing minimum capital requirements and financial reporting requirements on swap dealers (''SDs'') and major swap participants (''MSPs'') that are not subject to a prudential regulator. The Commission is also amending existing capital requirements for futures commission merchants (''FCMs'') to provide specific capital deductions for market risk and credit risk for swaps and security-based swaps entered into by an FCM. The Commission is further adopting amendments to its regulations to permit certain entities dually-registered with the Securities and Exchange Commission (''SEC'') to file an SEC Financial and Operational Combined Uniform Single Report in lieu of CFTC financial reports, to require certain Commission registrants to file notices of certain defined events, and to require notices of bulk transfers to be filed with the Commission electronically and within a defined period of time.

DATES:

Effective date: November 16, 2020.

Compliance date: October 6, 2021

FOR FURTHER INFORMATION CONTACT: Joshua Sterling, Director, 202–418–6056, *jsterling@cftc.gov;* Thomas Smith, Deputy Director, 202–418–5495, *tsmith@cftc.gov;* Joshua Beale, Associate Director, 202–418–5446, *jbeale@cftc.gov;* Jennifer Bauer, Special Counsel, 202–418–5472, *jbauer@cftc.gov;* Rafael Martinez, Senior Financial Risk Analyst, 202–418–5462, *rmartinez@cftc.gov,* Division of Swap Dealer and Intermediary Oversight; Paul Schlichting, Assistant General Counsel, Office of the General Counsel, 202–418–5884, *pschlichting@cftc.gov;* Lihong McPhail, Research Economist and Head of Academic Outreach, 202–418–5722, *lmcphail@cftc.gov,* Office of the Chief Economist; Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW, Washington, DC 20581; or Mark Bretscher, Special Counsel, 312–596–0598, *mbretscher@cftc.gov;* Division of Swap Dealer and Intermediary Oversight, Commodity Futures Trading Commission, 525 West Monroe Street, Suite 1100, Chicago, IL 60661.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Introduction
A. Background and Statutory Authority
B. Proposed Rulemakings and Reopening of the Comment Period
C. Consultation With U.S. Securities and Exchange Commission and Prudential Regulators
II. Final Regulations and Amendments to Existing Regulations
A. Capital Framework for FCMs, Covered SDs, and Covered MSPs
B. Capital Requirements for Stand-Alone FCMs and FCM–SDs
1. Introduction to General Capital Requirements for Stand-Alone FCMs and FCM–SDs
2. Minimum Capital Requirement for Stand-Alone FCMs and FCM–SDs
a. Minimum Fixed-Dollar Amount of Net Capital
b. Minimum Capital Requirement Based on 8% Risk Margin Amount
3. Stand-Alone FCM and FCM–SD Calculation of Net Capital and Adjusted Net Capital
a. Stand-Alone FCM and FCM–SD Standardized Market Risk Capital Charges
b. FCM and FCM–SD Standardized Counterparty Credit Risk Capital Charges
c. Model-Based Market Risk and Counterparty Credit Risk Capital Charges
(i) FCMs That Are SEC-Registered ANC Firms
(ii) Market Risk and Credit Risk Capital Models for FCM–SDs That Are Not SEC-Registered BDs
C. Capital Requirements for Swap Dealers and Major Swap Participants
1. Introduction to Covered SD and Covered MSP Capital Requirements
2. Capital Requirement for Covered SDs Electing the Net Liquid Assets Capital Approach
a. Computation of Minimum Capital Requirement
b. Computation of Net Capital To Meet Minimum Capital Requirement
(i) Swap Dealers Not Approved To Use Internal Capital Models
(ii) Swap Dealers Approved To Use Internal Capital Models
3. Capital Requirement for Covered SDs Electing the Bank-Based Capital Approach
a. Computation of Minimum Capital Requirement
4. Capital Requirement for Covered SDs Electing the Tangible Net Worth Capital Approach
5. Capital Requirements for Covered MSP
6. Requirements for Market Risk and Credit Risk Models
a. VaR Models
b. Stressed VaR Models
c. Specific Risk Models
d. Incremental Risk Models
e. Comprehensive Risk Models
f. Credit Risk Models
7. Model Approval Process for Covered SDs and FCM–SDs
8. Liquidity Requirements for Covered SDs and FCM–SDs
9. Equity Withdrawal Restrictions for Covered SDs and Covered MSPs
10. Leverage Ratio Requirements for Covered SDs
D. Swap Dealer and Major Swap Participant Financial Recordkeeping, Reporting and Notification Requirements
1. Routine Financial Reporting and Recordkeeping Requirements
2. Swap Dealer and Major Swap Participant Notice Requirements
3. Swap Dealers and Major Swap Participants Subject to the Capital Rules of a Prudential Regulator
4. Public Disclosures
5. Electronic Filing Requirements for Financial Reports and Regulatory Notices
6. Swap Dealer and Major Swap Participant Reporting of Position Information
7. Reporting Requirements for Swap Dealers and Major Swap Participants Approved To Use Internal Capital Models
8. Weekly Position and Margin Reporting
E. Comparability Determinations for Eligible Covered SDs and Covered MSPs
F. Additional Amendments to Existing Regulations
1. Financial Reporting Requirements for FCMs or IBs That Are Also Registered SBSDs
2. Amendments to the FCM and IB Notice Provisions in Regulation 1.12
3. FCM and IB Unsecured Receivables From Swap Transactions
4. Amendments to FCM and IB Notice and Disclosure Requirements for Bulk Transfers
5. Conforming Amendments to Delegated Authority Provisions in Regulation 140.91
G. Effective Date and Compliance Date
III. Related Matters
A. Regulatory Flexibility Act
B. Paperwork Reduction Act
1. Background
2. New Information Collection Requirements and Related Burden Estimates
i. FOCUS Report
ii. Notice of Failure To Maintain Minimum Financial Requirements
iii. Requests for Extensions of Time To File Financial Statements
iv. Capital Requirements Elections
v. Application for Use of Models
vi. Equity Withdrawal Requirements
vii. Financial Recordkeeping, Reporting and Notification Requirements for SDs and MSPs
viii. Capital Comparability Determinations
IV. Cost Benefit Considerations
A. Background
B. Regulatory Capital
C. General Summary of Rulemaking
D. Baseline
E. Overview of Approaches
1. Bank-Based Capital Approach
2. Net Liquid Assets Approach
3. Alternative Net Capital (''ANC'')

4. Tangible Net Worth
5. Substituted Compliance
F. Entities
1. Bank Subsidiaries
2. SD/BD (Without Models)
3. SD/BD/OTC Derivatives Dealers (Without Models)
4. FCM–SD (Without Models)
5. ANC Firms (SD/BD and/or FCMs That Use Models)
6. Stand-Alone SD (With and Without Models)
7. Non-Financial SD (With and Without Models)
8. MSP
9. Substituted Compliance
G. Liquidity Requirements
H. Equity Withdrawal Restrictions
I. Reporting and Recordkeeping Requirements
J. Section 15(a) Factors
1. Protection of Market Participants and the Public
2. Efficiency, Competitiveness, and Financial Integrity of Swaps Markets
3. Price Discovery
4. Sound Risk Management Practices
5. Other Public Interest Considerations
K. Attachment A to Cost Benefit Considerations

I. Introduction

A. Background and Statutory Authority

The Commission is adopting capital and financial reporting requirements for SDs and MSPs, and is amending existing capital rules for FCMs to provide explicit capital requirements for proprietary positions in swaps and security-based swaps that are not cleared by a clearing organization. The adoption of the capital requirements for SDs and MSPs completes the Congressional mandate directing the Commission to adopt rules imposing both capital requirements on SDs and MSPs that are not subject to a prudential regulator, and imposing initial and variation margin on uncleared swaps entered into by SDs and MSPs that are not subject to a prudential regulator.[1]

Title VII of the Dodd-Frank Act established a new regulatory framework for swap and security-based swap transactions.[2] The legislation was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system, including by: (i) Providing for the registration and comprehensive regulation of SDs, security-based swap dealers (''SBSDs''), MSPs and major security-based swap participants (''MSBSPs''); (ii) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; (iii) creating rigorous recordkeeping and real-time reporting regimes; and (iv) enhancing the rulemaking and enforcement authorities of the Commissions with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight. The Dodd-Frank Act further established a jurisdictional boundary by authorizing the Commission to regulate ''swaps,'' and granting the SEC authority to regulate ''security-based swaps.''[3] Sections 721 and 761 of the Dodd-Frank Act also added definitions of the terms ''swap dealer,'' ''security-based swap dealer,'' ''major swap participant,'' and ''major security-based swap participant'' to the CEA and Exchange Act.[4]

An additional provision of the new swap regulatory framework, section 731 of the Dodd-Frank Act, amended the CEA[5] by adding section 4s, which requires an entity meeting the definition of an SD or an MSP to register with the Commission.[6] Section 4s authorizes the Commission to adopt rules requiring such SDs and MSPs to maintain daily trading records of their swaps and all related records (including related cash or forward transactions) and recorded communications.[7] Section 4s further requires each SD or MSP to conform with the business conduct standards prescribed by the Commission that relate to: (i) Fraud, manipulation, and other abusive practices involving swaps; (ii) diligent supervision of the business of the SD or MSP; (iii) adherence to applicable position limits; and (iv) such other matters as the Commission determines appropriate.[8]

Section 4s(e) also addresses minimum capital requirements for SDs and MSPs, and imposes initial and variation margin obligations on swaps entered into by SDs and MSPs that are not cleared by a registered derivatives clearing organization.[9] Section 4s(e) applies a bifurcated approach with respect to capital and margin by requiring each SD and MSP subject to regulation by a prudential regulator to meet the minimum capital and margin requirements adopted by the applicable prudential regulator, and requiring each SD and MSP not subject to regulation by a prudential regulator to meet the minimum capital and margin requirements adopted by the Commission.[10] Therefore, the Commission's authority to impose capital and margin requirements extends to SDs and MSPs that are non-banking entities that are not subject to a prudential regulator, including non-banking subsidiaries of bank holding companies regulated by the Federal Reserve Board. SDs and MSPs subject to the Commission's capital and margin requirements are referred to in this document as ''covered SDs'' and ''covered MSPs,'' respectively. SDs and MSPs subject to the margin and capital requirements of a prudential regulator are referred to in this document as ''bank SDs'' and ''bank MSPs,'' respectively.

The Commission previously adopted rules imposing margin requirements for uncleared swap transactions entered into by covered SDs and covered MSPs as required by section 4s(e).[11] The prudential regulators also adopted rules imposing margin requirements for uncleared swap and security-based swap transactions entered into by bank SDs or bank MSPs.[12] The prudential regulators further adopted capital requirements applicable to bank SDs

[1] The term ''prudential regulator'' is defined for purposes of the section 4s(e) capital and margin requirements to mean the Board of Governors of the Federal Reserve System (''Federal Reserve Board''); the Office of the Comptroller of the Currency (''OCC''); the Federal Deposit Insurance Corporation (''FDIC''); the Farm Credit Administration; and the Federal Housing Finance Agency. *See* section 1a(39) of CEA (7 U.S.C. 1 *et. seq.*).

[2] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at *http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.*

[3] The term ''swap'' is defined in section 1a(47) of the CEA (7 U.S.C. 1a(47)) and Commission regulation § 1.3 (17 CFR 1.3). The term ''security-based swap'' is defined in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68)). Commission regulations referred to in this release are found at 17 CFR chapter I (2019), and are accessible on the Commission's website at *https://www.cftc.gov/LawRegulation/CommodityExchangeAct/index.htm.*

[4] *See* CEA sections 1a(33) and (49) (7 U.S.C. 1a(33) and (49)) for the definition of the terms ''major swap participant'' and ''swap dealer,'' respectively; *See* Exchange Act section 3(a)(67) and (71) (15 U.S.C. 3(a)(67) and (71)) for the definition of the terms ''major security-based swap participant'' and ''security-based swap dealer,'' respectively.

[5] 7 U.S.C. 1 *et seq.*

[6] 7 U.S.C. 6s(a).

[7] 7 U.S.C. 6s(g).

[8] 7 U.S.C. 6s(h).

[9] 7 U.S.C. 6s(e).

[10] 7 U.S.C. 6s(e)(1).

[11] The Commission adopted final rules on December 18, 2015 imposing initial and variation margin requirements on covered SDs and covered MSPs for swap transactions that are not cleared by a registered derivatives clearing organization (''DCO''). *See, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* 81 FR 636 (Jan. 6, 2016). The margin rules, which became effective on April 1, 2016, are codified in part 23 of the Commission's regulations (17 CFR 23.150–23.159, 23.161). In May 2016, the Commission amended the margin rules to add Commission regulation § 23.160, providing rules on the cross-border application of the margin rules. *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements,* 81 FR 34818 (May 31, 2016).

[12] The prudential regulators published final margin requirements in November 2015. *See Margin and Capital Requirements for Covered Swap Entities,* 80 FR 74840 (Nov. 30, 2015).

and bank MSPs that incorporate swap and security-based swap transactions into the capital framework.[13]

Furthermore, section 764 of the Dodd-Frank Act added section 15F to the Exchange Act to address capital and margin requirements associated with security-based swaps. Section 15F(e)(1)(B) directs the SEC to adopt capital and margin requirements for SBSDs and MSBSPs that do not have a prudential regulator (''nonbank SBSDs'' and ''nonbank MSBSPs''). The SEC adopted final capital rules for nonbank SBSDs and nonbank MSBSPs, as well as final margin rules for security-based swaps entered into by nonbank SBSDs and nonbank MSBSPs, in June 2019.[14]

In addition to the new capital authority over covered SDs and covered MSPs, the Commission also has separate statutory authority to adopt rules imposing minimum capital requirements on FCMs.[15] The Commission expects that certain FCMs will engage in a level of swap dealing activity that will require their registration as SDs with the Commission. Such FCMs that are dually-registered as SDs (''FCM–SDs'') will be subject to the Commission's long-standing FCM capital rules. In addition, other FCMs may engage in a level of swap dealing activity that is less than what is required to register as an SD; FCMs may engage in swaps and security-based swaps as part of their business to, for example, hedge financial and commercial risks (''stand-alone FCMs''). Although the general capital treatment of unsecured market gains as non-current assets and the capital charges for inventory and fixed price commitments have been applied as applicable to the market and credit risk of swap positions for FCMs, to now explicitly address both the market and credit risk of these positions for FCM–SDs and stand-alone FCMs, the Commission is adopting rules to specifically incorporate uncleared swaps and security-based swaps into the existing FCM capital framework by defining specific market risk charges and credit risk charges for such transactions. The Commission's FCM regulations are consistent with its authority under section 4f(b) of the CEA, which authorizes the Commission to impose minimum financial requirements, including capital requirements, on FCMs. This authority extends to establishing capital requirements with respect to all of an FCM's activities, including activities involving swaps and security-based swaps.[16] Under the Commission's final rules, an FCM–SD and a stand-alone FCM are subject to the FCM capital requirements set forth in regulation 1.17.

The Commission also is adopting financial reporting and recordkeeping requirements for SDs and MSPs. Section 4s(f)(2) of the CEA directs the Commission to adopt rules governing financial condition reporting and recordkeeping for SDs and MSPs, and section 4s(f)(1)(A) requires each registered SD and MSP to make such reports as are required by Commission rule or regulation regarding the SD's or MSP's financial condition.[17] The Commission also is adopting record retention and inspection requirements consistent with the provisions of section 4s(f)(1)(B).[18]

The final reporting requirements require covered SDs and covered MSPs to file periodic unaudited financial statements and an annual audited financial report with the Commission and with the registered futures association (''RFA'') of which they are a member.[19] The final regulations further require covered SDs and covered MSPs to file certain regulatory notices with the Commission and with the RFA of which they are a member. The notices are comparable to the existing FCM notices, and are intended to alert the Commission and RFA to scenarios that may indicate potential financial or operational issues, including instances of undercapitalization and failure to maintain current books and records. Covered SDs and covered MSPs are also required to file notice if certain triggering events regarding the failure to post or collect initial or variation margin with swap counterparties occur.

The Commission also is adopting a program for non-U.S. domiciled covered SDs or covered MSPs to petition the Commission for a program of substituted compliance. Non-U.S. domiciled covered SDs or covered MSPs may seek a determination from the Commission that they operate in a jurisdiction that has comparable capital adequacy and financial reporting objectives and goals as set forth by the Commission in the final regulations. Non-U.S. domiciled covered SDs or MSPs that operate in a jurisdiction that the Commission has determined meets the capital adequacy and financial reporting objectives of the CEA and the Commission's regulations may meet some or all of their capital and financial reporting requirements by complying with their home country jurisdiction requirements.

The Commission is also adopting several amendments to existing regulations as part of the proposed capital and financial recordkeeping and reporting requirements. The Commission is amending regulation 1.12 to require an FCM or an introducing broker (''IB'') that is subject to the capital rules of both the Commission and the SEC to file a notice with the Commission if the FCM or IB fails to meet the SEC's minimum capital requirement. The Commission is also adopting amendments to regulation 1.12 to require an FCM or an IB that is also registered with the SEC as an SBSD or an MSBSP to file a notice if the SBSD's or MSBSP's net capital falls below the ''early warning level'' established in the rules of the SEC.[20] The Commission is also adopting amendments to the bulk

[13] The prudential regulators have adopted capital rules addressing capital requirements for swap and security-based swap transactions. In this regard, the Federal Reserve Board and OCC have adopted revised capital rules to incorporate Basel III capital adequacy requirements. *See, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule,* 78 FR 62018 (Oct. 11, 2013).

[14] *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers,* Exchange Act Release No. 86175 (Jun. 21, 2019), 84 FR 43872 (Aug. 22, 2019) (''*2019 SEC Final Capital Rule*''). The compliance date for these rules is October 6, 2021.

[15] Section 4f(b) of the CEA (7 U.S.C. 6f(b)) authorizes the Commission to establish minimum financial requirements for FCMs. The Commission previously adopted minimum capital requirements for FCMs, which are set forth in Commission regulation § 1.17 (17 CFR 1.17).

[16] Section 4s(e)(3)(B) (7 U.S.C. 6s(e)(3)(B)) of the CEA provides that the nothing in section 4s shall limit, or be construed to limit, the authority of the Commission to set financial responsibility rules for an FCM.

[17] *See* 7 U.S.C. 6s(f)(1) and (2).

[18] The Commission previously finalized certain record retention requirements for SDs and MSPs regarding their swap activities. *See, Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants,* 76 FR 20128 (Apr. 3, 2012).

[19] Section 3 of the CEA states that a purpose of the CEA is to establish a system of effective self-regulation under the oversight of the Commission. Consistent with the self-regulatory concept established under section 3, section 17 of the CEA provides a process whereby an association of persons may register with the Commission as an RFA. Currently, the National Futures Association (''NFA'') is the only RFA under section 17 of the CEA.

[20] The SEC requires each SBSD for which there is no prudential regulator to provide notice within 24 hours if the SBSD's net capital or tentative net capital (as applicable) falls below 120% of the SBSD's minimum net capital or tentative net capital requirement. An MSBSP is required to provide notice within 24 hours if its tangible net worth falls below $20 million. *See* 17 CFR 240.18–8(b).

transfer provisions of regulation 1.65 by expanding from 5 to 10 days the advance notice that an FCM or an IB must provide to the Commission prior to the transfer. The Commission is further revising the bulk transfer rules to provide that the notice of the bulk transfer must be filed with the Commission electronically, and delegating the authority to accept delivery of such notice in a period shorter than 10 days to the Director of the Division of Swap Dealer and Intermediary Oversight, provided that the notice must be provided as soon as practicable and in no event later than the day of the transfer.

The Commission also proposed specific quantitative liquidity requirements for certain SDs. As discussed in section II.C.8. below, the Commission has determined to defer consideration of the proposed liquidity requirements at this time. Accordingly, the Commission is not adopting the proposed liquidity requirements in this final rulemaking. SDs will continue to be subject to the existing risk management program requirements, including the liquidity requirements, set forth in regulation 23.600.

The Commission intends to monitor the impact of the capital and financial reporting requirements being adopted today using data received from covered SDs and covered MSPs once they are subject to these capital and financial reporting requirements. Information that the Commission will receive and observe includes data regarding the level of capital that the covered SDs and covered MSPs are required to maintain, the level of capital actually maintained, the liquidity that the firms maintain, the leverage the firms employ, and the scale and types of swaps and other transactions that they are engaged in. The Commission also will continue to consult with the prudential regulators and the SEC to assess the capital adequacy of SDs, MSPs, SBSDs, and MSBSPs. The Commission will monitor the data resulting from the adoption of today's rules and general market events and consider modifications to the capital and financial reporting requirements in light of this information. The Commission also will monitor the information that it receives to assess the adequacy of the liquidity of SDs and, if appropriate, will consider proposing additional liquidity requirements as necessary.

B. Proposed Rulemakings and Reopening of the Comment Period

The Commission initially proposed capital and financial reporting requirements for covered SDs and covered MSPs in 2011.[21] The Commission received comments from a broad spectrum of market participants, industry representatives, and other interested parties. The commenters addressed numerous topics including the permissible use of models for computing market risk and credit risk capital charges and the need for harmonization of the Commission's capital and financial reporting requirements for covered SDs with the capital and financial reporting rules of the prudential regulators for bank SDs and with the rules of the SEC for nonbank SBSDs. Commenters particularly emphasized a need for the harmonization of regulatory requirements for covered SDs that also are registered with the SEC as SBSDs.

Shortly after the Commission issued the *2011 Capital Proposal,* the Basel Committee on Banking Supervision (''BCBS'') and the International Organization of Securities Commissions, in consultation with the Committee on Payment and Settlement Systems and the Committee on Global Financial Systems, formed a working group (the ''WGMR'') to develop internationally harmonized standards for margin requirements for uncleared swaps. Representatives of more than 20 regulatory authorities participated in the WGMR including the Commission, the SEC, Federal Reserve Board, OCC, FDIC, and the Federal Reserve Bank of New York. The Commission elected to defer consideration of the SD and MSP capital and financial reporting rules until the WGMR had completed its work and the Commission had adopted margin requirements for uncleared swap transactions. As noted above, the Commission subsequently adopted final margin requirements for uncleared swaps in December 2015, and the compliance period for the final rules is being phased-in through 2021.[22]

In 2016, in consideration of the substantial amount of time that had passed since the *2011 Capital Proposal,* the Commission re-proposed the capital and financial reporting rules for SDs and MSPs to provide commenters with an opportunity to provide further comment in recognition of the significant developments in the swaps marketplace since the *2011 Capital Proposal.*[23] These marketplace developments included more than 100 entities provisionally registering with the Commission as SDs, the Commission adopting final margin rules for uncleared swaps, the prudential regulators adopting final capital and margin rules for swap and security-based swap transactions, and the SEC proposing capital, margin, segregation and financial reporting requirements for SBSDs and MSBSPs.

The Commission again received comments from a broad spectrum of market participants and other interested parties. The commenters raised several issues with regards to the *2016 Capital Proposal,* including the appropriateness of basing a capital requirement on initial margin requirements, the appropriateness of a liquidity requirement for covered SDs, the use of models to compute market risk and credit risk capital charges, and the need for harmonization of the Commission's rules with the rules of the prudential regulators and the SEC. Commenters also requested that the Commission provide an additional opportunity for public comment on the *2016 Capital Proposal* once the SEC finalized its capital, margin, and financial reporting requirements for SBSDs and MSBSPs. The commenters noted the particular necessity for an opportunity to provide further comment on the *2016 Capital Proposal* as the Commission's Proposal would permit a covered SD to compute its capital as if it were a SBSD subject to the SEC's SBSD capital requirements. The commenters noted that the SEC had received many substantial comments on its proposed nonbank SBSD and nonbank MSBSP capital requirements. The commenters further stated that they would need to review the SEC's final capital, margin and financial reporting rules, including the SEC's response to the many comments on its proposal, in order to provide full comments on the *2016 Capital Proposal.*

The Commission ultimately reopened the comment period for the *2016 Capital Proposal.*[24] The *2019 Capital Reopening*

[21] *See Capital Requirements of Swap Dealers and Major Swap Participants,* 76 FR 27802 (May 12, 2011) (the ''*2011 Capital Proposal*'').

[22] *See* 81 FR 636 (Jan. 6, 2016) and Commission regulation § 23.161 (17 CFR 23.161)). The Commission also has proposed to extend the compliance date for the final phase-in period to September 1, 2022. *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* 85 FR 41463 (July 10, 2020).

[23] *Capital Requirements of Swap Dealers and Major Swap Participants,* 81 FR 91252 (Dec. 16, 2016) (the ''*2016 Capital Proposal*'' or the ''Proposal''). The comment letters for the *2016 Capital Proposal* are available at: *https://comments.cftc.gov/PublicComments/CommentList.aspx?id=1769* (the public comment file). Commenters included financial services associations, agricultural associations, energy associations, insurance associations, banks, brokerage firms, investment managers, insurance companies, pension funds, commercial end users, law firms, public interest organizations, and other members of the public.

[24] *See Capital Requirements of Swap Dealers and Major Swap Participants,* 84 FR 69664 (Dec. 16,

Continued

was published after the SEC had adopted final capital, margin, segregation, and financial reporting requirements for SBSD and MSBSPs. Accordingly, the *2019 Capital Reopening* provided interested parties with an additional opportunity to provide comments on the *2016 Capital Proposal* after the SEC finalized its capital and financial reporting rules.

One commenter stated that the Commission could not finalize the *2016 Capital Proposal* due to the lack of cost benefit analysis related to additional questions contained in the *2019 Capital Reopening* and was unable to fully assess the potential modifications to the proposed rules without re-proposal.[25] The commenter further argued that the *2019 Capital Reopening* contained only questions and requests for comment with no specific rule text or accompanying explanation, including evaluation of costs and benefits as the commenter believed required. As a result of this, the commenter posited any final rulemaking following the *2019 Capital Reopening* failed to provide adequate notice of identifiable regulatory outcomes to commenters and therefore, would not satisfy APA considerations for notice and comment rulemaking.[26] The Commission disagrees. The *2019 Capital Reopening* provided an additional opportunity for commenters to address aspects of the *2016 Capital Proposal* in light of the SEC's final capital rule for SBSDs and MSBSPs, which was itself incorporated by reference into the *2016 Capital Proposal.*

In 2016, the Commission re-proposed the SD Capital rules for a second time.[27] In that release, the Commission specifically noted that it had considered the comments from the 2011 proposal in developing the *2016 Capital Proposal.*[28] The *2016 Capital Proposal* again proposed complementary financial reporting rules and recognized the expected use of models. Further, the Commission stated at the time that it had also considered capital rules adopted by the prudential regulators and capital rules proposed by the SEC for security-based swap dealers and major security-based swap participants.[29] As such, the Commission specifically said that it had to a great extent drawn upon the SEC capital rules in developing the proposed capital requirements.[30] The *2019 Capital Reopening* did not change the 2016 proposed framework, which has largely remained intact since the original proposal in 2011—such as, what method an entity could use to calculate its required capital and the various capital minimums dependent upon the characteristics of the registered entity, while seeking to maintain comparability to the other capital regimes of the Prudential Regulators and the SEC, as statutorily required. The *2019 Capital Reopening* sought to specifically respond to commenters who had asked for an additional opportunity to comment on the *2016 Capital Proposal* following the finalization of capital rules for SBSDs by the SEC. It gave commenters the opportunity to provide their views on whether certain items should be included or how the process should account for them.[31] Each of the areas addressed in the *2019 Capital Reopening* signaled potential modifications that the Commission was considering in light of comments received, including modifications adopted by the SEC.[32] Modifications in the final rule, including a discussion and specific inclusion of various approaches, are therefore the logical outgrowth of the *2016 Capital Proposal.*

In addition, the *2016 Capital Proposal* included a comprehensive cost benefit consideration section, addressing the Section 15(a) factors in detail. The cost-benefit analysis discussed an elective approach utilizing similar tailored minimums depending on the characteristics of the registered entity—a net liquid asset approach incorporating the traditional FCM and SEC registered broker or dealer (''BD'') capital framework, a bank-based approach incorporating again the risk-weighted assets framework from banking rules, and again a tangible net worth approach for certain eligible firms. The *2016 Capital Proposal* again proposed complementary financial reporting rules and recognized the expected use of models. The public was asked to comment on all aspects of the proposal, and several comments were received in response. A more fulsome discussion is in the Cost-Benefit Consideration section of this document; however, as noted above, the potential modifications described in the *2019 Capital Reopening,* including a discussion and specific inclusion of potential rule language, were logical outgrowths of the *2016 Capital Proposal.*

C. Consultation With U.S. Securities and Exchange Commission and Prudential Regulators

The Dodd-Frank Act amended the CEA and the Exchange Act to require the Commission, SEC, and prudential regulators to coordinate and develop comparable capital requirements for SDs and SBSDs, and for MSPs and MSBSPs. Section 4s(e)(3)(D) of the CEA (7 U.S.C. 6s(e)(3)(D), in conjunction with section 15F(e)(3)(D) of the Exchange Act (15 U.S.C. 78o–10(e)(3)(D)), provides that, to the maximum extent practicable, the Commission, SEC and the prudential regulators shall establish and maintain comparable minimum capital requirements for SDs and SBSDs, and for MSPs and MSBSPs. Further, section 4s(e)(3)(D) and section 15F(e)(3)(D) provide that staff of the CFTC, SEC, and prudential regulators shall meet periodically, but no less frequently than annually, to consult on minimum capital requirements. Consistent with this Congressional mandate, the respective staffs of the Commission, SEC, and the prudential regulators have regularly shared drafts of proposed and final rulemakings with staffs of the other agencies for review and comment before taking final action with respect to the proposed or final rulemakings. Consistent with this approach, the Commission provided the SEC and prudential regulators with drafts of the final rules for review and comment, and the final rulemaking reflects comments received from the SEC and prudential regulators.

II. Final Regulations and Amendments to Existing Regulations

A. Capital Framework for FCMs, Covered SDs, and Covered MSPs

FCMs are subject to existing capital requirements set forth in regulation 1.17. The Commission is amending regulation 1.17 to establish capital requirements explicitly for swap and security-based swap transactions entered into by FCMs. The Commission is also amending regulation 1.17 to require an FCM–SD to comply with the amended FCM capital requirements. A discussion of the amendments to

2019) (the ''*2019 Capital Reopening*''). The comment letters for the *2019 Capital Reopening* are available at: *https://comments.cftc.gov/PublicComments/CommentList.aspx?id=1769* (the public comment file). Commenters included financial services associations, agricultural associations, energy associations, insurance associations, banks, brokerage firms, investment managers, insurance companies, pension funds, commercial end users, law firms, public interest organizations, and other members of the public.

[25] *See* Letter From Dennis M. Kelleher, President and CEO, Better Markets Inc. (March 3, 2020) (Better Markets 3/3/2020 Letter).

[26] *Id.* at page 7.

[27] 81 FR 91252 (Dec. 16, 2016).

[28] *Id.* at 91254.

[29] *Id.* In this regard, Section 4s(e)(3)(D) of the CEA provides that the CFTC, SEC, and prudential regulators shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements for SDs and MSPs.

[30] *Id.*

[31] *See* 84 FR 69665.

[32] *Id.*

regulation 1.17 for FCMs and FCM–SDs is contained in section II.B. of this release.

The Commission is also adopting final capital rules for covered SDs that are not FCM–SDs, and is adopting final capital rules for covered MSPs. The Commission is adopting a flexible approach that allows covered SDs to elect one of three alternative capital frameworks for establishing their minimum capital requirements and for computing their regulatory capital. The three alternative approaches draw to a great extent on the existing CFTC capital requirements for FCMs contained in regulation 1.17, as well as the SEC's capital requirements for BDs and nonbank SBSDs, and the prudential regulators' capital requirements for bank SDs. Specifically, the Commission's final capital rules, depending on the characteristics of a covered SD, permit such SD to elect: (i) A capital requirement consistent with the SEC's final capital requirements for SBSDs, as well as the existing CFTC capital rules for FCMs and the existing SEC capital rules for BDs (the ''Net Liquid Assets Capital Approach''); (ii) a capital requirement consistent with the prudential regulators' capital requirements for bank SDs, and that is based on existing Federal Reserve Board capital requirements for bank holding companies (the ''Bank-Based Capital Approach''); or (iii) a capital requirement based on the covered SD's tangible net worth, provided that the covered SD or its parent entity is predominantly engaged in non-financial activities as defined in the rule (the ''Tangible Net Worth Capital Approach''). Each of the approaches is discussed in section II. below.

With respect to covered MSPs, the Commission is adopting a minimum regulatory capital requirement based upon the tangible net worth of the MSP. While there currently are no provisionally-registered MSPs or entities pending registration as MSPs, the Commission is adopting final capital requirements in the event that entities seek registration in the future. A capital requirement based upon the tangible net worth of the MSP is consistent with the approach adopted by the SEC for nonbank MSBSPs, as discussed in section II.C.5. of this release.

Broadly speaking, in developing the proposed capital requirements, the Commission strived to advance the statutory goal of helping to protect the safety and soundness of covered SDs and covered MSPs, while also taking into account the diverse nature of the entities registered as SDs, and the existing capital regimes that apply to covered SDs and/or their financial group. In this regard, as of June 30, 2020, there were 108 provisionally registered SDs. Fifty-two of the provisionally registered SDs are bank SDs, subject to a prudential regulator. The remaining 56 SDs are covered SDs, subject to the Commission's capital rules. While each of the 56 covered SDs is registered with the Commission as a result of their swap dealing activities, the SDs represent a broad range of business activities and a diverse population of swap counterparties. Several of the covered SDs are primarily engaged in commodity-focused swap transactions with commercial counterparties, while other covered SDs are focused primarily with financial related swaps, including interest rate, foreign currency, and credit default swaps, and have a broad range of swaps counterparties that includes both commercial and financial counterparties.

The 56 covered SDs subject to the Commission's capital requirements are associated with 21 corporate families, with several families having more than 1 provisionally-registered covered SD. Many of these corporate families are part of U.S. bank or foreign bank holding companies that offer global financial services and are subject to prudential capital regulation, including BCBS-based capital requirements that may extend to some of the provisionally-registered covered SDs. The alternative capital approaches adopted by the Commission are intended to mitigate potential competitive disadvantages and unnecessary costs that might otherwise arise if the Commission were to impose a single capital approach in light of the existing different operating and corporate structures of the covered SDs. The Commission further believes that the flexibility of the capital approaches will potentially benefit market participants by providing a tailored capital regime that encourages SDs that are not part of global financial firms to continue to provide liquidity in the swaps market, particularly to smaller financial or commercial end users that do not have relationships with the large financial SDs.

As mentioned above, FCM–SDs are subject to the FCM capital requirements set forth in regulation 1.17. Covered SDs that are not FCM–SDs and covered MSPs that are not FCM–MSPs are subject to the final capital requirements set forth in regulation 23.101. Regulation 23.101 details the minimum capital requirements for each of the three capital approaches for covered SDs and the eligibility criteria (as applicable), and further defines the capital computations for each approach, including various market risk and credit risk capital charges. Regulation 23.101 also defines the minimum capital requirements for covered MSPs and defines the capital computation for covered MSPs. Each of these capital approaches is discussed below.

B. Capital Requirements for Stand-Alone FCMs and FCM–SDs

1. Introduction to General Capital Requirements for Stand-Alone FCMs and FCM–SDs

The capital requirements for FCMs are set forth in regulation 1.17 and require each FCM to maintain a minimum level of ''liquid assets'' in excess of the firm's liabilities to provide resources for the FCM to meet its financial obligations as a market intermediary in the regulated futures and cleared swaps markets. As a market intermediary, an FCM provides services to its customers and the marketplace, including, in the event of a customer default, guaranteeing the financial performance of each customer to clearing organizations that clear the customers' futures and cleared swap transactions. To ensure that an FCM is capable of meeting its financial obligations, regulation 1.17 requires an FCM to hold at all times more than one dollar of highly liquid assets for each dollar of liabilities (*e.g.,* money owed to customers, counterparties and creditors), excluding certain subordinated debt.[33] The FCM capital requirements also are intended to ensure that an FCM maintains a sufficient level of liquid assets in excess of its liabilities in order to effectively and efficiently wind-down its operations by transferring customer positions and funds to other FCMs in the event that the FCM voluntarily or involuntarily ceases operations.

The FCM capital requirement contains two components. The first component is a minimum level of ''adjusted net capital'' that an FCM is required to maintain at any given time. The minimum adjusted net capital requirement is generally the greater of the following: (i) A fixed-dollar amount; (ii) an amount computed based upon the clearing organization margin imposed on customer and noncustomer futures, foreign futures, and cleared swap

[33] Commission regulation § 1.17(h) (17 CFR 1.17(h)) permits an FCM to exclude certain qualifying subordinated debt from its liabilities in computing its net capital. In order to qualify, the person lending cash to the FCM must subordinate its claim against the FCM to all other creditors of the FCM in addition to agreeing to other conditions, including potential restrictions associated with scheduled repayments of the debt.

positions carried by the FCM; (iii) the amount of net capital required by the SEC for FCMs that are dually-registered as BDs (''FCM/BDs''); or, (iv) the amount of adjusted net capital required by an RFA of which the FCM is a member.[34]

The second component of the FCM capital requirement is the amount of adjusted net capital that an FCM actually maintains based upon the assets and liabilities of the firm. In determining its adjusted net capital, an FCM is first required to compute its net worth under generally accepted accounting principles (''GAAP'') as adopted in the United States, and then is required to apply certain rule-based adjustments to reduce its net worth to the extent it contains illiquid assets such as fixed assets and unsecured receivables. The resulting calculation reflects the FCM's ''net capital.'' The FCM is then required to apply certain rule-based capital charges or haircuts to reflect market risk associated with its liquid assets. The resulting calculation reflects the FCM's ''adjusted net capital.'' The calculation of adjusted net capital in this manner is intended, as noted above, to ensure that the FCM holds at least one dollar of highly liquid assets to meet each dollar of liabilities, excluding certain qualifying subordinated liabilities.

The Commission proposed several amendments to regulation 1.17 in recognition that the current capital requirements do not explicitly reflect FCMs transacting in uncleared swap or security-based swap transactions, or engaging in swap dealing activities. The Commission also proposed to require FCM–SDs to comply with the FCM capital requirements.[35] The Commission proposed to require FCM–SDs to comply with regulation 1.17 due to the Commission's experience regulating FCMs and its belief that the FCM capital requirements, with its emphasis on liquidity, are well-designed to ensure that an FCM will be able to continue to perform its critical functions in the futures and cleared swaps marketplace. As noted above, FCMs are market intermediaries that provide customers with access to the futures and cleared swaps markets. As market intermediaries, FCMs play a central role in the daily settlement process at derivatives clearing organizations by paying or collecting their customers' initial and variation margin obligations. FCMs also guarantee their customers' financial performance to each DCO, and contribute to DCO guarantee funds. FCMs also provide numerous services for their customers, including providing confirmations of each transaction and periodic account statements. Based on its experience with FCMs, the Commission believes that the FCM capital rule, which is a liquidity-based capital rule, is appropriate for FCM–SDs.

2. Minimum Capital Requirement for FCMs and FCM–SDs

a. Minimum Fixed-Dollar Amount of Net Capital

Regulation 1.17(a)(1)(i) requires an FCM to maintain a minimum amount of adjusted net capital that is equal to or greater than the highest of: (i) $1 million; (ii) for an FCM that engages in off-exchange foreign currency transactions with retail forex customers,[36] $20 million, plus 5% percent of the FCM's liabilities to the retail forex customers that exceed $10 million; (iii) 8% percent of the sum of the risk margin of futures, options on futures, foreign futures, and swap positions cleared by a clearing organization and carried by the FCM in customer and noncustomer accounts; (iv) the amount of adjusted net capital required by the RFA of which the FCM is a member; and (v) for an FCM that is also registered with the SEC as a BD, the amount of net capital required by the rules of the SEC.[37]

The term ''risk margin'' is defined in regulation 1.17(b)(8) as the level of maintenance margin or performance bond required for the customer or noncustomer positions by the applicable exchanges or clearing organizations, and, where margin or performance bond is required only for accounts at the clearing organization, for purposes of the FCM's risk-based capital calculations applying the same margin or performance bond requirements to customer and noncustomer positions in accounts carried by the FCM, subject to the following: (i) Risk margin does not include the equity component of short or long option positions maintained in an account; (ii) the maintenance margin or performance bond requirement associated with a long option position may be excluded from risk margin to the extent that the value of such long option position does not reduce the total risk maintenance or performance bond requirement of the account that holds the long option position; (iii) the risk margin for an account carried by an FCM which is not a member of the exchange or the clearing organization that requires collection of such margin should be calculated as if the FCM were such a member; and (iv) if an FCM does not possess sufficient information to determine what portion of an account's total margin requirement represents risk margin, all of the margin required by the exchange or the clearing organization that requires collection of such margin for that account, shall be treated as risk margin.[38]

The Commission proposed amending regulation 1.17(a)(1)(i)(A) to increase the minimum fixed-dollar amount of adjusted net capital from $1 million to $20 million for FCM–SDs. The Commission did not propose to amend the required minimum fixed-dollar amount of adjusted net capital for stand-alone FCMs that may engage in swap activities at a level that does not require registration as an SD, as the Commission believed that the existing minimum fixed-dollar amount of required adjusted net capital was properly calibrated for such firms.

The Commission believes that the proposed higher minimum dollar amount of adjusted net capital for FCM–SDs is appropriate given the enhanced risk that an FCM–SD assumes in engaging in swap dealing activities, while also continuing to carry futures and cleared swaps customers.[39] As noted above, FCMs act primarily as market intermediaries for futures and cleared swaps customers and typically do not use their balance sheet to facilitate customer transactions. Absent a customer default, an FCM does not take on market risk of its customers' positions in performing this market intermediary function. FCMs that are FCM–SDs, however, are engaging in swap dealing activities. As dealers, FCM–SDs use their balance sheet to facilitate customer transactions as they are counterparties on swap positions in addition to performing market intermediary functions for their customers. Dealing activities present additional risks to FCM–SDs. As dealers, an FCM–SD is potentially exposed to market risks on uncleared

[34] *See* Commission regulation § 1.17(a)(1)(i) (17 CFR 1.17(a)(1)(i)).

[35] Section 4s(e)(3)(B)(i) of the CEA (7 U.S.C. 6s(e)(3)(B)(i)) states that nothing in section 4s(e) imposing capital and margin requirement on SDs and MSPs limits, or shall be construed to limit, the authority of the Commission to set financial responsibility rules for FCMs pursuant to section 4f(a).

[36] Commission regulation § 5.1(k) (17 CFR 5.1(k)) defines the term ''retail forex customer'' as a person, other than an eligible contract participant as defined in section 1a(18) of the CEA, acting on its own behalf in any account agreement, contract or transaction described in section 2(c)(2)(B) or 2(c)(2)(C) of the CEA (7 U.S.C. 2(c)(2)(B) or 2(c)(2)(C)).

[37] *See* Commission regulation § 1.17(a)(1)(i) (17 CFR 1.17(a)(1)(i)).

[38] Commission regulation § 1.17(b)(8) (17 CFR 1.17(b)(8)).

[39] *2016 Capital Proposal,* 81 FR 91252.

swap positions, and is exposed to counterparty credit risk from swap counterparties. FCM–SDs also may be required to post initial margin and pay variation margin to swap counterparties on a daily basis for their proprietary uncleared swap positions. The proposed increase in the fixed-dollar amount of the minimum adjusted net capital was intended to address the potential increase in risks posed to FCM–SDs from dealing activities, including the impact that dealing may have on the liquidity of FCM–SDs. The proposed increase in the minimum capital requirement also was intended to otherwise help ensure the safety and soundness of the FCM–SD, as the insolvency of an FCM–SD could have potential adverse consequences to the efficient operation of the market, particularly as the insolvency impacts the futures and cleared swaps customers of the FCM–SD. The Commission further noted that the proposed $20 million minimum adjusted net capital requirement was consistent with the $20 million minimum dollar amount of adjusted net capital imposed by Congress and the Commission on retail foreign exchange dealers (''RFEDs'') or FCMs that enter into off-exchange foreign currency transactions with retail persons under section 2(c)(2)(C) of the CEA and regulation 5.7(a).

The Commission also proposed amending regulation 1.17(a)(1)(ii) to require an FCM–SD that receives approval from the Commission or from an RFA of which it is a member to use internal market risk or credit risk models to compute capital charges in lieu of the standardized capital charges or deductions to maintain net capital equal to or in excess of $100 million, and adjusted net capital equal to or in excess of $20 million. The requirement to maintain a minimum $100 million fixed-dollar amount of net capital was intended to address the issue that while models are more risk sensitive and generally result in substantially lower market risk and credit risk capital charges than standardized charges, models may not capture all risks, including extreme market losses (*i.e.,* tail risk) or liquidity concerns. The requirement for an FCM–SD that is approved to use capital models to maintain a minimum of $100 million of net capital and $20 million of adjusted net capital is consistent with the SEC's final capital rule for SBSDs that are not registered BDs (''stand-alone SBSDs'') and that are approved to use internal models to compute market risk and credit risk capital charges. These entities are required to maintain fixed-dollar tentative net capital of $100 million and fixed-dollar net capital of $20 million.[40]

The Commission did not receive comment on the proposed $20 million fixed-dollar amount of adjusted net capital required of FCM–SDs. The Commission received a comment stating that the proposed $100 million net capital requirement for FCM–SDs that have approval to use internal models to compute market risk or credit risk capital charges in lieu of the standardized capital charges would create an unnecessary barrier to entry.[41]

The Commission has considered the proposed amendments of the minimum fixed-dollar amount of net capital and adjusted net capital that FCM–SDs would be required to maintain and is adopting the amendments as proposed.[42] As noted above, FCMs play a central role as market intermediaries for futures and cleared swaps transactions, including guaranteeing each customer's financial performance to clearing organizations or carrying FCMs. An adequate level of capital is necessary to ensure that FCMs meet their financial obligations, which in turn promotes customer protection and helps ensure the cleared futures and cleared swaps markets operate efficiently. The increase in adjusted net capital for FCM–SDs to $20 million is also necessary to address the additional risk that is inherent in an SD's dealing activities. As a dealer, an FCM–SD uses its balance sheet to facilitate customer swap transactions, is a counterparty in swap transactions, and is obligated to post and collect initial margin and settle variation margin with swap counterparties. Furthermore, the final requirement for an FCM–SD to maintain a minimum of $20 million of adjusted net capital is consistent with the Commission's required minimum adjusted net capital of $20 million for RFEDs, and is consistent with the SEC's final minimum capital requirements for SBSDs.

With respect to the comment that a $100 million minimum net capital requirement for FCM–SD's seeking approval to use capital models may act as a barrier to entry, the Commission notes that the regulation was designed to account for the fact that model-based market risk and credit risk capital charges, while more risk sensitive than standardized capital charges, tend to be substantially lower than standardized charges. The $100 million of net capital is intended to address potential model errors and tail risk and other factors that may not be fully or accurately captured in the models. The Commission further notes that currently the only FCM–SDs provisionally registered are four BD/FCMs that are subject to substantially higher minimum capital requirements under SEC and CFTC rules as discussed in section II.B.3.c.(i). below. Accordingly, no provisionally-registered FCM–SD will be subject to the $100 million minimum net capital requirement based on the current list of provisionally registered SDs.

b. Minimum Capital Requirement Based on 8% Risk Margin Amount

Another component of the minimum capital requirements in regulation 1.17 provides that each FCM must maintain adjusted net capital equal to or greater than 8% of the risk margin amount associated with the futures, foreign futures, and cleared swaps positions carried by the FCM in customer and noncustomer accounts.[43] As discussed in section II.B.2.a. above, the term ''risk margin'' for an account generally means the level of maintenance margin or performance bond required for customer and noncustomer positions by the applicable exchanges or clearing organizations.[44] Clearing organizations generally set initial margin requirements for futures, foreign futures, and cleared swap positons at a level to cover one-day market moves with a 99% level of confidence.[45]

In computing the 8% risk margin amount, an FCM is required to compute risk margin on the positions of each customer on a customer-by-customer basis, and multiply the resulting aggregate risk margin amount by 8%. The 8% risk margin amount is a risk

[40] *See* SEC rule 18a–1(a)(2) (17 CFR 240.18a–1(a)(2)).

[41] *See* Letter from Joanna Mallers, FIA Principal Traders Group (May 24, 2017) (FIA–PTG 5/24/2017 Letter).

[42] The *2019 SEC Final Capital Rule* requires BDs that use internal models to compute market risk and credit risk capital charges in lieu of standardized capital charges to maintain $5 billion of net capital and $1 billion of adjusted net capital. FCM/SDs that also are registered with the SEC as BDs are required to comply with the SEC's capital requirements in meeting the Commission's minimum capital requirement.

[43] A noncustomer account is an account that an FCM carries for persons that generally are officers or employees of the FCM (*i.e.,* the persons are not customers of the FCM and the account is not the proprietary account of the FCM). *See* Commission regulation § 1.17(b)(4) (17 CFR 1.17(b)(4)).

[44] *See* Commission regulation § 1.17(b)(8) (17 CFR 1.17(b)(8)).

[45] *See,* for example, Commission regulation § 39.13(g) (17 CFR 39.13(g)) which provides that a derivatives clearing organization must set margin for futures and swaps on agricultural commodities, energy commodities, and metals using a one-tailed 99% confidence interval with a minimum one-day liquidation period, and must set margin for all other swaps using a one-tailed 99% confidence interval with a minimum five-day liquidation period.

sensitive calculation in that an FCM's minimum capital requirement is tied to the level of exchange or clearing organization margin associated with each customer's and noncustomer's account. Accordingly, an FCM's minimum capital requirement increases or decreases as the aggregate of its customer and noncustomer risk margin increases or decreases. The 8% risk margin amount is also a volume-based metric as it requires an FCM to compute the risk margin amount on each individual customer and noncustomer account, with no offsets between accounts to reflect offsetting positions or to reflect margin collected on the accounts. As a volume-based metric, an FCM's minimum capital requirement increases or decreases based upon the aggregate amount of risk margin required of each customer and noncustomer account carried by the FCM.

The Commission proposed amending the minimum capital requirement in regulation 1.17(a)(1)(i)(B) by expanding the types of positions that an FCM–SD must include in the 8% risk margin amount calculation. The Commission did not propose to expand the types of positions that must be included in the risk margin amount calculation for stand-alone FCMs. An FCM that is not an FCM–SD must continue to calculate the 8% risk margin amount based upon the customer and noncustomer futures, foreign futures, and cleared swap positions carried by the FCM.[46]

Regulation 1.17(a)(1)(i)(B) currently requires an FCM, as noted above, to include the risk margin associated with the futures, foreign futures, and cleared swap positions carried in customer and noncustomer accounts in the 8% risk margin amount calculation. The *2016 Capital Proposal* expanded the list of products that an FCM–SD must include in the 8% risk margin amount calculation to further include the cleared security-based swap positions carried for customers and noncustomers, as well as the FCM–SD's proprietary cleared swaps and proprietary cleared security-based swap positions. The positions in the risk margin amount calculation was proposed to be further extended to include the FCM–SD's uncleared swap and uncleared security-based swap positions.

The Proposal required an FCM–SD to include all swaps and security-based swaps in the risk margin amount calculation, including swaps that are excluded from the Commission's margin rules for uncleared swaps and any security-based swaps that the SEC excluded from its margin rules. Specifically, the proposal provided that an FCM–SD must include in its computation of the risk margin amount each outstanding uncleared swap, including swaps exempt from the scope of the Commission's uncleared swaps margin rules by regulation 23.150 (''TRIPRA Exemption),[47] legacy swaps, foreign exchange swaps as the term is defined in regulation 23.151, or netting set of swaps or foreign exchange swaps, for each counterparty, as if the counterparty were an unaffiliated SD. The Proposal further required an FCM–SD to include the initial margin for all uncleared swaps that would otherwise fall below the $50 million initial margin threshold amount or the $500,000 minimum transfer amount, as defined in regulation 23.151, for purposes of computing the uncleared swap margin amount.[48]

The Commission received comments on various aspects of the proposed 8% risk margin amount calculation for FCM–SDs. Commenters to the *2016 Capital Proposal* and the *2019 Capital Reopening* objected to including cleared and uncleared security-based swaps in the 8% risk margin amount calculation for FCM–SDs.[49] Commenters stated that the Commission should not include security-based swaps in the 8% risk margin amount calculation as security-based swaps are products regulated by the SEC, and that including SEC-regulated products in the Commission's minimum capital requirement is inconsistent with long-standing CFTC and SEC capital requirements for FCMs and BDs.[50]

A commenter noted that a dually-registered FCM/BD is generally required to maintain adjusted net capital equal to the greater of (i) 8% of the margin required for futures, foreign futures, and cleared swaps carried by the FCM for customers and noncustomers, or (ii) 2% of the debit items calculated in respect of the BD's customer securities positions.[51] The commenter further stated that the approach of setting separate, as opposed to aggregate, requirements for Commission and SEC regulated products allows the agency that Congress selected to regulate a given product to determine the appropriate balance between robust capital cushions and robust market liquidity.[52]

The commenter further noted that the *2019 SEC Final Capital Rule* continued this historical approach as the SEC elected to include in its minimum capital requirement the initial margin associated only with customer and noncustomer cleared security-based swaps and the SBSD's uncleared security-based swaps.[53] The SEC's final rule did not incorporate initial margin associated with customer cleared swap positions or uncleared swap positions, or otherwise include positions that are not subject to the SEC's jurisdiction.

One commenter stated that FX forwards and swaps should be excluded from the 8% risk margin amount calculation as Congress gave the United States Treasury Department the authority over these products.[54]

The Commission has considered the proposal and the comments received, and is adopting a minimum capital requirement based upon a percentage of the risk margin amount. The Commission is modifying the final rule, however, to exclude cleared security-based swap and uncleared security-based swap positions from the risk margin amount calculation. The Commission acknowledges that in setting minimum capital requirements for FCMs, including FCMs that are dually-registered as FCM/BDs, it has historically considered only the futures related activities of an FCM. In this regard, the Commission's initial minimum capital requirement was based upon a percentage of futures customer and noncustomer funds held by an FCM, and was subsequently

[46] A commenter noted an ambiguity in the *2016 Capital Proposal* in that the Commission stated in the preamble that the proposed increases in the minimum capital requirements would be applicable only to FCM–SDs and not to stand-alone FCMs, but that the proposed rule text in Commission regulation § 1.17 did not clearly draw that distinction. *See* Letter from Walt Lukken, Futures Industry Association, March 3, 2020 (FIA 3/3/2020 Letter). The Commission confirms that the proposed increases in the minimum capital requirements were only applicable to FCM–SDs, and has modified the final rule text to clarify this point.

[47] Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 amended sections 731 and 764 of the Dodd-Frank Act to provide that the Commission's margin requirements shall not apply to a swap in which a counterparty: (i) Qualifies for an exception under section 2(h)(7)(A) of the CEA; (ii) qualifies for an exemption issued under section 4(c)(1) of the CEA for cooperative entities as defined in such exemption; and (iii) satisfies the criteria in section in section 2(h)(7)(D) of the CEA. *See* Public Law 114–1, 129 Stat. 3.

[48] *2016 Capital Proposal,* 81 FR 91252 at 91258.

[49] *See* FIA 3/3/2020 Letter; Letter from Briget Polichene, Institute of International Bankers, Scott O'Malia, International Swaps and Derivatives Association, and Kenneth Bentsen, Jr., Securities Industry and Financial Markets Association (March 3, 2020) (IIB/ISDA/SIFMA 3/3/2020 Letter).

[50] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] *See* Letter from Joanna Mallers, FIA Principal Traders Group (March 3, 2020) (FIA–PTG 3/3/2020 Letter).

amended to be based upon a percentage of the risk margin associated with futures and cleared swaps customer and noncustomer positions carried by an FCM.[55] The Commission has not historically required an FCM/BD to maintain a level of minimum capital necessary to meet the aggregate of the CFTC's minimum requirement and the SEC's minimum requirement, which is based on the FCM/BD's securities activities.

The Commission believes that the overall adequacy of the minimum capital requirement at an FCM–SD should be based upon the activities of the FCM–SD in CFTC-regulated markets. This allows the Commission to monitor the adequacy of the minimum capital requirements based upon its expertise and experience with Commission-regulated products and markets. In addition, an FCM–SD that is also registered as a BD would continue to be subject to the minimum capital requirements established by the SEC for BDs in addition to the minimum capital requirements established by the Commission for FCM–SDs. The Commission's current capital rule requires an FCM/BD to maintain a minimum level of capital that is greater than the higher of the CFTC minimum requirement for FCMs or the SEC minimum requirement for BDs.[56] Therefore, an FCM–SD that is registered as a BD will have to maintain minimum capital in an amount based upon the greater of the CFTC or SEC minimum requirement. This would help ensure the safety and soundness of the FCM–SD by providing readily available financial resources to address operational, legal, compliance, or other risks, and, if necessary, by providing financial resources to assist with the orderly liquidation of the FCM–SD in the event of its insolvency.

Commenters also stated that the Commission's proposed inclusion of the proprietary futures and proprietary cleared swap positions in an FCM–SD's 8% risk margin amount calculation would duplicate existing capital charges required under regulation 1.17.[57] The commenters noted that regulation 1.17(c)(5)(x) currently requires an FCM to take a capital charge in an amount equal to 100% or 150% of the margin required by a clearing organization for proprietary futures and cleared swap positions[58] in computing its adjusted net capital.[59] Another commenter stated that including margin associated with proprietary cleared swaps in the 8% risk margin amount was not necessary as proprietary cleared positions present minimal credit risk to an FCM–SD as the only credit exposure is to a clearing organization or broker.[60] The proprietary futures and cleared swaps capital charge also would apply to FCM–SDs under the Commission's Proposal, as FCM–SDs are required to comply with regulation 1.17. One commenter also stated that the SEC in its final rules requires a BD or SBSD to take a standardized capital charge for cleared security-based swaps equal to 100% of the margin required by a clearing agency, and does not impose a 150% charge for positions held by non-clearing BDs or SBSDs.[61] The commenter stated that if the Commission adopts this capital charge, it should do so in a manner that is consistent with the SEC's final rule.

The Commission has reconsidered the Proposal and the comments received and is modifying final regulation 1.17(a)(1)(i)(B) to not include proprietary futures, foreign futures, and proprietary cleared swaps from the risk margin amount calculation. The Commission believes that the requirement for an FCM–SD to take a capital charge equal to 100% or 150% of the required initial margin or required maintenance margin, as applicable, on its proprietary cleared positions adequately accounts for the risk associated with those positions, as it reflects the potential market risk presented by the positions as determined by a clearing organization or broker and further recognizes that the initial margin posted with the clearing organization or broker is no longer available for use in the FCM–SD's business and, thus, warrants at least a 100% capital charge. The market risk capital charge imposed on proprietary futures and cleared swaps for FCM–SDs approved to use capital models for market risk would be model-based and not the margin imposed by a clearing organization. Since a market risk charge would reduce the FCM–SD's capital, the Commission believes that it is appropriate to exclude the proprietary cleared positions from the 8% risk margin amount calculation.

The Commission believes that under such circumstances it is not necessary to impose an additional capital requirement in the form of an increase in the minimum capital requirement equal to 8% of the margin associated with the FCM–SD's proprietary cleared futures, foreign futures, and swaps positions. In this regard, the Commission notes that an FCM–SD's credit exposure is limited on cleared positions to either a clearing organization or to an FCM that carries the FCM–SD's account (or in the case of foreign futures, a foreign broker that carries the FCM–SD's account). The credit exposure on such cleared positions is limited as clearing organizations and FCMs/foreign brokers are regulated entities that are generally subject to financial requirements, including capital, margining, and financial reporting requirements. Clearing organizations and FCMs/foreign brokers are also subject to regulations regarding the holding of customer funds to ensure that such funds are used solely for the benefit of the customer and not for the benefit of other customers or of the clearing organization or FCM/foreign broker.[62] Furthermore, as noted above, an FCM–SD will be required to maintain a level of net capital that is sufficient to cover the market risk charges associated with the proprietary cleared futures, foreign futures, and cleared swap positions.

The Commission is also modifying the final regulation to set the risk margin amount multiplier for uncleared swaps at 2% of the ''uncleared swap margin'' amount required on such positions. The term ''uncleared swap margin'' is defined in regulation 1.17(b)(11) to mean the amount of initial margin that the FCM–SD would compute on each uncleared swap position pursuant to the calculation requirements of regulation 23.154. The FCM–SD must include all uncleared swap positions in the

[55] *See Minimum Financial and Related Reporting Requirements for Futures Commission Merchants and Introducing Brokers,* 69 FR 49784 (Aug. 12, 2004).

[56] *See* Commission regulation § 1.17(a)(1)(i)(D) (17 CFR 1.17(a)(1)(i)(D)).

[57] *See* FIA 3/3/2020 Letter.

[58] Commission regulation § 1.17(c)(5)(x) (17 CFR 1.17(c)(5)(x)) currently requires an FCM that is a clearing member of a clearing organization to take a capital charge equal to 100% of the margin required by the clearing organization for the cleared positions. FCMs that are not clearing members are required to take a capital charge equal to 150% of the maintenance margin required by the applicable clearing organization for the cleared positions.

[59] *See* Letter from Stephen Berger, Citadel Securities (May 15, 2017) (Citadel 5/15/2017 Letter); Letter from Mary Kay Scucci, Securities Industry and Financial Markets Association (May 15, 2017) (SIFMA 5/15/2017 Letter); Letter from Walter Lukken, Futures Industry Association (May 15, 2017) (FIA 5/15/2017 Letter); FIA–PTG 5/24/2017 Letter; FIA 3/3/2020 Letter; FIA–PTG 3/3/2020 Letter.

[60] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[61] *See* IIB/ISDA/SIFMA 3/3/2020 Letter. *See also,* SEC rule 15c3–1(c)(2)(vi)(O) (17 CFR 240.15c3–1(c)(2)(vi)(O)) which provides that capital charge for a proprietary cleared security-based swaps is the margin amount of the clearing agency or, if the security-based swap references an equity security, the broker or dealer may take a deduction using the method specified in rule 15c3–1a (17 CFR 240.15c3–1a).

[62] *See, e.g.,* Commission regulations §§ 1.20, 1.22, and 39.15 (17 CFR 1.20, 1.22 and 39.15).

calculation of the uncleared swap margin amount, including uncleared swaps that are exempt from the scope of the Commission's margin regulations for uncleared swaps pursuant to regulation 23.150, exempt foreign exchange swaps or foreign exchange forwards, or netting set of swaps or foreign exchange swaps, for each counterparty, as if the counterparty was an unaffiliated swap dealer. Furthermore, in computing the uncleared swap margin amount, an FCM–SD may not reduce the uncleared swap margin amount to reflect the *initial margin threshold amount* or the *minimum transfer amount* as such terms are defined in regulation 23.151.[63]

The Commission is modifying the risk margin amount multiplier in recognition that the Commission's margin requirements generally impose a higher margin requirement on uncleared swap positions relative to cleared swaps and futures positions. Minimum initial margin requirements for cleared futures and swap transactions are generally set by clearing organizations. In this regard, the FCM minimum capital requirement of 8% of the risk margin amount on futures and cleared swaps is based upon margin calculations using clearing organization models that require a 99% one-tailed confidence interval over a minimum liquidation period of one day for futures, agricultural swaps, energy swaps, and metal swaps, and a minimum liquidation period of five days for all other swaps, including financial swaps such as interest rate swaps.[64] In contrast, initial margin for uncleared swaps is required to be calculated at a 99% one-tailed confidence interval over minimum liquidation period of 10 business days (or the maturity of the swap if shorter).[65] The greater margin period of risk for uncleared swaps generally requires a higher level of initial margin, which would increase the FCM–SD's minimum capital requirement for uncleared swaps relative to cleared transactions. The modification of the final rule to set the risk margin amount multiplier at 2% for uncleared swap positions is appropriate given the generally higher initial margin requirements imposed on such positions under the Commission's regulations relative to cleared positions. In addition, as noted above, FCM–SD's will also be required to take market risk charges for each of its proprietary positions, including uncleared swaps, in computing its adjusted net capital.

As noted by a commenter, the 8% risk margin amount was proposed in 2003, and subsequently adopted in 2004, based upon an analysis and comparison of the then existing FCM capital regime that was based on a percentage of the customer funds held by an FCM, with a minimum capital requirement based upon risk margin associated with the customer positions carried by the FCM.[66] Staff also had the benefit of observing data of the actual performance of the two capital regimes for an extended period of time as each FCM was required to calculate its minimum capital requirement based on customer funds and its capital requirement based on a percentage of its risk margin amount for approximately two years as part of a pilot program.[67]

The Commission does not have the benefit of similar comprehensive data regarding the multiplier for the uncleared swaps risk margin amount at this time. However, the Commission's decision to modify the final rule by removing cleared and uncleared security-based swaps, as well as proprietary futures, foreign futures, and cleared swaps positions from the risk margin amount calculation, and to set the multiplier at 2% should mitigate many of the commenters' concerns that the proposed 8% risk margin amount calculation was over inclusive of the types of positions included in the calculation and was set at a percentage that was too high.

The modification to remove proprietary futures, foreign futures, cleared swap, and cleared and uncleared security-based swap positions from the risk margin amount calculation also mitigates concerns raised by commenters that the capital rule ''double counts'' positions by requiring an FCM–SD to include such positions in its minimum capital requirement while also requiring the FCM–SD to take market risk and credit risk charges in computing its adjusted net capital. The modifications to the final rule also more closely aligns the Commission's minimum capital requirement for FCM–SDs with the approach adopted by the SEC for setting minimum capital requirements for BDs that are SBSDs and stand-alone SBSDs.

The Commission will review within five years of the effective date of this rule, the impact that the 2% risk margin amount has on the level of minimum capital required of FCM–SDs after the compliance date of the rules. The Commission will use the financial statements and other information that it will receive from FCM–SDs under existing FCM financial reporting requirements to assess whether the minimum capital requirements for FCM–SDs are adequately calibrated to ensure their safety and soundness. The information that the Commission will receive will allow it to determine if it would be appropriate to propose amending the minimum capital requirement by, among other things, increasing or decreasing the risk margin amount multiplier.

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

As previously noted, the second component of the FCM and FCM–SD capital requirement is the computation of the firm's adjusted net capital based upon the assets and liabilities of the firm. Regulation 1.17(c)(5) defines the term ''adjusted net capital'' as an FCM's ''current assets'' (*i.e.,* current, liquid assets excluding, however, most unsecured receivables), less all of the FCM's liabilities (except certain qualifying subordinated debt). An FCM is further required to impose certain prescribed capital deductions (''capital charges'' or ''haircuts'') from the current market value of the FCM's proprietary positions (*e.g.,* futures, securities, debt instruments, money market instruments, and commodities) in computing its adjusted net capital to reflect potential market risk associated with the firm's proprietary positions, as well as to provide a capital cushion against other potential risks, including liquidity, legal, and operational risk.

Regulation 1.17(c)(5) establishes specific standardized capital charges for market risk for an FCM's proprietary positions in physical inventory, forward contracts, fixed price commitments, and securities. Regulation 1.17(c)(5), however, did not explicitly address market risk capital charges for uncleared swap or security-based swap positions. While FCMs have not historically engaged in a significant level of swaps or security-based swap transactions, the Commission has required FCMs to use the standardized market risk capital charges specified in regulation

[63] The Commission is modifying the definition of the term ''uncleared swap margin'' in final paragraph (b)(11) of Commission regulation 1.17 (17 CFR 1.17(b)(11)) to align the wording of the regulation to be consistent with the definition of the term ''uncleared swap margin'' in regulation 23.100 for SDs that are not also registered FCMs.

[64] *See* Commission regulation § 39.13(g) (17 CFR 39.13(g)).

[65] *See* Commission regulation § 23.154(b)(2) (17 CFR 23.154(b)(2)).

[66] *See Minimum Financial and Related Reporting Requirements for Futures Commission Merchants and Introducing Brokers,* 68 FR 40835 (July 9, 2003) and 69 FR 49784 (Aug. 12, 2004). *See also, CFTC Division of Trading and Markets, Review of Standard Portfolio Analysis of Risk Margining System Implemented by the Chicago Mercantile Exchange, Board of Trade Clearing Corporation, and the Chicago Board of Trade (Apr. 2001) (''T&M 2001 Report''). See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[67] *See T&M 2001 Report.*

1.17(c)(5)(ii), or the standardized market risk capital charges established by SEC rule 15c3–1 (17 CFR 240.15c3–1) (''SEC rule 15c3–1'') for dually-registered FCM–BDs, to compute market risk capital charges for uncleared swap and security-based swap positions.[68]

The Commission proposed amendments to regulation 1.17(c)(5) to more explicitly provide for specific standardized market risk capital charges for an FCM's or FCM–SD's proprietary positions in uncleared swaps and security-based swaps.[69] The Proposal further provided that an FCM or FCM–SD that obtained approval to use internal market risk capital models could use such models in lieu of the standardized market risk charges. In order to use capital models, an FCM–BD must have obtained SEC approval to use capital models. These dually-registered FCM–BDs are referred to as ''Alternative Net Capital Firms'' (''ANC Firms''), and are subject to enhanced minimum capital requirements as discussed below. An FCM which is not a BD, but also is registered as an SBSD would also be subject to the approval of both the Commission and the SEC to use models, but with lesser applicable fixed dollar net capital and adjusted net capital thresholds. The proposed standardized market risk charges and model-based charges are also discussed below.

a. Stand-Alone FCM and FCM–SD Standardized Market Risk Capital Charges

FCMs currently are required to take standardized market risk charges for proprietary positions in computing their adjusted net capital under regulation 1.17. The current standardized market risk charges are aligned with the SEC's market risk capital charges for BDs, and reflect the two agencies' long-standing efforts of maintaining a uniform capital rule for FCMs and BDs as most FCMs are dually-registered as BDs. In this regard, regulation 1.17 requires FCMs that hold positions in securities and securities-related products, such as U.S. Government securities, equity securities and options, municipal securities, commercial paper, and certificates of deposit, to take market risk capital charges on such positions in the manner and amount specified by SEC rule 15c3–1 and rule 15c3–1a (17 CFR 240.15c3–1a) (''SEC rule 15c3–1a''). FCMs that hold positions in commodities, including foreign currency and physical commodities, are required to take market risk capital charges set forth in Commission regulation 1.17(c)(5). For example, regulation 1.17(c)(5) requires an FCM to take a capital charge equal to 0% to 20% of the market value of inventory depending on whether the FCM's inventory position is adequately offset (or ''covered'') by proprietary futures positions.[70] The standardized Commission and SEC market risk capital charges are generally computed based upon the market value of the position multiplied by a percentage factor set forth in the rule or regulation.

Regulation 1.17 and SEC rules, however, did not provide explicit market risk capital charges for swaps or security-based swaps. To the extent an FCM engages in uncleared swap or security-based swap transactions, the FCM is required to take a market risk capital charge based upon the standardized capital charges contained in SEC rules 15c3–1, 15c3–1a, or Commission regulation 1.17(c)(5) that are applicable to proprietary positions in securities, inventory, foreign currency, fixed price commitments, or forward contracts. For example, an energy swap is treated as a fixed price commitment under regulation 1.17(c)(5), and an FCM is required to take a market risk capital charge equal to 20 percent of the notional value of the swap.[71] The purpose of the market risk capital charge is to require an FCM, in computing its adjusted net capital, to reserve a minimum level of capital to cover potential future losses in the value of the swap.

The *2016 Capital Proposal* proposed amending the standardized market risk capital charges to explicitly reflect uncleared swap and security-based swap positions. The Commission proposed to amend regulation 1.17(c)(5)(iii) to provide a schedule of standardized market risk capital charges for positions in uncleared credit default swaps, interest rate swaps, foreign exchange swaps, commodity swaps, and all other uncleared swaps.[72] The Commission also proposed that an FCM or an FCM–SD must take the applicable standardized capital charge in SEC rule 15c3–1, as such rule was proposed to be amended, for proprietary positions in uncleared security-based swaps, including uncleared security-based credit default swaps and equity swaps.[73]

Credit default swaps are generally defined by the reference asset or entity, the notional amount, the duration of the contract, and credit events. The Commission proposed standardized market risk capital charges for credit default swaps using maturity grids. The ''maturity grid'' was based on a ''maturity grid'' approach that was proposed and subsequently adopted by the SEC for credit default swaps and security-credit default swaps.[74] Market risk capital charges for uncleared credit default swaps were proposed to be based on two variables under the *2016 Capital Proposal:* (i) The length of time to maturity of the credit default swap; and (ii) the amount of the current offered basis point spread on the uncleared credit default swap. The standardized market risk charge for an unhedged short position in a credit default swap was the applicable percentage specified in the grid. The deduction for an unhedged long position was 50% of the applicable deduction specified in the grid.[75]

The *2016 Capital Proposal* also permitted an FCM to net long and short positions where the uncleared credit default swaps reference the same entity or obligation, reference the same credit events that would trigger payment by the seller of the protection, reference the same basket of obligations that would determine the amount of payment by the seller of protection upon the occurrence of a credit event, and are in the same or adjacent maturity and spread categories (as long as the long and short positions each have maturities within three months of the other maturity category). In this case, the FCM was required to take the specified market risk percentage deduction only

[68] For example, existing Commission regulation § 1.17(c)(5)(ii)(C) (17 CFR 1.17(c)(5)(ii)(C)) imposes a market risk capital charge on inventory positions held by an FCM equal to 20% of the market value of the inventory, and § 1.17(c)(5)(ii)(G) (17 CFR 1.17(c)(5)(ii)(G)) imposes the same market risk capital charge of 20% on the value of fixed price commitments and forward contracts. FCMs holding agricultural swaps or energy swaps have been required to take a market risk capital charge equal to 20% of the notional value of the swap under the application of either of these two provisions.

[69] *2016 Capital Proposal,* 81 FR 91252 at 91266–67.

[70] *See* Commission regulation § 1.17(j) (17 CFR 1.17(j)) for the definition of the term ''cover.''

[71] For example, swaps with a reference asset of a physical commodity are subject to a capital charge equal to 20% of the notional value of the contract (*See* Commission regulation § 1.17(c)(5)(ii)(G) (17 CFR 1.17(c)(5)(ii)(G)).

[72] *See 2016 Capital Proposal,* 81 FR 91252 at 91266–67.

[73] The SEC proposed amending rules 15c3–1 and 15c3–1b to establish standardized capital charges for security-based swaps and swaps that would apply to stand-alone BDs and BDs that are also registered SBSDs. *See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers,* 77 FR 70214 (Nov. 23, 2012) (''*SEC 2012 Proposed Capital Rule*'').

[74] SEC rule 15c3–1(c)(2)(vi)(P)(*1*) (17 CFR 240.15c3–1(c)(2)(vi)(P)(*1*)).

[75] *See* proposed paragraph (c)(5)(iii)(A) of Commission regulation § 1.17; *2016 Capital Proposal,* 81 FR 91252 at 91307.

on the notional amount of the excess long or short position.[76]

For uncleared interest rate swaps, the Commission proposed a standardized market risk capital charge approach that required multiplying the notional amount of the swap by a stated percent.[77] The percentage that applied to the notional amount was determined by referencing the standardized haircuts in SEC rule 15c3–1(c)(2)(vi)(A) for U.S. government securities with comparable maturities to the interest rate swaps maturities, and would range from 0% (for interest rate swaps with a remaining time to maturity of less than 3 months) to 6% (for interest rate swaps with a remaining time to maturity of 25 years or more). The *2016 Capital Proposal* further provided that an FCM may net certain long and short uncleared interest rate swaps to reduce the net notional amount of the interest rate swaps subject to the market risk capital charge. The net amount of the long and short interest rate swaps was determined based upon the existing SEC netting schedule for government securities, which is based upon the time to maturity of the interest rate swaps. For example, long and short interest rate swaps with maturity dates ranging between 3 years to less than 5 years are subject to market risk capital charge equal to 3% on the net long or short interest rate swap position.

The Proposal further provided that the market risk capital charge for interest rate swaps must not be less than 0.5% of the amount of the long position that was netted against a short position, notwithstanding that the netting provisions contained in SEC rule 15c3–1 does not impose a market risk capital charge on U.S. government securities with less than 3 months to maturity.[78] The 0.5% floor on the total amount of the long interest rate swaps netted against the short interest rate swaps was designed to account for potential differences between the movement of interest rates on U.S. government securities and interest rates upon which swap payments are based.

The Commission also proposed specific market risk capital charges for foreign currency swaps, commodity swaps, security-based swaps, and all other uncleared swaps. The Proposal requires FCM and FCM–SDs to take a market risk capital charge for foreign currencies swaps that is consistent with the standardized market risk charges for foreign currency positions and foreign currency forwards contained in regulation 1.17(c)(5). Specifically, the Commission proposed market risk charges equal to 6% of the notional value of a foreign currency swap that references euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs. Foreign currency swaps that reference any other currency are subject to a market risk capital charge equal to 20% of the notional value of the respective swap.

With respect to swaps referencing a physical commodity, the Proposal required FCM and FCM–SDs to take a market risk capital charge equal to 20% of the market value of the relevant commodity underlying a commodity swap. Consistent with the foreign currency and interest rate swaps, the proposed commodity swap market risk capital charge was based upon the existing capital charges for physical commodities set forth in regulation 1.17(c)(5). The Proposal further required an FCM or FCM–SD to take the market risk capital charges specified in SEC rules for security-based swaps, which would include equity swaps, and for any swap that has a reference asset that is subject to specific SEC market risk capital charges and is not otherwise subject to a Commission imposed capital charge.

Commenters objected to the proposed standardized market risk capital charges as being too punitive and not tailored to the risk posed by the relevant portfolios of positions.[79] Specifically, commenters noted that the proposed standardized market risk charges for interest rate swaps are substantially higher than the capital charges based on clearing house maintenance margin requirements for cleared interest rate futures contracts.[80] One commenter provided a sample matched book portfolio of interest rate swaps demonstrating that an FCM would have substantially higher capital charges under the proposed standardized approach as compared to the model approach or as compared to clearing house maintenance margin requirements.[81] These commenters indicated that the excessive capital requirements derived from the proposed standardized market risk capital charges would particularly impact small to mid-sized SDs that are not approved or otherwise do not use internal market risk capital models.[82]

Commenters also requested that the Commission reconsider the standardized capital charge on currency swaps.[83] The commenters noted that an FCM or FCM–SD would have to take a market risk capital charge equal to 20% of the notional amount of an uncleared foreign currency non-deliverable forward contract, while the standardized (or grid-based) initial margin requirements on such a contact is 6% of the notional amount.[84] One commenter recommended that the final rule align the capital charge with the volatility and liquidity conditions of the relevant currency pair.[85] Another commenter stated that the standardized capital charge is too high for a product that is highly liquid and recommended that the capital charge be aligned with the standardized initial margin requirement of 6% under the uncleared margin rules.[86]

Another commenter stated that a covered SD that enters into a swap with uncleared swap contracts containing a flip-clause should require a charge for required margin on such contract plus market risk.[87]

The Commission acknowledged in the *2019 Capital Reopening* that the proposed standardized market risk charges would impact FCMs, FCM–SDs, and covered SDs that do not have approval to use internal market risk capital models, which are more likely to be smaller to mid-sized firms that may not be part of a financial group that has the approval of the SEC, a prudential regulator, or a foreign regulator to use internal capital models. The Commission further believed that establishing a more appropriate market risk capital charge for uncleared interest

[76] *See 2016 Capital Proposal,* 81 FR 91252 at 91267.

[77] *Id.*

[78] The SEC proposed minimum standardized market risk charge of 1% of the net notional value of the interest rate swaps for SBSDs and 0.5% for BDs. *See SEC Proposed Capital Rule,* 77 FR 70214 at 70345; Proposed rule 18a–1b(b)(2)(C) for SBSDs and proposed rule 15c3–1b(2)(ii)(C).

[79] *See* SIFMA 5/15/2017 Letter; Letter from Michael Sharp, Jefferies Group LLC (May 12, 2017) (Jefferies 5/12/2017 Letter).

[80] SIFMA and Jefferies each estimated that the proposed standardized market risk charges for uncleared interest rate swaps would be substantially higher than the clearing house margin requirements. *See Id.*

[81] *See* Jefferies 5/12/2017 Letter.

[82] *See* proposed Commission regulation § 23.101(a)(1), *2016 Capital Proposal,* 81 FR 91252 at 91310–11. *See* SIFMA 5/15/2017 Letter; Letter from Ryan Hayden, ED&F Man Derivative Products, Inc./INTL FCStone Markets, LLC (March 3, 2020) (ED&F Man/INTL FCStone 3/3/2020 Letter); IIB/ISDA/SIFMA 3/3/2020 Letter; FIA 3/3/2020 Letter; Letter from Alexander Lange, ABN AMRO Securities (USA) LLC; Michael Bando, ING Capital Markets LLC; Adam Hopkins, Mizuho Capital Markets LLC; David Moser, Nomura Holding America Inc. (January 29, 2018) (ABN/ING/Mizuho/Nomura 1/29/2018 Letter).

[83] Letter from Stephen John Berger, Citadel Securities, March 3, 2020 (Citadel 3/3/2020 Letter); FIA–PTG 3/3/2020 Letter.

[84] IIB/ISDA/SIFMA 3/3/2020 Letter; Citadel 3/3/2020 Letter.

[85] Citadel 3/3/2020 Letter.

[86] FIA–PTG 3/3/2020 Letter.

[87] Letter from William Harrington (3/3/2020) (Harrington 3/3/2020 Letter).

rates swaps, in particular, given the relatively high market risk capital charge would benefit market participants by encouraging smaller to mid-sized FCMs, FCM–SDs, and covered SDs to remain in the market or to enter the market. Accordingly, the Commission requested further comment on the proposed standardized market risk charge for uncleared interest rate swaps. The Commission also noted that the SEC's final capital rule for BDs and SBSDs imposed a minimum capital requirement for uncleared interest rate swaps equal to ⅛ of one percent (0.125%) and only applicable to the matched long position that is netted against a short position in the case of a uncleared interest rate swap with a maturity of three months or more.[88]

The Commission has considered the comments and is adopting the proposed standardized market risk charges for uncleared swaps and uncleared security-based swaps as proposed, with several modifications that are discussed below. The standardized market risk capital charges being adopted are generally based on existing Commission and SEC standardized market risk charges for positions in foreign currencies, commodities, U.S. treasuries, equities and other instruments, which, in the Commission's long experience, have generally proven to be effective and appropriately calibrated to address potential market risk in the positions. The Commission believes at this time that this approach, in conjunction with other charges discussed herein, appropriately accounts for the wide variety of possible uncleared swap transactions that FCMs, FCM–SDs, and covered SDs may engage in, including bespoke swap transactions involving flip-clauses or other unique features. Overtime, the Commission may consider adjusting these charges as a result of experience with their impacts on required capital in these firms and as market developments may warrant.

In response to several commenters, the Commission recognizes that standardized market risk charges are not as risk sensitive as market risk models, and generally result in higher market risk capital charges than internal models. The Commission notes, however, the lower capital charges for firm's approved to use market risk model is one of the reasons that model approved firms are subject to the higher minimum capital requirements. As noted in section II.B.2.a. above, FCM–SDs that are approved to use internal market risk models are required to maintain net capital of at least $100 million and adjusted net capital of $20 million, while FCM–SDs that are not approved to use internal market risk models are required to maintain $20 million of adjusted net capital, but are not subject to the $100 million dollar net capital requirement. The imposition of $100 million net capital requirement is to provide protection for potential model errors or the failure of the models to address all applicable risks. The Commission believes that it is appropriate to require FCM–SDs that do not use internal models and therefore have a lower capital requirement to be subject to the higher standardized market risk capital charges. The approach is also consistent with the approach adopted by both the Commission and SEC with respect to ANC Firms that have been approved to use internal capital models and, which under the *2019 SEC Final Capital Rule,* are subject to a minimum capital requirement of $5 billion of tentative net capital and $1 billion of net capital.[89]

In addition, the Commission believes that FCM–SDs will seek approval to use model-based market risk charges. There currently are four FCM–SDs provisionally-registered with the Commission. Each of the FCM–SDs is an ANC Firm that is approved to use market risk capital models and, which under the *2019 SEC Final Capital Rule,* is subject to the SEC's minimum capital requirement of $5 billion of tentative net capital and $1 billion of net capital. In order to effectively compete with the existing FCM–SDs and other covered SDs, any new FCM–SD registrant would need to obtain model approval.

The Commission is also modifying the final regulation by reducing the minimum capital charge for a portfolio of interest rate swaps to align with the SEC's final capital requirement for BD's and SBSD's using standardized capital charges. In reviewing the comments, the Commission realizes that the standardized market risk charges for interest rate swaps that it proposed in its *2016 Capital Proposal* was too high relative to the market risk of the positions. The Proposal's imposition of a minimum market risk capital charge of .5% of the notional amount of the matched long interest rate swaps has been shown by commenters to be poorly calibrated to the market risk of the positions. Therefore, under the final regulation, an FCM–SD or FCM is required to take a capital charge of at least ⅛ of one percent (0.125%) of the matched long interest rate swap positions that is netted against a short interest rate swap positions with a maturity of three months or more. The Commission believes that in making this change, the overall effect on the amount of capital held by an FCM or an FCM–SD will not have a substantial adverse impact on the safety and soundness of these entities. The Commission, however, will monitor the standardized capital charges and refine the percentages as it obtains experience with the level of interest rate swaps transactions entered into by stand-alone FCMs and FCM–SDs and magnitude of the market risk charges on such positions.

The Commission is also making a technical modification to the final capital rule for credit default swaps. As noted in the *2019 Capital Reopening,* the *2019 SEC Final Capital Rule* includes the same standardized capital charges for credit default swaps for BDs and SBSDs as proposed by the Commission for FCMs, FCM–SDs, and covered SDs. There is a slight difference between the Commission's Proposal and the SEC's final rule, however, in applying the capital charges based upon the time to maturity. Specifically, the maturity grids differ by one month, and there are some slight changes to the rule text. The Commissions is modifying the time to maturity grids and the wording in the final rule to align with the SEC's final rule to avoid having dually-registered entities being subject to slightly different regulatory requirements with respect to market risk charges for credit default swaps. The Commission believes that this modification will have no material impact on its capital requirements.

The Commission is also modifying the final rule to provide that an FCM or FCM–SD may reduce market risk charges for uncleared swap positions, other than credit default swaps which as proposed provided for netting, to account for comparable offsetting positions.[90] The Commission noted in the *2019 Capital Reopening* that the SEC adopted a netting proviso applicable to both BDs and SBSDs, permitting a reduction of the resulting market risk capital charge by an amount equal to any reduction recognized for comparable long or short positions in the reference asset or interest rate under

[88] *See 2019 SEC Final Capital Rule,* rule 18a–1b(b)(2)(ii)(A)(*3*) (17 CFR 240.18a–1b(b)(2)(ii)(A)(*3*) for SBSDs and rule 15c3–1b(b)(2)(ii)(A)(*3*) (17 CFR 240.15c3–1b(b)(2)(ii)(A)(*3*)) for BDs.

[89] SEC rule 15c3–1(a)(7) (17 CFR 240.15c3–1(a)(7)).

[90] *See* paragraph (c)(5)(iii)(D) of Commission regulation § 1.17, as amended (17 CFR 1.17(c)(5)(iii)(D)).

regulation 1.17 or SEC rule 15c3–1.[91] For example, an FCM or FCM–SD that is required to take market risk charges on equal and opposite legs of a portfolio of foreign currency swaps is permitted to net the market risk charges on the long and short positions to the extent that the positions are comparable.

The Commission stated in the *2019 Capital Reopening* that it intended to maintain consistency with the *2019 SEC Final Capital Rule* with respect to the applicability of the standardized market risk charges for uncleared currency and commodity swaps, and requested comment on including the same netting proviso to regulation 1.17(c)(5)(iii).[92] Commenters to the *2019 Capital Reopening* generally supported the netting provision.[93] One commenter stated that such an approach would be consistent with common and current risk management practices and would allow non-financial SDs to be more responsive to customer needs.[94]

The Commission believes that it is appropriate that an FCM or an FCM–SD be permitted to net offsetting swap positions in computing the market risk on the portfolio of swap positions in an identical fashion as the SEC has adopted for BDs and SBSDs. Otherwise, the capital rule would require individual capital charges on each swap position without any consideration of the actual risk of the positions. Such an approach would discourage FCMs or FCM–SDs from hedging their exposures and from participating in the swaps market. The ability to net offsetting positions in computing market risk is also a fundamental approach that has been adopted by other regulators including the SEC, prudential regulators, and others. Therefore the Commission is adopting the netting provision as set forth at regulation 1.17(c)(5)(iii)(D).

FCMs currently are required by regulation 1.17(c)(5)(x) to take standardized capital charges on proprietary cleared futures and cleared swap positions. The capital charge is equal to 100% of the margin requirement imposed by the clearing organization on the positions if the FCM is a clearing member of such clearing organization. For FCMs that are not clearing members of the clearing organization that clears the positions, the capital charge is equal to 150% of the applicable maintenance margin requirement of the applicable board of trade or clearing organization, whichever is greater. FCM–SDs also are subject to these capital charges as such firms must comply with the FCM capital requirements set forth in regulation 1.17.

Several commenters requested that the Commission eliminate the requirement for an FCM to take capital charges equal to 150% of the margin for proprietary futures or cleared swap positions. One commenter stated that there is no justification for a higher capital charge as market risk is independent of whether the firm is or is not a clearing firm.[95] This commenter also noted that the SEC's final capital rules for SBSDs impose a capital requirement for proprietary cleared positions equal to 100% of the required clearing organization margin, and do not require a non-clearing SBSD to take a higher capital charge of 150% of required margin.[96] Another commenter stated that there is no justification for assessing covered SDs that are non-clearing members the higher 150% charge and imposing such a requirement is placing the SDs at an unnecessary competitive disadvantage. The commenter recommended that all SDs should be able to take a standardized market risk charge equal to the clearing organizations' margin requirement.[97]

The Commission has considered the Proposal and comments and is not revising regulation 1.17(c)(5)(x). The capital requirement for FCMs to take a capital charge for cleared proprietary positions has been in place for many years. The higher capital charge for non-clearing FCMs takes into consideration that such firms are not subject to heightened capital and other requirements that are imposed by clearing organizations on clearing members. FCM clearing members also are required to post guarantee fund contributions to clearing organizations to support their financial obligations, and are subject to clearing organization assessment authority in the event that a shortfall results from the default of a fellow clearing member. The higher capital charge for non-clearing FCMs and FCM–SDs is intended to ensure that such firms retain an appropriate level of capital and liquid resources to meet their financial obligations, including to their carrying FCMs and ultimately to clearing organizations, and the Commission believes that the 150% capital charge is appropriate to help ensure the safety and soundness of the FCM or FCM–SD.

b. FCM and FCM–SD Standardized Counterparty Credit Risk Capital Charges

FCMs currently are required to take standardized capital charges to reflect counterparty credit risk associated with uncleared swap and security-based swap positions. The Commission's capital rule requires an FCM that holds swap or security-based swap positions to mark the positions to their respective fair market values in their financial records.[98] Swap and security-based swap positions that have mark-to-market losses result in the FCM recognizing variation margin payables to swap and security-based swap counterparties. Such losses reduce the FCM's capital either by the payment of variation margin or the recognition of a liability. Swap and security-based swap positions that have mark-to-market gains result in the FCM recognizing variation margin receivables from the swap and security-based swap counterparties. The variation margin receivables, however, are subject to a 100% counterparty credit risk capital charge unless the receivables are secured by readily marketable collateral.[99]

The Commission proposed to retain the 100% counterparty credit risk charges for unsecured receivables from swap and security-based swap counterparties in the Proposal, and further proposed extending this treatment to FCM–SDs. The Proposal further imposed the 100% counterparty credit risk treatment applied to all swap and security-based swap counterparties of the FCM or FCM–SD, including commercial end users, that are exempt from the requirement to exchange variation margin.[100] The FCM or FCM–SD also would be required to take a 100% capital charge on unsecured receivables resulting from transactions that are exempt from the margin requirements, including legacy swap and security-based swap transactions and foreign exchange forward and swap

[91] SEC rule 15c3–1b(b)(2)(ii)(B) (17 CFR 240.15c3–1b(b)(2)(ii)(B)) for BDs and rule 18a–1b(b)(2)(ii)(B) (17 CFR 240.18a–1b(b)(2)(ii)(B)) for SBSDs.

[92] *See 2019 Capital Reopening,* 84 FR 69664 at 69672.

[93] *See* Citadel 3/3/2020 Letter; IIB/ISDA/SIFMA 3/3/2020 Letter; Letter from Alexander Holtan, Commercial Energy Working Group (March 3, 2020) (CEWG 3/3/2020 Letter); Letter from Sebastian Crapanzano and Soo-Mi Lee, Morgan Stanley (March 3, 2020) (MS 3/3/2020 Letter).

[94] *See* Citadel 3/3/2020 Letter page 5.

[95] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[96] *Id.*

[97] *See* FIA–PTG 3/3/2020 Letter.

[98] Commission regulation § 1.17(c)(1) (17 CFR 1.17(c)(1)).

[99] *See* Commission regulation § 1.17(c)(1) and (2) (17 CFR 1.17(c)(1) and (2)), which defines the term ''net capital'' and requires an FCM to include unrealized gains and losses in the computation of net capital, and further provides that an FCM must generally exclude unsecured receivables (including unsecured receivables from swap and security-based swap counterparties).

[100] *See* Commission regulation § 23.150 (17 CFR 23.150).

transactions, as well as any receivables from counterparties that are subject to a $500,000 minimum transfer amount.[101]

The Commission proposed the 100% capital charge on unsecured receivables from swap and security-based swap counterparties as it is was consistent with the Commission's general approach of requiring an FCM to exclude unsecured receivables from its adjusted net capital. As noted above, the Commission's capital rule focuses on the liquidity of the FCM and unsecured receivables do not reflect a liquid asset to the FCM that it may use in order to meet its own financial obligations.

The Proposal effectively required an FCM or FCM–SD that did not have approval to use models to compute counterparty credit risk to take a 100% capital charge for unsecured receivables due from swap and security-based swap counterparties. This would include counterparties that are not obligated to exchange variation margin with the FCM or FCM–SD, including commercial end users, affiliates, and counterparties engaging foreign exchange swaps as the term is defined in regulation 23.151.

FCM–SDs are also subject to the Commission's margin rules for uncleared swap transactions and may be directly or indirectly subject to the SEC's margin rules for uncleared security-based swaps. Under the Commission's margin rules, an FCM–SD is generally required to post initial margin for uncleared swap transactions entered into with other SDs or financial end users with a third-party custodian and may post initial margin with the custodian for security-based swaps. Stand-alone FCMs that engage in swaps and security-based swaps also may be obligated or elect to post initial margin for such transactions with a third-party custodian in accordance with the Commission's or the SEC's respective uncleared swap and security-based swap margin rules. Such deposits would generally be treated under the Commission's capital rule as an unsecured receivable from the third-party custodian, and subject to a 100% capital charge.

The Commission proposed to amend regulation 1.17(c)(2)(ii)(G) to permit an FCM or an FCM–SD to include initial margin funds it deposited with third-party custodians for uncleared swaps and uncleared security-based swaps in its capital computation, provided that the margin is held in accordance with the requirements established by the applicable Commission or SEC margin rules.[102] The Commission proposed to permit FCMs and FCM–SDs to include initial margin posted with third-party custodians as capital in recognition that the Commission's capital rules require an FCM–SD or stand-alone FCM to post initial margin for their uncleared swap transactions with third-party custodians to ensure that the FCM–SD or FCM meets its financial obligations to swap counterparties. The Commission also believes that the FCM–SD has minimal credit risk from the third-party custodian as the Commission's margin regulations require that the FCM–SD enter into a custodial agreement with the third-party custodian that prohibits the custodian from rehypothecating, repledging, reusing, or otherwise transferring (including though repurchase agreements) the collateral held by the custodian.[103] The custodial agreement also must be a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions including in the event of a bankruptcy, insolvency, or similar proceeding.[104]

The Commission is adopting the amendment to regulation 1.17(c)(2)(ii)(G) to permit FCMs and FCM–SDs to recognize margin posted with a third-party custodian for swap and security-based swap transactions as a current asset in computing their adjusted net capital. In order to qualify as a current asset, the initial margin must be deposited by the FCM or FCM–SD with a third-party custodian in accordance with the requirements specified in the Commission's uncleared swap margin rules set forth in regulations 23.150 through 23.161, or the SEC's uncleared security-based swap margin rules. The Commission is modifying the final regulation to clarify that initial margin posted by an FCM or FCM–SD with third-party custodians for uncleared swaps or uncleared security-based swaps entered into with bank SDs subject to the margin rules of a prudential regulator and entered into with foreign registered SDs that operate in a jurisdiction that has received a margin Comparability Determination by the Commission under regulation 23.160 also may be recognized as a current asset in computing adjusted net capital.

The Commission also proposed to require an FCM–SD to take a capital charge to reflect undermargined uncleared swap positions with a counterparty.[105] A capital charge for undermargined positions protects the FCM–SD by ensuring that it maintains capital to cover potential future credit exposure to swap counterparties, which is consistent with the statutory objective of ensuring the safety and soundness of the FCM–SD. The proposed undermargined capital charge further provided that an FCM–SD could reduce the amount of the capital charge by any amount owed by the FCM–SD to the counterparty resulting from uncleared swap transactions. The undermargined capital charge for uncleared swap positions is consistent with existing Commission undermargined capital charges for customer and noncustomer futures, foreign futures, and cleared swap accounts carried by an FCM.[106] The Commission did not receive comments on the proposed capital charges, and is adopting the undermargined capital charges with modifications as discussed below.

The Commission is modifying final paragraph (c)(5)(xv) of regulation 1.17 by adopting two separate paragraphs. Final regulation 1.17(c)(5)(xv) requires an FCM–SD to take a capital charge in an amount necessary for a swap counterparty or security-based swap counterparty to meet its respective Commission margin requirement for uncleared swap positions and the SEC margin requirement for uncleared security-based swap transactions to the SD. The final regulation would apply only to uncleared swaps and uncleared security-based swaps that are subject to the Commission's or SECs' margin requirements under applicable regulations. The final regulation further provides that the FCM–SD may reduce the amount of the undermargined charge to reflect calls for margin issued by the FCM–SD to the counterparty that are outstanding within the respective time frames established in the margin rules of the Commission and SEC, as applicable, to collect margin from a counterparty. This provision replaces

[101] Commission regulation § 23.153 (17 CFR 23.153), provides that a covered SD is not required to collect or post variation margin with a particular swaps counterparty until the combined initial and variation margin required to be exchanged with the counterparty exceeds $500,000.

[102] *See 2016 Capital Proposal,* 81 FR 91252 at 91306–07, proposed paragraph (c)(2)(ii)(G) of Commission regulation § 1.17.

[103] *See* Commission regulation § 23.157 (17 CFR 23.157).

[104] *Id.*

[105] Proposed paragraph (c)(5)(xv) of Commission regulation § 1.17 did not specifically impose undermargined capital charges for security-based swaps. *See 2016 Capital Proposal,* 81 FR 91252 at 91308. Such charges, however, are applicable to an FCM–SD under Commission regulation § 1.17(b)(1) (17 CFR 1.17(b)(1)), which provides that an FCM (including an FCM–SD) that has an asset or liability defined in the capital rules of the SEC shall treat such assets or liabilities for capital purposes in accordance with the rules of the SEC, provided that the Commission did not define a specific capital treatment in regulation 1.17.

[106] *See* Commission regulation § 1.17(c)(5)(viii) and (ix) for undermargined capital charges for customer and noncustomer futures, foreign futures, and cleared swap accounts.

the proposed language in regulation 1.17(c)(5)(xv) that would have permitted a covered SD to reduce the undermargined capital charge by any amount owed by the counterparty to the SD. The modified provision more accurately reflects the process of an SD calling for outstanding margin and is consistent with the undermargined capital charges for an FCM carrying customer and noncustomer accounts and the undermargined capital charge adopted by the SEC for SBSDs.

Final regulation 1.17(c)(5)(xvi) requires an FCM–SD to take a capital charge for uncleared swaps and uncleared security-based swaps that are exempt or excluded from the Commission's or SEC's margin requirements, such as commercial end users and transactions entered into prior to the compliance date of the margin regulations (*i.e.,* legacy swaps). In this regard, swaps entered into prior to the Phase 6 uncleared margin compliance date or with excluded counterparties for which no margin has been collected are treated no differently than other uncollateralized exposures under the Commission's rules. Such treatment for capital purposes of these counterparty exposures is consistent with the capital rules of both the SEC and prudential regulators as applied to their respective registrants.[107] The final regulation further provides that the FCM–SD may reduce the amount of the undermargined capital charge by any funds deposited by the counterparty to margin its swaps or security-based swap positions. These deposits would include funds deposited by the counterparty and held by third-party custodians or held by the FCM directly.

The Commission also modified the final rule text to clarify that the undermargined swap capital charges in regulation 1.17(c)(5)(xv) and (xvi) are applicable only to FCM–SDs and not FCMs, as FCM–SDs are subject to the Commission's margin requirements for uncleared swap transactions. Stand-alone FCMs, however, are not directly subject to the Commission's uncleared swap margin requirements as they are not SDs. Final regulations 1.17(c)(5)(xv) and (xvi) also have been modified to align the regulatory text more closely with the comparable SEC rule text requiring SBSDs to take capital charges for undermargined uncleared security-based swap and uncleared swaps positions from counterparties.[108] As noted above, the final regulation is designed to help ensure the safety and soundness of the FCM–SD by requiring the firm to reserve capital in the event a counterparty defaults on its swaps and security-based positions that are undermargined.

The Commission also requested comment on whether FCM–SD's or covered SD's should be permitted to recognize alternative forms of collateral (*e.g.,* letters of credit and liens) provided by commercial end-users that are exempt from clearing and from the uncleared margin requirements in computing the FCM–SD's or SD's counterparty credit risk charges for uncleared swap transactions.[109] Several commenters supported such alternative or non-financial collateral. One commenter stated that alternative forms of collateral, such as parent guarantees, letters of credit, or liens on assets are frequently used by SDs as credit risk mitigants when non-financial end-users do not post cash collateral on uncleared derivatives.[110] The commenter stated that allowing FCM–SDs to recognize alternative forms of collateral in computing credit risk charges is consistent with Congressional intent that FCM–SD capital requirements should not be punitive to end-users. This commenter further stated that permitting FCM–SDs to recognize non-cash collateral as a credit risk mitigant is consistent with the prudential regulators' final rule on the standardized approach to counterparty credit risk (''SA–CCR''), which provides that banks may take into account non-cash collateral in computing credit risk charges for OTC derivatives. Another commenter stated that non-cash collateral allows for the value of the commercial market participant's assets making it an effective method for satisfying credit requirements without unnecessarily setting aside capital from a productive use.[111] One commenter also stated that the Commission could require FCM–SD's to appropriately haircut non-cash collateral to address the general illiquid nature of non-cash collateral.[112]

The Commission has considered the comments and is not modifying the credit risk charges to recognize non-cash collateral. Margin provides an FCM–SD or a covered SD with protection from a potential counterparty default. In a default situation, non-financial collateral may not be immediately available, or the collateral may be available but may take time to liquidate. This may exacerbate potential losses to the FCM–SD or covered SD or expose such firms to additional risk by, for example, leaving them exposed to the market risk of cash market positions that were being hedged by the swap. While the Commission is not modifying the final rules to reflect non-cash collateral, it will continue to monitor and assess FCM–SD's and covered SD's acceptance of non-cash collateral from commercial end-users and consider possible revisions to its rules after it gains further experience with the capital condition of such firms.

c. Model-Based Market Risk and Counterparty Credit Risk Capital Charges

(i) FCMs That Are SEC-Registered ANC Firms

Commission regulation 1.17(c)(6) permits an FCM that is dually-registered with the SEC as a BD to use internal models to compute market risk and credit risk capital charges in lieu of standardized capital charges in computing its adjusted net capital under Commission regulation 1.17 provided that the SEC has approved the FCM/BD's use of such models for computing net capital under SEC rule 15c3–1. The SEC has approved certain FCM/BDs to use internal models to compute market risk capital charges for proprietary positions in securities, debt instruments, futures, security-based swaps and swaps in lieu of standardized capital charges contained in SEC rules 15c3–1 or 15c3–1b. The SEC also has approved the use of internal models to compute credit risk charges associated with exposures from swap and security-based swap counterparties in lieu of the standardized 100% unsecured receivable capital charges. As noted in section II.B.3. above, these FCM/BDs are referred to as ANC Firms. Five FCMs currently are ANC Firms, with four of the firms also provisionally-registered SDs.

Regulation 1.17(c)(6) requires an ANC Firm to file a notice with the Commission in order to use the SEC's approved capital models. The notice must include the SEC's approval order and other information, including: (i) A list of the categories of positions that the ANC Firm holds in its proprietary accounts, and, for each such category, a description of the methods that the ANC Firm will use to calculate its deductions for market risk and credit risk, and also, if calculated separately, deductions for specific risk; (ii) a description of the value at risk (VaR) models to be used for its market risk and credit risk

[107] *See, e.g.,* SEC rule 18a–1(c)(1)(viii) (17 CFR 240.18a–1(c)(1)(viii)).

[108] *See* SEC rule 18a–1(c)(viii) (17 CFR 240.18a–1(c)(1)(viii)).

[109] *See 2019 Capital Reopening,* at 69681.

[110] *See* CEWG 3/3/2020 Letter; NCGA/NGSA 3/3/2020 Letter; Shell 3/3/2020 Letter.

[111] *See* NCGA/NGSA 3/3/2020 Letter.

[112] *See* Shell 3/3/2020 Letter.

deductions, and an overview of the integration of the models into the internal risk management control system of the ANC Firm; (iii) a description of how the ANC Firm will calculate current exposure and maximum potential exposure for its deductions for credit risk; (iv) a description of how the futures commission merchant will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable; and (v) a description of the estimated effect of the alternative market risk and credit risk deductions on the amounts reported by the ANC Firm as net capital and adjusted net capital. Further qualitative and quantitative requirements for such market risk and credit risk models are discussed in section II.C.6. of this release.

ANC Firms also are subject to heightened SEC capital requirements as a condition of using the capital models. The *2019 SEC Final Capital* rule requires an ANC Firm, including an FCM that is dually-registered as an ANC Firm, to maintain tentative net capital of at least $5 billion and net capital of not less than the greatest of $1 billion or the sum of (i) 2% of the risk margin amount associated with customer cleared security-based swaps and uncleared security-based swaps and (ii) the aggregate indebtedness of the ANC Firm or 2% of the aggregate debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to rule 15c3–3).[113] The *2019 SEC Final Capital* rule also requires an ANC Firm to provide the SEC, and CFTC if dually-registered as an FCM, with a written notice if its tentative net capital falls below $6 billion.[114]

The Commission proposed to retain the above notice and filing process to permit ANC Firms that register as FCMs or FCM–SDs to use the SEC-approved internal capital models in lieu of the standardized market risk and credit risk capital charges in computing their adjusted net capital under regulation 1.17. Currently, only four of the 56 provisionally-registered covered SDs are FCMs, and each of the FCM–SDs is an ANC Firm with capital model approval from the SEC. Accordingly, such FCM–SDs will be required to maintain tentative net capital of no less than $5 billion and net capital of no less than $1 billion upon the compliance date of the *2019 SEC Final Capital Rule.*[115] The Commission is electing to retain regulation 1.17(c)(6) to permit ANC Firms to engage in swap and security-based swap transactions under the existing regulatory structure, including the SEC's revised minimum capital requirements, as it believes that the minimum capital requirements are adequately designed to help ensure the safety and soundness of the FCM–SD.

(ii) Market Risk and Credit Risk Capital Models for FCM–SDs That Are Not SEC-Registered BDs

The Commission proposed amending regulation 1.17(c)(6) to permit FCM–SDs that are not SEC registered BDs to apply to the Commission, or an RFA of which the FCM–SD is a member, for approval to use internal market risk or credit risk models in lieu of the standardized capital charges. If an FCM or covered SD is also a registered BD, it may only use market risk and credit risk capital models if the SEC has approved such firm to use such models and the firm meets the capital requirements of an ANC Firm. Therefore, the Commission's proposal to extend the use of capital models to FCM–SDs is only applicable to FCM–SDs that are not registered with the SEC as BDs. The purpose of the amendment proposed in regulation 1.17(c)(6) was to provide FCM–SDs that were not dually-registered as BDs with the ability to use internal capital models in lieu of the standardized capital charges and to establish a mechanism for the FCM–SDs to obtain approval for such models. FCM–SDs that may also be registered as SBSDs or OTC Derivatives Dealers but not BDs would also be able to use this provision with respect to the use of models; however, they would separately need to obtain the SEC's approval to use models as registered SBSDs and OTC Derivatives Dealers. While currently the only FCMs that are provisionally-registered as SDs are the four ANC Firms, the Commission believed that other stand-alone FCMs may register as SDs and that the regulations should provide an opportunity for such firms to use capital models to compute market and credit risk.

Proposed regulation 1.17(c)(6)(v) required an FCM–SD to apply in writing, and further required that the market risk and credit risk models contain specified qualitative and quantitative requirements proposed to be established by the Commission in new regulation 23.102 and Appendix A to regulation 23.102.[116] The qualitative and quantitative requirements for the FCM–SD's models are comparable to the existing SEC model requirements for ANC Firms and non-BD SBSDs, and the Commission's proposed model requirements for covered SDs. The qualitative and quantitative requirements for the capital models are discussed in detail in section II.C.6. of this release.

The Commission also proposed enhanced fixed-dollar minimum capital requirements as a condition for an FCM–SD to obtain capital model approval. Specifically, the Commission proposed that FCM–SDs must maintain net capital of no less than $100 million and adjusted net capital of no less than $20 million in order to use capital models. The $100 million net capital requirement was in recognition that model-based capital charges are generally substantially lower than the Commission's standardized capital charges, and that models may not fully capture all risks at all times.[117] The minimum fixed-dollar capital requirement is also consistent with the Commission's proposed minimum fixed-dollar capital requirement for covered SDs, and is consistent with the SEC's minimum fixed-dollar capital requirement for OTC derivative dealers and non-BD SBSDs.[118]

The proposed $100 minimum fixed-dollar amount of net capital for FCM/SDs, however, is not consistent with the SEC's current approach for ANC Firms or SBSDs/ANC Firms approved to use internal models. As noted above, ANC Firms are subject to minimum fixed-dollar tentative net capital requirement of $5 billion, and a minimum fixed-dollar net capital requirement of $1 billion. The Commission stated in the Proposal that it believed that FCM/SDs that are not BDs do not raise the same types of risks as ANC Firms that would

[113] *See 2019 SEC Final Capital Rule,* 84 FR 43872 at 43874; 17 CFR 240.15c3–1(a)(7). All ANC firms currently use the 2% aggregate debit item financial ratio (the ''alternative standard'') under rule 15c3–1(a)(1)(ii).

[114] *Id.*

[115] The Commission's term ''net capital'' is equivalent to the SEC's term ''tentative net capital'' and the Commission's term ''adjusted net capital'' is equivalent to the SEC's term ''net capital.'' The term ''tentative net capital'' is generally defined as an entity's assets less liabilities (excluding certain qualifying subordinated debt), and ''net capital'' as tentative net capital less certain capital deductions such as market risk and credit risk deductions. *See* 17 CFR 240.18a–1.

[116] Please note that due to changes in **Federal Register** publication requirements, the appendix that had been referred to as Appendix A to section 23.102 in previous documents is being published in this final rule as Appendix A to Subpart E of Part 23.

[117] *See* section II.B.2.a. above for a discussion of the fixed-dollar minimum capital requirements for FCM–SDs.

[118] *See* sections II.C.2.a. and II.C.3.a. of this release for a discussion of the Commission's minimum capital requirements for covered SDs. *See* SEC rule 15c3–1(a)(5) (17 CFR 240.15c3–1(a)(5)) for minimum capital requirements for OTC Derivative Dealers that are not SBSDs and rule 18a–1(a)(2) (17 CFR 240.18a–1(a)(2)) for SBSDs that are not BDs, other than OTC Derivatives Dealers.

warrant a $5 billion minimum tentative net capital requirement. The Commission noted that ANC firms represent the largest BDs and are engaged in significant brokerage businesses including providing customer financing for securities transactions, engaging in repurchase transactions and other activities. FCMs generally have limited proprietary futures trading and operate primarily as market intermediaries for customers trading futures and foreign futures transactions. In this capacity, FCMs receive and hold customer funds in segregated accounts that are used to satisfy the customers' financial obligations to clearing organizations. Even in their capacity as SDs, the margin regulations mitigate the risks to and from the FCM as they generally are required to exchange variation margin on swaps on a daily basis with all other SDs and financial end users, and to post and collect initial margin with counterparties that are SDs and financial end users.

The Commission did not receive specific comments on the use of models by FCM–SDs that are not ANC Firms. The Commission has considered the issue and is adopting the proposed amendment to regulation 1.17(c)(6) to provide a model approval process for FCM–SDs that are not BDs substantially as proposed, but with a modification to not adopt the proposed liquidity requirement and also to comport with the final model process requirements for covered SDs.[119] While the four FCM–SDs provisionally-registered with the Commission are ANC Firms and already approved to use models, the Commission believes that other, non-BD FCM–SDs have the potential to enhance market liquidity in certain sections of the swaps market, particularly with smaller counterparties and less frequently traded products. The Commission believes that it is important to provide an opportunity for such firms to potentially enter the market and service counterparties that may not have significant choice in selecting SDs. For example, FCM–SDs may be more willing to make markets in commodity swaps to agricultural firms and smaller commercial end users such as farmers and ranchers that might not otherwise be able to use such markets to manage risks in their businesses or might have to pay higher fees to engage in swaps if the number of SDs was limited. The Commission further believes that given the nature of the business operations of FCM–SDs, the proposed minimum capital requirement of $100 million of adjusted net capital is consistent with the objective of section 4s(e) of the CEA of helping to ensure the safety and soundness of the FCM–SD.

C. Capital Requirements for Swap Dealers and Major Swap Participants

1. Introduction to Covered SD and Covered MSP Capital Requirements

The Commission is adopting final capital requirements for covered SDs and covered MSPs in order to help ensure the safety and soundness of the SDs and MSPs by requiring such firms to maintain a minimum level of financial resources that is based upon the level of margin associated with the uncleared swaps entered into by the firms. The appropriate setting of minimum capital requirements will help ensure that covered SDs and covered MSPs are able to meet their respective financial obligations to swap and security-based swap counterparties, and to creditors generally. The ability of the covered SDs and covered MSPs to meet their financial obligations will provide for a more efficient and effective swaps marketplace for participants by reducing the potential for covered SDs or covered MSPs to default on their obligations to swap and security-based swap counterparties.

There are currently 56 covered SDs subject to the Commission's capital requirements. As noted in section II.A. above, these 56 covered SDs represent a diverse group of corporate entities, ranging from subsidiaries of major global financial and banking institutions to entities that are primarily engaged in physical commodities such as agriculture and energy. The Commission also understands that these 56 covered SDs have a significant level of diversity in swap counterparties, ranging from financial end users to commercial enterprises.

The Commission is providing flexibility to address the diversity of the business models of the covered SDs by permitting each SD that is not also a registered FCM to elect one of two possible capital alternatives.[120] The first alternative is the Net Liquid Assets Capital Approach, which is based on the liquidity-based capital rule for FCMs in regulation 1.17, as well as the liquidity-based capital requirements imposed on BDs and SBSDs by the SEC. The second alternative is the Bank-Based Capital Approach, which is based on the capital requirements established by the Federal Reserve Board for bank holding companies and is generally consistent with the prudential regulators' capital rules applicable to bank SDs. The flexibility provided by the Commission's covered SD capital rules is consistent with the Congressional mandate in the Dodd-Frank Act directing the Commission, SEC, and prudential regulators to adopt, to the maximum extent practicable, comparable minimum capital requirements for SDs and SBSDs.[121]

The Commission's final rule further allows certain eligible covered SDs to elect to compute their regulatory capital under the Tangible Net Worth Capital Approach. The Tangible Net Worth Capital Approach requires a covered SD to maintain a tangible net worth, computed in accordance with GAAP, equal to or greater than the highest of: (i) $20 million, plus the market risk and credit risk exposures associated with its swap and related hedge positions that are part of the covered SD's dealing activities; (ii) 8% uncleared swap margin associated with the covered SD's swaps positions; and (iii) the amount of capital required by an RFA of which the covered SD is a member.

To use the Tangible Net Worth Capital Approach, a covered SD must be predominantly engaged in non-financial activities, or be part of a corporate parent entity that is predominantly engaged in non-financial activities. The Commission is adopting the Tangible Net Worth Capital Approach as it would be available only for covered SDs that, either directly or at their corporate parent level, are primarily involved in non-financial, commercial activities. As the Commission has previously noted, financial firms generally present a higher level of systemic risk to the financial system than commercial firms as the profitability and viability of financial firms are more tightly linked to the health of the financial system than commercial firms.[122]

The Commission's final capital requirements for covered MSPs require such firms to maintain a positive

[119] Commission regulation § 1.17(c)(6) (17 CFR 1.17(c)(6)) provides that an FCM–SD may apply for model approval with the Commission or with an RFA of which it is a member. *See* section II.C.7. below for a discussion of model approvals, including the Commission's standards and process for reviewing and approving capital models, and the process that the Commission will use in determining whether NFA's approval of an FCM–SD's capital models may serve as an alternative means of complying with the Commission's model approval requirement.

[120] SDs that are FCM–SDs are required to comply with the FCM capital requirements contained in Commission regulation § 1.17 (17 CFR 1.17), as amended by this final rulemaking. *See* section II.B. above for a further discussion.

[121] *See* section 4s(e)(3)(D) of the CEA (7 U.S.C. 6s(e)(3)(D)) and section 15F(e)(3)(D)(ii) of the Exchange Act (15 U.S.C. 78o–10(e)(3)(D)(ii)).

[122] *See 2016 Capital Proposal,* 81 FR 91252 at 91255.

tangible net worth. The final MSP capital requirements are discussed in section II.C.5. below.

2. Capital Requirement for Covered SDs Electing the Net Liquid Assets Capital Approach

a. Computation of Minimum Capital Requirement

The Commission's capital requirements for covered SDs electing the Net Liquid Assets Capital Approach generally incorporate by reference the SEC's capital requirements contained in rule 18a–1 for SBSDs that are not also registered as BDs.[123] The capital requirements are set forth in regulation 23.101, and are comprised of two components. The first component of the capital rule requires a covered SD to compute the minimum amount of capital that the SD is required to hold at any given point in time. The second component of the capital rules requires a covered SD to compute, based upon its balance sheet and certain adjustments including market risk and credit risk capital charges to its swaps, security-based swaps, and other proprietary positions, the actual amount of capital that the covered SD maintains. The covered SD's actual capital must be equal to or greater than its minimum capital requirement at all times in order for the covered SD to be in compliance with the rules.

The *2016 Capital Proposal* required a covered SD electing the Net Liquid Assets Capital Approach to maintain a minimum level of net capital[124] equal to or greater than the highest of the following criteria:

(1) $20 million; or

(2) Net capital equal to or greater than 8% of the sum of:

(a) The amount of ''uncleared swap margin'' (as that term was proposed to be defined in regulation 23.100)[125] for each uncleared swap position open on the books of the covered SD, computed on a counterparty-by-counterparty basis pursuant to Commission regulation 23.154 (17 CFR 23.154);

(b) The amount of initial margin required for each uncleared security-based swap position open on the books of the covered SD, computed on a counterparty-by-counterparty basis pursuant to SEC Rule 18a–3(c)(1)(i)(B) (17 CFR 240.18a–3(c)(1)(i)(B)), without regard for any amounts that may be excluded or exempted under the SEC's rules;

(c) The amount of ''risk margin requirement'' (as that term is defined in Commission regulation 1.17(b)(8) (17 CFR 1.17(b)(8))) for the covered SD's cleared futures, foreign futures, and swaps positions open on the books of the covered SD; and

(d) The amount of initial margin required by a clearing organization for proprietary cleared security-based swaps positions open on the books of the covered SD; or

(3) The capital required by the RFA of which the covered SD is a member.[126] The *2016 Capital Proposal* also required a covered SD that received approval from the Commission, or from an RFA of which the covered SD was a member, to use internal models to compute market risk and credit risk capital charges for its swaps, security-based swaps, and other proprietary positions when computing its capital, as described in section II.C.2.a. of this release, to maintain a minimum level of tentative net capital equal to $100 million.

Fixed-Dollar Capital Requirement for Net Liquid Assets Capital Approach

The first criterion under the Net Liquid Assets Capital Approach required a covered SD to maintain a minimum of $20 million of net capital and, if the covered SD was approved to use market risk or credit risk models, $100 million of tentative net capital and $20 million of net capital.[127] The Commission requested comment in the *2016 Capital Proposal* on the appropriateness of the fixed-dollar capital requirements of $100 million of tentative net capital and $20 million of net capital.[128] The Commission received one comment regarding the proposed requirement that covered SDs must maintain a minimum of $20 million of net capital, and a minimum of $100 million of tentative net capital and $20 million of net capital if approved to use market risk or credit risk models.[129] The commenter stated that the requirement that SDs using internal models must have $100 million in tentative net capital would create an unnecessary barrier to entry.[130] The Commission recognizes the commenter's concern but believes that covered SDs must maintain a minimum of $100 million of tentative net capital if approved to use models in order to provide an appropriate buffer of capital to protect against model errors and to protect against the models not recognizing all types of risk, such as operational risk, compliance risk, legal risk, and liquidity risk. Models will result in substantially lower market risk charges than the standardized market risk charges, which will allow a covered SD to engage in more of the transactions than they otherwise would be able to enter into at the same level of capital. In order to protect against model errors, the Commission believes that it is necessary to have an enhanced minimum capital requirement.

The Commission has considered the Proposal further and is adopting the requirements as proposed. The Commission believes, given the role that covered SDs play in the financial markets by engaging in swap dealing activities, it is appropriate to require all covered SDs to maintain a minimum level of net capital, stated as an absolute fixed-dollar amount, that does not fluctuate with the level of the firms' dealing activities to help ensure the safety and soundness of the covered SDs. The $20 million minimum net capital requirement also is consistent with the minimum regulatory capital requirements adopted for covered SDs that elect the Bank-Based Capital Approach or the Tangible Net Worth Capital Approach, as discussed in sections II.C.3. and II.C.4., respectively, of this release. Furthermore, the $20

[123] Rule 18a–1 (17 CFR 240.18a–1) (''rule 18a–1'') also applies to SBSDs that are OTC derivatives dealers, as that term is defined in SEC Rule 3b–12 (17 CFR 240.3b–12).

[124] As noted above, covered SDs electing the Net Liquid Assets Capital Approach are subject to the SEC's capital requirements for SBSDs set forth in SEC rule 18a–1, which has been incorporated into the Commission's rules by reference. The Commission and SEC use different terms to express capital requirements. The Commission's term ''net capital'' is equivalent to the SEC's term ''tentative net capital'' and the Commission's term ''adjusted net capital'' is equivalent to the SEC's term ''net capital.'' The term ''tentative net capital'' is generally defined as an entity's assets less liabilities (excluding certain qualifying subordinated debt), and ''net capital'' as tentative net capital less certain capital deductions such as market risk and credit risk deductions. *See* 17 CFR 240.18a–1. This document will use the SEC defined terms for purposes of the discussion of the Net Liquid Assets Capital Approach.

[125] The term ''uncleared swap margin'' is defined in Commission regulation § 23.100 to mean the amount of initial margin that a swap dealer would be required to collect from each swap counterparty pursuant to the margin rules for uncleared swap transactions (Commission regulation § 23.154 (17 CFR 23.154)). The term ''uncleared swap margin'' includes all uncleared swaps that an SD is required to collect margin for under the margin regulations, and also includes all uncleared swaps that are exempt or excluded from the margin requirements including swaps with commercial end users, swaps entered into prior to the respective compliance dates of the Commission's margin requirements set forth in Commission regulation § 23.161 (17 CFR 23.161) (*i.e.,* legacy swaps), and excluded swaps with an affiliated entity.

[126] *See 2016 Capital Proposal,* 81 FR 91252 at 91260–61.

[127] *See 2016 Capital Proposal,* 81 FR 91252 at 91261.

[128] *See 2016 Capital Proposal,* 81 FR 91252 at 91262.

[129] *See* FIA–PTG 5/24/2017 Letter.

[130] *Id.* at 3–4.

million minimum net capital requirement for covered SDs that elect the Net Liquid Assets Capital Approach is consistent with the minimum capital requirements adopted by the SEC for SBSDs.[131] In addition, the requirement for a covered SD to maintain a minimum of $100 million of tentative net capital if approved to use models is consistent with the SEC minimum capital requirement for stand-alone SBSDs approved to use capital models.[132]

Risk Margin Amount Calculation Under Net Liquid Assets Capital Approach

The second criterion under the proposed Net Liquid Assets Capital Approach required a covered SD to maintain a minimum level of net capital equal to or greater than 8% of the sum of: (i) The amount of ''uncleared swap margin'' (as that term was proposed to be defined in regulation 23.100) for each uncleared swap position open on the books of the covered SD, computed on a counterparty-by-counterparty basis pursuant to Commission regulation 23.154; (ii) the amount of initial margin required for each uncleared security-based swap position open on the books of the covered SD, computed on a counterparty-by-counterparty basis pursuant to SEC rule 18a–3(c)(1)(i)(B) without regard to any initial margin exemptions or exclusions that the rules of the SEC may provide to such security-based swap positons; (iii) the amount of ''risk margin'' (as defined in Commission regulation 1.17(b)(8)) required by a clearing organization for the covered SD's futures, swaps, and foreign futures positions that are open on the books of the covered SD; and (iv) the amount of initial margin required by a clearing organization for security-based swaps that are open on the books of the covered SD.[133] The proposed 8% risk margin amount required a covered SD to include all swaps and security-based swaps in its computation of the margin for uncleared swaps and security-based swaps subject to the 8% risk margin amount calculation, including any swaps positions that are not included in the margin requirements under Commission regulations 23.150 through 23.161, and any security-based swaps positions that are exempt or excluded from the SEC's margin requirements in rule 18a–3(c)(1)(i)(B).

The proposed 8% risk margin amount was based on the Commission's minimum capital requirements for FCMs, which includes a requirement that each FCM must maintain a level of adjusted net capital that is equal to or greater than 8% of the risk margin amount associated with the futures, foreign futures, and cleared swap positions carried in customer and noncustomer accounts.[134] This requirement was intended to ensure that a covered SD electing the Net Liquid Assets Capital Approach maintains a minimum level of capital that is proportionate to all risks associated with the SD's operations and activities. The Commission believed that the proposed 8% risk margin amount was an appropriate approach as the minimum capital requirement was correlated with the ''risk'' of the SD's futures, foreign futures, swaps, and security-based swaps positions as measured by the margin required on the positions. Specifically, a covered SD's minimum capital requirement would increase or decrease in proportion to the number, size, complexity, and market risk inherent in the SD's derivatives business.[135]

The proposed 8% risk margin amount also was consistent with the proposed minimum capital requirements for covered SDs that elect the Bank-Based Capital Approach, as discussed in section II.C.3. below, and was consistent with the capital requirements of the Tangible Net Worth Capital Approach, discussed in section II.C.4. below. The proposed 8% risk margin amount also was comparable with the SEC's capital requirements for SBSDs, with the exception that the SEC's proposal required a SBSD to include a significantly more limited set of positions in the 8% risk margin amount calculation. Specifically, a SBSD's risk margin amount would include only customer cleared security-based swaps and uncleared security-based swaps.[136]

The Commission received numerous comments regarding the proposed 8% risk margin amount in response to the *2016 Capital Proposal.* One commenter strongly supported the 8% risk margin amount threshold on a comprehensive basis.[137] The commenter noted a concern that basing capital requirements on internal models could be manipulated, and that a floor based on 8% of initial margin of a covered SDs positions was appropriate as a counterbalance to ensure that internal modelling does not reduce loss absorbency.[138]

Commenters, however, raised concerns with the proposed 8% risk margin amount.[139] Commenters stated that the proposed 8% risk margin amount has a limited relationship to the actual risk of the covered SD's swaps, SBS, futures, and foreign futures positions.[140] Commenters noted that the 8% risk margin amount is computed on a counterparty-by-counterparty basis and not on the aggregate of all of the covered SD's positions across all counterparties, which may overstate the covered SD's risk by not taking into account offsetting positions across multiple counterparties, including hedging positions.[141] A commenter also noted that the 8% risk margin amount did not reflect the actual risk of a covered SD's proprietary cleared swap, cleared security-based swaps, futures, and foreign futures positions, as the risk margin amount is required to be computed on a clearing organization-by-clearing organization basis and, therefore, does not recognize hedging and risk-reducing portfolio margin across multiple clearing organizations.[142]

Commenters further noted that the Net Liquid Assets Capital Approach double counts the risks of various positions held by a covered SD.[143] The commenters stated that the 8% risk

[131] *See* SEC rule 18a–1(a)(2) (17 CFR 240.18a–1(a)(1)).

[132] *See* SEC rule 18a–1(a)(2) (17 CFR 240.18a–1(a)(2)).

[133] *See* paragraph (a)(1)(ii)(A)(*1*) of proposed Commission regulation § 23.101. *See 2016 Capital Proposal,* 81 FR 91252 at 91310.

[134] *See* section II.B. above for a discussion of the minimum capital requirements for FCMs.

[135] *See* 2016 Capital Proposal, 81 FR 91252 at 91258.

[136] *See SEC 2012 Proposed Capital Rule,* 77 FR 70214 at 70223. The SEC modified the capital requirement in the final rule to require a SBSD to maintain net capital in excess of 2% of the risk margin amount, with the possibility of the SEC increasing the percentage amount to 4% or less after the third anniversary of the rule's compliance date, and then to 8% or less after the fifth anniversary of the rule's compliance date. The rule further provides that the SEC will only raise the 2% risk margin amount multiplier after publishing a notice of the potential change. *See* rule 18a–1(a)(1) (17 CFR 240.18a–1(a)(1)).

[137] *See* Letter from Marcus Stanley, Americans for Financial Reform (May 15, 2017) (AFR 5/15/2017 Letter).

[138] *Id.*

[139] *See, e.g.,* SIFMA 5/15/2017 Letter; FIA 5/15/2017 Letter; Citadel 5/15/2017 Letter); Letter from William Dunaway, INTL FCStone Markets, LLC (May 15, 2017) (IFM 5/15/2017 Letter); Letter from Sebastien Crapanzano and Soo-Mi Lee, Morgan Stanley (May 15, 2017) (MS 5/15/2017 Letter); Letter from Christine Stevenson, BP Energy Company (May 15, 2017) (BPE 5/15/2017 Letter); Letter from Steven Kennedy, International Swaps and Derivatives Association (May 15, 2017) (ISDA 5/15/2017 Letter); Letter from the Japanese Bankers Association (March 14, 2017) (JBA 3/14/2017 Letter); and, FIA–PTG 5/24/2017 Letter.

[140] *Id.*

[141] *See, e.g.,* ISDA 5/15/2017 Letter; JBA 3/14/2017 Letter; SIFMA 5/15/2017 Letter.

[142] *See* FIA–PTG 5/24/2017 Letter.

[143] *See* SIFMA 5/15/2017 Letter; ISDA 5/15/2017 Letter; FIA 5/15/2017 Letter; FIA–PTG 5/24/2017 Letter; JBA 3/14/2017 Letter; Letter from Sunhil Cutinho, CME Group, Inc. (May 15, 2017) (CME 5/15/2017 Letter); and Citadel 5/15/2017 Letter.

margin amount requires a covered SD to hold net capital equal to or in excess of the 8% risk margin amount, while also requiring the covered SD to reduce the amount of capital it actually holds by the amount of market risk and credit risk charges associated with the covered SD's positions.[144] The commenters noted that including these positions in the 8% risk margin amount effectively results in both an increase in the amount of capital that a covered SD is required to hold to meet its minimum requirement and a decrease to the amount of capital the covered SD actually maintains due to the market risk and credit risk charges.

Several commenters also generally stated that the 8% risk margin amount was both too high of a percentage and over-inclusive of the various types of business activities engaged in by covered SDs.[145] One commenter suggested that the Commission consider limiting the 8% risk margin amount solely to uncleared swaps subject to the Commission's uncleared margin rules,[146] and another commenter requested the Commission to reconsider the application of the 8% risk margin threshold to cleared swaps.[147]

Several commenters also stated that if the Commission were to retain the 8% risk margin amount as a component of the minimum capital requirement for covered SDs, that the Commission adjust the 8% to a lower multiplier, such as 2%, for a period of time to allow the Commission to gather empirical data in order to determine an appropriate level.[148]

The Commission acknowledged in the *2019 Capital Reopening* the receipt of a significant number of comments concerning the proposed 8% risk margin amount and the potential impact that it may have on driving a covered SD's minimum capital requirement, and, consequently, the funding and business activities of the covered SD. The *2019 Capital Reopening* invited interested parties to comment on all aspects of the proposed 8% risk margin amount. The Commission also requested comment and supporting data on the quantification of the potential minimum capital requirements required of covered SDs electing the Net Liquid Assets Capital Approach as a result of the proposed 8% risk margin amount threshold. The Commission further requested comment and supporting data on how the amount of potential minimum capital based upon the 8% risk margin requirement compared with the amount of capital currently maintained by entities that are provisionally registered as covered SDs, and how such amounts compared with the amounts of capital required of SBSDs under the *2019 SEC Final Capital Rule.*[149]

The *2019 Capital Reopening* also requested comment and supporting data on whether the proposed 8% risk margin amount should be modified for covered SDs electing the Net Liquid Assets Capital Approach to a lower percentage requirement, such as 4%, or to another percentage, and requested that commenters state why the suggested percentage was an appropriate percentage properly calibrated to the inherent risk of a covered SD and the activities that it engages in.[150] The Commission further requested commenters to quantify the difference in the amount of capital that would be required of a covered SD pursuant to the proposed 8% risk margin amount and 4%, or any other suggested lower percentage, of risk margin amount, and to the extent possible to model the impact of different percentages of risk margin on the minimum capital requirements for an actual or hypothetical portfolio of positions.[151]

The *2019 Capital Reopening* also requested comment on whether the proposed 8% risk margin amount should be harmonized with the approach adopted by the SEC for SBSDs in the *2019 SEC Final Capital Rule.*[152] Specifically, the Commission requested comment on whether the proposed regulation should be revised to lower the risk margin amount percentage from 8% to 2%, and whether the regulation should be further modified to authorize the Commission by order to increase the risk margin amount percentage in stages from 2% to 4% or less, and from 4% to 8% or less based upon the Commission's future experience with covered SD capital levels after the implementation of the final regulations.[153]

The Commission received several comments in response to the *2019 Capital Reopening* addressing the 8% risk margin amount. One commenter stated that the Commission should eliminate the 8% risk margin amount requirement for covered SDs from the Net Liquid Assets Capital Approach.[154] This commenter stated that while the Commission based the 8% risk margin amount on an existing requirement of an FCM to maintain adjusted net capital in excess of 8% of the risk margin amount for futures, foreign futures, and cleared swap positions carried by the FCM in customer and noncustomer (*i.e.,* affiliates) accounts, there are fundamental differences between the business activities of FCMs and covered SDs that makes the application of the 8% risk margin amount requirement to covered SDs illogical.[155] This commenter further stated that the 8% risk margin amount is not necessary to ensure that covered SDs maintain appropriate capital levels, noting that market risk and credit risk charges will apply to all of the covered SD's derivatives positions under the proposed Net Liquid Assets Capital Approach, and noting that other applicable regulatory authorities do not impose a requirement similar to the 8% risk margin amount, which indicates that it is not necessary for a robust capital framework.[156]

The commenter also stated that the 8% risk margin requirement would discourage covered SDs from hedging market risk.[157] This commenter noted that a covered SD enters into swaps and other derivatives transactions as a counterparty, which exposes the derivative positions to market risk. The commenter further noted that the covered SD may hedge this market risk by entering into offsetting positions with other counterparties. The commenter stated that instead of recognizing the risk-mitigating effects of entering into hedged positions, the Proposal penalizes the covered SD by requiring the initial margin of both the original and hedge positions to be subject to the 8% risk margin amount, which increases costs to the covered SD and discourages risk management.[158]

Commenters also stated that the 8% risk margin amount fails to recognize the risk-reducing effects resulting from

[144] *Id.* See also IIB/ISDA/SIFMA 3/3/2020 Letter.

[145] *Id.*

[146] *See* IFM 5/15/2017 Letter.

[147] *See* ISDA 5/15/2017 Letter.

[148] *See* SIFMA 5/15/2017 Letter; MS 5/15/2017 Letter.

[149] *See 2019 Capital Reopening,* 84 FR 69664 at 69668–69 (Dec. 19, 2019).

[150] *Id.*

[151] *Id.*

[152] *Id.*

[153] *Id.*

[154] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[155] *Id.*

[156] *Id.* The commenter noted that the capital rules of the prudential regulators rely on setting a minimum capital requirement based on the risk-weighted assets of prudentially-regulated institutions, including bank SDs, without any 8% risk margin amount add-on. The commenter stated that the Commission did not articulate a rationale for departing from the approaches of other regulators, and that the CEA requires the Commission, SEC, and prudential regulators to maintain comparable minimum capital requirements to the maximum extent practicable.

[157] *Id.*

[158] *Id.*

the collection of initial margin.[159] One commenter noted that the proposed 8% risk margin amount would impose the same minimum capital requirement on a covered SD regardless of whether the SD collected initial margin from the counterparty.[160] Another commenter stated that the 8% risk margin amount would be improved through the recognition of initial margin that is collected by the covered SD and held by an independent custodian as required by the Commission's margin rules.[161] The commenter stated that the collection of initial margin reduces the potential credit risk exposure that a covered SD has from a counterparty, which should be reflected in the minimum capital requirements.[162]

One commenter stated that the 8% risk margin amount would impose significant and expensive operational burdens on covered SDs.[163] The commenter noted that proposed 8% risk margin amount requires a covered SD to include positions in the calculation that are not subject to the Commission's uncleared swap margin rules. The commenter stated that the requirement to include positions, such as certain foreign currency forwards and foreign currency swaps, legacy swaps and other swaps and security-based swaps that are excluded from the Commission's or SEC's uncleared margin rules in the 8% risk margin amount calculation will potentially require a covered SD to obtain approval from NFA to use a model to compute initial margin for these positions in order to avoid having to include the initial margin requirements based upon the standardized table in the Commission's margin rules. The commenter further noted that notwithstanding the burden and potential costs associated with obtaining model approval for these positions that are otherwise exempt from uncleared margin requirements, there is a burden and cost associated with computing margin for swaps and security-based swaps that are not subject to the Commission's or SEC's margin requirements. The commenter also noted that the traditional 8% risk margin amount under the FCM capital rules does not present the same challenges and costs as the traditional FCM rule applies only to cleared customer and noncustomer transactions where clearing organizations provide the relevant initial margin requirements.[164]

This commenter also stated that the proposed 8% risk margin amount could make it difficult for covered SDs and other market participants to enter into swaps that facilitate the transition from interbank offered rates (''IBORs'') to other risk-free rates.[165] The commenter stated that the Commission has previously recognized that market participants may seek to transition swap or other portfolios that reference IBORs to an alternative reference rate by means of a basis swap that swaps the entire IBOR basis of a portfolio with an alternative reference rate basis.[166] The commenter note that the basis swaps and other similar transactions serve to reduce risk, both to covered SDs and to their counterparties. The transactions, however, may also increase the aggregate gross notional amount of a covered SD's swaps as well as the initial margin that a covered SD is required to collect, and that absent a revision in the final rule, the transactions may also increase the minimum capital requirement under the 8% risk margin amount.[167]

The commenter also stated that the 8% risk margin amount would exacerbate the impacts resulting from the current limited availability of portfolio margining.[168] The commenter noted that under current Commission and SEC margin rules, a dually-registered SD/SBSD is required to compute initial margin separately for uncleared swaps and security-based swaps with a single counterparty, which prevents the SD/SBSD from recognizing the risk-reducing impacts of offsetting swaps and security-based swap positions. The commenter stated the Commission was distorting the minimum capital requirement by establishing an 8% risk margin amount that scaled up with the initial margin requirements and not the actual risk of the positions viewed from a portfolio basis.[169]

Several commenters stated that certain elements of the 8% risk margin amount calculation should be revised if the Commission were to adopt it as part of a covered SD's minimum capital requirements. Commenters stated that the Commission should revise the 8% risk margin amount contained in the Net Liquid Assets Capital Approach to eliminate the ''double-counting'' of a covered SD's positions.[170] These commenters noted that under the proposed Net Liquid Assets Capital Approach, a covered SD is required to maintain capital equal to 8% of the risk margin amount computed on the covered SD's futures, foreign futures, cleared and uncleared swaps, and cleared and uncleared security-based swaps positions. The covered SD is also required to subtract the amount of the market risk and credit risk associated with its proprietary positions in futures, foreign futures, cleared and uncleared swaps, and cleared and uncleared security-based swaps in determining the amount of capital that the covered SD has in order to meet the minimum capital requirement. The commenters stated that the proposed Net Liquid Assets Capital Approach double counts a covered SD's proprietary positions as the approach both reduces the covered SD's net capital (through the proposed market and credit risk charges) and increases the covered SD's minimum capital requirement (through the proposed 8% risk margin amount). The commenters stated that the Net Liquid Assets Capital Approach's double-counting overstates the risk that swaps present to the covered SD, and places the covered SD at a competitive disadvantage relative to covered SDs that elect the Bank-Based Capital Approach, which does not double-count a covered SD's proprietary positions.[171]

Commenters stated that the Commission should address the ''double-counting'' issue by revising the final Net Liquid Assets Capital Approach to impose the 8% risk margin amount as a capital requirement prior to the imposition of proprietary market and credit risk charges.[172] Under this approach, a covered SD electing the Net Liquid Assets Capital Approach would be required to maintain minimum tentative net capital equal to or greater than 8% of the risk margin amount.

Commenters also stated that the Commission should reduce the multiplier if it adopts the 8% risk margin amount.[173] Commenters noted

[159] *See* IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter.

[160] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[161] *See* MS 3/3/2020 Letter.

[162] *Id.*

[163] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[164] *Id.*

[165] *Id.*

[166] *See* Letter No. 19–28 (Dec. 17, 2019); Letter No. 19–27 (Dec. 17, 2019); Letter 19–26 (Dec. 17, 2019).

[167] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[168] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[169] *Id.*

[170] *See* FIA–PTG 3/3/2020 Letter.

[171] Supra fn 143. *See* also IIB/ISDA/SIFMA 3/3/2020 Letter. As discussed further in section II.C.3.a. below, under the Bank-Based Capital Approach, a covered SD is required to maintain a minimum amount of regulatory capital that is equal to or in excess of the greater of 8% of (i) the risk margin amount or (ii) the SD's risk-weighted assets. A covered SD that elects the Bank-Based Capital Approach is not required to deduct the market risk or credit risk associated with its proprietary positions in computing its regulatory capital necessary to meet the above to minimum standards.

[172] *Id.*

[173] *Id.*

that the 8% risk margin amount was based upon the Commission's capital requirements for FCMs, which imposes an obligation on FCMs to maintain adjusted net capital of at least 8% of the margin required on customer and noncustomer futures, foreign futures, and cleared swaps positions.[174] One commenter stated that there is no evidence to support a conclusion that an 8% calibration is appropriate in the context of non-cleared swaps markets, with fundamentally different regulatory standards and risk management principles than FCM's customers and noncustomer clearing activities.[175]

Another commenter stated that the FCM capital requirement based on 8% of customer and noncustomer margin was never intended to apply broadly to the uncleared swaps market.[176] This commenter stated that data collected almost two decades ago in the context of futures positions does not provide a logical foundation for the adoption of the 8% risk margin requirement, as it does not reflect appropriately the risks faced by covered SDs on their positions, particularly their uncleared positions, which are subject to higher margin requirements based on a 10-day liquidation horizon as opposed to a 1-day horizon common for futures.

The commenter also stated that if the Commission did not modify the 8% risk margin amount requirement to reflect the ''double-counting'' discussed above, then reducing the 8% risk margin amount multiplier would be necessary to prevent competitive disparities. The commenter also stated that based on data it had compiled, an 8% multiplier for the risk margin amount would be high for covered SDs that elect the Net Liquid Assets Capital Approach.[177]

Such a requirement would dramatically increase the amount of capital required to support the derivatives activities well beyond any current capital requirements applicable to such SDs.[178] Further, this same higher required capital would occur on covered SDs regardless of the elected approach under the Commission's proposed framework or relative to capital requirements for bank SDs on portfolios of similar positions.[179]

Commenters also explicitly stated that if the Commission adopts a minimum capital requirement based upon the initial margin of a covered SD's proprietary positions, the multiplier should be reduced from 8% to 2%.[180] The commenters further stated that a 2% risk margin amount would be consistent with the *2019 SEC Final Capital Rule.* One of the commenters also stated that consistency with the SEC's 2% calibration is particularly important for dually-registered SD/SBSDs, otherwise the Commission would be setting the risk margin multiplier for security-based swaps, which effectively undermines the SEC's capital approach to SBSDs that are also covered SDs.[181]

Commenters also stated that the Commission should exclude proprietary futures, cleared swaps and cleared security-based swaps from the calculation if the Commission adopts the 8% risk margin amount.[182] One commenter stated that including proprietary futures, cleared swaps and cleared security-based swaps in the 8% risk margin amount fails to recognize the limited risks and leverage associated with proprietary cleared positions. Unlike customer cleared positions or proprietary uncleared swaps and security-based swaps, proprietary positions present minimal credit risk as the covered SD's only exposure is to clearing organizations. The commenter further noted that centrally cleared transactions present limited leverage since the initial margin associated with such transactions is not reused, but maintained at the clearing organization or custodian. The commenter further stated that the proposed 8% risk margin amount would treat proprietary cleared positions no differently from uncleared swaps, thereby eliminating the incentive to clear transactions and subjecting product types that present markedly different risks to the same capital treatment.[183] Another commenter stated that including a covered SD's cleared futures, swap and security-based swap positions in the 8% risk margin amount fails to recognize the risk mitigating nature of centralized clearing.[184]

The Commission has considered the comments on the 8% risk margin amount and continues to believe that a minimum capital requirement based on initial margin is an appropriate component of a covered SD's minimum capital requirement under the Net Liquid Assets Capital Approach. The Commission acknowledges commenters' views that the risk margin amount could more precisely measure portfolio-related risks if it were to recognize the risk mitigating effects of margin collateral received from counterparties or if it was computed on a total portfolio basis as opposed to being computed on a counterparty-by-counterparty basis. However, the intent of the risk margin amount requirement was to establish a method of developing a minimum amount of capital for a covered SD to meet all of its obligations as a SD to market participants, and to cover potential operational risk, legal risk, and liquidity risk, and not just the risks of its trading portfolio.

The Commission believes that the risk margin amount is a minimum capital requirement that provides a floor based on a measure of the risk of the positions, the volume of positions, the number of counterparties and the complexity of operations of the covered SD. Initial margin reflects the degree of risk associated with the positions, with lower risk positions having lower initial margin requirements and higher risk positions having higher initial margin requirements. Therefore, the amount of the minimum capital required of a covered SD under the risk margin amount calculation is directly related to the volume, size, complexity and risk of the covered SD's positions, however, the minimum capital requirement is intended to cover a multitude of potential risks faced by the SD. This concept is generally consistent with the FCM capital rule, which bases the minimum capital requirement on margin associated with customer and noncustomer futures, foreign futures and cleared swaps transactions, but is intended to address the general risks of operating an FCM such as operational, legal, liquidity and other risks in addition to risks arising from carrying customer accounts. Therefore, the Commission believes that it is appropriate to set a minimum capital requirement for covered SDs that is a floor that reflects the risk margin associated with the SD's uncleared swap positions.

The Commission, however, is modifying the final rule in response to its reconsideration of the issues and the comments received. The Commission is modifying the proposed risk margin amount by removing cleared and uncleared security-based swap positions from the calculation. As noted in section II.B.2.b. above, the Commission believes that a registrants' minimum capital requirements should be based upon the transactions that are within

[174] *See* Commission regulation § 1.17(a)(1)(i) (17 CFR 1.17(a)(1)(i)).

[175] *See* MS 3/3/2020 Letter. The commenter further noted, for instance, that SDs act as counterparties to market participants, and not as financial guarantors of their customers.

[176] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[177] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[178] *Id.*

[179] *Id.*

[180] *See* IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter; FIA–PTG 3/3/2020 Letter.

[181] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[182] *See* IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter; FIA–PTG 3/3/2020 Letter.

[183] *See* IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter.

[184] *See* FIA–PTG 3/3/2020 Letter.

the Commission's jurisdiction and not the jurisdiction of another regulatory agency. This allows the Commission to set minimum capital requirements for registrants, including covered SDs, based upon markets and products that the Commission regulates and for which it has expertise.

Modifying the proposed risk margin amount by removing security-based swaps also maintains a consistency with the long-standing historical approach that the Commission and SEC have followed with respect to dually-registered FCM/BDs. Under the existing FCM/BD capital rules, the Commission sets minimum capital requirements for FCMs based upon the firm's futures and cleared swaps activities, and the SEC sets the minimum capital requirements based upon the firm's securities activities.[185] As noted by commenters above, the proposed inclusion of security-based swap positions in the Commission's minimum capital requirement for dually-registered SD/SBSDs not only goes against this historical approach, it also effectively overrides the SEC's decision regarding the appropriate level of capital that should be imposed on SBSDs with respect to SEC-regulated security-based swap products, particularly if the Commission's and SEC's multiplier are different. In addition, the Commission notes that security-based swaps have only been excluded from the risk margin amount, which establishes the minimum capital requirement. To the extent that a covered SD engages in security-based swaps or other proprietary transactions, including equities, foreign currencies, physical commodities, futures, and swaps, the covered SD is required to reflect these transactions in its capital in the form of market risk and, as appropriate, credit risk charges, and the SD is required to hold capital in an amount sufficient to cover such charges. The exclusion of the security-based swaps from the risk margin amount addresses commenters concern that the proposed Net Liquid Assets Capital Approach ''double counts'' the covered SD's security-based swap positions in the capital computation by including such positions in the both the computation of net capital and in the calculation of the minimum capital requirement. The Commission also notes that to the extent a covered SD is also a registered SBSD, it will be subject to a minimum capital requirement established by the SEC, which requires the SBSD to maintain minimum net capital equal to the greater of $20 million or 2% of the risk margin amount associated with the SBSD's uncleared security-based swaps and customer cleared security-based swaps. Therefore, to the extent a covered SD that is dually-registered as a SBSD engages in a substantial amount of security-based swaps such that its SEC minimum capital requirement is greater than the CFTC minimum capital requirement, the SD would have to maintain compliance with the higher SEC minimum capital requirement in order to comply with the SEC rules.

The Commission is also modifying the proposed risk margin amount calculation to exclude proprietary futures, foreign futures, and cleared swap transactions. The Commission believes that it is appropriate to revise the proposed risk margin amount to exclude proprietary cleared positions from the minimum capital requirement as the covered SD's credit exposure is limited on such positions to either a clearing organization or to an FCM that carries the SD's account (or in the case of foreign futures, a foreign broker that carries the SD's account). The credit exposure on such cleared positions is limited relative to swap counterparties as clearing organizations and FCM/foreign brokers are regulated entities that are generally subject to financial requirements, including capital, margining, and financial reporting requirements. Clearing organizations and FCM/foreign brokers are also subject to regulations regarding the holding of customer funds to ensure that such funds are used solely for the benefit of the customer and not for the benefit of other customers or of the clearing organization or FCM/foreign broker.[186] The clearing of the positions also ensures that the potential default by the SD is reduced as it is obligated to post initial margin with an FCM/foreign broker or clearing organization, and to settle open positions on a daily basis. Therefore, any default on the part of the SD is promptly identified by the FCM/foreign broker or clearing organization and steps are taken to mitigate the potential losses resulting from the default. These types of restrictions on the holding of customer funds by FCMs, foreign brokers, and clearing organizations and the clearing organizations' daily margining processes mitigate the risk associated with the covered SD's cleared futures, foreign futures, and cleared swaps transactions. Furthermore, while the cleared proprietary positions are being excluded from the minimum capital requirement based upon the risk margin amount, the positions are reflected in the covered SD's capital in the form of market risk and credit risk charges and the covered SD is required to hold capital sufficient to cover those charges.

The Commission is also modifying the proposed 8% risk margin amount for covered SDs electing the Net Liquid Assets Capital Approach by setting the multiplier at 2%. The Commission has reviewed the proposed capital requirements and has considered the comments received and believes that it is appropriate to modify the risk margin amount multiplier in the Net Liquid Assets Capital Approach, and to retain the 8% risk margin amount multiplier in the Bank-Based Capital Approach and the Tangible Net Worth Capital Approach. Therefore, under the final regulation, a covered SD that elects the Net Liquid Assets Capital Approach must maintain a minimum level of net capital that is equal to or greater than 2% of the initial margin of its uncleared swaps, computed on a counterparty-by-counterparty basis.

The Commission believes that modifying the risk margin amount multiplier under the Net Liquid Assets Capital Approach is appropriate due to (i) differences in the assets that comprise regulatory capital under the Net Liquid Assets Capital Approach relative the Bank-Based Capital Approach and the Tangible Net Worth Capital Approach, and (ii) differences in how the minimum capital requirement is applied under the Net Liquid Assets Capital Approach relative the Bank-Based Capital Approach and the Tangible Net Worth Capital Approach. As previously discussed, the Net Liquid Assets Capital Approach is a liquidity-based capital approach that requires a covered SD to hold at least one dollar of highly liquid assets for each dollar of the firm's liabilities (excluding qualifying subordinated debt). With respect to the assets that comprise net capital under the Net Liquid Assets Capital Approach, a SD is required to calculate its net worth in accordance with U.S. GAAP, and subtract all illiquid assets, such as fixed assets and intangible assets, and deduct all of the firm's liabilities (except certain qualifying subordinated debt) to determine its tentative net capital. The SD then deducts market risk charges on all of its proprietary positions, including uncleared swap and security-based swap positions, and credit risk charges on its exposures to counterparties on its derivative positions, to determine its net capital.

In contrast to the liquidity-based approach of the Net Liquid Assets

[185] *See* Commission regulation § 1.17(a)(1)(i) (17 CFR 1.17(a)(1)(i)) and SEC rule 15c3–1.

[186] *See, e.g.,* Commission regulations §§ 1.20, 1.22 and 39.15 (17 CFR 1.20, 1.22 and 39.15).

Capital Approach, the Bank-Based Capital Approach and the Tangible Net Worth Capital Approach are more properly viewed as solvency-based capital requirements that require a covered SD to maintain positive balance sheet equity. Under the Bank-Based Capital Approach and Tangible Net Worth Capital Approach, a covered SD is not required to deduct fixed assets or other illiquid assets from its balance sheet equity.[187] A covered SD is also not required to deduct market risk and credit risk charges from its balance sheet equity. Therefore, the capital that is available and that may be used to meet the minimum capital requirement is substantially more conservative under the Net Liquid Assets Capital Approach than it is under the Bank-Based Capital Approach and the Tangible Net Worth Capital Approach.

In addition to what assets qualify as capital, the risk margin amount requirement is applied in a more conservative manner to covered SDs under the Net Liquid Assets Capital Approach than it is under the Bank-Based Capital Approach and the Tangible Net Worth Capital Approach. Under the proposed Net Liquid Assets Capital Approach, a covered SD was required to maintain a level of net capital (as defined above) that equaled or exceeded 8% of the risk margin amount. Covered SDs electing the proposed Bank-Based Capital Approach or Tangible Net Worth Capital Approach were required to maintain balance sheet equity (without deductions for fixed assets and market risk and credit risk charges) that equaled or exceeded 8% of the risk margin amount. Therefore, covered SDs electing the Bank-Based Capital Approach or Tangible Net Worth Capital Approach may have substantially more assets that qualify as capital to meet the proposed 8% risk margin amount requirement.

The Commission recognizes that the differences in the capital approaches discussed above may provide a competitive advantage to covered SDs electing the Bank-Based Capital Approach and Tangible Net Worth Capital Approach due to the ability of such SDs to include fixed assets and not have to deduct market and credit risk charges. To address this potential competitive disadvantage, the Commission is modifying the regulation by setting the risk margin amount multiplier at 2% under the Net Liquid Assets Capital Approach. Given the differences in the operation of the respective capital approaches as discussed above, the Commission believes that setting the risk margin amount multiplier at 2% for covered SDs electing the Net Liquid Assets Capital approach imposes a minimum capital requirement that is more equivalent to the 8% risk margin amount requirement for Bank-Based Capital Approach and Tangible Net Worth Capital Approach SDs. Setting the risk margin amount at 2% also mitigates commenters' concern that the Net Liquid Assets Capital Approach results in ''double counting'' of positions in the capital computation.

The Commission proposed an 8% risk margin amount multiplier based upon its experience with FCM capital requirements, which requires each FCM to maintain a minimum capital requirement based upon 8% of the risk margin on the futures, foreign futures, and cleared swap positions carried in customer and noncustomer accounts. As noted by a commenter, the 8% risk margin amount was proposed in 2003 and adopted in 2004 based upon an analysis and comparison of the capital regime in effect at the time, which was based on a percentage of the customer funds held by an FCM, with a minimum capital requirement based upon risk margin associated with the customer positions carried by the FCM.[188] Staff also had the benefit of observing data of the actual performance of the two capital regimes for an extended period of time as each FCM was required to calculate its minimum capital requirement based on customer funds and its capital requirement based on a percentage of its risk margin amount for approximately three years as part of a pilot program.[189]

The Commission does not have sufficient data to perform a quantitative analysis of the optimal level to set the multiplier for the risk margin amount at this time. However, the Commission's decision to modify the final rule by removing cleared and uncleared security-based swaps, as well as proprietary futures, foreign futures, and cleared swaps positions from the risk margin amount calculation and to set the multiplier at 2% should mitigate many of the commenters' concerns that the proposed 8% risk margin amount calculation was over inclusive of the types of positions included in the calculation and was set at a percentage that was too high. In addition, as the commenters noted, the FCM capital requirement of 8% of the risk margin on futures, foreign futures and cleared swaps is based upon margin calculations using clearing organization models that require the clearing organization to use a 99% one-tailed confidence interval over a minimum liquidation period of one day for futures, agricultural swaps, energy swaps, and metal swaps of one day, and a minimum liquidation period of five days for all other swaps.[190] In contrast, initial margin for uncleared swaps is required to be calculated at a 99% one-tailed confidence interval over minimum liquidation period of 10 business days (or the maturity of the swap if shorter).[191] The greater minimum holding period for uncleared swaps generally requires a higher level of initial margin, which would increase the covered SD's minimum capital requirement relative to cleared transactions.

Also, the Commission's final approach is consistent with the Congressional mandate to adopt capital requirements that are to the maximum extent practicable, comparable with the SEC and prudential regulators' capital requirements. The SEC's final rules require a SBSD to maintain net capital (not tentative net capital) that is equal to or greater than 2% of the risk margin amount calculated on its customer cleared security-based swaps and uncleared security-based swaps. Therefore, the Commission's final regulation is comparable with the SEC's final rule for SBSDs.[192]

The Commission believes it will be necessary to monitor and evaluate whether the numerical percentage is effective in achieving the statutory requirement for capital. Therefore, unlike the SEC, the Commission is not committing to a predetermined upward ratcheting percentage, but will

[187] SDs electing the Tangible Net Worth Capital Approach are required to deduct intangible assets.

[188] *See Minimum Financial and Related Reporting Requirements for Futures Commission Merchants and Introducing Brokers,* 68 FR 40835 (July 9, 2003) (''2003 *Proposed Risk-based Capital Rulemaking*''). The final rule is available at 69 FR 49784 (Aug. 12, 2004). *See also,* IIB/ISDA/SIFMA 3/3/2020 Letter.

[189] *See 2003 Proposed Risk-based Capital Rulemaking,* 68 FR 40835 at 40839.

[190] *See* Commission regulation § 39.13(g) (17 CFR 39.13(g)).

[191] *See* Commission regulation § 23.154(b)(2) (17 CFR 23.154(b)(2)).

[192] Under the Commission's final rule, a covered SD will be required to maintain a minimum level of adjusted net capital equal to or greater than 2% of the risk margin associated with the SD's proprietary uncleared swap transactions. Under the SEC's final rule, a stand-alone SBSD will be required to maintain a minimum level of net capital equal to or greater than 2% of the sum of the SBSD's customer cleared security-based swaps and uncleared security-based swaps. Covered SDs that clear customer swaps would be required to register as an FCM and will be subject to the FCM–SD capital requirements discussed in section II.B. above, which includes a minimum capital requirement of 8% of the risk margin amount associated with the FCM–SD's cleared customer futures, foreign futures, and cleared swap positions.

continually monitor and evaluate, which provides the Commission more flexibility in making fact-based assessments about the efficacy of the final rule in the future.

The Commission will monitor the impact that the 2% risk margin amount has on the level of minimum capital required of covered SDs electing the Net Liquid Assets Capital Approach after the compliance date of the rules. The Commission intends to use the financial statements and other information that it will receive from covered SDs under the financial reporting requirements discussed in section II.D. below to continually monitor the minimum capital requirements under the final rule, ensuring the Commission's capital requirements are adequately calibrated to protect the safety and soundness of the covered SDs. The information that the Commission will receive will allow it to determine if it would be appropriate to propose amending the minimum capital requirements by, among other things, increasing or decreasing the risk margin amount multiplier.

The Commission also has considered the comments that the minimum capital requirement should be revised to require a covered SD to maintain tentative net capital in excess of the risk margin amount as opposed to the proposed net capital requirement. The Commission is not modifying the final rule to reflect these comments. While the Commission acknowledges that a covered SD electing the Net Liquid Assets Capital Approach is required to both include its uncleared swaps in the 2% risk margin amount calculation in order to establish its minimum capital requirement and to take capital charges for market risk and credit risk on the uncleared swaps in computing the amount of capital the covered SD holds, the Commission does not believe that it would be appropriate to revise the final rule at this time to only apply to tentative net capital. If the Commission were to revise the final regulation consistent with the comments, then a covered SD would be subject only to the minimum fixed-dollar net capital requirement of $20 million (and those approved to use capital models, a tentative net capital requirement of $100 million). Including the uncleared swaps in establishing a minimum capital requirement is intended to provide a floor of net capital that each SD following the Net Liquid Assets Capital Approach is required to maintain to cover all risks to the firm, including market, credit, operation, liquidity, and legal risk.

With respect to commenters' concerns that the proposed risk margin amount would exacerbate the impact of a covered SD's inability to portfolio margin uncleared swaps and uncleared security-based swaps with a counterparty in a single account, the Commission recognizes the capital and margin efficiencies that portfolio margining provides to covered SDs and counterparties. The Commission also recognizes that the inability of a covered SD that is dually-registered with the SEC as a SBSD to portfolio margin uncleared swaps and uncleared security-based swaps impacts the SD's ability to compete with bank SDs that may margin uncleared swaps and security-based swaps in a single account, subject to the rules of the applicable prudential regulator. Under the Dodd-Frank Act framework, the Commission has the authority to establish margin requirements for swaps and the SEC has the authority to establish margin requirements for security-based swaps. Therefore, the respective Commissions need to take coordinated action in order for a dually-registered covered SD and SBSD to margin uncleared swaps and security-based swaps with a counterparty in a single account. The Commission will consult with the SEC regarding portfolio margining and, as part of such consultation, address capital issues.

With respect to comments that the risk margin amount may make it difficult for covered SDs and other market participants to enter into swaps that facilitate the transition from interbank offered rates to other risk-free rates, the Commission invites market participants that may be impacted by the capital rule to seek guidance from Commission staff. As noted above, Commission staff has provided no-action relief, including margin relief, to facilitate a covered SD's transition of open swaps with an interbank offered rate to other rates.

Minimum Capital Requirement of a Registered Futures Association Under Net Liquid Assets Capital Approach

The third criterion of the proposed Net Liquid Assets Capital Approach required a covered SD to maintain net capital that was equal to or greater than the amount of net capital required by an RFA of which the covered SD was a member. As noted in the *2016 Capital Proposal,* the proposed minimum capital requirement based on membership requirements of an RFA is consistent with section 17(p)(2) of the CEA and current regulation 1.17 for FCMs and IBs.[193]

Section 17(p)(2) of the CEA provides, in relevant part, that an RFA must adopt rules establishing minimum capital and other financial requirements applicable to the RFA's members for which such requirements are imposed by the Commission.[194] Section 17(p)(2) further requires an RFA to implement a program to audit and enforce its members' compliance with such capital and other financial requirements. As noted above, the NFA currently is the only RFA, and each SD is required to be a member of NFA.[195]

The *2016 Capital Proposal* noted that NFA is required by section 17 of the CEA to adopt SD capital rules once the Commission imposes capital requirements on SDs, and that NFA's capital rules must be at least as stringent as the Commission's capital requirements on covered SDs.[196] The Commission's proposed Net Liquid Assets Capital Approach incorporated the NFA minimum capital requirement into the Commission's capital rule, which would make a violation of the NFA's rule also a violation of the Commission's rule in a manner that is consistent with the current FCM capital rules.[197]

The Commission received several comments regarding the proposed requirement that a covered SD must meet the capital rules adopted by the NFA. Several commenters stated that any future NFA capital rules for covered SDs should be subject to public comment.[198] One commenter also stated that creating, revising and implementing

[193] *See* Commission regulations §§ 1.17(a)(1)(i)(C) and 170.16 (17 CFR 1.17(a)(1)(i)(C) and 170.16).

[194] *See* section 17(p)(2) of the CEA (7 U.S.C. 21(p)(2)), which requires RFAs to adopt rules establishing minimum capital and other financial requirements applicable to its members for which such requirements are imposed by the Commission, provided that such requirements may not be less stringent than the requirements imposed by the CEA or by Commission regulations.

[195] Commission regulation § 170.16 (17 CFR 170.16) provides, in relevant part, that each person registered as an SD must become and remain a member of at least one futures association that is registered with the Commission under section 17 of the CEA and provides for the membership of SDs. NFA is currently the only RFA and accepts SD members.

[196] *See 2016 Capital Proposal,* 81 FR 91252 at 91259 and footnote 87 at 91269.

[197] Commission regulation § 1.17(a)(1)(i)(C) (17 CFR 1.17(a)(1)(i)(C)) currently incorporates NFA's minimum capital requirement for an FCM into the Commission's minimum capital requirement by providing that each person registered as an FCM must maintain adjusted net capital required by an RFA of which the FCM is a member.

[198] ED&F Man/INTL FCStone 3/3/2020 Letter; Letter from Scott Earnest, Shell Trading Risk Management LLC (March 2, 2020) (Shell 3/3/2020 Letter).

systems, controls, processes, reporting and related internal mechanisms requires ample notice of uninterrupted requirements that could be jeopardized by an inconsistent NFA capital requirement.[199] To address this issue, the commenter requested that the Commission require NFA to establish a public comment period to solicit feedback on any covered SD capital requirements prior to mandating compliance with such requirements.[200]

Another commenter stated that the Commission's efforts to obtain public input pursuant to the *2016 Capital Proposal* and the *2019 Capital Reopening* may be nullified if the NFA adopts capital rules that are different from the Commission's final rules.[201] The commenter requested that the Commission require NFA to adopt capital rules that closely mirror the Commission's final capital rules, or, at the least, require NFA to conduct a rigorous notice and comment process prior to finalizing its capital rules.[202]

The Commission appreciates the commenters concerns regarding the need for conformity between its final capital rules governing covered SDs and those that may be adopted by NFA as an RFA in the future. The Commission believes, however, that the concerns are largely mitigated by the existing statutory and Commission regulatory requirements as well as the internal governance structure of NFA, which was established to comply with these requirements. Section 17(j) of the CEA, for example, requires NFA to file with the Commission any change in or addition to its rules. Any such change or addition is effective within 10 days of submission unless NFA requests, or the Commission notifies NFA of its intent to subject the filing to, a review and approval process.[203] To the extent NFA plans to adopt significant new rules, it typically has worked very closely with Commission staff to ensure, among other things, consistency with existing Commission regulations. The current capital and financial requirements applicable to FCMs and IBs, are essentially the same under both Commission regulations and NFA rules.[204]

Further, the statutory and Commission regulatory requirements and NFA's governance structure ensure that SDs are represented and given a voice in the potential adoption of NFA rules, including capital and financial reporting rules, that may impact them. Specifically, section 17(b)(5) of the CEA and regulation 170.3 require generally that the rules of an RFA assure fair representation of its members in the adoption of any rule, in the selection of its officers, directors, and in other aspects of its administration.[205] In this regard, NFA's Articles of Incorporation require that its Board of Directors include 5 elected representatives of registered (or provisionally-registered) SDs, registered (or provisionally registered) major swap participants and registered RFEDs. Of these representatives, at least 2 must be SDs that are Large Financial Institutions [206] (as of June 30 of the prior calendar year) and at least 2 others must be representatives of SDs, MSPs or RFEDs that are not Large Financial Institutions.[207]

In light of NFA's governance structure, the Commission's review process with respect to new NFA rules and the typically close interaction between Commission and NFA staff with regard to NFA's adoption of new rules, the Commission believes that an additional mandatory public comment period for NFA capital rules would be unnecessary. Accordingly, the Commission is adopting the third criterion that a covered SD electing the Net Liquid Assets Capital Approach must maintain capital in an amount equal to or in excess of an amount of capital, if any, imposed by an RFA of which the covered SD is a member.

b. Computation of Net Capital To Meet Minimum Capital Requirement

The second component of the proposed Net Liquid Assets Capital Approach required a covered SD to compute the amount of ''tentative net capital'' and ''net capital'' that the SD maintains in order to satisfy its minimum capital requirement. Proposed regulation 23.101(a)(1)(ii) required each covered SD electing the Net Liquid Assets Capital Approach to compute its tentative net capital and net capital in accordance with the SEC's computation of tentative net capital and net capital for nonbank SBSDs under Rule 18a–1 as if the covered SD was a nonbank SBSD, subject to several adjustments.[208]

The Net Liquid Assets Capital Approach and the SEC capital approach for SBSDs are based on the existing FCM and BD capital rules and place an emphasis on liquidity of the entity. The FCM and BD capital rules are liquidity-based capital requirements that generally require a firm to maintain at all times at least $1 dollar of highly liquid assets to cover each dollar of its unsubordinated liabilities, which is generally money owed to customers, counterparties and creditors.

A covered SD electing the Net Liquid Assets Capital Approach will compute net capital by first determining its net worth under U.S. GAAP, which generally reflects the firm's total assets less its total liabilities. The covered SD would then adjust its net worth by deducting certain assets such as unsecured receivables and undermargined counterparty accounts. The covered SD would also be able to add back to its net worth certain qualifying subordinated liabilities. The result of these adjustments would be the covered SD's ''tentative net capital.''

The covered SD will then compute its ''net capital'' by deducting from ''tentative net capital'' prescribed capital charges from the mark-to-market value of its proprietary swap, security-based swap, equities, and commodity positions. The prescribed capital charges for the covered SD's proprietary positions are the existing standardized capital charges set forth in Commission regulation 1.17 for FCMs and SEC rule 15c3–1 for BDs. The Proposal also provided that a covered SD could seek approval from the Commission or an RFA to use internal models to compute market risk and credit risk capital charges in lieu of the standardized capital charges. The application and approval process for market risk and credit risk capital models is discussed in section II.C.7. below.

(i) Swap Dealers Not Approved To Use Internal Capital Models

The *2016 Capital Proposal* required a covered SD electing the Net Liquid Assets Capital Approach to apply, in computing its net capital, standardized market risk and credit risk capital

[199] ED&F Man/INTL FCStone 3/3/2020 Letter.

[200] *Id.*

[201] *See* Shell 3/3/2020 Letter.

[202] *Id.*

[203] *See* section 17(j) of the CEA (7 U.S.C. 21(j)).

[204] *Cf.* Commission regulation § 1.17 (17 CFR 1.17) with NFA Financial Requirements.

[205] 7 U.S.C. 21(b)(5) and Commission regulation § 170.3 (17 CFR 1.17). *See also,* section 17(b)(11) of the CEA (7 U.S.C. 21(b)(11)) which requires that an RFA provide for meaningful representation on the governing board of such association of a diversity of membership interests and provides that no less than 20 percent of the regular voting members of the board be comprised of qualified nonmembers of or persons not regulated by such association.

[206] The term ''Large Financial Institution'' is defined in Article XVIII(n) of NFA's Articles of Incorporation as ''a Swap Dealer included in a well defined, publicly available and independent list of financial institutions that the Board of Directors identifies by resolution from time to time.''

[207] Article XVII, Section 2A(d) of NFA Articles of Incorporation. Article VIII, Section 3(c)(iv) requires that NFA's Executive Committee composition include 13 Directors, 2 of whom represent SDs, MSPs or RFEDs.

[208] *See 2016 Capital Proposal,* 81 FR 91252 at 91260–61.

charges set forth in SEC Rule 18a–1, and the appendices thereto, for positions in swaps, security-based swaps, and other proprietary positions, if the covered SD had not obtained Commission or RFA approval to use internal models. The standardized market risk charges under SEC rule 18a–1 are rules-based capital charges that require a covered SD to compute market risk capital charges for swaps, security-based swaps, and other positions by multiplying the notional amount or fair market value of the positions by a specified percentage set forth in SEC rule 18a–1.[209] The resulting market risk charges would be deducted from the covered SD's tentative net capital to arrive at the firm's net capital.

Standardized credit risk charges under SEC Rule 18a–1 generally provide that unsecured receivables are subject to a 100 percent credit risk capital charge (*i.e.,* the covered SD would have to deduct 100 percent of any unsecured receivable balance, including receivables from swap and security-based swap counterparties for unpaid variation margin or mark-to-market gains, from tentative net capital in computing net capital).[210] Accordingly, under the proposed standardized credit risk charges, covered SDs were required to deduct any unsecured receivables arising from not collecting variation margin from any counterparty, including counterparties that are exempt or excepted from having to pay and collect variation margin with the covered SD. Therefore, covered SDs would have to take a capital charge for any exposures arising from unpaid variation margin to any counterparties, including commercial end users and counterparties excluded from or exempt from the requirement to exchange variation margin with the covered SD.

The Commission proposed several adjustments that a covered SD electing the Net Liquid Assets Capital Approach could make to the standardized credit risk capital charges set forth in SEC rule 18a–1. In this regard, the Commission proposed that a covered SD, in computing its regulatory capital, may recognize unsecured receivables from third-party custodians as a current asset in computing its regulatory capital, where the receivable represents the amount of initial margin that the covered SD posted with the third-party custodian for uncleared swaps or uncleared security-based swaps pursuant to the margin rules of the Commission or SEC, as applicable.[211] Absent this modification of the application of Rule 18a–1, a covered SD would have to take a 100% capital charge for the receivables from the third party custodians.[212] The Commission proposed this modification to rule 18a–1 to take into account that covered SDs are required to post initial margin for all swaps with SD counterparties and with all financial end users with material swaps exposure under the uncleared swap margin rules, while the SEC's final rules do not require a SBSD to post initial margin for security-based swaps with other SBSDs or with financial end users.[213]

The Commission received a comment on the proposed adjustment to permit covered SDs to recognize receivables from third-party custodians as a current asset in computing their net capital under SEC rule 18a–1.[214] The commenter stated that it supported the proposed adjustment, but noted that the rule was too restrictive by recognizing initial margin held by third-party custodian pursuant to the Commission's rules and the rules of the SEC. The commenter noted that covered SDs may enter into uncleared swap or security-based swap transactions with SDs that are subject to the margin rules of a prudential regulator, or a SD that operates in a foreign jurisdiction that has received a margin comparability determination from the Commission. The commenter stated that in order to avoid creating unwarranted disparities depending on the parties with which a covered SD trades, the Commission should expand the adjustment to allow an SD to recognize IM posted in accordance with the margin rules of a prudential regulator or foreign jurisdiction for which the Commission has made a comparability determination.[215]

The Commission has considered the comment and is modifying the final regulation to allow a covered SD electing the Net Liquid Assets Capital Approach to recognize initial margin for uncleared swaps and security-based swaps deposited with third-party custodians as a current asset in computing its net capital. The covered SD must deposit the initial margin with a third-party custodian in accordance with the applicable rules of the Commission, SEC, prudential regulators, or a foreign jurisdiction that has obtained a margin comparability determination from the Commission. The modification of the final regulation is consistent with the original intent of the proposed regulation, which was to permit covered SDs to recognize initial margin posted with third-party custodians pursuant to the new margin framework which requires a SD to both post and collect initial margin with a swap dealer counterparty or with a financial end user with material swaps exposure.[216] The modification more fully and accurately reflects the types of counterparties that a covered SD may transact with, and the regulations that may govern such uncleared swap and security-based swap transactions.

The Commission also proposed to permit a covered SD that elects the Net Liquid Assets Capital Approach to exclude a capital charge contained in proposed SEC rule 18a–1(c)(viii). Applying SEC proposed rule 18a–1(c)(viii) would require a covered SD to take a capital charge to the extent that standardized market risk charges computed on a portfolio of customer security-based swaps exceeded the clearinghouse margin associated with such cleared security-based swaps positions.[217] The SEC did not include this capital charge in its final rules, and the Commission is deleting the exception from this capital charge in final regulation 23.101(a)(1)(ii) as it is no longer necessary.

[209] *See, e.g.,* SEC rule 18a–1.

[210] *See* 2019 SEC Final Capital Rule, 84 FR 43872 at 44053.

[211] *See* paragraph (a)(1)(ii)(A)(*4*) of proposed Commission regulation § 23.101; *2016 Capital Proposal,* 81 FR 91252 at 91310.

[212] The *2019 SEC Final Capital Rule* provides interpretive guidance stating that a BD or a stand-alone SBSD does not have to take a capital charge for initial margin for swaps and security-based swaps that is posted with a third-party custodian if: (i) The initial margin requirement is funded pursuant to a fully-executed written loan agreement with an affiliate of the stand-alone BD or SBSD; (ii) the loan agreement provides that the lender waives re-payment of the loan until the initial margin is returned to the stand-alone BD or SBSD; and (iii) the liability of the stand-alone BD or SBSD to the lender can be fully satisfied by delivering the collateral serving as the initial margin to the lender. *See 2019 SEC Final Capital Rule,* 84 FR 43872 at 43887.

[213] Commission regulation § 23.152 (17 CFR 23.152).

[214] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[215] *Id.*

[216] The term ''material swaps exposure'' is defined by Commission regulation 23.150 (17 CFR 23.150) to mean that the entity and its margin affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards, and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds $8 billion.

[217] *See SEC 2012 Proposed Capital Rule,* 77 FR 70214 at 70335. The SEC also requested comment on proposed rule text that extended the capital charge to cleared swaps in addition to cleared SBS. *See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers,* 83 FR 53007 (Oct. 19, 2018).

(ii) Swap Dealers Approved To Use Internal Capital Models

The *2016 Capital Proposal* permitted a covered SD electing the Net Liquid Assets Capital Approach to seek Commission or RFA approval to use internal models to compute market risk and credit risk capital charges on its swaps, security-based swaps and other proprietary positions in lieu of the standardized deductions contained in the SEC Rule 18a–1.[218] In order to be considered for approval, the SD's models must meet the qualitative and quantitative requirements set forth in proposed regulation 23.102 and Appendix A to regulation 23.102.

The Commission noted in the *2016 Capital Proposal* that the Federal Reserve Board had adopted quantitative and qualitative requirements for internal models used by bank holding companies to compute market risk and credit risk capital charges.[219] In developing the proposed market risk and credit risk requirements for covered SDs, including the proposed quantitative and qualitative internal model requirements, the Commission incorporated the market risk and credit risk model requirements adopted by the Federal Reserve Board.[220] The Commission's proposed model requirements are also comparable to the SEC's model requirements for SBSDs and for BDs.[221] The model requirements and the process for obtaining Commission or RFA review is set forth in section II.C.7. of this release.

The Commission's *2016 Capital Proposal* required a covered SD electing the Net Liquid Assets Capital Approach to compute its credit risk charges as if the covered SD were a SBSD subject to SEC rule 18a–1.[222] The *SEC 2012 Proposed Capital Rule* limited the use of credit risk models to transactions with commercial end users.[223] The Commission, however, believed that a covered SD should be able to use credit risk models to compute capital charges for uncleared swap and security-based swap transactions with all counterparties, and not just commercial end users. In this regard, the Commission proposed that covered SDs that elect the Net Liquid Assets Capital Approach or the Bank-Based Capital Approach, and FCM–SDs could use models to compute credit risk charges for swap and security-based swaps counterparties. Therefore, the Commission proposed to add paragraph (a)(1)(ii)(A)(*3*) to regulation 23.101 to allow a covered SD electing the Net Liquid Assets Capital Approach to use credit risk models to compute credit risk charges for uncollected variation margin and initial margin from swap and security-based swap counterparties.

In its final rule adopting capital requirement for SBSDs, the SEC modified its rule 18a–1 from the proposal to permit SBSDs approved to use credit risk models to use such models to compute credit risk capital charges from all classes of swap and security-based swap counterparties and not just commercial end users.[224] Therefore, the Commission has modified the final regulation 23.101 by deleting paragraph (a)(1)(ii)(A)(*3*) as the provision is no longer necessary as the SEC and CFTC rules are aligned in that a covered SD may use an approved model to compute counterparty credit risk charges for swap and security-based swap transactions with all counterparties.

3. Capital Requirement for Covered SDs Electing the Bank-Based Capital Approach

a. Computation of Minimum Capital Requirement

The *2016 Capital Proposal* provided covered SDs with an option of electing the Bank-Based Capital Approach, which is based on the Federal Reserve Board's capital requirements for bank holding companies.[225] The Federal Reserve Board's bank holding company capital requirements are consistent with the bank capital framework adopted by the BCBS.[226] The BCBS framework is an internationally-recognized framework for setting capital requirements for banks and bank holding companies, and was developed to provide prudential standards to help ensure the safety and soundness of bank and bank holding companies. The Bank-Based Capital Approach also offers a covered SD that is part of bank holding company structure with potential efficiencies as the covered SD may maintain financial accounting records in a manner that provides for the efficient consolidation of the SD into the financial reporting requirements of the bank-holding company.

The Commission's Bank-Based Capital Approach was set forth in proposed regulation 23.101(a)(1)(i), and required a covered SD to maintain a minimum level of regulatory capital that is equal to or in excess of the greatest of the following four criteria:

(1) $20 million of common equity tier 1 capital, as defined under the bank holding company regulations in 12 CFR 217.20, as if the SD itself were a bank holding company subject to 12 CFR part 217;[227]

(2) common equity tier 1 capital, as defined under the bank holding company regulations in 12 CFR part 217.20, equal to or greater than 8% of the SD's risk-weighted assets computed under the bank holding company regulations in 12 CFR part 217 as if the SD were a bank holding company subject to 12 CFR part 217;

(3) common equity tier 1 capital, as defined under 12 CFR 217.20, equal to or greater than 8 percent of the sum of:

(a) The amount of ''uncleared swap margin'' (as that term is defined in proposed regulation 23.100) for each uncleared swap position open on the books of the SD, computed on a counterparty by counterparty basis pursuant to regulation 23.154;

(b) the amount of initial margin that would be required for each uncleared security-based swap position open on the books of the SD, computed on a counterparty-by-counterparty basis pursuant to proposed SEC Rule 18a–3(c)(1)(i)(B), without regard to any initial margin exemptions or exclusions that the rules of the SEC may provide to such security-based swap positions; and

(c) the amount of initial margin required by a clearing organization for cleared proprietary futures, foreign

[218] The Commission proposed that a covered SD's market risk models must calculate the total market risk for its proprietary positions under SEC rule 18a–1(d) (17 CFR 240.18a–1(d)) as the sum of the VaR measure, stressed VaR measure, specific risk measure, comprehensive risk measure, and incremental risk measure of the portfolio of proprietary positions in accordance with proposed Commission regulation § 23.102 and proposed Appendix A of regulation § 23.102. *See* paragraph (a)(1)(ii)(A)(*2*) of proposed Commission regulation § 23.101; *2016 Capital Proposal,* 81 FR 91252 at 91310.

[219] *See 2016 Capital Proposal,* 81 FR 91252 at 91258; *See,* 12 CFR 217, subparts E and F.

[220] *See 2016 Capital Proposal,* 81 FR 91252 at 91258.

[221] *See 2016 Capital Proposal,* 81 FR 91252 at 91278.

[222] *See 2016 Capital Proposal,* 81 FR 91252 at 91310; Proposed regulation 23.101(a)(1)(ii).

[223] *See SEC 2012 Proposed Capital Rule,* 77 FR 70214 (Nov. 23, 2012) at *70245–46.*

[224] *See 2019 SEC Final Capital Rule,* 84 FR 43872 at 43902–93.

[225] *See* paragraph (a)(1)(i) of proposed Commission regulation § 23.101, *2016 Capital Proposal,* 81 FR 91252 at 91310.

[226] BCBS is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Institutions represented on the BCBS include the Federal Reserve Board, the European Central Bank, Deutsche Bundesbank, Bank of France, Bank of England, Bank of Japan, and Bank of Canada.

[227] Common equity tier 1 capital is defined in 12 CFR 217.20 of the Federal Reserve Board's rules. Common equity tier 1 capital generally represents the sum of a bank holding company's common stock instruments and any related surpluses, retained earnings, and accumulated other comprehensive income.

futures, swaps, and security-based swap positions open on the books of the SD; or

(4) the capital required by an RFA of which each SD is a member. Commenters generally supported the proposed Bank-Based Capital Approach as it represents an internationally recognized capital regime for establishing capital that is designed to promote the safety and soundness of banking institutions under standards issued by the BCBS. One commenter stated that the Bank-Based Capital Approach is a significant and necessary pillar in the Commission's proposed regulatory framework as it fosters greater comparability of covered SDs with bank SDs, provides a risk-sensitive capital methodology for covered SD business models that are not adequately captured in traditional net capital calculations, and provides covered SD subsidiaries of bank holding companies with potential risk management and operational synergies.[228] Another commenter supported the Bank-Based Capital Approach noting that the Commission's proposal of offering distinct capital approaches recognizes that covered SDs have a wide range of business models, many of which do not fit easily within other proposed capital frameworks.[229] This commenter further stated that covered SDs that are not dually-registered as SBSDs or FCMs generally do not maintain custody of customer assets nor are they subject to insolvency regimes premised on liquidation and the return of customer assets and, therefore, it makes sense for the Commission not to apply the Net Liquid Assets Capital Approach or FCM approach which are premised on the customer profile and insolvency regime applicable to SBSDs and FCMs, respectively.[230]

Fixed-Dollar Minimum Capital Requirement Under Bank-Based Capital Approach

The first criterion under the Commission's Proposal required covered SDs electing the Bank-Based Capital Approach to maintain a minimum of $20 million of common equity tier 1 capital. The Commission believed that given the role that a SD performs in the financial markets by engaging in swap dealing activities that it was appropriate to require each SD to maintain a minimum level of capital, stated as an absolute dollar amount, that does not fluctuate with the level of the firm's dealing activities to help ensure the safety and soundness of the SD.

The proposed $20 million of minimum capital also was consistent with the minimum regulatory capital requirements proposed by the Commission for SDs that elect the Net Liquid Assets Capital Approach or the Tangible Net Worth Capital Approach as discussed in sections II.C.2.a. and II.C.4., respectively, of this release. The proposed $20 million minimum capital requirement also was consistent with the net capital requirements adopted by the SEC for SBSDs, and was consistent with the current minimum net capital requirements for OTC derivatives dealers registered with the SEC.[231] The Commission did not receive comment on the proposed $20 million dollar minimum capital requirement, and is adopting the requirement as proposed.

Minimum Capital Based on Risk-Weighted Assets Under Bank-Based Capital Approach

The second criterion of the minimum capital requirement for covered SDs electing the Bank-Based Capital Approach required a covered SD to maintain common equity tier 1 capital equal to or greater than 8% of the covered SD's risk-weighted assets computed under the bank holding company regulations in 12 CFR part 217 as if the covered SD was a bank holding company. In effect, this provision of proposed regulation 23.101(a)(1)(i) imposed a capital approach on a covered SD that is generally consistent with the capital approach that the Federal Reserve Board imposes on bank holding companies.[232] For purposes of the *2016 Capital Proposal,* as is also the case for the Federal Reserve Board's minimum ratio requirement, the assets and off-balance sheet transactions or exposures of the bank holding company would be weighted relative to their respective risk.[233] Thus, under the *2016 Capital Proposal,* the greater the perceived risk of the assets and the off-balance sheet items, the greater the weighting for the risk and the greater the amount of capital necessary to cover 8% of the risk-weighted assets.[234] The Commission believed it was important to include this criterion in its minimum capital requirements so that a covered SD maintained a level of common equity tier 1 capital that was comparable to the level that the SD would maintain if it were subject to the capital rules of the Federal Reserve Board.

Proposed paragraph (a)(1)(i) of regulation 23.101 required a covered SD electing the Bank-Based Capital Approach to compute its risk-weighted assets in accordance with the Federal Reserve Board's capital requirements contained in 12 CFR part 217. The Proposal included two general approaches to computing risk-weighted assets under 12 CFR part 217. The first approach was for covered SDs that did not have Commission or RFA approval to calculate their risk-weighted assets using internal market risk or credit risk models. Proposed regulation 23.103 required these covered SDs to use a standardized, or rules-based, approach to computing their risk-weighted assets. Under the standardized approach, the covered SDs would use the credit risk charges from the Federal Reserve Board's standardized approach under subpart D of 12 CFR 217 and the standardized market risk charges for FCMs set forth in regulation 1.17.[235] As discussed in section II.B.3.a. above, regulation 1.17 contains the standardized market risk capital charges that have been imposed on FCMs for many years and is being amended by this rulemaking to reflect explicit

[228] *See* MS 3/3/2020 Letter.

[229] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[230] *Id.*

[231] The SEC capital requirements for SBSDs impose a minimum net capital requirement of $20 million for SBSDs that are not approved to use internal capital models and a $100 million dollar tentative net capital and $20 million net capital requirement for SBSDs that are approved to use internal capital models *See 2019 SEC Final Capital Rule,* 84 FR 43872 at 43884. SEC rule 15c3–1(a)(5) (17 CFR 240.15c3–1(a)(5)) currently requires an OTC derivatives dealer that has obtained approval to use capital models to maintain a minimum of $100 million of tentative net capital and $20 million of net capital. *See 2019 SEC Final Capital Rule,* 84 FR 43872 at 44042, 44052.

[232] As discussed further below, the Commission's Proposal differed from the rules of the Federal Reserve Board in that the Commission's Proposal would require a covered SD to adjust its risk-weighted assets calculation by including the market risk capital charges computed in accordance with Commission regulation § 1.17 (17 CFR 1.17) if the covered SD had not obtained approval from the Commission or from an RFA to use internal market risk models.

[233] *See* 12 CFR 217 subparts D, E, and F.

[234] Large, complex banks also must make further adjustments to these risk-weighted assets, calculated pursuant to approved models, for the additional capital they must hold to reflect the market risk of their trading assets *See* 12 CFR 217 subpart F. The market risk requirements generally apply to Federal Reserve Board-regulated institutions with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets or one billion dollars or more.

[235] The Federal Reserve Board's standardized approach under subpart D of 12 CFR 217 applies only to credit risk charges; the Federal Reserve Board has not adopted standardized market risk charges. Bank and bank holding companies that are subject to market risk charges are required to use internal models and, accordingly, subpart D of 12 CFR 217 does not include a standardized approach for computing market risk charges. To address this issue, the Commission proposed that a covered SD that had not obtained Commission or RFA approval to use internal market risk models must apply the standardized market risk capital charges contained in Commission regulation § 1.17 (17 CFR 1.17) in computing its total risk-weighted assets.

standardized capital charges for swap and security-based swap positions that are aligned with the SEC's standardized market risk capital charges. Generally, market risk charges are computed under regulation 1.17 by multiplying the notional value or market value of the position or asset by a fixed percentage set forth in the regulation.[236] The market risk charges are then multiplied by a factor of 12.5 and added to the total risk-weighted assets of the SD.[237]

The second approach to computing risk-weighted assets permitted covered SDs that have Commission or RFA approval to use internal market risk and credit risk models to use such models to calculate their risk-weighted assets. The models would have to meet the qualitative and quantitative requirements set forth in proposed regulation 23.102 and Appendix A to regulation 23.102 in order to be approved. The qualitative and quantitative requirements were based on the Federal Reserve Board's qualitative and quantitative requirements for capital models in 12 CFR part 217.[238] The proposed qualitative and quantitative requirements for the models, and the proposed model submission process, are discussed in section II.C.7. of this release.

The Commission acknowledged in the *2016 Capital Proposal* that limiting a covered SD's ability to use only common equity tier 1 capital to meet its minimum capital requirement based upon 8% of its risk-weighted assets was a departure from the Federal Reserve Board's requirements, which allow a bank holding company to meet its minimum capital requirements with a combination of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital.[239] The Commission stated in the *2016 Capital Proposal* that it was proposing the stricter standard as common equity tier 1 capital is a more conservative form of capital than additional tier 1 or tier 2 capital, particularly as it relates to the permanence of the capital and its availability to absorb unexpected losses.[240] The Commission also proposed the stricter common equity tier 1 requirement as it did not propose to include in the SD's minimum capital requirement certain of the prudential regulators' capital add-ons, including the capital conservation buffer and the countercyclical capital buffer.[241]

The Commission received comments regarding the proposed limitation of the type of capital that a covered SD may use under the Bank-Based Capital Approach in satisfying its 8% of risk-weighted assets to common equity tier 1 capital ratio requirement. One commenter supported the proposed limitation noting that the more conservative common equity tier 1 capital is appropriate given the Commission's Proposal does not include all of the capital add-ons and supervisory safeguards that are set forth in the prudential regulators' capital framework.[242]

Other commenters stated that the proposed minimum capital requirement of common equity tier 1 capital equal to or greater than 8% of risk-weighted assets would impose a capital requirement on covered SDs that is materially higher and more restrictive than the prudential regulators' capital requirement for banks and bank holding companies.[243] These commenters noted that the prudential regulators' minimum capital requirements provide that an entity is ''adequately capitalized'' if its common equity tier 1 capital is equal to or greater than 4.5% of the SD's risk-weighted assets, and is ''well capitalized'' if its common equity tier 1 capital is at least 6.5% of its risk-weighted assets.[244] These commenters further stated that the Commission's proposed ''early warning capital requirement'' would effectively require SDs to maintain common equity tier 1 capital equal to at least 9.6% (120% × 8%) of risk-weighted assets as entities subject to the ''early warning capital requirements'' generally ensure that their regulatory capital exceeds such requirements.[245] Another commenter stated that the Proposal may make it difficult for covered SDs subject to the Commission's capital rule to compete with bank SDs subject to the capital rules of a prudential regulator, and more generally would deviate from the more tailored risk-based approach taken by the prudential regulators.[246]

In addition, a commenter requested that the Commission revise its Bank-Based Capital Approach to recognize subordinated debt as capital in meeting the 8% of risk-weighted assets capital ratio.[247] This commenter noted that prudential regulators' capital requirements permit a bank or a bank holding company to recognize certain subordinated debt as capital in meeting the 8% of risk-weighted assets capital ratio requirement.[248]

The Commission requested additional comment in the *2019 Capital Reopening* on whether the proposed minimum capital requirement based upon a covered SD's common equity tier 1 capital was appropriate.[249] The Commission also requested comment on whether a covered SD should be able to

[236] For example, U.S. Treasuries are subject to capital charges of between zero and six percent depending on the time to maturity of each treasury instrument, and readily marketable equity securities are subject to a 15 percent capital charge. *See* Commission regulation § 1.17(c)(5)(v) (17 CFR 1.17(c)(5)(v)), which references SEC rule 15c3–1(c)(2)(vi) (17 CFR 240.15c3–1(c)(2)(vi)). SEC rule 15c3–1(c)(2)(vi)(A)(1) (17 CFR 240.15c3–1(c)(2)(vi)(A)(1)) provides that a BD shall take a capital charge on U.S. Treasuries of between zero and six percent of the fair market value of the instrument depending upon the time to maturity. SEC rule 15c3–1(c)(2)(vi)(J) (17 CFR 240.15c3–1(c)(2)(vi)(J)) provides a capital charge for equities equal to 15 percent of the fair market value of the securities.

[237] The 12.5 multiplication factor is necessary to ensure that the SD maintains a level of common equity tier 1 capital to cover the full amount of the market risk charge. Since the SD is required to maintain common equity tier 1 capital equal to or in excess of 8% of the risk-weighted assets, the market risk charge is multiplied by 12.5, which effectively requires the SD to hold common equity tier 1 capital in an amount equal to the full amount of the market risk charge. This approach is consistent with the Federal Reserve Board's approach to bank holding companies.

[238] Federal Reserve Board model-based capital charges for credit risk and market risk are set forth in 12 CFR part 217 subparts E and F, respectively.

[239] Under the Federal Reserve Board's rules, a bank holding company's total capital must equal or exceed at least 8% of its risk-weighted assets. In addition, at least six percent of the bank holding company's capital must be in the form of tier 1 capital, and at least 4.5 percent of the tier 1 capital must qualify as common equity tier 1 capital. The remaining two percent of capital may be comprised of tier 2 capital. Tier 1 capital includes common equity tier 1 capital and further includes such instruments as preferred stock. Tier 2 capital includes certain types of instruments that include both debt and equity characteristics (*e.g.,* certain perpetual preferred stock instruments and subordinated term debt instruments). *See* 12 CFR 217.10.

[240] *See 2016 Capital Proposal,* 81 FR 91252 at 91259–60.

[241] *See* 12 CFR 217.11. The capital conservation buffer and the countercyclical capital buffer represent capital ''add-ons'' to the bank capital requirements and are intended to require entities subject to the rules to have certain levels of capital in order to make capital distributions and discretionary bonuses.

[242] *See* AFR 5/15/2017 Letter.

[243] *See* ISDA 5/15/2017 Letter; MS 5/15/2017 Letter; SIFMA 5/15/2017 Letter.

[244] *Id.*

[245] *Id.* The *2016 Capital Proposal* required each covered SD subject to the Bank-Based Capital Approach, the Net Liquid Assets Capital Approach, or the Tangible Net Worth Capital Approach to provide written notification to the Commission within 24 hours of the covered SD's regulatory capital falling below 120 percent of the SD's minimum requirement. This proposed notice provision, which is consistent with current FCM requirements in Commission regulation § 1.12 (17 CFR 1.12), is generally referred to as the ''early warning capital requirement.'' The proposed ''early warning capital requirement'' for SDs was included in paragraph (c)(2) of proposed Commission regulation § 23.105. *See 2016 Capital Proposal,* 81 FR 91252 at 91318.

[246] *See* JBA 3/14/2017 Letter.

[247] *See* SIFMA 5/15/2017 Letter.

[248] *Id.*

[249] *See 2016 Capital Proposal,* 81 FR 91252 at 91260.

use additional tier 1 and tier 2 capital, including subordinated debt, in addition to common equity tier 1 capital in meeting the 8% of its risk-weighted assets requirement.[250]

Common Equity Tier 1 Capital

The Commission received comments in response to the *2019 Capital Reopening* generally supporting the minimum capital requirement based on a percentage of the covered SD's risk-weighted assets, including the requirement for covered SDs electing the Bank-Based Capital Approach to maintain common equity tier 1 capital equal to a specific percentage of the risk-weighted assets. Commenters, however, stated that the proposed requirement that a covered SD maintain only common equity tier 1 capital in excess of 8% of its risk-weighted assets was not consistent with prudential regulators' requirements and was higher than the comparable requirements imposed by the Federal Reserve Board for bank holding companies.[251] These commenters noted that the prudential regulators requirements permit banks to use a combination of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital in meeting their regulatory capital requirements.[252]

Several commenters further noted, consistent with comments received from the *2016 Capital Proposal,* that the Commission was effectively imposing a requirement for a covered SD electing the Bank-Based Capital Approach to maintain common equity tier 1 capital in excess of 9.6 percent of the SD's risk-weighted assets due to the proposed ''early warning capital requirements'' that requires a covered SD to notify the Commission if its regulatory capital falls below 120 percent of its minimum requirement.[253] Commenters further stated that the resulting 9.6% common equity tier 1 capital requirement is not consistent with any bank-based capital methodology.[254]

Commenters suggested that the Commission align the proposed 8% common equity tier 1 capital requirement with the Federal Depository Insurance Corporation's prompt corrective action (''PCA'') framework, which is calibrated based on the U.S. Basel III risk-weighted average framework.[255] Under the PCA framework, a bank is deemed ''adequately capitalized'' if it maintains common equity tier 1 capital of at least 4.5 percent of the bank's risk-weighted assets, and is deemed ''well capitalized'' if it maintains common equity tier 1 capital of at least 6.5 percent of the bank's risk-weighted assets.[256] Commenters recommended revising the final regulations to provide that a covered SD that elects the Bank-Based Capital Approach must maintain common equity tier 1 capital at a level that is not less than 4.5 percent of the SD's risk-weighted assets, and must maintain common equity tier 1 capital in excess of 6.5 percent of the SD's risk-weighted assets in computing the ''early warning capital requirement'' under proposed regulation 23.105(c)(2).[257] Another commenter suggested that the Commission adopt a risk-weighted asset ratio that is tiered based on the size and complexity of the covered SD's business (*e.g.,* a 4.5% common equity tier 1 requirement with the tier 2 capital being eligible for the remaining 3.5%).[258]

The Commission has considered the proposed requirement for a covered SD electing the Bank-Based Capital Approach to maintain common equity tier 1 capital equal to or in excess of 8% of the SD's risk-weighted assets, and has considered the comments that have been received. The Commission is adopting the requirement as a component of the final capital rule for covered SDs electing the Bank-Based Capital Approach, subject to the following modifications. The Commission is retaining the minimum requirement for a covered SD to maintain capital at a level equal to or in excess of 8% of the SD's risk-weighted assets. The Commission is modifying the final regulation, however, to require that at least 6.5% of the minimum 8% capital requirement must be common equity tier 1 capital, with the remaining 1.5% to be comprised of common equity tier 1 capital, additional tier 1 capital, or tier 2 capital, as defined by the Federal Reserve Board in 12 CFR 217.20. The Commission is further modifying the final rule to provide that any capital that is in the form of subordinated debt must meet the conditions adopted by the SEC for qualifying subordinated debt for SBSDs set forth in rule 18a–1d (17 CFR 240.18a–1d). In addition, a covered SD may use additional tier 1 and tier 2 capital (including qualifying subordinated debt) to meet the early warning capital requirement above the 6.5% of common equity tier 1 capital.

The Commission is adopting these modifications as it believes that it establishes an appropriate balance between ensuring that a covered SD maintains an appropriate level of permanent capital in the form of common equity tier 1 capital and permitting an SD to use other forms of capital formation, including qualifying subordinated debt. As noted below, the subordinated debt qualifications require the lender to subordinate their claims against the covered SD to the claims of all other creditors, which is comparable to the position of holders of common equity capital. The subordinated debt regulations further place restrictions on the ability of the SD to repay the subordinated debt if it would adversely impact the capital of the SD.[259] In addition, final regulation 23.104 imposes limitations on the withdrawal of equity from a covered SD by actions of its shareholders, including paying dividends and similar distributions, if such distributions would result in the SD holding less than 120% of its minimum capital requirement.[260] These additional regulatory requirements effectively ensure that the capital, including capital provided in the form of subordinated debt, is retained in the covered SD ensuring its safety and soundness.

The final rule is also consistent with the Commission's capital rules for FCMs, the SEC's rules for BDs and SBSDs, and the prudential regulators' rules for banks and bank holding companies, all of which recognize certain qualifying subordinated debt as capital.[261] The final regulations also impose identical terms and conditions on qualifying subordinated debt under the Bank-Based Capital Approach and the Net Liquid Assets Capital Approach as covered SDs electing either approach

[250] *Id.*

[251] *See, e.g.,* MS 3/3/2020 Letter; IIB/ISDA/SIFMA 3/3/2020 Letter.

[252] *Id.*

[253] *Id.*

[254] *See* MS 3/3/2020 Letter.

[255] *Id.*

[256] *See* 12 CFR 208.43(b) for the Federal Reserve Board's capital measures and capital levels that are used for determining the supervisory actions for insured depository institutions that are not adequately capitalized.

[257] *See* IIB/ISDA/SIFMA 3/3/2020 Letter. MS 3/3/2020 Letter at 8.

[258] *See* Shell 3/3/2020 Letter.

[259] *See, e.g.,* SEC rule 18a–1d(b)(7) (17 CFR 240.18a–1(b)(7)) which suspends a SBSD's obligation to make a scheduled payment on a subordinated loan agreement if, after giving effect to the payment obligation (and to any other payment obligations under other subordinated debt agreements that are scheduled to be paid on or before the payment date of the subordinated loan agreement in question), the SBSD's net capital would fall below 120 percent of the SBSD's minimum net capital or tentative net capital requirement, as applicable.

[260] *See* final Commission regulation § 23.104.

[261] *See, e.g.,* Commission regulation § 1.17(h) (17 CFR 1.17), SEC rules 15c3–1d and 18a–1d (17 CFR 240.15c3–1d and 17 CFR 240.18a–1d), and Federal Reserve Board rule 217.20 (12 CFR 217.20) for rules governing subordinated debt as capital for FCMs, BDS and SBDS, and banks and bank holding companies, respectively.

are subject to the subordinated debt provision of SEC rule 18a–1d.[262]

The SEC's qualification conditions in Rule 18a–1d require that the loan agreement must: (i) Be in writing and have a minimum term of at least one year; (ii) be a valid and binding obligation enforceable in accordance with its terms against the SD and the lender; and (iii) effectively subordinate any right of the lender to receive any payment with respect to the loan agreement to the prior payment in full of all claims of all present and future creditors of the covered SD arising out of any matter occurring prior to the date on which the related payment obligation matures, except for claims which are the subject of subordinated loan agreements that rank on the same priority as, or junior to, the claim of the lender under the subordinated loan agreement. Rule 18a–1d also contains conditions intended to ensure that the SBSD does not make payments on subordinated loans if such payments would reduce the SBSD's net capital below 120% of its minimum capital requirement. These terms and conditions effectively result in the subordinated debt having the characteristics of common equity as the issuances of the subordinated loan rank just above common equity holders in the event of the insolvency of the covered SD. Therefore, the Commission believes that it is appropriate to recognize subordinated debt that meets the conditions of SEC rule 18a–1d to qualify as tier 2 capital under the Commission's final regulation.

Calculation of Risk-Weighted Assets

As noted above, the Proposal required a covered SD electing the Bank-Based Capital Approach to compute its risk-weighted assets in accordance with the Federal Reserve Board's capital requirements contained in 12 CFR part 217. Covered SDs using the standardized approach were required to use the credit risk charges from the Federal Reserve Board's standardized approach under subpart D 12 CFR part 217. Covered SDs using internal capital models were required to use models that met the qualitative and quantitative requirements set forth in proposed regulation 23.102 and Appendix A to regulation 23.102. The qualitative and quantitative requirements set forth in regulation 23.102 and Appendix A were based on the Federal Reserve Board's qualitative and quantitative requirements for capital models in 12 CFR part 217. Federal Reserve Board model-based capital charges for credit risk and market risk are set forth in 12 CFR part 217 subparts E and F, respectively.

Commenters noted that the Federal Reserve's capital approach is currently undergoing significant transformation as it implements the revised Basel III framework adopted in 2017.[263] One commenter stated that the Federal Reserve Board's implementation of certain fundamental aspects of the Basel III framework, including approaches for credit, market, and operational risks remain pending, and further noted that the BCBS is also making further revisions to the credit valuation adjustment risk framework to further align it with other capital requirements.[264] Another commenter stated that there are significant ongoing efforts to revise specific credit risk and market risk methodologies, which will likely require at least two, and potentially several, years to reach finalization.[265] The commenters stated that it is essential that the Commission adopt a Bank-Based Capital Approach that provides covered SDs with certainty of application despite these and other future changes to the bank capital framework.[266] The commenters stated that given the ongoing revisions to the banking regulators' capital requirements, the Commission should revise its rules to incorporate the Federal Reserve Board's rules by reference instead of setting forth explicit capital model provisions and quantitative and qualitative capital requirements in Appendix A of regulation 23.102.

The commenters also specifically stated that given the current unsettled nature of the prudential regulators' requirements, covered SDs electing the Bank-Based Capital Approach that are approved to use internal market risk and credit risk models should be permitted to choose whether or not to apply the Federal Reserve Board's provisions for advanced approaches for Federal Reserve Board-regulated institutions.[267] The Commenter further stated that covered SDs should also be permitted to compute their credit risk-weighted assets using the current exposure method (''CEM''), the internal models method (''IMM''), or SA–CCR with certain modifications.[268]

The Commission has considered the Proposal and the comments requesting flexibility in adopting the Bank-Based Capital Approach. The Commission understands that some critical elements of Basel III are still being revised and adoption by the Federal Reserve Board is an ongoing process that may span several years, which makes incorporating specific market risk and credit risk components of the Federal Reserve Board's rules into Appendix A of regulation 23.102 difficult. In this process the Federal Reserve Board also may allow for alternative calculation methods, some transitionally and some permanently, which further makes specific incorporation of bank capital requirements into Appendix A challenging.

The Commission does not want to introduce conflicting deadlines, contradictory guidance, or cause firms to incur duplicative model implementation costs during this implementation process. Thus, the Commission is modifying the final rules to incorporate the Federal Reserve Board's market risk and credits requirements by referencing the applicable sections of the Federal Reserve Board's regulations in 12 CFR part 217 instead of incorporating specific market risk and credit risk requirements contained in 12 CFR part 217 into Appendix A of regulation 23.102. This modification of the rule text will provide legal certainty to the covered SDs that future changes to the relevant market risk and credit risk requirements in 12 CFR part 217 will be appropriately incorporated into the Commission's capital requirements without further Commission action, such as a rulemaking. The Commission will retain Appendix A of regulation 23.102 as it will be applicable to covered SDs electing the Net Liquid Assets Capital Approach or the Tangible Net Worth Capital Approach to compute market risk and credit risk capital charges.

The Commission is also modifying the final rule to provide that where the Federal Reserve Board's rules allow for alternative calculation methods, the Commission's final rule also allows for the same alternatives. For example, commenters noted that subpart D of 12 CFR part 217 currently provides that bank holding companies may compute standardized credit risk charges for OTC

[262] A covered SD that elects the Net Liquid Assets Capital Approach is permitted under SEC rule 18a–1 (17 CFR 240.18a–1) to recognize subordinated debt that meets the qualification standards in SEC rule 18a–1d (17 CFR 240.18a–1d) in meeting its minimum capital requirements.

[263] IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter.

[264] IIB/ISDA/SIFMA 3/3/2020 Letter.

[265] MS 3/3/2020 Letter.

[266] *See* IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter.

[267] *Id.*

[268] *Id.* The CEM, IMM, and SA–CCR approaches for computing credit risk are set forth in the Federal Reserve Board's capital rules for bank holding companies, 12 CFR part 217.

derivative transactions using either the CEM or SA–CCR calculation methods. The Commission's final rule permits covered SDs to elect to use either method, recognizing that both CEM and SA–CCR are part of the BCBS international capital framework and have been adopted by the prudential regulators.

Furthermore, the choice of calculation method elected by a covered SD does not have to be the same as the calculation method the covered SD's banking parent or affiliate elects to use or is required to use under the Federal Reserve Board's rules. For example, a covered SD may elect to use the CEM method notwithstanding that its banking affiliate uses the SA–CCR method. However, a covered SD must address these differences in its model application, particularly if it relies upon or uses model documentation provided by a banking affiliate to prudential regulators as part of a model approval or oversight process by the prudential regulators. The covered SD also must inform the Commission or NFA if another regulator has denied its or its affiliate's use of an alternative calculation.

In choosing an alternative calculation the non-bank SD must adopt the entirety of the alternative. The Commission understands that some alternatives may include charges or deductions for risks not otherwise part of market and credit risk models described in this rule (*e.g.,* operational risk), however, the Commission is not prepared to accept partial application of alternative calculation methods or to compensate this inclusion by reducing other charges calculated per this rule outside of the market and credit risk models.

The Commission is implementing the above revisions to the final rules by modifying regulation 23.100 to include a definition of the term ''BHC equivalent risk-weighted assets'' that defines the method that a covered SD that elects the Bank-Based Capital Approach uses to compute market risk and credit risk using either models or standardized charges in computing its regulatory capital. Under the BHC equivalent risk-weighted assets definition, a covered SD that is not approved to use models would compute market risk in accordance with the standardized charges in Commission regulation 1.17 and SEC rule 18a–1, and would compute credit risk charges in accordance with the standardized charges using the bank holding company regulations in subpart D of 12 CFR part 217. Covered SDs approved to use models would compute market risk in accordance with the bank holding company requirements set forth in subpart F of 12 CFR part 217, and would compute credit risk charges in accordance with the bank holding company requirements in subpart E of 12 CFR part 217. The Commission also is modifying regulation 23.103 to remove the calculation of market and credit risk under the Bank-Based Capital Approach as it is now contained in revised regulation 23.100, and modifying definitions in regulation 23.100 to define the terms ''advanced approaches Board-regulated institution'' and ''OTC derivative contract'' to effect the above revisions to the rule text.

Commenters also requested that the Commission modify the final rules by providing an adjustment to the Federal Reserve Board's SA–CCR credit risk calculation when the SD applies SA–CCR in computing its capital.[269] One commenter stated that the Federal Reserve Board's SA–CCR rules set a ''supervisory factor'' for energy derivatives of between 18%, for oil and natural gas transactions, and 40%, for electricity transactions.[270] The commenter represented that when adopting the calibrations, the Federal Reserve Board calibrated the supervisory factors to spot prices rather than forward prices. The commenter stated that SDs active in the oil, natural gas, and electricity markets are heavily concentrated in forward markets, which have very different volatilities and credit risk profiles than those of spot markets.

The Commission is not modifying the final regulations to reset the supervisory factors adopted by the Federal Reserve Board for derivative transactions. This is an issue that the Commission will assess during the implementation of the rule.

Minimum Capital Requirement Based on Risk Margin Amount Under Bank-Based Capital Approach

The third criterion comprising the minimum capital requirement under the proposed Bank-Based Capital Approach required a covered SD to maintain common equity tier 1 capital equal to or in excess of 8% of the sum of: (i) The covered SD's uncleared swap margin requirements for uncleared swaps transactions; (ii) the initial margin that would be required for each uncleared security-based swap transaction pursuant to SEC's proposed Rule 18a–3(c)(1)(i)(B), without regard for any amounts of security-based swaps that may be exempted or excluded under the SEC's proposal; (iii) the risk margin required on the covered SD's cleared futures, foreign futures, and swaps positions; and (iv) the amount of initial margin required by a clearing organization that clears the covered SD's proprietary security-based swaps.[271]

This requirement was intended to ensure that a covered SD electing the Bank-Based Capital Approach maintains a minimum level of capital that is comprehensive with respect to all of the SD's operations and activities. The Commission believed that the proposed 8% risk margin amount was an appropriate approach as the minimum capital requirement was correlated with the ''risk'' of the covered SD's futures, foreign futures, swaps, and security-based swaps positions as measured by the margin required on the positions. Specifically, a covered SD's minimum capital requirement would increase or decrease in proportion to the number, size, complexity and all risks inherent in the SD's customer, client, and proprietary derivatives business.[272]

Commenters generally raised the same concerns regarding the 8% risk margin amount as discussed in detail in section II.C.2.a. above for the covered SDs electing the Net Liquid Assets Capital Approach. Specifically, commenters stated the 8% risk margin amount is too high a percentage and includes too many types of derivatives products. Commenters also stated that the risk margin amount is not a good measure of the risk of the positions to the covered SD.

One commenter also stated that the Commission should not adopt the 8% risk margin amount for covered SDs electing the Bank-Based Capital Approach. One commenter stated that prudential regulators do not have a minimum capital requirement based on a bank SD's risk margin amount.[273]

One commenter stated that if the Commission adopted the risk margin amount, the Commission should modify the final regulation to permit covered SDs electing the Bank-Based Capital Approach to include additional tier 1 capital and tier 2 capital in addition to common equity tier 1 capital in meeting the risk margin amount.[274]

The Commission has considered the proposed risk margin amount requirement for covered SDs electing the Bank-Based Capital Approach and has considered the comments received, and is adopting the requirement with

[269] *See* IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter.

[270] *See* MS 3/3/2020 Letter.

[271] *See 2016 Capital Proposal,* 81 FR 91252 at 91258–59.

[272] *See* 2016 Capital Proposal, 81 FR 91252 at 91258.

[273] IIB/ISDA/SIFMA 3/3/2020 Letter.

[274] *Id.*

several modifications. The final regulation will require a covered SD electing the Bank-Based Capital Approach to maintain a combination of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital in an amount equal to or greater than 8% of the covered SD's uncleared swap margin. The term ''uncleared swap margin'' is defined in regulation 23.100, and means the amount of initial margin computed in accordance with the Commission's uncleared margin rules (regulation 23.154; 17 CFR 23.154) that a SD would be required to collect from each counterparty for each outstanding swap position of the SD, including all swap positions that are excluded or exempt from the uncleared margin rules under regulation 23.150 (17 CFR 23.150), legacy swap positions, exempt foreign exchange swaps or foreign exchange forwards.

As discussed in section II.C.2.a. above, the Commission believes that a minimum capital requirement based on initial margin is an appropriate component of a covered SD's minimum capital requirement. The intent of the risk margin amount requirement was to ensure that a covered SD has a sufficient level of capital to meet its obligations as a SD, and to cover potential operational risk, legal risk, and other risks, and not just the risks of its trading portfolio. The Commission believes that the risk margin amount is a minimum capital requirement that provides a floor based on a measure of the risk of the swap positions, the volume of positions, the number of counterparties and the complexity of operations of the covered SD. The risk margin amount is based on the initial margin that is computed on the proprietary positions held by the covered SD. Initial margin reflects the degree of risk associated with the positions, with lower risk positions having lower initial margin requirements and higher risk positions having higher initial margin requirements. Therefore, the Commission believes that because the risk margin amount calculation is directly related to the volume, size, complexity and risk of the covered SD's uncleared swap positions, it serves as a good proxy for inherent risk in the SD's positions, operations, and other risks, and is used to calibrate the amount of the minimum capital required of a covered SD.

The Commission, however, is not modifying the regulation by lowering the risk margin amount multiplier from 8% to 2% or to a different percentage. As discussed in section II.C.2.a. above, the minimum capital requirement based upon the risk margin amount is applied in a different manner in the Bank-Based Capital Approach as compared with the Net Liquid Assets Capital Approach. Under the Bank-Based Capital Approach, a covered SD is required to maintain balance sheet equity in excess of 8% of the risk margin on uncleared swap positions. This approach is a less conservative approach than the Net Liquid Assets Capital Approach, which requires a covered SD to maintain current, liquid assets, less market risk and credit risk capital charges on proprietary positions including swaps and security-based swaps, in excess of 2% of the risk margin amount on uncleared swaps. Due to the different approaches, the Commission believes that it is appropriate to set the risk margin amount multiplier at 8% under the Bank-Based Capital Approach to help ensure that the minimum capital requirement ensures the safety and soundness of the covered SD.

The Commission also believes that many of the commenters' concerns are mitigated by the modifications that the Commission is making to the final regulation. Consistent with its approach for FCM–SDs and Net Liquid Assets Capital Approach, the Commission is modifying the final regulation to exclude cleared and uncleared security-based swap positions, and proprietary futures, foreign futures, and cleared swap positions from the risk margin amount calculation.

In addition, as noted above, the Commission will monitor the risk margin amount after the compliance date of the regulations to assess whether adjustments are necessary to the regulations to ensure the safety and soundness of the covered SD. The Commission will use the information that it obtains from financial reports submitted by covered SDs and from the Commission's and NFA's ongoing oversight of the SDs to continually monitor and evaluate the adequacy of the minimum capital requirements.

Minimum Capital Requirement of a Registered Futures Association Under Bank-Based Capital Approach

The fourth criterion of the proposed minimum capital requirements required a covered SD to maintain the minimum level of capital required by an RFA of which the covered SD is a member. As noted above, the proposed minimum capital requirement based on membership requirements of an RFA is consistent with current FCM capital requirements under regulation 1.17, and reflects Commission regulations that require each covered SD to be a member of an RFA.[275] As further noted above, the Proposal is also consistent with section 17(p)(2) of the CEA, which provides, in relevant part, that an RFA must adopt rules establishing minimum capital and other financial requirements applicable to the RFA's members for which such requirements are imposed by the Commission.[276] The Proposal recognizes that the NFA, as the only RFA, would be required by section 17 of the CEA to adopt capital rules for covered SDs once the Commission imposes capital requirements on covered SDs, and would incorporate the NFA minimum capital requirements into the Commission's regulation.

The Commission received general comments regarding the proposed requirement that a covered SD must meet the capital rules adopted by the NFA. Several commenters stated that any future NFA capital rules for covered SDs should be subject to public comment.[277] Another commenter stated that the Commission's efforts to obtain public input pursuant to the *2016 Capital Proposal* and the *2019 Capital Reopening* may be nullified if the NFA adopts capital rules that are different from the Commission's final rules, and requested that the Commission require NFA to adopt capital rules that closely mirror the Commission's final capital rules, or, at the least, require NFA to conduct a rigorous notice and comment process prior to finalizing its capital rules.[278]

As discussed in section II.C.2.a. above, the Commission believes that commenters' concerns are largely mitigated by the existing statutory and Commission regulatory requirements as well as the internal governance structure of NFA, which was established to comply with these requirements. Section 17(j) of the CEA requires NFA to file with the Commission any change in or addition to its rules. Any such change or addition is effective within 10 days of submission unless NFA requests, or the Commission notifies NFA of its intent to subject the filing to, a review and approval process.[279] Further, NFA's governance structure ensures that SDs are represented in the

[275] *See* Commission regulations §§ 1.17(a)(1)(i)(C) and 170.16 (17 CFR 1.17(a)(1)(i)(C) and 170.16).

[276] *See* section 17(p)(2) of the CEA, which requires RFAs to adopt rules establishing minimum capital and other financial requirements applicable to its members for which such requirements are imposed by the Commission, provided that such requirements may not be less stringent than the requirements imposed by the CEA or by Commission regulations.

[277] ED&F Man/INTL FCStone 3/3/2020 Letter; Shell 3/2/2020 Letter.

[278] *See* Shell 3/2/2020 Letter.

[279] *See* section 17(j) of the CEA (7 U.S.C. 21(j)).

potential adoption of NFA rules, including capital and financial reporting rules, that may impact them. As noted in section II.C.2.a. above, section 17(b)(5) of the CEA and regulation 170.3 require generally that the rules of an RFA assure fair representation of its members in the adoption of any rule, in the selection of its officers, directors, and in other aspects of its administration.[280] Therefore, the Commission is adopting this component of the minimum capital requirements of the Bank-Based Capital Approach as proposed.

Final Minimum Capital Requirement for Covered SDs Electing the Bank-Based Capital Approach

As noted above, the Commission proposed that a covered SD electing the Bank-Based Capital Approach must maintain common equity tier 1 capital equal to or greater than the greatest of (i) $20 million, (ii) 8% of the covered SD's risk margin amount, (iii) 8% of the covered SD's risk-weighted assets, or (iv) the amount of capital required by an RFA. Also as noted above, the Commission is modifying the final regulation to permit a covered SD to hold common equity tier 1, additional tier 1, and tier 2 capital to meet the 8% of the risk margin amount and to meet the 8% of risk weighted assets. Therefore, the Commission is modifying the final minimum capital requirement to require a covered SD to satisfy each of the four minimum capital requirements. This modification is intended to align the final rule with the original proposal, which required a covered SD to hold a sufficient amount of common equity tier 1 capital to meet each of the four minimum capital requirements. Under the final rule, the covered swap dealer will continue to have to meet each of the four criteria, but may use capital other than common equity tier 1 capital to meet such requirements consistent with the rule.

4. Capital Requirement for Covered SDs Electing the Tangible Net Worth Capital Approach

The Commission proposed to permit covered SDs that are ''predominantly engaged in non-financial activities,'' as defined below, to elect a capital requirement based on the SD's tangible net worth (the ''Tangible Net Worth Capital Approach'').[281] The term ''tangible net worth'' was proposed to be defined as the net worth of a covered SD, as determined in accordance with U.S. GAAP, excluding goodwill and other intangible assets.[282] The *2016 Capital Proposal* further required a covered SD, in computing its tangible net worth, to include all liabilities or obligations of a subsidiary or affiliate that the covered SD guaranteed, endorsed, or assumed either directly or indirectly to ensure that the tangible net worth of the covered SD reflects the full extent of the covered SD's potential financial obligations.[283] The proposed definition further provided that in determining net worth, all long and short positions in swaps, security-based swaps, and related positions must be marked to their respective market values to ensure that the tangible net worth reflected the current market value of the covered SD's swap and security-based swap positions, including any accrued losses on such positions.[284]

The Commission further proposed that a covered SD eligible for the Tangible Net Worth Capital Approach must maintain tangible net worth in an amount equal to or in excess of the greatest of:

(1) $20 million plus the amount of the covered SD's market risk exposure requirement and credit risk exposure requirement associated with the covered SD's swap and related hedge positions that are part of the covered SD's swap dealing activities;

(2) 8% of the sum of:

(a) The amount of uncleared swap margin (as that term was defined in regulation 23.100) for each uncleared swap position open on the books of the covered SD, computed on a counterparty by counterparty basis pursuant to regulation 23.154 without regard to any initial margin exemptions or thresholds that the Commission's margin rules may provide;

(b) the amount of initial margin that would be required for each uncleared security-based swap position open on the books of the covered SD, computed on a counterparty by counterparty basis pursuant to 17 CFR 240.18a–3(c)(1)(i)(B) without regard to any initial margin exemptions or exclusions that the rules of the SEC may provide to such security-based swap positions; and

(c) the amount of initial margin required by clearing organizations for cleared proprietary futures, foreign futures, swaps and security-based swaps positions open on the books of the covered SD; or

(3) The amount of net capital required by the registered futures association of which the covered SD is a member.

The *2016 Capital Proposal* further provided that a covered SD could use internal models to compute market risk and credit risk capital charges provided that the models were approved by the Commission or an RFA.[285] A covered SD that did not obtain Commission or RFA approval to use internal models was required to compute standardized market risk and credit risk charges for its proprietary swaps, security-based swaps, or other financial positions in accordance with the FCM standardized market risk and credit risk capital charges set forth under regulation 1.17, as proposed to be amended.[286]

The Commission also proposed that to be eligible to use the Tangible Net Worth Capital Approach, a covered SD's financial activities must be de minimis in relation to its overall financial and non-financial activities. Specifically, the *2016 Capital Proposal* provided that the covered SD must be ''predominantly engaged in non-financial activities.'' The term ''predominantly engaged in non-financial activities'' was proposed to be defined by referencing the definition of the term ''financial activities'' under the Federal Reserve Board's regulations establishing criteria for determining if a nonbank financial company is ''predominantly engaged in financial activities'' and therefore, subject to Federal Reserve Board oversight.[287]

Title I of the Dodd-Frank Act established the Financial Stability Oversight Council (''FSOC''), which, among other authorities and duties, may subject a nonbank financial company to supervision by the Federal Reserve Board and consolidated prudential standards if the FSOC determines that material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could pose a threat to the financial stability of the U.S. Title I of the Dodd-Frank Act defines a ''nonbank financial company'' to include both a U.S. nonbank financial

[280] 7 U.S.C. 21(b)(5) and Commission regulation § 170.3 (17 CFR 1.17). *See also,* section 17(b)(11) of the CEA (7 U.S.C. 21(b)(11)) which requires that an RFA provide for meaningful representation on the governing board of such association of a diversity of membership interests and provides that no less than 20 percent of the regular voting members of[the board be comprised of qualified nonmembers of or persons not regulated by such association.

[281] *See* proposed Commission regulation § 23.101(a)(2)(ii), *2016 Capital Proposal,* 81 FR 91252 at 91311.

[282] *See* proposed Commission regulation § 23.100, *2016 Capital Proposal,* 81 FR 91252 at 91309–10.

[283] *See* proposed definition of ''tangible net worth'' in Commission regulation § 23.100, *2016 Capital Proposal,* 81 FR 91252 at 91310.

[284] *Id.*

[285] *See* proposed Commission regulation § 23.102(a), *2016 Capital Proposal,* 81 FR 91252 at 91311.

[286] *See* section II.B.3.a above for a discussion of the standardized market risk and credit risk capital charges for FCMs and FCM–SDs.

[287] *See* 12 CFR 242.3.

company and foreign nonbank financial company that, among other things, are ''predominantly engaged in financial activities.'' For purposes of Title 1 of the Dodd-Frank Act, a company is considered to be ''predominantly engaged'' in financial activities if either (i) the annual gross revenue derived by the company and all of its subsidiaries from financial activities, as well as from the ownership or control of an insured depository institution, represented 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated assets of the company.

The Commission proposed to adopt this Federal Reserve Board standard to distinguish covered SDs that are predominantly engaged in financial activities from covered SDs that are predominantly engaged in non-financial activities. The Commission, however, modified the test for purposes of the eligibility of the Tangible Net Worth Capital Approach to provide that a covered SD would be considered ''predominantly engaged in non-financial activities'' if: (i) The consolidated annual gross financial revenues of the covered SD in either of its two most recently completed fiscal years represented less than 15 percent of the consolidated gross revenue in that fiscal year (''15% Revenue Test''); and (ii) the consolidated total financial assets of the covered SD at the end of its two most recently completed fiscal years represented less than 15 percent of the consolidated total assets as of the end of the fiscal year (''15% Asset Test'').

The *2016 Capital Proposal* also proposed to define the financial activities covered by the 15% Revenue Test and 15% Asset Test by reference to the listed financial activities set forth in Appendix A of 12 CFR part 242, which covers an extensive range of financial activities and services.[288] The financial activities set forth in Appendix A of 12 CFR part 242 include, among other things: (i) Lending, exchanging, transferring, investing for others, or safeguarding money or securities; (ii) insuring, guaranteeing, or indemnifying against loss or harm, damage or death in any state; (iii) providing financial, investment, or economic advisory services; (iv) issuing or selling interests in a pool; (v) underwriting, dealing in, or making a market in securities; and (vi) engaging as principal in the investment and trading of certain financial instruments. The Commission, however, proposed to explicitly provide that accounts receivable from non-financial activities, which may meet the definition of financial activities under 12 CFR part 242, may be excluded by the covered SD from the computation of its financial activities.[289] The Commission stated that the purpose of providing this exclusion was to prevent the covered SD's non-financial activities from becoming part of the computation of the covered SD's financial activities merely on the basis that the non-financial activities result in the covered SD recognizing receivables.

The Commission proposed the Tangible Net Worth Capital Approach in recognition that certain entities that engage predominantly in non-financial activities may currently or in the future meet the statutory and regulatory definition of the term ''swap dealer'' and, therefore, will be required to register as such with the Commission.[290] The Commission stated that while these entities may meet the definition of a ''swap dealer'' they may also be primarily commercial entities engaged predominantly in non-financial activities.[291] The Commission further recognized that covered SDs that are primarily engaged in commercial activities differ from financial entities in various ways, including the composition of their respective balance sheets (*e.g.,* the types of assets they hold), the types of transactions they enter into, and the types of market participants and swap counterparties that they deal with. Because of these differences, the Commission stated that application of the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach could result in inappropriate capital requirements that would not be proportionate to the risk taken by such covered SDs, and proposed to permit these covered SDs to have an option of electing the Tangible Net Worth Capital Approach.[292] The Commission, however, modified the standards established by the Federal Reserve Board as it believed that covered SDs that engage in anything more than a de minimis level of financial activities must be subject to either the Net Liquid Assets Capital Approach or the Bank-Based Capital Approach in order for the Commission's regulations to achieve the Congressional mandate that the SD capital requirements ensure the safety and soundness of the SD.

The Commission received comments generally supporting the proposed Tangible Net Worth Capital Approach, but also stating that the qualifying criteria were overly narrow and entity specific.[293] Commenters generally noted that a parent entity that is ''predominantly engaged in non-financial activities'' as defined by the regulation would not be permitted in any practical way to establish a covered SD subsidiary that would qualify to use the Tangible Net Worth Capital Approach as the swaps activity of the SD subsidiary would be considered financial activities.[294] Another commenter stated that commercial firms often establish subsidiaries to perform centralized risk management operations for the full commercial enterprise, including entering into swap transactions, and that such subsidiaries should have the ability to elect a Tangible Net Worth Capital Approach.[295] Commenters further noted that the proposed Tangible Net Worth Capital Approach would discriminate against corporate entities that are predominantly engaged in non-financial activities but elect to maintain their swap dealing activities in separate legal entities.[296] Several commenters suggested that the Commission should address these concerns by modifying the Proposal to permit a covered SD to elect the Tangible Net Worth Capital Approach if the SD or its parent meets the qualifying criteria of ''predominantly engaged in non-financial activities.''[297]

In reopening the comment period in 2019, the Commission requested further

[288] *See* definition of ''predominantly engaged in non-financial activities'' in proposed Commission regulation § 23.100, *2016 Capital Proposal,* 81 FR 91252 at 91309.

[289] *Id.*

[290] The term ''swap dealer'' is defined by section 1a(49) of the CEA and Commission regulation § 1.3 (17 CFR 1.3). Regulation 1.3 provides that an entity may apply to limit its designation as an SD to specified categories of swaps or specified activities in connection with swaps.

[291] *See 2016 Capital Proposal,* 81 FR 91252 at 91255.

[292] Furthermore, as an SD, the firm is subject to the Commission's final swaps margin requirements.

[293] *See, e.g.,* Letter from Phillip Lookadoo, and Jeremy Weinstein, International Energy Credit Association (May 15, 2017) (IECA 5/15/2017 Letter); Letter from Scott Earnest, Shell Trading Risk Management LLC (May 15, 2017) (Shell 5/15/2017 Letter); Letter from David McIndoe, Commercial Energy Working Group (May 15, 2017) (CEWG 5/15/2017 Letter); and Letter from Michael P. LeSage, Cargill Risk Management, a unit of Cargill, Inc. (May 15, 2017) (Cargill 5/15/2017 Letter).

[294] *See* IECA 5/15/2017 Letter; Shell 5/15/2017 Letter; CEWG 5/15/2017 Letter.

[295] *See* Letter from National Corn Growers Association and National Gas Supply Association, (May 15, 2017) (NCGA/NGSA 5/15/2017 Letter).

[296] *See, e.g.,* Shell 5/15/2017 Letter.

[297] *See* IECA 5/15/2017 Letter; CEWG 5/15/2017 Letter; NCGA/NGSA 5/15/2017 Letter.

comment on the Tangible Net Worth Capital Approach based upon issues raised in the *2016 Capital Proposal.*[298] The Commission requested comment on whether a covered SD that does not meet the ''predominantly engaged in non-financial activities'' standard should be eligible to use the Tangible Net Worth Capital Approach if its parent entity, or the ultimate parent of its consolidated ownership group, satisfies the qualifying standards.[299] The Commission further requested comment on whether a covered SD that relies on a parent entity to satisfy the ''predominantly engaged in non-financial activities'' criteria should be required to obtain parent guarantees, or some other form of financial support, for its swaps obligations.[300]

The Commission also requested comment in the *2019 Capital Reopening* on whether a covered SD that was primarily engaged in commodity swaps should be permitted to use the Tangible Net Worth Capital Approach notwithstanding that its parent entity does not meet the ''predominantly engaged in non-financial activities'' requirements (*i.e.,* the parent is primarily engaged in financial activities).[301] Finally, the Commission requested comment regarding modifications that commenters believed the Commission should consider to the 15% Asset Test and/or the 15% Revenue Test, and requested that commenters explain why such modifications were necessary to achieve the purpose and objective of the Tangible Net Worth Capital Approach.[302]

The Commission received comments in response to the *2019 Capital Reopening,* and the commenters continued to generally support a Tangible Net Worth Capital Approach.[303] Several commenters, however, continued to express the concern that the eligibility criteria, as expressed in the 15% Asset Test and the 15% Revenue Test, are not broad enough and should be expanded to provide more covered SDs with the ability to elect the Tangible Net Worth Capital Approach.[304] One commenter stated that the Commission should revise the qualifications to permit more covered SDs to elect the Tangible Net Worth Capital Approach, which the commenter viewed as a more suitable approach than the Bank-Based Capital Approach and the Net Liquid Assets Capital Approach.[305]

Other commenters stated that the Commission should revise the eligibility criteria for the Tangible Net Worth Capital Approach to provide that a covered SD may use such capital approach if it is part of a holding company or corporate structure that is itself ''predominantly engaged in non-financial activities'' and satisfies the 15% Asset Test and the 15% Revenue Test.[306] Several of these commenters noted that parent entities that are non-financial entities often ''ring-fence'' financial activities (including swap dealing activities and treasury functions) in affiliates that are stand-alone legal entities, and that the Commission's Proposal effectively prevents such stand-alone entities from being eligible for the Tangible Net Worth Capital Approach as they are not ''predominantly engaged in non-financial activities.'' [307] A commenter stated that centralizing financial functions into a single subsidiary provides efficiencies for some holding companies that are primarily involved in non-financial businesses, such as energy production or agriculture, and that the Commission's rules should be corporate-structure neutral.[308] An additional commenter stated that the ultimate parent level is the proper level at which to determine whether a corporate enterprise, and its subsidiaries, is predominantly engaged in non-financial activity.[309] Another commenter stated that a covered SD that otherwise qualifies for and elects the Tangible Net Worth Capital Approach should not be required to obtain a parent guarantee for obligations arising from its swaps activities.[310]

The Commission also received comments that the eligibility criteria for the Tangible Net Worth Capital Approach should be modified to permit a covered SD to use such approach if the SD's swap dealing activity is focused on agricultural and exempt swap transactions (a ''commodity-focused covered SD''), even if the covered SD is part of a financial holding company or a corporate parent that provides general financial services.[311] Two entities submitted a joint comment stating that the Commission's capital rules should recognize unique issues of small, commodity-focused covered SDs by expanding the eligibility criteria for the Tangible Net Worth Capital Approach to include smaller covered SDs with portfolios predominantly centered around counterparties that qualify for the hedging end user exception under section 2(h)(7) of the CEA.[312] The joint comment stated that smaller commodity-focused covered SDs do not present the type of interconnectedness and systemic risk to the broader financial markets in comparison to other covered SDs, in part due to (i) relatively lower trading volumes (*i.e.,* market impact); and (ii) the non-financial and hedging nature of their customer base.[313] The joint commenters further stated that a significant percentage of the customer base and trading activities of smaller commodity-focused covered SDs may qualify for the hedging end user exception under section 2(h)(7) of the CEA, entering into swap transactions for the purpose of hedging physical commodity risk. The commenters claim that as a result of the end user exception from clearing and margin, smaller commodity-focused covered SDs may not collateralize these relationships fully or the extent they would otherwise be required when dealing with financial entities or financial end users, and that they would be required to internalize capital charges for all uncollateralized exposures, placing burdensome costs on these SDs, their market presence, and ultimately commercial end user customers.[314] The commenters suggest that the Commission should modify the final rule by adopting an additional qualifying test for smaller commodity-

[298] *See 2019 Capital Reopening,* 84 FR 69664 at 69674–75.

[299] *Id.*

[300] *Id.*

[301] *Id.*

[302] *Id.*

[303] *See, e.g.,* IIB/SIFMA/ISDA 3/3/2020 Letter; MS 3/3/2020 Letter; CEWG 3/3/2020 Letter; Letter from Jennifer Fordham, National Corn Growers Association/Natural Gas Supply Association (March 3, 2020) (NCGA/NGSA 3/3/2020 Letter); ED&F Man/INTL FCStone 3/3/2020 Letter; and Shell 3/3/2020 Letter.

[304] *See, e.g.,* Shell 3/3/2020 Letter; CEWG 3/3/2020 Letter; MS 3/3/2020 Letter; IIB/SIFMA/ISDA 3/3/2020 Letter; NCGA/NGSA 3/3/2020 Letter.

[305] *See* NCGA/NGSA 3/3/2020 Letter. The NCGA/NGSA suggested that the Commission base the eligibility of the Tangible Net Worth Capital Approach based on the definition of the term ''financial entity'' contained in section 2(h)(7)(C)(i)(VIII) of the CEA (7 U.S.C. 2(h)(7)(C)(i)(VIII)).

[306] *See* Shell 3/3/2020 Letter; CEWG 3/3/2020 Letter; NCGA/NGSA 3/3/2020 Letter.

[307] *See* Shell 5/15/2017 Letter; NCGA/NGSA 3/3/2020 Letter.

[308] *See* NCGA/NGSA 3/3/2020 Letter.

[309] *See* CEWG 3/3/2020 Letter.

[310] *See* Shell 3/3/2020 Letter.

[311] *See* ED&F Man/INTL FCStone 3/3/2020 Letter; MS 3/3/2020 Letter; CEWG 3/3/2020 Letter.

[312] *See* ED&F Man/INTL FCStone 3/3/2020 Letter.

[313] *Id.* To demonstrate the nature of their customer base as commercial end users, and the relative size of their trading activities, the two commenters represent that as of March 3, 2020, the two firms have not come into scope for complying with the Commission's margin requirement for uncleared swap transactions.

[314] *Id.*

focused covered SDs with portfolios predominantly centered on counterparties that are commercial end users.[315]

One commenter stated that it agreed with comments filed in response to the *2016 Capital Proposal,* which supported an expansion of the eligibility for the Tangible Net Worth Capital Approach to covered SDs that provide access to physical hedging markets.[316] Commenters also suggested that the Commission should modify the ''predominantly engaged in non-financial activities'' criteria by, for instance, providing that covered SDs whose swaps notional amounts are at least 85 percent concentrated in commodity reference assets (*e.g.,* agricultural and exempt commodities) are eligible for the Tangible Net Worth Capital Approach.[317]

Commenters also suggest modifications to the 15% Assets Test and 15% Revenue Test. One commenter stated the respective tests should consider the assets and revenue derived from trading and investing in physical commodities to be non-financial in nature.[318] This commenter further suggested that all hedges of commercial risk should be considered non-financial in nature as the activity is more indicative of an entity being a commercial end user rather than an entity engaged in activity that is financial.[319] Another commenter stated that the Commission should exclude financial hedges of physical commodity, interest rate, or other corporate risks from being considered ''financial activities'' for purposes of the 15% Assets Test and the 15% Revenue Test.[320] This commenter asserted that the use of financial derivatives to manage commercial risk is common for non-financial entities and is not indicative of an entity being engaged in financial activity.[321] The commenter further stated that the Commission should consider assets and revenue derived from trading and investing in physical commodities to be non-financial in nature as including such activity as ''financial in nature'' under the Federal Reserve Board's definition of that term, was not because such activity is financial, but because certain banks need the ability to transact in physical commodity markets to support their financial derivatives activity.[322]

The Commission has considered the comments received on the proposed Tangible Net Worth Capital Approach and is adopting the regulations as proposed, subject to the following modifications. The Commission is modifying the definition of the term ''predominantly engaged in non-financial activities'' in regulation 23.100 to effectively extend the eligibility of the Tangible Net Worth Capital Approach to covered SDs that are subsidiaries of parent entities that are commercial enterprises. Specifically, the definition in regulation 23.100 is modified to provide that a swap dealer is predominantly engaged in non-financial activities if: (1) The swap dealer's consolidated annual gross financial revenues, or if the swap dealer is a wholly owned subsidiary, then the swap dealer's consolidated parent's annual gross financial revenues, in either of its two most recently completed fiscal years represents less than 15 percent of the swap dealer's consolidated gross revenue in that fiscal year, and (2) the consolidated total financial assets of the swap dealer, or if the swap dealer is wholly owned subsidiary, the consolidated total financial assets of the swap dealer's ultimate parent, at the end of its two most recently completed fiscal years represents less than 15 percent of the swap dealer's consolidated total assets as of the end of the fiscal year. The modifications to the definition of the term ''predominantly engaged in non-financial activities'' will permit a covered SD that either directly satisfies the 15% Asset Test and the 15% Revenue Test, or is a subsidiary of an ultimate parent entity that satisfies the 15% Asset Test and the 15% Revenue Test, to elect the Tangible Net Worth Capital Approach.

The Commission is adopting this modification as it recognizes that certain corporate entities that are predominantly engaged in nonfinancial activities establish separate legal entities to operate as financial affiliates to act on behalf of itself and the other affiliates of the corporate enterprise. The Commission believes that by allowing the ultimate consolidated parent entity to conduct the test it provides a better indication as to whether the overall entity is commercial in nature or financial in nature, and whether the covered SD should be viewed as a commercial SD or financial SD. The Commission does not believe that covered SDs that are separately established subsidiaries of commercial entities should be precluded from electing the Tangible Net Worth Capital Approach as it was not the intent of the Proposal to prohibit a commercial enterprise from establishing financial subsidiaries that otherwise meet the definition of a swap dealer due to their support of the activities of their parent entity, affiliates, and their respective commercial customers from electing a Tangible Net Worth Capital Approach.

The Commission is not modifying the final rule to require a covered SD that is eligible to elect the Tangible Net Worth Capital Approach as a result of its parent satisfying the ''predominantly engaged in non-financial activities'' standard to obtain any specific financial support or guarantees from its parent. The test to determine whether a SD can elect the Tangible Net Worth Capital Approach at the ultimate parent level is only to determine whether the consolidated entity is commercial in nature; however, the final Tangible Net Worth Capital Approach requires the covered SD to maintain its own regulatory capital in the form of tangible net worth equal to or greater than $20 million plus the amount of market risk charges and credit risk charges associated with the covered SD's swaps and related hedge positions that are part of the its swap dealing activities. In addition, the covered SD is required to reflect its positions in swaps, security-based swaps, and related positions at fair market value, which ensures that all market-to-market losses are deducted from the SD's tangible net worth. The tangible net worth is intended to ensure that a covered SD has an appropriate level of financial resources available to directly meet its obligations as they arise, which will ensure the safety and soundness of the covered SD. Furthermore, covered SDs electing the Tangible Net Worth Capital Approach are subject to the risk management requirements of Commission regulation 23.600, which requires the SD, among other things, to assess its liquidity resources and outlays on a daily basis, including margin obligations, to ensure that it has both the financial resources and liquidity to meet its financial obligations to swap counterparties.

The Commission also is not modifying the final regulation to allow commodity-focused covered SDs that are direct or indirect subsidiaries of global financial holding companies to

[315] *Id.*

[316] *See* ED&F Man/INTL FCStone 3/3/2020 Letter (citing Letter from Christine Stevenson, BP Energy Company (May 15, 2017), Letter from William Dunaway, INTL FCStone Inc. (May 15, 2017), and Shell 5/15/2017 Letter).

[317] *See* MS 3/3/2020 Letter; IIB/ISDA/SIFMA 3/3/2020 Letter; CEWG 3/3/2020 Letter.

[318] *See* Shell 3/3/2020 Letter. *See also,* CEWG 3/3/2020 Letter representing that the inclusion by the Federal Reserve Board of trading and investing in physical commodities in the definition of activities that are ''financial in nature'' was because certain banks need the ability to transact in physical commodity markets to support their derivatives activity.

[319] *Id.*

[320] *See* CEWG 3/3/2020 Letter.

[321] *Id.*

[322] *Id.*

elect the Tangible Net Worth Capital Approach. As noted above, the Commission proposed the Tangible Net Worth Capital Approach in recognition that not all covered SDs would be financial firms and able to satisfy the Net Liquid Assets Capital Approach or the Bank-Based Capital Approach due to the measurement of illiquid assets necessary to commercial activities. The Commission limited the availability of the Tangible Net Worth Capital Approach to covered SDs that are not predominantly engaged in financial activities. Further, as discussed above, the Commission believes that it is appropriate to extend the Tangible Net Worth Capital Approach to accommodate covered SDs that are direct or indirect subsidiaries of holding companies or corporate parent entities that are not predominantly engaged in financial activities, in order to allow such holding companies or corporate parent entities to establish separate SD subsidiaries to provide financial services for the corporate group, including engaging in swaps on behalf of the corporate group. In such situations, the covered SD is established to act on behalf of the commercial parent entity by, for example, entering into swaps with commercial end users that are seeking to manage their commercial risks with swaps, and to offset the risks incurred by its commercial affiliates by entering into swaps with counterparties, including other SDs or financial end users.

Covered SDs that are subsidiaries of financial holding companies or corporate entities, however, present different issues. While the covered SD may engage in commodity-focused swaps and may also engage in trading of physical commodities, it is doing so as a subsidiary of a financial parent entity. The Commission has generally perceived greater risk from global financial entities than it does from commercial enterprises, and, for this reason does not believe that it would be appropriate to extend the more limited capital treatment of the Tangible Net Worth Capital Approach to such covered SDs. Therefore, the Commission is adopting the Tangible Net Worth Capital Approach as proposed, without requiring parent guarantee and subject to the limited modification to eligibility discussed above, in order to be neutral as to the overall corporate structure employed by commercial entities.

5. Capital Requirements for Covered MSPs

The Commission proposed to establish a minimum capital requirement for covered MSPs as directed by section 4s(e) of the CEA.[323] An MSP is defined as a person that is not a swap dealer and that: (i) Maintains a substantial position in swaps, excluding positions held to hedge or mitigate commercial risk; (ii) has outstanding swaps that create ''substantial counterparty exposures that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets;'' or (iii) is a financial entity that is highly leveraged, is not subject to capital requirements of a prudential regulator, and has a substantial position in swaps, including positions used to hedge and mitigate commercial risk.[324]

Proposed regulation 23.101(a)(2)(ii) required a covered MSP to maintain the greater of (i) positive tangible net worth, or (ii) the amount of capital required by the RFA of which the covered MSP was a member. The term ''tangible net worth'' was proposed to be defined as the net worth of a covered MSP as determined in accordance with US GAAP, excluding goodwill and other intangible assets. The Proposal further required a covered MSP in computing its tangible net worth to include all liabilities or obligations of a subsidiary or affiliate that the covered MSP guarantees, endorses, or assumes, either directly or indirectly, to ensure that the tangible net worth reflects the full extent of the covered MSP's potential financial obligations. The proposed definition further provided that in determining net worth, all long and short positions in swaps, security-based swaps and related positions must be marked to their market value to ensure that the tangible net worth reflects the current market value of the covered MSP's swaps and security-based swaps, including any accrued losses on such positions.

A positive tangible net worth standard was proposed for MSPs, rather than an alternative approach, including the Net Liquid Assets Capital Approach, Bank-Based Capital Approach, or Tangible Net Worth Capital Approach, as the Commission anticipated that entities that register as MSPs may be engaging in a range of business activities that are different from, and broader than, the activities of covered SDs. In addition, covered MSPs are expected to use swaps for different purposes (*e.g.,* hedging or investing) than covered SDs, which generally engage in swaps as a dealing activity. Covered MSP's also may engage in commercial activities that require the holding of a substantial amount of fixed assets or engage in financial activities that are beyond swap dealing activities, which results in the holding of assets that are not consistent with the general Net Liquid Assets Capital Approach or the Bank-Based Capital Approach, such as fixed assets or intangible assets.

The *2016 Capital Proposal* also considered the impact of the final margin rules for uncleared swap transactions in developing the proposed positive tangible net worth requirement for covered MSPs. Covered MSPs subject to the Commission's margin regulations are required to post and collect initial margin and variation margin with SDs, other MSPs, and financial end users (subject to certain thresholds and minimum transfer amounts).[325] The exchanging of variation margin and the exchange of initial margin by covered MSPs and certain of their counterparties would substantially reduce the uncollateralized exposures that the covered MSPs and the counterparties have to each other, which mitigates the possibility that covered MSPs could destabilize the financial markets or present systemic risk. Lastly, the Commission's proposed covered MSP capital standards are comparable with the SEC's capital standards for MSBSPs subject to the SEC's capital requirements, and are intended to require a covered MSP to maintain a sufficient level of assets to meet its obligations to counterparties and creditors and to help ensure the safety and soundness of the covered MSP.[326]

The Commission requested additional comment on the proposed capital requirements for covered MSPs in the *2016 Capital Proposal.* Specifically, the Commission requested comment on whether the positive tangible net worth capital requirement was an appropriate standard for MSPs; whether the Net Liquid Assets Capital Approach or the Bank-Based Capital Approach would be a more appropriate method for establishing capital requirements for covered MSPs; and whether other capital approaches should be considered for covered MSPs.[327] The Commission further requested comment on whether the positive tangible net worth capital requirement should include a minimum fixed-dollar amount requirement, for example, equal to $20 million or some other amount, and

[323] *See 2016 Capital Proposal,* 81 FR 91252 at 91264–65. There currently are no MSPs provisionally registered with the Commission.

[324] *See* Commission regulation § 1.3 (17 CFR 1.3). There currently are no MSPs provisionally registered with the Commission.

[325] *See* 17 CFR part 23, subpart E (Capital and Margin Requirements for Swap Dealers and Major Swap Participants).

[326] *See* 17 CFR 240.18a–2.

[327] *See 2016 Capital Proposal,* 81 FR 91252 at 91264–25.

whether the positive tangible net worth capital requirements should include a requirement for a covered MSP to maintain positive tangible net worth in an amount in excess of the market risk and credit risk charges on the covered MSP's swap and security-based swap positions.[328] The Commission did not receive comments addressing these issues.

The Commission has considered the proposed capital requirements for covered MSPs, and is adopting the capital requirements as proposed. The Commission believes that it is appropriate to impose a capital requirement on a covered MSP that requires such entity to maintain the greater of (i) positive tangible net worth, or (ii) the amount of capital required by an RFA of which the covered MSP is a member. The Commission also recognizes that the positive tangible net worth capital requirement is a less rigorous requirement than the Net Liquid Assets Capital Approach or the Bank-Based Capital Approach. The Commission believes, however, that the positive tangible net worth capital requirement is appropriate to help ensure the safety and soundness of the covered MSP.

Under the final rule as adopted, a covered MSP is required to maintain the greater of (i) positive tangible net worth, or (ii) the minimum amount of capital required by an RFA of which the covered MSP is a member.[329] The final rule further requires a covered MSP to mark its swaps, security-based swaps and related positions to their market values in computing its tangible net worth, and to include in its liabilities obligations of a subsidiary or affiliate that the covered MSP guarantees, endorses, or assumes either directly or indirectly, to ensure that the tangible net worth of the covered MSP reflects the extent of such potential financial obligations.[330]

As noted above, there are no MSPs currently provisionally-registered with the Commission, and only two firms have ever provisionally-registered as MSPs. Therefore, the Commission has limited experience with MSPs and such experience does not provide reliable information or data on how such firms may be structured or operate in future. This lack of information and data makes establishing a more tailored capital requirement beyond the positive tangible net worth requirement challenging. Accordingly, the Commission will monitor any future developments with MSPs and assess the appropriateness of the positive tangible net worth capital requirement to such firms to ensuring the safety and soundness of the MSPs. The Commission will consider any rule amendments that may be necessary based upon the information and data that it will receive from any registered MSP. In addition, the final capital rule provides that an MSP must also maintain a level of capital as established by the RFA of which it is a member. This provision is consistent with section 17 of the CEA, which provides that an RFA must establish minimum capital requirements for members that are at least as stringent as applicable capital requirements adopted by the Commission. This provision authorizes NFA, as the only RFA, to adopt capital requirements for its member MSPs that are higher than the Commission's MSP capital requirement. This provides an additional level of assurance that the Commission or NFA can adjust, if necessary, capital requirements relative to the business activities of any MSPs that the Commission in the future believes present systemic risk.

6. Requirements for Market Risk and Credit Risk Models

The Commission's Proposal recognized that internal market risk and credit risk capital models, including value-at-risk (''VaR'') models, can provide a more effective means of measuring economic risk from complex trading strategies involving swaps, security-based swaps, and other proprietary positions than the standardized market risk and credit risk charges set forth in regulation 1.17. In order to use internal capital models to compute its capital, the covered SD or FCM–SD must obtain the approval of the Commission or an RFA of which it was a member.

In developing the specific proposed market risk and credit risk models requirements, including the proposed quantitative and qualitative requirements of the models discussed below, the Commission incorporated the market risk and credit risk model requirements adopted by the Federal Reserve Board for bank holding companies, including the value at risk (''VaR''), stressed VaR, specific risk, incremental risk, and comprehensive risk qualitative and quantitative standards and requirements. The Commission's proposed qualitative and quantitative requirements for capital models also are comparable to the SEC's existing capital model requirements for ANC Firms and the capital model requirements adopted for SBSDs.

a. VaR Models

Proposed regulation 23.102 required that a VaR model's quantitative criteria include the use of a VaR-based measure that incorporates a 99 percent, one-tailed confidence interval.[331] The VaR-based measure must be based on a price shock equivalent to a ten business-day movement in rates or prices. Price changes estimated using shorter time periods must be adjusted to the ten-business-day standard. The minimum effective historical observation period for deriving the rate or price changes is one year, and data sets must be updated at least quarterly or more frequently if market conditions warrant. The Commission noted that for many types of positions it would be appropriate for a covered SD or FCM–SD to update its data positions more frequently than quarterly. In all cases, a covered SD or FCM–SD must have the capability to update its data sets more frequently than quarterly in anticipation of market conditions that require such updating.

The covered SD or FCM–SD also would not need to employ a single internal capital model to calculate its VaR-based measure. A covered SD or FCM–SD may use any generally accepted approach, such as variance-covariance models, historical simulations, or Monte Carlo simulations, based on the nature and size of the positions the model covers. The internal capital model must use risk factors sufficient to measure the market and credit risk inherent in all positions. The risk factors must address the risks including interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk. For material positions in the major currencies and markets, modeling techniques must incorporate enough segments of the yield curve—in no case less than six—to capture differences in volatility and less than perfect correlation of rates along the yield curve.

The internal capital model may incorporate empirical correlations within and across risk categories, provided that the covered SD or FCM–SD validates and demonstrates the reasonableness of its process for measuring correlations. If the internal capital model does not incorporate empirical correlations across risk categories, the covered SD or FCM–SD must add the separate measures from its internal capital models for the

[328] *Id.*

[329] *See* paragraph (a)(2) of Commission regulation § 23.101, as adopted.

[330] *See* definition of the term ''tangible net worth'' in Commission regulation § 23.100, as adopted.

[331] *2016 Capital Proposal,* 81 FR 91252, 91269–72.

appropriate risk categories as listed above to determine its aggregate VaR-based measure of capital.

The VaR-based measure must include the risks arising from the nonlinear price characteristics of options positions or positions with embedded optionality and the sensitivity of the fair value of the positions to changes in the volatility of the underlying rates, prices or other material factors. A covered SD or FCM–SD with a large or complex options portfolio must measure the volatility of options positions or positions with embedded optionality by different maturities and/or strike prices, where material.

The internal capital model also must be subject to backtesting requirements that must be calculated no less than quarterly. A covered SD or FCM–SD must compare its daily VaR-based measure for each of the preceding 250 business days against its actual daily trading profit or loss, which includes realized and unrealized gains and losses on portfolio positions as well as fee income and commissions associated with its activities. If the quarterly back-testing shows that the covered SD's or FCM–SD's daily net trading loss exceeded its corresponding daily VaR-based measure, a back-testing exception has occurred. If a covered SD or FC–SD experiences more than four back-testing exceptions over the preceding 250 business days, it is generally required to apply a multiplication factor in excess of three when it calculates its VaR-based capital requirements.

The qualitative requirements proposed would specify, among other things, that: (i) Each VaR model must be integrated into the covered SD's or FCM–SD's daily internal risk management system; (ii) each VaR model must be reviewed periodically by the firm's internal audit staff and annually by a third party service provider; and (iii) the VaR measure computed by the model must be multiplied by a factor of at least three but potentially a greater amount if there are exceptions to the measure resulting from quarterly backtesting results.

A covered SD or FCM–SD would also be subject to on-going supervision by staff of the Commission and RFA with respect to its internal risk management, including its use of VaR models.

b. Stressed VaR Models

The Commission proposed that covered SDs or FCM–SDs approved to use VaR models to compute market risk deductions also must include a stressed VaR component in the calculation. The stressed VaR measure supplements the VaR measure, as the VaR measure's inherent limitations produced an inadequate amount of capital to withstand the losses sustained by many financial institutions in the financial crisis of 2007–2008.[332] The stressed VaR measure also should contribute to a more appropriate measure of the risks of a covered SD's or an FCM–SD's positions as stressed VaR is intended to account for more volatile and extreme price changes.

The *2016 Capital Proposal* required a covered SD or FCM–SD to use the same model that it uses to compute its VaR measure for its stressed VaR measure. The model inputs however would be calibrated to reflect historical data from a continuous 12-month period that reflects a period of significant financial stress appropriate to the covered SD's or FCM–SD's portfolio. The stressed VaR measure must be calculated at least weekly and be no less than the VaR measure. The Commission further noted that it expected that the stressed VaR measure would be substantially greater than the VaR measure.

The Commission also required that the stress tests take into account concentration risk, illiquidity under stressed market conditions, and other risks arising from the covered SD's or FCM–SD's activities that may not be captured adequately in the covered SD's or FCM–SD's internal VaR models. For example, it may be appropriate for the covered SD or FCM–SD to include in its stress testing large price movements, one-way markets, nonlinear or deep out-of-the-money products, jumps-to-default, and significant changes in correlation. Relevant types of concentration risk include concentration by name, industry, sector, country, and market.

The Proposal also provided that a covered SD or FCM–SD must maintain policies and procedures that describe how it determines the period of significant financial stress used to compute its stressed VaR measure and be able to provide empirical support for the period used. These policies and procedures must address: (i) How the covered SD or FCM–SD links the period of significant financial stress used to calculate the stressed VaR-based measure to the composition and directional bias of the covered SD's or FCM–SD's portfolio; and (ii) the covered SD's or FCM–SD's process for selecting, reviewing, and updating the period of significant financial stress used to calculate the stressed VaR measure and for monitoring the appropriateness of the 12-month period in light of the covered SD's or FCM–SD's current portfolio. Before making material changes to these policies and procedures, a covered SD or FCM–SD must obtain approval from the Commission or RFA. The Commission or the RFA also may require a covered SD or FCM–SD to use a different period of stress to compute its stressed VaR measure.

c. Specific Risk Models

The Commission proposed to allow covered SDs or FCM–SDs to model their specific risk. Under the Proposal, the specific risk model must be able to demonstrate the historical price variation in the portfolio, be responsive to changes in market conditions, be robust to an adverse environment, and capture all material aspects of specific risk for its positions. The Proposal required that a covered SD's or FCM–SD's models capture event risk (such as the risk of loss on equity or hybrid equity positions as a result of a financial event, such as the announcement or occurrence of a company merger, acquisition, spin-off, or dissolution) and idiosyncratic risk, and capture and demonstrate sensitivity to material differences between positions that are similar but not identical, and to changes in portfolio composition and concentrations. If a covered SD or FCM–SD calculates an incremental risk measure for a portfolio of debt or equity positions under paragraph (I) of proposed 23.102 Appendix A, the covered SD or FCM–SD is not required to capture default and credit migration risks in its internal models used to measure the specific risk of these portfolios.

The Commission noted in the Proposal that it understood that not all debt, equity, or securitization positions (for example, certain interest rate swaps) have specific risk. Therefore, the Commission proposed that there would be no specific risk capital requirement for positions without specific risk. A covered SD or FCM–SD, however, must have clear policies and procedures for determining whether a position has specific risk.

The Commission also stated in the Proposal that it believed that a covered SD or FCM–SD should develop and implement VaR-based models for both market risk and specific risk. A covered SD's or FCM–SD's use of different approaches to model specific risk and general market risk (for example, the use of different models) would be reviewed to ensure that the overall capital requirement for market risk is

[332] *See Revisions to the Basel II market risk framework,* published by the Basel Committee on Banking Supervision for an explanation of the implementation of the stressed VaR requirement.

commensurate with the risks of the covered SD's or FCM–SD's positions.

d. Incremental Risk Models

The Commission proposed an incremental risk requirement for covered SDs or FCM–SDs that measures the specific risk of a portfolio of debt positions using internal models. Incremental risk consists of the default risk and credit migration risk of a position. Default risk means the risk of loss on a position that could result from the failure of an obligor to make timely payments of principal or interest on its debt obligation, and the risk of loss that could result from bankruptcy, insolvency, or similar proceeding. Credit migration risk means the price risk that arises from significant changes in the underlying credit quality of the position. A covered SD or FCM–SD also may include portfolios of equity positions in the incremental risk model with the prior permission from the Commission or RFA, provided that the covered SD or FCM–SD consistently includes such equity positions in how it internally measures and manages the incremental risk for such positions at the portfolio level. Default is assumed to occur with respect to an equity position that is included in its incremental risk model upon the default of any debt of the issuer of the equity position.

e. Comprehensive Risk Models

The *2016 Capital Proposal* required a covered SD or FCM–SD to compute all material price risks of one or more portfolios of correlation trading positions using an internal model. The Commission required the model to measure all price risk consistent with a one-year time horizon at a one-tail, 99.9 percent confidence level, under the assumption either of a constant level of risk or of constant positions. The Commission stated that it expected that the covered SD or FCM–SD remains consistent in its choice of constant level or risk or positions, once it makes a selection. Also, the covered SD's or FCM–SD's choice of a liquidity horizon must be consistent between its calculation of its comprehensive and incremental risk.

The Commission also required a covered SD's or FCM–SD's comprehensive risk model to capture all material price risk, including, but not limited to: (i) The risk associated with the contractual structure of cash flows of each position, its issuer, and its underlying exposures (for example, the risk arising from multiple defaults, including the ordering of defaults in tranched products); (ii) credit spread risk, including nonlinear price risks; (iii) volatility of implied correlations, including nonlinear price risks such as the cross-effect between spreads and correlations; (iv) basis risks; (v) recovery rate volatility as it relates to the propensity for recovery rates to affect tranche prices; and (vi) to the extent that the comprehensive risk measure incorporates benefits from dynamic hedging, the static nature of the hedge over the liquidity horizon. The Commission noted that additional risks that are not explicitly discussed but are a material source of price risk must be included in the comprehensive risk measure.

The Commission also required a covered SD or FCM–SD to have sufficient market data to ensure that it fully captures the material price risks of the correlation trading positions in its comprehensive risk measure. Moreover, a covered SD or FCM–SD must be able to demonstrate that its model is an appropriate representation of comprehensive risk in light of the historical price variation of its correlation trading positions. A covered SD or FCM–SD also would be required to inform the Commission and RFA if the covered SD or FCM–SD plans to extend the use of a model that has been approved to an additional business line or product type.

The Proposal required that the comprehensive risk measure must be calculated at least weekly. In addition, a covered SD or FCM–SD must at least weekly apply to its portfolio of correlation trading positions a set of specific stressed scenarios that capture changes in default rates, recovery rates, and credit spreads, and various correlations. A covered SD or FCM–SD must retain and make available to the Commission and the RFA the results of the stress testing, including comparisons with capital generated by the covered SD's or FCM–SD's comprehensive risk model. A covered SD or FCM–SD must promptly report to the Commission or the RFA any instances where the stress tests indicate any material deficiencies in the comprehensive risk model.

f. Credit Risk Models

The *2016 Capital Proposal* required covered SDs or FCM–SDs seeking to obtain Commission or RFA approval to use internal models to compute credit risk to submit credit risk models that satisfy the quantitative and qualitative requirements set forth in Appendix A to proposed regulation 23.102. With respect to uncleared derivatives contracts, a covered SD or FCM–SD would need to determine an exposure charge for each counterparty to its uncleared derivatives positions. The exposure charge for a counterparty that is insolvent, in a bankruptcy proceeding, or in default of an obligation on its senior debt, is the net replacement value of the uncleared derivatives contracts with the counterparty (*i.e.,* the net amount of uncollateralized current exposure to the counterparty). The counterparty exposure charge for all other counterparties is the credit equivalent amount of the covered SD's or FCM–SD's exposure to the counterparty multiplied by an applicable credit risk-weight factor multiplied by 8%. The credit equivalent amount is the sum of the covered SD's or FCM–SD's (i) maximum potential exposure (''MPE'') multiplied by a backtesting determined factor; and (ii) current exposure to the counterparty. The MPE amount is a charge to address potential future exposure and is calculated using the VaR model as applied to the counterparty's positions after giving effect to a netting agreement, taking into account collateral received, and taking into account the current replacement value of the counterparty's positions.

The Commission in its margin requirements (*see* Commission regulations 23.150 through 23.161) set forth the requirements for eligible collateral for uncleared swaps. In order to account for collateral in its VaR model for the credit risk charges, the Commission stated that it expected a covered SD or FCM–SD to account only for the collateral that complies with Commission regulation 23.156 and is held in accordance with regulation 23.157 for uncleared swaps that are subject to the Commission's margin rules. A covered SD or FCM–SD would be able to take into consideration in its VaR calculation collateral that does not comply with regulation 23.156 and is not held in accordance with regulation 23.157, for uncleared swaps that are not subject to the Commission's margin rules.

The Commission proposed to allow covered SDs or FCM–SDs to use internal methodologies to determine the appropriate credit risk-weights to apply to counterparties, if it has received the Commission's or the RFA's approval. A higher percentage credit risk-weight factor would result in a larger counterparty exposure charge amount. The Commission stated that it expected that the counterparty credit risk-weight should be based on an assessment of the creditworthiness of the counterparty.

The Commission stated that its proposed approach to calculating credit risk charges is appropriate given that its requirements are based on a method of

computing capital charges for credit risk exposures in the international capital standards for banking institutions. Since credit risk is the risk that a counterparty could not meet its obligations on an OTC derivatives contract in accordance with agreed terms (such as failing to pay), the considerations that inform a covered SD's or FCM–SD's assessment of a counterparty's credit risk should be broadly similar across the various relationships that may arise between the dealer and the counterparty. Therefore, the Commission believes that its approach is a reasonable model, as the SEC also uses a similar approach for its ANC BDs and SBSDs using models.

The Commission also proposed that covered SDs or FCM–SDs that are subject to the Bank-Based Capital Approach requirement could also request Commission or RFA approval to use the Federal Reserve Board's internal ratings-based and advanced measurement model approaches to compute risk-weighted assets for the credit exposures listed in subpart E of 12 CFR 217. The covered SD or FCM–SD would have to include such exposures in its application to the Commission and RFA, and explain how its proposed models are consistent with the Federal Reserve Board's model criteria in subpart E of 12 CFR 217.

The Commission received several comments concerning the use of internal capital models. One commenter expressed a strong concern regarding the *2016 Capital Proposal's* potential heavy reliance on the use of internal models.[333] The commenter stated that a reliance on internal models can permit regulated entities to manipulate risk controls to increase their own profits at the cost of increasing risks to the public. The commenter pointed out that analysis of the financial crisis experience evidenced manipulation of models to reduce capital charges. While the commenter acknowledged post-crisis refinements to internal model requirements, both in technique and governance, it argued that resource limitations at regulators, as well as continuing pressure from industry, may limit regulators' ability to prevent weakening standards and model misuse. The commenter thus advocated for strong limitations and floors to counterbalance the use of internal models.[334]

The Commission appreciates the commenter's concerns regarding models generally, and the need for the Commission to maintain strong limitations and floors. In this regard, the Commission is providing that only capital models that satisfy specified quantitative and qualitative requirements set forth in the regulations will be approved for use by covered SDs. Such requirements are consistent with the standards established by the BCBS and SEC for banking institutions and BDs, respectively. In addition, the Commission plans to work with NFA to establish a comprehensive ongoing examination program over the capital models used by covered SDs, which will be designed to identify and address issues with model performance through such means as back-testing results. These steps should assist with mitigating concerns regarding model performance.

Other commenters generally supported the Commission's Proposal to permit internal capital models in lieu of standardized market and credit risk capital charges.[335] Another commenter stated that it strongly supports permitting SDs the flexibility to use internal models, when appropriate.[336]

Two commenters stated that the detailed quantitative and qualitative requirements for market risk and credit risk models set forth in Appendix A of proposed regulation 23.102 do not reflect the requirements of all of the models that a bank or bank holding company may use for market risk and credit calculations under the capital rules of the Federal Reserve Board.[337] One of the commenters stated that the prudential regulators have undertaken an extensive effort to revise U.S. Basel III risk-weighted asset standards, which has includes significant ongoing efforts to revise specific credit risk and market risk methodologies that will require several years to finalize.[338] One of the commenters stated that the differences between the Federal Reserve Board rules and the requirements of Appendix A would require a covered SD electing the Bank-Based Capital Approach to submit a model application that contains more information than the information required by the Federal Reserve Board.[339] The commenters also state that the calculations of market risk and credit risk under some of the Federal Reserve Board rules differ from the calculation requirements under proposed Appendix A of regulation 23.102. The commenters recommended that the Commission modify proposed regulation 23.102 and appendix A to allow a Bank-Based Capital Approach to use models approved to calculate market risk and credit risk exposures if the model satisfies the relevant Federal Reserve Board requirements for market risk and credit risk models, as appropriate. The commenters also recommended that the Commission permit a covered SD that has obtained approval to use credit risk models to calculate its credit risk exposure using the Federal Reserve Board's advance approaches capital framework, contained in subpart E of 12 CFR part 217, and further permit a covered SD that has obtained approval to use market risk models to calculate its market risk using the Federal Reserve Board's rules contained in subpart F of 12 CFR part 217. The commenters stated that the above modifications would allow covered SDs electing the Bank-Based Capital Approach to calculate market risk and credit risk consistently with how bank SDs and many foreign SDs calculate their exposures for capital purposes.

The Commission recognizes that the Federal Reserve Board's capital rules are continuing to evolve and will evolve further in the future as global banking regulators continue to harmonize capital requirements under the Basel capital framework. The Commission proposed the Bank-Based Capital Approach in recognition that it reflected a global banking capital regime that was designed for safety and soundness. The proposed approach also provided covered SDs that are non-bank subsidiaries of bank holding companies the ability to use capital models approved by prudential regulators for their bank affiliates.

The Commission understands that model requirements set forth in proposed Appendix A of regulation 23.102 do not reflect fully the market risk and credit risk options available at this time to banking organizations under the rules of the Federal Reserve Board. The Commission also understands that each of the market risk and credit risk options under the Federal Reserve Board's rules are, and will continue to be, based on Basel capital requirements, and thus appropriate for calculating market risk or credit risk for covered SDs. Therefore, the Commission is modifying regulation 23.102 to both clarify and expand the market risk and credit risk models that may be used by a covered SD such that the requirement aligns with requirements of the Federal Reserve Board. Specifically, the Commission is modifying paragraph (c) of regulation 23.102 to provide that a covered SD's application for market risk models must include the information

[333] *See* AFR 5/15/17 Letter.

[334] *Id.*

[335] *See, e.g.,* ISDA 5/15/17 Letter; SIFMA 5/15/17 Letter; MS 5/15/17 Letter.

[336] *See* IFM 5/15/17 Letter.

[337] *See IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter.*

[338] *Id.*

[339] IIB/ISDA/SIFMA 3/3/2020 Letter.

specified in Federal Reserve Board's rules contained in subpart F of 12 CFR part 217, and the information required under subpart E of 12 CFR part 217 for credit risk models. The Commission believes that the modifications are appropriate in that they provide model requirements that are identical to the Federal Reserve Board's requirements and, by incorporating the Federal Reserve Board's rules by reference, address concerns raised regarding the ongoing revisions to the rules as Basel enhancements continue to be adopted.

7. Model Approval Process for Covered SDs and FCM–SDs

The Commission's Proposal required each covered SD and FCM–SD to submit an application for approval to use internal capital models to compute market risk or credit risk capital charges to the Commission and to the RFA of which the SD or FCM–SD was a member.[340] The Proposal provided that a covered SD's or FCM–SD's application must be in writing and must be filed with the Commission and with an RFA in accordance with applicable filing requirements. Proposed Appendix A to regulation 23.102 required the application to include: (i) A list of categories of positions that the covered SD or FCM–SD holds in its proprietary accounts and a brief description of the methods the covered SD or FCM–SD would use to calculate market risk and credit risk charges; (ii) a description of the mathematical models to be used to price positions and to compute market risk and credit risk; (iii) a description of how the covered SD or FCM–SD would calculate current exposure and potential future exposure for its credit risk charges, and (iv) a description of how the covered SD or FCM–SD would determine internal credit risk-weights of counterparties, if applicable. The Commission or RFA also may require a covered SD or FCM–SD to supplement its application with additional information necessary for a proper evaluation.[341]

The Proposal also provided that the Commission or RFA could deny the application or approve the application, subject to any conditions or limitations that the Commission or RFA may require, if such denial or approval is found to be in the public interest. In making a public interest determination, the Commission will consider whether the applicant's models meet the quantitative and qualitative requirements, and assess the governance structure regarding the development, operation, and ongoing monitoring of the models. The Commission will further assess the qualification of personnel with the responsibility for operating the models and the personnel with responsibility for supervising the daily operations and reporting to senior management. The Commission's assessment is intended to determine that the use of capital models does not impair the overall safety and soundness of the covered SD or FCM–SD. The Commission also will consider the potential benefits that models provide by more appropriately reflecting market and credit risk as compared to standardized capital charges, which encourages FCM–SDs and covered SDs to provide markets to market participants and provides for a more efficient use of FCM–SD and covered SD capital.

A covered SD or FCM–SD also would be required to cease using the models if: (i) The models are altered or revised materially, or if the SD's or FCM–SD's internal risk management is materially changed, and such changes have not been submitted to the Commission and RFA for approval; (ii) the Commission or RFA determines that the models are no longer sufficient or adequate to compute market or credit risk charges; (iii) the SD or FCM–SD fails to comply with the regulations governing the use of models; or (iv) the Commission by written order finds that permitting the SD or FCM–SD to continue to use the internal models is no longer appropriate.

The Commission requested comment in the *2016 Capital Proposal* on all aspects of the proposed model review process, including the viability of the proposed model review process given the number of provisionally-registered covered SDs, the number of capital models that may be required to be approved for each provisionally-registered covered SD, and the complexity of the models that may be submitted for approval.[342] The Commission also requested comment on whether the regulation should include a process for the automatic approval or temporary approval of capital models that had been reviewed and approved by a prudential regulator or an appropriate foreign regulator.[343]

Commenters generally stated that it was necessary for the Commission to develop an efficient approach for the review and approval of internal models and noted that covered SDs or FCM–SDs that did not have model approval at the compliance date would be at a significant competitive disadvantage relative to covered SDs and FCM–SDs that had the approval to use models at the compliance date. In this connection, one commenter stated that in no event should a covered SD be required to use the proposed standardized capital charges while awaiting model approval at the compliance date.[344] Another commenter requested that the Commission clarify that no covered SD would be required to use the proposed standardized capital charges while awaiting model approval.[345]

Other commenters suggested various approaches that the Commission should adopt to ensure that covered SDs and FCM–SDs have the ability to use capital models at the compliance date. One commenter stated that capital models should be deemed ''provisionally approved'' while under review by the Commission or NFA at the compliance date.[346] Several commenters stated that the Commission should automatically approve market risk models and credit risk models of covered SDs or FCM–SDs that have already been approved by a prudential regulator, the SEC, or certain foreign regulators.[347] One commenter stated that Commission's final rule should provide for the recognition of internal capital models used throughout corporate families if such models have been approved by a prudential regulator, the SEC, or a foreign regulator in a jurisdiction that has adopted the Basel capital requirements, provided that the relevant regulatory authority has ongoing periodic assessment power with regard to the model and provides the CFTC and the NFA with appropriate information.[348]

The Commission invited interested persons to provide additional comment on the model approval process in the *2019 Capital Reopening.* Commenters generally reiterated their views that the Commission needed to adopt an efficient and effective model review process that recognizes the complexity of the undertaking, and ensures that all covered SDs and FCM–SDs that want to use models have authorization to use such models at the compliance date in

[340] *See 2016 Capital Proposal,* 81 FR 91252 at 91269–70. FCMs and FCM–SDs that also are registered BDs would have to obtain SEC approval as an ANC Firm in order to use market risk and credit risk models in lieu of taking standardized capital charges. *See* Commission regulation § 1.17(c)(6)(i), as adopted.

[341] *See 2016 Capital Proposal,* 81 FR 91252 at 91269–70.

[342] *See 2016 Capital Proposal,* 81 FR 91252 at 91272–73.

[343] *Id.*

[344] *See* ISDA 5/15/17 Letter.

[345] *See* IFM 5/15/17 Letter.

[346] *See* ISDA 5/15/17 Letter.

[347] *See, e.g.,* FIA 5/15/17 Letter; SIFMA 5/15/17 Letter. *See also,* ABN/ING/Mizuho/Nomura 1/29/2018 Letter.

[348] *See* ISDA 5/15/17 Letter.

order to avoid competitive disadvantages for firms not permitted to use models.[349] One commenter stated that the failure to create and implement a flexible capital model approval process and timeline creates a competitive disadvantage for smaller covered SDs (including smaller commodity-focused covered SDs) relative to bank and bank holding company-affiliate SDs.[350] The commenter noted that many larger SDs currently operate with approved models, and noted that smaller SDs do not have off-the-shelf or pre-approved internal models that can be used or leveraged for capital compliance purposes, and anticipate significant expense and resource will be necessary for the development of counterparty credit risk and market risk model procedures, processes, and systems.[351] One commenter stated that firms submitting models for the first time must be provided with sufficient time to complete the approval process.[352]

Another commenter stated that commodity-focused covered SDs should be subject to models that focus on risks associated with the physical commodity market, and the capital model should not need to account for non-applicable risks.[353] The commenter requested that the Commission confirm that a commodity-focused covered SD's capital model needs only to account for the positions and risks relevant to the applicable business and does not need to address every risk and requirement set forth in proposed Appendix A to regulation 23.102.[354]

Commenters also expressed the view that the Commission should provide automatic model approval or provisional model approval to SDs and FCM–SDs that use models that have been reviewed and approved by the SEC, a prudential regulator, or a qualified foreign regulator. One commenter also stated that the Commission should provide provisional approval for models submitted by covered SDs in good faith, subject to further review and approval if necessary.[355]

NFA expressed its willingness to undertake the review of covered SDs and covered FCM–SDs capital models for compliance with the regulatory requirements.[356] NFA noted that it currently has a team with significant model experience that has been focusing on the review, approval, and ongoing monitoring of covered SD's initial margin models for uncleared swaps. NFA stated that it would leverage the experience it has gained in reviewing and approving initial margin models, and would allocate similar resources to the review of covered SDs' internal capital models for compliance with the Commission's requirements.

NFA also commented, however, that the capital model review process will be significantly more complex than the process conducted for initial margin models. The additional complexity is attributable in part to the lack of an industry-wide, standardized internal capital model and the fact that each covered SD may have several models under the proposed capital rules to address various aspects of market risk (*e.g.,* VaR models and stressed VaR models). The review process is further challenged in that the Commission did not propose a multi-year compliance schedule that would allow capital models to be phased-in over a sufficiently long period of time comparable to the now six-year phase-in schedule for initial margin requirements for uncleared swaps.[357]

NFA estimated that as many as 51 covered SDs (from 21 corporate families) could be subject to the Commission's capital rules and may seek model review and approval prior to the compliance date. NFA also commented that it would need to build systems and processes to receive the requisite model information from covered SDs and FCM–SDs, and that its review would need to occur over a period of time given the complexity of the market and credit risk models. To address these concerns, NFA suggested several modifications that the Commission could make to the process of reviewing and approving capital models. Specifically, NFA suggested that a covered SD electing a Bank-Based Capital Approach that uses the internal market and credit risk capital models previously reviewed by a prudential regulator for an affiliated SD (*e.g.,* a bank holding company) be permitted to use such models without a formal review or approval of the covered SD's capital models prior to the compliance date. NFA also stated that the Commission should consider implementing a similar process for covered SDs that use internal market risk and credit risk models that have been reviewed or approved for the covered SD's use or for use by an affiliate of the covered SD by a foreign regulator in a jurisdiction that has implemented the Basel III capital standards. NFA stated that for covered SDs or covered FCM–SDs that are permitted to use capital models without a pre-compliance date review and approval as outlined above, it would review the SDs' or FCM–SDs' overall capital compliance, including their use of models after the compliance date through NFA's examination process and ongoing compliance monitoring program.

NFA commented that if the above framework is implemented, it will work with the Commission to develop a pre-compliance date model review and approval process, including appropriate information gathering and certification requirements for covered SDs with models that have not been reviewed by a prudential or qualified foreign regulator, as well as an appropriate post-compliance date model review and monitoring process. NFA stated that it is committed post compliance date to monitor the overall governance and use of market and credit risk models by all covered SDs that are subject to a model pre-approval process or post-compliance model review including, at a minimum, assessing model performance test results and monitoring for compliance with the Commission's SD capital rules.

NFA further estimated that if the above framework is adopted that as many as 12 covered SDs that are provisionally-registered may require immediate capital model review. These 12 covered SDs have not obtained direct regulatory approval to use capital models and are not part of corporate families that have obtained any other regulatory approval to use capital models. NFA also estimated that it will take approximately 15 months to review and approve capital models for these 12 covered SDs.

NFA also recommended a modification to the final rule language. NFA stated that to make the post-compliance date framework effective, since NFA will not formally approve a

[349] *See, e.g.,* NCGA/NGSA 3/3/2020 Letter; CEWG 3/3/2020 Letter; FIA–PTG 3/3/2020 Letter.

[350] *See* ED&F Man/INTL FCStone 3/3/2020 Letter.

[351] *Id.*

[352] *See* FIA–PTG 3/3/2020 letter.

[353] *See* CEWG 3/3/2020 Letter.

[354] *Id.*

[355] *See* NCGA/NGSA 3/3/2020 Letter. The NCGA/NGSA also stated that the Commission's capital rules should allow for the use of unencumbered cash to be considered part of a covered SD's capital base even when the cash is swept into a corporate omnibus account and held overnight at a financial institution. The Commission acknowledges that under the proposed Tangible Net Worth Capital Approach, unencumbered cash deposits, including cash transferred to an affiliate, would be considered a tangible asset and part of the capital base. *See also,* CEWG 3/3/2020 Letter.

[356] *See* Letter from Carol Wooding, National Futures Association (March 2, 2020) (NFA 3/2/2020 Letter).

[357] *Id.* The Commission's margin rules for uncleared swap transactions are subject to a phase-in period that extended from September 1, 2016 to September 1, 2021. *See* Commission regulation § 23.161 (17 CFR 23.161).

covered SD's use of market and credit risk models previously reviewed by a prudential regulator a qualified foreign regulator, it believed that it is important that the Commission and/or NFA reserve the authority to require that a covered SD cease at any time using internal models if the covered SD is not in compliance with the Commission's capital requirements. To address this issue, NFA recommended that the Commission modify regulation 23.102(e) to clarify the Commission's and NFA's authority to rescind a covered SD's use of models that were not formally ''approved'' prior to the requirements compliance date.[358]

The Commission has considered the Proposal and the comments received, and is adopting the model approval process as proposed with several modifications discussed below. The Commission recognizes the substantial resources that are necessary in order to effectively and efficiently review and approve capital models submitted by covered SDs, and further recognizes that Commission staff would not be able to perform such reviews in a reasonable period of time. Therefore, final regulations 1.17(c)(6)(v) and 23.102 provides two alternative approaches for FCM–SDs and covered SDs, respectively. An FCM–SD or a covered SD may submit an application to the Commission for approval to use internal models to compute market risk and credit risk capital charges in lieu of standardized charges. In the alternative, an FCM–SD or a covered SD may submit an application to NFA (as an RFA) to use internal models provided that the Commission has made a determination that NFA's process to approve internal models is consistent with the Commission's approval process and NFA's approval would be accepted as an alternative means of compliance with the Commission's model requirements and approval as contained in Regulation 23.102.[359]

In this release, the Commission is setting forth a process for determining whether the NFA's standard and process for reviewing and approving an FCM–SD's and a covered SD's capital models is comparable to those of the Commission's. As part of the Commission's assessment, the Commission will perform a review of the NFA's FCM–SD and covered SD capital requirements for consistency with the Commission's requirements. The Commission also will assess the sufficiency of the NFA's planned model review process and procedures to ensure that such processes and procedures are adequate for providing NFA with an appropriate basis for determining whether an FCM–SD's or a covered SD's capital models satisfy the NFA's model requirements. Based on these assessments, the Commission will issue a determination that the NFA's approval of an FCM–SD's or a covered SD's capital models may serve as an alternative means of complying with the Commission's model approval requirement. The Commission is delegating authority to issue the determination to the Director of the Division of Swap Dealer and Intermediary Oversight under the revisions to regulation 140.91.

Due to limited Commission resources, the Commission anticipates that FCM–SDs and covered SDs will seek model approval from the NFA in order to help ensure a timely review. As noted in its comment letter, NFA has devoted substantial efforts to obtain the personnel and other resources necessary to perform the review, approval, and ongoing assessment of FCM–SDs' and covered SDs' models to calculate initial margin for uncleared swaps, and plans to leverage these resources and experience in its review and assessment of capital models.

In addition, as noted in section II.B.2. above, NFA is required by section 17(p) of the CEA to adopt capital requirements for SDs that are at least as stringent as the Commission's capital requirements for covered SDs. In this regard, the Commission has approved NFA Compliance Rule 2–49, which incorporates the Commission's part 23 rules into NFA's rules. Therefore, the capital and financial reporting requirements set forth in this final rulemaking will become NFA requirements 60 days after the publication of this **Federal Register** release (the effective date). The NFA SD capital requirements will include the options for market risk and credit risk models and will require SDs to obtain NFA approval to use such models under the NFA SD capital rules.[360]

The Commission further acknowledges that the model review process will require a period of time that will prevent the Commission or NFA from reviewing and approving models for all covered SDs that seek model approval prior to the compliance date of the regulations. The Commission also recognizes that a process that results in some covered SDs receiving approval to use capital models while the capital models of other covered SDs are under review at the compliance date solely due to the inability of the Commission or NFA to complete the necessary review would place the non-model covered SDs at a substantial competitive disadvantage.

To address this issue, the Commission is modifying regulation 23.102 by providing a new paragraph (f) to provide that a covered SD may use capital models after filing an application for model approval with the Commission, and pending approval by the Commission or the NFA, provided that the covered SD submits a certification to the Commission and to NFA certifying that the models have been approved for use by the covered SD, or an affiliate of the covered SD, by the SEC, a prudential regulator, a foreign regulatory authority in a jurisdiction that the Commission has found to be eligible for substituted compliance under Commission regulation 23.106, or a foreign regulatory authority whose capital adequacy requirements are consistent with the BCBS bank capital requirements. The certification must be signed by the covered SD's Chief Executive Officer, Chief Financial Officer, or other appropriate official with knowledge of the covered SD's capital requirements and the capital models, and must include a representation that the models are in substantial compliance with Commission's model requirements.

The final rule further requires a covered SD to revise its certification to address any material changes or revisions to the models, or to reflect any regulatory restrictions placed on the models by the regulatory authority that approved the models. The covered SD is also required to cease using the models if the regulatory authority that previously approved the models for use by the SD, or by the SD's affiliate, withdraws its approval prior to the Commission or NFA approving the models.

To clarify, the covered SD is not required to submit a model application to NFA with its certification. NFA will

[358] NFA noted that proposed Appendix A to Commission regulation § 23.102, which provides that the Commission or an RFA may revoke a covered SD's internal market and credit risk models. NFA stated that this provision of Appendix A should be modified to clarify that the Commission or an RFA may revoke a covered SD's ability to use internal market and credit risk models that have been approved by a prudential regulator or qualified foreign regulator. *See* NFA 3/2/2020 Letter.

[359] At this time, NFA is the only RFA.

[360] The Commission also revised paragraph (c) of Appendix A of final regulation 23.102 to provide that a covered SD that files a model application with the Commission may request confidential treatment under the Freedom of Information Act. Paragraph (c) of Appendix A does not apply to applications filed with the NFA, which is not subject to the Freedom of Information Act.

obtain any necessary documentation and model information as part of its ongoing examination and monitoring of the covered SD, including the information necessary to approve the models of the covered SD.

The covered SD will be subject to the Commission's and NFA's supervision and ongoing monitoring pending the Commission's or NFA's final determination to approve or not approve the application. This supervision and monitoring will include the review of the models performance and compliance with Commission requirements through examination and review of periodic reports, including back-testing results.

The Commission is not, however, adopting a process to permit FCM–SDs to use capital models pending the Commission's or NFA's approval. FCM–SDs must have approval in order to use capital models. The Commission is making this distinction as FCM–SDs carry customer and noncustomer funds, and act as intermediaries in the futures markets by performing daily settlement cycles on behalf of customers and noncustomers, and guaranteeing their customers' and noncustomers' financial performance to clearing organizations and other FCMs. As noted above, capital models have the potential to substantially reduce the market risk and credit risk capital charges that an FCM must take relative to the standardized charges. The Commission believes that given the important role that FCMs perform in the futures markets, and in order to provide greater protection to customers and their funds, that FCM–SDs must have model approval prior to using such models to compute their adjusted net capital. Furthermore, the Commission notes that currently the only FCM–SDs provisionally-registered with the Commission are four ANC Firms that have existing approvals to use capital models and may continue to use such models after the compliance date of these rules.

The *2016 Capital Proposal* also included proposed amendments to the Commission's delegation of authority to the Director of the Division of Swap Dealer and Intermediary Oversight contained in regulation 140.91. The proposed amendments delegated to the Director the authority of the Commission to approve capital models submitted to the Commission under regulation 23.102 and Appendix A. The authority to revoke a previously approved model was not delegated to the Director. The Commission did not receive comments on the proposed amendments to the delegation of authority under regulation 140.91 and, for the reasons discussed in the *2016 Capital Proposal,* is adopting the amendments substantially as proposed.

8. Liquidity Requirements for Covered SDs and FCM–SDs

The *2016 Capital Proposal* required FCM–SDs and covered SDs electing the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach to satisfy specific liquidity requirements.[361] The *2016 Capital Proposal* did not proposed liquidity requirements for covered SDs electing the Tangible Net Work Capital Approach, covered MSPs, bank SDs, or bank MSPs.

Proposed regulation 23.104(a)(1) required covered SD electing the Bank-Based Capital Approach to meet the liquidity requirements established by the Federal Reserve Board for banking entities. Specifically, proposed regulation 23.104(a)(1) required covered SDs to comply with the liquidity coverage ratio requirements set forth in 12 CFR part 249, and apply such requirements as if the covered SD were a bank holding company subject to 12 CFR part 249.[362] The proposed liquidity coverage ratio required the SD to maintain each day an amount of high quality liquid assets (''HQLAs''), as defined in 12 CFR 249.20, that is no less than 100 percent of the SDs total net cash outflows over a prospective 30 calendar-day period (the ''HQLA Proposal'').[363]

The Commission proposed several adjustments to the liquidity coverage ratio to better reflect the business of an SD. For example, the Commission proposed to permit a covered SD to consider cash deposits that are readily available to meet the general obligations of the SD as a level 1 liquid asset in computing its liquidity coverage ratio.[364] The Commission also proposed modifying the liquidity coverage ratio so that covered SDs organized and domiciled outside of the U.S. could recognize certain foreign deposited assets in computing its liquidity coverage ratio. Finally, the Commission's Proposal required a covered SD to maintain a contingency funding plan component, as well as, certain internal senior management notifications and approvals.[365]

Proposed regulation 23.104(b) required covered SDs electing the Net Liquid Assets Capital Approach and FCM–SDs to adopt a liquidity stress test requirement that addressed the types of liquidity outflows experienced by SEC-registered BDs that are ANC Firms in times of stress (the ''LST Proposal''). Under the Commission's proposed LST Proposal, a covered SD or FCM–SD would be required to perform a liquidity stress test at least monthly that took into account certain assumed conditions lasting for 30 consecutive days. The results of the liquidity stress test would be reviewed by senior management periodically. The covered SD or FCM–SD also would be required to have a contingency funding plan to address potential liquidity issues.

In proposing these requirements, the Commission intended to address the potential risk that a covered SD or FCM–SD may not be able to meet both expected and unexpected current and future cash flow and collateral needs as a result of adverse events impacting the covered SD's or FCM–SD's daily operations or financial condition. Further, the proposed liquidity requirements were consistent with those that had been proposed at the time for SBSDs by the SEC and the existing liquidity requirements adopted by the Federal Reserve Board for bank holding companies.[366]

The Commission received comments on the proposed HQLA Proposal and the LST Proposal. One commenter suggested that covered SDs should be able to elect either the HQLA Proposal or the LST Proposal, without regard to the SD's chosen capital approach.[367] Another commenter stated that the requirements of the HQLA Proposal and the LST Proposal should be revised to be more similar to each other given that both approaches have the comparable regulatory objective of helping to ensure that a covered SD or FCM–SD has sufficient access to liquidity to meet its obligations during periods of expected and unexpected market activity.[368] The commenter specifically noted that the LST Proposal's definition of liquidity reserves is materially narrower than the HQLA Proposal's definition of HQLA, and that the Commission should expand the definition under the LST Proposal to match the definition under the HQLA

[361] *See 2016 Capital Proposal,* 81 FR 91252 at 91273–75.

[362] *Id.*

[363] *See* 12 CFR 249.10. Federal Reserve Board rules require a regulated institution to maintain a liquidity coverage ratio of HQLA to net cash outflows that is equal to or greater than 1.0 on each business day.

[364] *See* proposed Commission regulation § 23.104(a)(1); *2016 Capital Proposal,* 81 FR 91252 at 91317.

[365] *See* proposed Commission regulation § 23.104; *2016 Capital Proposal,* 81 FR 91252 at 91317–18.

[366] *See* SEC proposed rule 18a–1(f), 77 FR 70213 (Nov. 23, 2012), and 12 CFR part 249.

[367] *See, e.g.,* MS 5/15/17 Letter.

[368] *See* SIFMA 5/15/17 Letter.

Proposal so as to recognize the full range of assets that are actually available to a firm to support its liquidity needs.[369]

Commenters also raised the concept of a third alternative, which would be the application of a more qualitative than quantitative requirement applicable to covered SDs that are subsidiaries of bank holding companies and already subject to comprehensive overall liquidity risk management program requirements at a parent level.

The Commission requested additional comments regarding the proposed liquidity requirements in the *2019 Capital Reopening.* The Commission requested specific comment on whether it was necessary for the proposed SD capital rules to include additional liquidity requirements given that the Commission had previously adopted a risk management program set forth in regulation 23.600 for both bank SDs and covered SDs that includes liquidity requirements.

The Commission received comments in response to the *2019 Capital Reopening.* Several commenters suggested that the Commission defer adopting separate and distinct quantitative liquidity requirements as part of the SD capital rule given that the SD risk management program adopted by the Commission in regulation 23.600 requires a covered SD to assess liquidity risk.[370] One commenter stated that the Commission should not adopt the proposed specific liquidity requirement as SDs have a diversity of business models, making standard quantitative liquidity requirements difficult to apply across SDs. The commenter further stated that the Commission should instead rely on the qualitative liquidity requirements in regulation 23.600, and evaluate the sufficiency of the liquidity program based on the specific business and associated risks of the covered SD.[371] The commenter noted that regulation 23.600 is tailored specifically to address liquidity needs associated with posting margin and performing on swap transactions. In this regard, the commenter stated that a covered SD is required under regulation 23.600 to measure liquidity needs on a daily basis, assess procedures to liquidate non-cash collateral in a timely manner without significant effect on price, and apply appropriate collateral haircuts that accurately reflect market risk and credit risk, as well as requiring a covered SD to establish and enforce a system of risk management policies and procedures to monitor and manage market and credit risk associated with its dealing activities. The commenter further stated that the requirements of regulation 23.600 achieve the objective of ensuring SD liquidity in a flexible manner, without imposing a separate and standardized quantitative approach for firms that have different operations.

One commenter noted that many covered SDs engage in multiple business lines, not just swap dealing, which may be subject to separate regulatory frameworks which address liquidity risk. For example, a dual-registered BD/SD would be subject to either the Net Liquid Assets Capital Approach or the FCM approach if the SD is also a registered FCM, which is a liquidity-based capital requirement that requires the entity to take net capital deductions for nonmarketable or otherwise illiquid assets.[372] In addition, this commenter noted that a quantitative standard applicable at a covered SD level may trap liquid assets within the covered SD and make such assets unavailable at the SD's holding company level.[373] The commenter stated that this may make the holding company and other affiliates of the covered SD less resilient by removing the flexibility to liquidate assets held at the covered SD and deploy the cash where and when it is needed most.[374]

Commenters also noted that many of the covered SDs are directly or indirectly already subject to various forms of quantitative liquidity requirements due to their status as subsidiaries of large U.S. bank holding companies. One commenter stated that liquidity coverage ratios and Federal Reserve regulation YY-mandated internal liquidity stress testing programs apply and operate on a consolidated basis across large U.S. bank holding companies, ensuring that liquidity risks arising in covered SDs are addressed in consolidated liquidity requirements. This commenter further noted that U.S. bank holding companies subject to Recovery and Resolution Planning requirements are required to consider funding and liquidity requirements of SDs that are ''material operating entities'', which may result in a requirement to preposition liquidity and funding in a covered SD.

The Commission has considered the comments received and assessed the additional proposed liquidity requirements and has determined to defer the adoption of final rules at this time. As noted by the Commission in the *2019 Capital Reopening* and by many of the commenters, regulation 23.600 currently imposes liquidity requirements on covered SDs. Regulation 23.600 requires each SD to establish, document, maintain, and enforce a system of written risk management policy and procedures designed to monitor and manage the risk associated with the covered SD's swaps activities. A covered SD' risk management policies and procedures must take into account market, credit, foreign currency, legal, operational, settlement, and any other applicable risks in addition to liquidity risk. With respect to liquidity risk, the risk management policies and procedures must, at a minimum, monitor and/or manage the daily measurement of liquidity needs and include an assessment of the procedures to liquidate non-cash collateral in a timely manner and without significant effect on the price realized for the non-cash collateral.

Moreover, staff's review of covered SDs' risk exposure reports has revealed that there is a wide disparity in how covered SDs establish their liquidity risk management policies and procedures, and assess their liquidity needs. This disparity is in part due to the variety of provisionally-registered SDs under the Commission's jurisdiction. Some covered SDs are subsidiaries of much larger parent organizations, many of which are banking entities, that are subject to sophisticated liquidity risk management policies and procedures at both the parent and subsidiary levels. Other covered SDs are not part of a large bank holding company or financial organization and have different, less sophisticated liquidity policies and procedures that are more suited to the type of swaps activities that they engage in with counterparties. Given the diversity of the provisionally-registered SDs, the Commission believes that it is not advisable to impose a single, mandated method of measuring liquidity needs at a covered SD, and the Commission has determined to defer the adoption of detailed quantitative liquidity requirements at this time. Commission staff will monitor covered SDs' liquidity as part of its ongoing monitoring of the financial reporting submitted by covered SDs and will reassess the appropriateness of recommending to the Commission additional liquidity risk management requirements that are a supplement to, enhancement of, or replacement of, the

[369] *Id.*

[370] *See* IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter; Shell 3/3/2020 Letter.

[371] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[372] *See* IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter; Shell 3/3/2020 Letter.

[373] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[374] *Id.*

current liquidity risk management requirements in regulation 23.600. Such additional liquidity requirements would be based upon the Commission staff's assessment and experience with actual liquidity practices and procedures used by covered SDs and would be tailored to address any potential deficiencies or lapses in liquidity risk management.

9. Equity Withdrawal Restrictions for Covered SDs and Covered MSPs

The *2016 Capital Proposal* proposed to prohibit certain withdrawals of equity capital from covered SDs.[375] The restrictions were based upon existing equity withdrawal restrictions for FCMs set forth in regulation 1.17(e). The Proposal generally provided that the capital of a covered SD, or any subsidiary or affiliate of the covered SD that has any of its liabilities or obligations guaranteed by the covered SD, may not be withdrawn by action of the covered SD or by its equity holders if the withdrawal, and any other similar transactions scheduled to occur within the succeeding six months, would result in the covered SD holding less than 120 percent of the minimum regulatory capital that the covered SD is required to hold pursuant to proposed regulation 23.101. The Proposal also included an exception permitting the covered SD to pay required tax payments and reasonable compensation to equity holders of the SD.

In addition to the equity withdrawal restrictions, proposed regulation 23.104(d) authorized the Commission to issue an order to restrict for up to 20 business days the withdrawal of capital from a covered SD, or to prohibit the covered SD from making an unsecured loan or advance to any stockholder, partner, member, employee or affiliate of the covered SD. The Proposal further authorized the Commission to issue an order restricting or prohibiting the withdrawal of capital if, based upon the information available, the Commission concludes that the withdrawal, loan or advance may be detrimental to the financial integrity of the covered SD, or may unduly jeopardize the covered SD's ability to meet its financial obligations to counterparties or to pay other liabilities which may cause a significant impact on the markets or expose the counterparties and creditors of the covered SD to loss.[376]

As noted in the Proposal, the proposed equity withdrawal restrictions discussed above are consistent with existing equity withdrawal restrictions imposed on FCMs and BDs, and with equity withdrawal restrictions adopted by the SEC for SBSDs.[377] In addition, the grant of authority to the Commission to issue an order temporarily restricting certain unsecured loans or advances is consistent with the existing Commission authority under regulation 1.17(g)(1) for FCMs and with the SEC's authority over BDs and SBSDs.[378] Further, the Commission proposed to make the existing language of 1.17(g)(1) as applicable to FCMs more consistent with same language contained in final SEC equity withdrawal restrictions for BDs and SBSDs, and received no comments thereon.

The Commission did not receive comments on the proposed equity withdrawal requirements. The Commission has considered the Proposal and for the reasons set out in the 2016 Proposal is adopting them with a minor modification. The equity withdrawal restrictions were proposed in paragraphs (c) and (d) of regulation 23.104. The Commission is redesignating paragraphs (c) and (d) of regulation 23.104 as paragraphs (a) and (b) in the final rule to reflect the removal of the proposed liquidity requirements in proposed regulation 23.104(a) and (b) as discussed above. The Commission is further adopting the amendment to 1.17(g)(1) as proposed to make the language of the FCM equity withdrawal order restriction consistent with the same language as effective for BDs and SBSDs, and now regulation 23.104 for SDs.

10. Leverage Ratio Requirements for Covered SDs

The Commission requested comment in the *2019 Capital Reopening* as to whether it would be appropriate for the Commission, at a future date after notice and comment, to revise the covered SD capital requirements by adopting a leverage ratio for SDs in lieu of the proposed percentage of the risk margin amount, if adopted as final. The Commission also requested comment on the cost, if any, in terms of additional required capital that a leverage ratio requirement would impose on a covered SD relative to the Net Liquid Assets Capital Approach, Bank-Based Capital Approach, and Tangible Net Worth Capital Approach, and how the adoption of a leverage ratio requirement would affect the efficiency, competitiveness, integrity, safety and soundness, and price discovery of the swap markets.[379]

Commenters generally opposed the adoption of a leverage ratio. One commenter stated that while leverage ratios have been argued to serve as effective backstops to guard against miscalculations of market risk or credit risk, leverage ratios are very blunt instruments that create perverse incentives.[380] This commenter noted that a leverage ratio would discourage a covered SD from maintaining a reserve of safer, lower-yielding, securities and cash positions, despite the liquidity and safety and soundness benefits of such instruments.[381] The Commission is not adopting a leverage ratio as part of its capital requirements at this time.

D. Swap Dealer and Major Swap Participant Financial Recordkeeping, Reporting and Notification Requirements.

Section 4s(f) of the CEA requires SDs and MSPs to make any reports regarding transactions and positions, as well as any reports regarding financial condition, that the Commission adopts by rule or regulation.[382] Consistent with section 4s(f), the Commission proposed new regulation 23.105, which require SDs and MSPs to satisfy current books and records requirements, ''early warning'' and other notification filing requirements, and periodic and annual financial report filing requirements with the Commission and with any RFA of which the SDs and MSPs are members.

The notice and financial reporting requirements proposed by the Commission differentiate covered SDs and covered MSPs from bank SDs and bank MSPs.[383] For covered SDs and covered MSPs, the Commission proposed a financial reporting, notification and recordkeeping approach that was modelled after the existing reporting regimes followed by FCMs and BDs, and that was proposed by the SEC for SBSDs. Where applicable, the Commission proposed flexibility for foreign-domiciled SDs and MSPs recognizing that a significant number of these SDs and MSPs would likely be subject to existing financial

[375] *See 2016 Capital Proposal,* 81 FR 91252 at 91275.

[376] *Id.* The Proposal further provided that the covered SD may request a hearing on the order, which must be held within two business days of the date of the written request by the covered SD.

[377] Equity withdrawal restrictions for FCMs are set forth in Commission regulation § 1.17(e) (17 CFR 1.17(e)), and for BDs are set forth in SEC rule 15c3–1(e)(2) (17 CFR 240.15c3–1(e)(2)). SEC equity withdrawal restrictions for SBSDs are contained in SEC rule 18a–1(h)(2) (17 CFR 240.18a–1(h)(2)).

[378] *See* SEC rule 15c3–1(e)(3) (17 CFR 240.15c3–1(e)(3)) for BDs and rule 18a–1(h)(3) (17 CFR 240.18a–1(h)(3)) for SBSDs.

[379] *See 2019 Capital Reopening,* 84 FR 69664 at 69669.

[380] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[381] *Id.*

[382] 7 U.S.C. 6s(f).

[383] *See* proposed Commission regulation § 23.105(a)(2); *2016 Capital Proposal,* 81 FR 91252 at 91318.

reporting requirements. For bank SDs and bank MSPs, the Commission proposed more limited requirements as the financial condition of these entities will be predominantly supervised by the applicable prudential regulator and subject to its capital and financial reporting requirements.

The recordkeeping, reporting and notification requirements in the *2016 Capital Proposal* were intended to facilitate effective oversight over the Commission's capital requirements and improve internal risk management, via requiring robust internal procedures for creating and retaining records central to the conduct of business as an SD or MSP.[384] The *2016 Capital Proposal* proposed to require covered SDs and covered MSPs to, among other things: (i) Maintain current ledgers and other similar records summarizing transactions affecting their assets, liabilities, income, and expenses; (ii) file notices of certain events with the Commission, including notices of failing to comply with the applicable minimum capital requirements; (iii) file monthly unaudited and annual audited financial statements with the Commission; and (iv) provide the Commission with additional information as requested.[385] The Proposal also required bank SDs and bank MSPs to file certain information with the Commission. Such information included: (i) Quarterly statements of financial condition, regulatory capital computations, and aggregate swaps position information; (ii) notice filings, including notice of a failure to maintain the minimum applicable capital requirement; and (iii) additional information as requested by the Commission.[386]

The Commission received several detailed comments regarding the 2016 proposed financial reporting, notification and recordkeeping requirements. Several commenters noted the importance of harmonizing the Commission's financial reporting and notification requirements with the requirements of other regulators, namely the SEC and the prudential regulators.[387] Commenters generally supported the Commission's approach of permitting non-U.S. SDs and MSPs to use International Financial Reporting Standards (''IFRS'') in lieu of U.S. GAAP in the preparation of required financial statements, but some asked that the Commission remove the foreign domicile requirement to use IFRS.[388] Several commenters to the Proposal also expressed concern that the 60-day timeline for annual certified financial statement reporting was not practical for many large non-financial companies as they are typically permitted to provide audited financial statements within 90 days of the end of their fiscal year.[389] Other commenters expressed concern for the weekly position reporting requirements.[390] Several covered SDs that are subsidiaries of non-financial public companies requested that the posting period for public disclosures be extended or eliminated altogether, noting that additional time would be necessary to allow for internal and external auditors to review the information.[391]

In the *2019 Capital Reopening,* the Commission asked several additional questions in response to these comments. The Commission specifically asked whether the IFRS requirement should be expanded to include a broader set of eligible covered SDs and whether the annual audit reporting timelines for certain covered SDs should be lengthened to 90 days.[392] The Commission also asked whether it should harmonize certain requirements, including the public disclosure timelines of bank SDs, with the finalized reporting, notification and recordkeeping requirements of SBSDs adopted by the SEC.[393]

The Commission received several comments in response to the questions.[394] Certain commenters stated that the Commission should permit non-U.S. covered SDs and U.S. covered SDs that are subsidiaries of non-U.S. parent companies to use IFRS, one stating that there would be no material difference in its financial statements if they were produced under IFRS versus GAAP.[395] Several commenters did not believe that the Commission should adopt the weekly margin position reporting requirements, citing that information required under the reporting is duplicative of information received or proposed to be received under the Commission proposed part 45 data requirements.[396] Several commenters also stated that the Commission should harmonize public disclosure requirements with those adopted by the SEC for stand-alone SBSDs.[397] One commenter stressed that the Commission should not adopt any financial reporting requirements for bank SDs, and that covered SDs following the Bank-Based Capital Approach should be subjected to the same reporting timeline (45 days after quarter end) as a bank.[398]

After considering those comments and in light of the final financial reporting, notification and recordkeeping requirements for MSBSP and SBSDs adopted by the SEC,[399] the Commission is adopting the recordkeeping, notice and financial reporting requirements as proposed with the following modifications.

1. Routine Financial Reporting and Recordkeeping Requirements

Proposed regulation 23.105(b) required a covered SD or a covered MSP to prepare current ledgers or other similar records showing or summarizing each transaction affecting its asset, liability, income, expense, and capital accounts.[400] The accounts must be classified in accordance with U.S. GAAP provided, however, that if the covered SD or covered MSP is organized under the laws of a foreign jurisdiction and is not otherwise required to prepare its records or financial statements in accordance with U.S. GAAP, the SD or MSP may prepare the required records in accordance with IFRS issued by the International Accounting Standards Board.[401] The Commission also proposed to require covered SDs and covered MSPs to file periodic financial

[384] *See 2016 Capital Proposal,* 81 FR 91252 at 91295.

[385] *See* Proposed Commission regulation § 23.105; *2016 Capital Proposal,* 81 FR at 91252 at 91318–22.

[386] *Id.*

[387] *See* SIFMA 5/15/17 Letter.

[388] *See, e.g.,* Shell 5/15/17 Letter; BPE 5/15/17 Letter.

[389] *See, e.g.,* Shell 5/15/17 Letter; Cargill 5/15/17 Letter.

[390] *See* MS 5/15/17 Letter at 9; SIFMA 5/15/17 Letter at 29.

[391] *See* Shell 5/15/17 Letter; NCGA/NGSA 5/15/2017 Letter; and CEWG 5/15/2017 Letter.

[392] *See 2019 Capital Reopening,* 84 FR 69664 at 69678 (Dec. 19, 2019).

[393] *Id. See also, Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers,* 84 FR 68550 (Dec. 16, 2019).

[394] Shell Trading 3/3/2020 Letter; NCGA/NGSA 3/3/2020 Letter; IIB/ISDA/SIFMA 3/3/2020 Letter.

[395] *See* Shell 3/3/2020 Letter at 3: CEWG 3/3/2020 Letter at 5–6; NCGA/NGSA 3/3/2020 at 6–7; IIB/ISDA/SIFMA 3/3/2020 Letter at 52.

[396] *See* NCGA/NGSA 3/3/2020 Letter; IIB/ISDA/SIFMA 3/3/2020 Letter at 53.

[397] *See* CEWG 3/3/2020 Letter at 6; IIB/ISDA/SIFMA 3/3/2020 Letter.

[398] *See* IIB/ISDA/SIFMA 3/3/2020 Letter at 50–51.

[399] *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers,* 84 FR 68550 (Dec. 16, 2019).

[400] These proposed requirements are based upon existing FCM and BD financial recordkeeping and reporting requirements. Commission regulation § 1.18 (17 CFR 1.18) requires each FCM to prepare and keep current ledgers or other similar records which show or summarize, with appropriate references to supporting documents, each transaction affecting its asset, liability, income, expense and capital accounts. SEC rule 17a–3 (17 CFR 240.17a–3) requires a BD to make and maintain comparable ledgers and other similar records reflecting its assets, liabilities, income and expenses.

[401] FCMs are required to classify accounts only in accordance with U.S. GAAP.

reports with the Commission and with the SDs' or MSPs' RFA.[402] In proposed regulation 23.105(d)(2) and (e)(3), the monthly unaudited and annual audited financial statements must also be prepared in accordance with U.S. GAAP, provided, however, that the Commission proposed to permit covered SDs or covered MSPs that are organized and domiciled outside of the U.S., and otherwise are not required to prepare financial statements in accordance with U.S. GAAP, to prepare the financial statements in accordance with IFRS or another local accounting standard, after requesting approval by the Commission, which is discussed below, in lieu of U.S. GAAP.[403]

Commenters generally supported the Commission's approach of permitting non-U.S. covered SDs and covered MSPs to use IFRS in lieu of U.S. GAAP in the preparation of required financial statements. However, several commenters requested that the proposed regulation be modified to permit U.S.-based covered SDs that are subsidiaries of non-U.S. parent entities to prepare required financial statements in accordance with IFRS.[404] These commenters stated that U.S. covered SDs that are subsidiaries of foreign-based holding companies may prepare their financial statements in accordance with IFRS as the subsidiary is consolidated with the parent in producing the parent's consolidated financial statements, and further stated that requiring U.S. GAAP financial statements in such situations would impose unnecessary costs on covered SDs without providing substantial enhancements to the regulatory objectives.[405] Three commenters to the *2019 Capital Reopening* stated that the Commission should permit non-U.S. covered SDs and U.S. covered SDs that are subsidiaries of non-U.S. parent companies to use IFRS, one stating that there would be no material difference in its financial statements if they were prepared in accordance with IFRS versus U.S. GAAP.[406]

The Commission is adopting regulation 23.105(b), (d)(2) and (e)(3) as proposed with the exception of a modification to the eligibility requirement for the use of IFRS to address concerns raised by commenters. The Commission is generally comfortable with both U.S. GAAP and IFRS accounting standards for covered SDs and covered MSPs, especially as both standards continue to move towards greater convergence. However, the Commission's preference continues to be U.S. GAAP, and therefore, the Commission is requiring that covered SDs or covered MSPs that are not included in the exception described below, must prepare their financial statements in accordance with U.S. GAAP. In response to commenters, the Commission has removed the requirement that an eligible covered SD or covered MSP must be domiciled outside the U.S in order to be permitted to use IFRS. However, all covered SDs and covered MSPs that are also registered as FCMs or BDs must continue to prepare their financial statements in accordance with U.S. GAAP and are not eligible to use IFRS. The Commission notes that foreign domiciled covered SD or covered MSP may also apply under final regulation 23.106 for a Capital Comparability Determination and has retained language in regulation 23.105(o) to make clear that such a determination could consider different, yet comparable financial reporting requirements including the use of a local accounting standard other than U.S. GAAP or IFRS.

The Commission proposed in regulation 23.105(d)(1) to require a covered SD or covered MSP to file a monthly unaudited financial report within 17 business days of the close of business each month, and proposed in regulation 23.105(e)(1) to require a covered SD or covered MSP to file an annual audited financial report within 60 days of the close of the SD's or MSP's fiscal year-end date. Proposed regulation 23.105(e)(2) required the annual financial statements to be audited by a public accountant that is in good standing in the accountant's home country jurisdiction.[407]

The *2019 Capital Reopening* asked several questions regarding whether it would be appropriate to expand the 60-day annual audit reporting requirement.[408] In response, the Commission received several comments advocating for extending the financial reporting timelines in general, not just the 60-day audit requirement. One commenter requested that the Commission permit covered SDs that elect to use the Bank-Based Capital Approach to submit quarterly reports, as opposed to monthly, and that such reports should be filed within 45 days of the end of the quarter, as is currently required of banks and bank holding companies by regulations of prudential regulators.[409] Another commenter supported the proposition that monthly financial reporting be eliminated for non-bank covered SDs.[410] Other commenters supported an extension of the annual audited financial statement requirement from 60 to 90 days after the end of the covered SD's fiscal year.[411]

As noted in the Proposal, the timing of the proposed financial reporting requirements is consistent with the existing requirements for FCMs, which is harmonized with that required of BDs and SBSDs by the SEC.[412] Timely financial reporting is the Commission's primary method for routine monitoring for compliance with the Commission's capital rule across multiple registrants. The Commission does not expect this timing to be operationally challenging for non-commercial covered SDs, as many of these registrants already prepare financial reports within the organization on a routine basis. In addition, several of these firms are expected to be dually registered with the SEC as either a SBSD or BD, and will be subject to a monthly financial reporting requirement and 60-day reporting timeline for annual audited financial statements.[413]

On the other hand, covered SDs eligible to use the Tangible Net Worth Capital Approach and who are not dually-registered with the SEC could engage in a wide variety of business

[402] As noted in the proposal, these periodic financial reporting requirements are consistent with existing requirements for FCMs and BDs. *See* Commission regulation § 1.10 (17 CFR 1.10), which requires FCMs to submit unaudited monthly and audited annual financial reports to the Commission and to the FCMs' respective designated self-regulatory organization. SEC rule 17a–5 (17 CFR 240.17a–5) directs BDs to file unaudited monthly reports and annual audited reports with the SEC.

[403] *See* proposed Commission regulations §§ 23.105(d)(2) and (e)(3), *2016 Capital Proposal,* 81 FR at 91252 at 91319. Commission regulation § 1.10 (17 CFR 1.10) provides that FCMs must present its unaudited monthly reports and audited annual reports in accordance with U.S GAAP.

[404] *See, e.g.,* Shell 5/15/17 Letter; BPE 5/15/17 Letter.

[405] *Id.*

[406] *See* Shell 3/3/2020 Letter at 3: CEWG 3/3/2020 Letter at 5–6; NCGA/NGSA 3/3/2020 at 6–7; IIB/ISDA/SIFMA 3/3/2020 Letter at 52.

[407] The monthly unaudited and the annual audited financial reports must be prepared in the English language and denominated in U.S. dollars. The proposal also required that the monthly unaudited and annual audited financial reports include: (1) A statement of financial condition; (2) a statement of income or loss; (3) a statement of cash flows; (4) a statement of changes in ownership equity; (5) a statement of the applicable capital computation; and (6) any further materials that are necessary to make the required statements not misleading. Proposed Regulation 23.105(e)(4)(iii) would further require that the annual audited financial statements also include any necessary footnote disclosures. *See 2016 Capital Proposal,* 81 FR 91252 at 91320.

[408] *2019 Capital Reopening* at 69679.

[409] *See* IIB/ISDA/SIFMA 3/3/2020 Letter at 52.

[410] *See* NCGA/NGSA 3/3/2020 at 6.

[411] *See* NCGA/NGSA 3/3/2020 at 6.

[412] *See* Commission regulation § 1.10(b) (17 CFR 1.10(b)), and 17 CFR 240.17a–5, and 240.18a–7.

[413] *See* 17 CFR 240.18a–7(a)(1) and (c)(5).

operations and may be closely held corporations, partnerships or subsidiaries thereof. These covered SDs may not be subject to routine reporting requirements and could require longer periods to perform year-end audit requirements based on the composition of their balance sheet and financial statements. Therefore, the Commission is modifying the timeline for commercial firms by moving the monthly unaudited requirement to a quarterly requirement, and expanding the annual audit timeline for these firms to 90 days. This expanded approach will only be available to covered SDs that elect the Tangible Net Worth Capital Approach under regulation 23.101(a)(2).

The Commission notes that regardless of a covered SD's reporting timeline or elected approach, compliance with the Commission's capital rule is an ''at all times'' requirement. As such, covered SDs should routinely monitor their capital position and notify the Commission and its RFA of material changes in accordance notification requirements discussed herein. In this regard, regulation 23.105(h) provides that the Commission or RFA may, by written notice, require any covered SD or covered MSP to file financial or operational information to the Commission or RFA.[414] Accordingly, covered SDs and covered MSPs eligible to file financial information on a quarterly basis in accordance with regulation 23.105(d), may be required by the Commission or RFA to furnish such information on a monthly or more frequent basis as provided by such notices under regulation 23.105(h). As such, covered SDs and covered MSPs should therefore maintain their books and records in a manner capable of furnishing such information upon request by the Commission or RFA under a written notice issued under regulation 23.105(h) and to be able to demonstrate compliance with notification requirements under regulation 23.105(c). Therefore, the Commission is adopting the financial reporting process and timelines for covered SDs as proposed in regulation 23.105(d)(1), 23.105(e)(1), and 23.105(h) with the modifications discussed above for covered SDs and covered MSPs eligible to use the Tangible Net Worth Capital Approach and regarding furnishing additional reports as requested by the Commission or RFA.

The Commission also proposed in regulation 23.105(d)(3), (4) and (e)(5) to permit a covered SD or covered MSP that is registered with the Commission as an FCM or registered with the SEC as a BD to satisfy the Commission's SD or MSP financial statement reporting requirements by submitting a CFTC Form 1–FR–FCM or its applicable SEC Financial and Operational Combined Uniform Single (''FOCUS'') Report in lieu of the specific financial statements required under proposed regulation 23.105.[415] Similarly, the Commission proposed to permit covered SDs and covered MSPs dually registered with the SEC as either SBSDs or MSBSPs to comply with the Commission's financial reporting and notification requirements under regulation 23.105 by filing simultaneously with the Commission all applicable notices or reports required under the SEC's rules.[416] This proposed framework is consistent with the Commission's long history of permitting SEC registrants to meet their financial statement filing obligations with the Commission by submitting a FOCUS Report in lieu of CFTC Form 1–FR–FCM and reduces the burden on dually registered firms by not requiring two separate financial reporting requirements.

The SEC finalized reporting requirements which require SBSDs and MSBSPs to file a FOCUS form X–17A–5 Part II, no longer requiring a separate FORM SBS as proposed.[417] The Commission is not changing its approach permitting dual registrants the ability to file SEC forms in lieu of the financial reporting and notification requirements of the CFTC. Accordingly, regulation 23.105(d) and (e) have been modified to permit these dual registered covered SDs to file FOCUS reports as discussed in lieu of the Commission's financial reporting requirements.

The Commission has made further technical modifications to the general financial reporting requirements to align them with existing rules for FCMs and dually-registered SBSDs and BDs. The Commission is making these modifications to prevent different treatment between dually-registered SDs and stand-alone SDs. The Commission is modifying regulation 23.105(d) to remove the statement of cash flows, as this schedule is not necessary to assess the financial condition and safety and soundness of the covered SD, nor required of existing FCMs under regulation 1.10 or for BDs under 17 CFR 240.17a–5. For the same reasons, regulation 23.105(d) is also modified to include a statement of changes in liabilities subordinated to the claims of general creditors and references to the annual audited or certified financial report throughout regulation 23.105 have been renamed annual financial report. The Commission has also included references to SEC rule § 240.17a–5 to paragraphs (d)(3) and (e)(5) of regulation 23.105, as SBSDs and MSBSPs which are dually-registered BDs file financial reports in accordance with that rule.

The Commission did not receive comments on the other aspects not discussed herein in regards to regulation 23.105(d) and (e) and is adopting such provisions substantially as proposed.

2. Swap Dealer and Major Swap Participant Notice Requirements

The *2016 Capital Proposal* required SDs and MSPs to file certain regulatory notices with the Commission and with the RFA of which the SDs or MSPs are members if certain defined events occurred.[418] Certain of the notice provisions applied solely to covered SDs and covered MSPs, while other notice provisions applied solely to bank SDs and bank MSPs. The Commission also proposed notice provisions that applied to all registered SDs and MSPs. The proposed notice provisions were based on the existing notice provisions

[414] As discussed in the *2016 Capital Proposal,* the Commission's intention is to require all covered SDs and covered MSPs to file financial reports and notices required under regulation 23.105 with both the Commission and the RFA. As noted, this is consistent with the existing approach under Commission regulations §§ 1.10 and 1.12 (17 CFR 1.10 and 1.12) applicable to FCMs and IBs. Regulation 23.105(h) and elsewhere in regulations 23.105(c), (d), and (e), have been modified to clarify such reporting requirements.

[415] FCMs are required to file monthly unaudited and annual audited Forms 1–FR–FCM with the Commission and with their designated self-regulatory organization. The Forms 1–FR–FCM include, among other information, a statement of financial condition, a statement of income or loss, a statement of changes in ownership equity, a statement of liabilities subordinated to the claims of general creditors, a statement of the computation of regulatory minimum capital, and any further information as may be necessary to make the required statements not misleading. *See* Commission regulation § 1.10(d) (17 CFR 1.10(d)). SEC FOCUS Reports are required to contain, among other statements and information, a statement of financial condition, a statement of income or loss, a statement of changes in ownership equity, a statement of liabilities subordinated to the claims of general creditors, and a statement of the computation of regulatory minimum capital. *See* SEC rule 17a–5 (17 CFR 240.17a–5).

[416] *See* Commission regulation § 23.105(c)(5) (17 CFR 23.105(c)(5)) referencing proposed 17 CFR 240–18a–8 for notification requirements for SBSDs and MSBSPs. *See* § 23.105(d)(3) and § 23.105(e)(5) (17 CFR 23.105(d)(3) and 23.105(e)(5)) referencing proposed 17 CFR 240.18a–7, for monthly and annual financial reporting requirements for SBSDs and MSBSPs.

[417] *See* Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers, 84 FR 68550 (December 16, 2019). *See* SEC rule 18a–7 (17 CFR 240.18a–7), 84 FR 68550 at 68662–67; SEC rule 18a–10 (17 CFR 240.18a–10), 84 FR 68550 at 68668–69.

[418] *See 2016 Capital Proposal,* 81 FR 91252 at 91277–78.

applicable to FCMs, and are intended to require registrants to provide the Commission and RFA with notice of certain events that may indicate that the registrants are experiencing an actual or a potential adverse event, affecting their financial or operational condition.[419] Upon filing of a notice, the Commission or an RFA would initiate an inquiry, including engaging directly with the SD or MSP as necessary, to assess if the notice is an indication of potential issues with the registrant regarding its ability to meet its obligations to customers, counterparties, clearing organizations, creditors, and the marketplace in general.

The Commission proposed in regulation 23.105(c) to require a covered SD or a covered MSP to provide the Commission and RFA with immediate written notice when the firm is: (i) Undercapitalized; (ii) fails to maintain capital at a level that is in excess of 120 percent of its minimum capital requirement; or (iii) fails to maintain current books and records. Proposed regulation 23.105(c) also required a covered SD or covered MSP, as applicable, to provide notice to the Commission and to an RFA within 24 hours of: (i) Failing to comply with the liquidity requirements under proposed regulation 23.104, (ii) experiencing a 30 percent reduction in capital as compared to the last reported capital in a financial report filed with the Commission, or (ii) failing to post or collect initial margin for uncleared swap and security-based swap transactions or exchange variation margin for uncleared swap or security-based swap transactions as required by the Commission's uncleared swaps margin rules or the SEC's uncleared security-based margin rules, respectively, if the total amount that has not been exchange is equal to or greater than: (1) 25 percent of the SD's or MSP's required capital under final regulation 23.101 calculated for a single counterparty or group of counterparties that are under common ownership or control; or (2) 50 percent of the SD's or MSP's required capital under final regulation 23.101 calculated for all of the SD's counterparties.[420]

Proposed regulation 23.105(c) also required a covered SD or covered MSP to provide the Commission and an RFA with a minimum two days advance notice of an intention to withdraw capital by an equity holder that would exceed 30 percent of the SD's or MSP's excess regulatory capital.[421] Finally, the proposal required a covered SD or covered MSP that is dually-registered with the SEC as an SBSD or MSBSP to file with the Commission and with its RFA a copy of any notice that the SBSD or MSBSP is required to file with the SEC under SEC Rule 18a–8 (17 CFR 240.18a–8). SEC Rule 18a–8 requires SBSDs and MSBSPs to provide written notice to the SEC for comparable reporting events as proposed by the Commission in regulation 23.105(c), including if a SBSD or MSBSP is undercapitalized or fails to maintain current books and records.[422] The Commission proposed to require covered SDs and covered MSPs that are dually-registered with the SEC to file copies with the Commission of notices filed with the SEC under Rule 18a–8 to allow the Commission to be aware of any events that may indicate that the SD or MSP is unable to meet its operational or financial obligations on an ongoing basis.

The Commission did not receive comments on the proposed notice provisions in regulation 23.105(c). The Commission has considered the proposal, and is adopting the SD and MSP notice requirements as proposed, with a modification to eliminate the notice provision relating to liquidity requirements that the Commission did not adopt.

3. Swap Dealers and Major Swap Participants Subject to the Capital Rules of a Prudential Regulator

The Commission proposed limited financial reporting for bank SDs and bank MSPs that are subject to the capital requirements of a prudential regulator, as these SDs and MSPs are already subject to existing financial reporting requirements by such prudential regulator. As such, the Commission did not propose to require a bank SD or bank MSP to file monthly unaudited or annual audited financial statements with the Commission or with the RFA of which the SD or MSP is a member. The Commission also did not propose to require such bank SDs or bank MSPs to file notifications contained in Regulation 23.105(c) with the Commission or with an RFA. The Commission did, however, propose to require bank SDs and bank MSPs to file quarterly unaudited financial reports. The Commission also proposed certain regulatory notices that bank SDs and bank MSPs must file with the Commission and with an RFA.

Under the Proposal, bank SDs and bank MSPs were required to file financial reports and specific position and margin information with the Commission and with the RFA of which the SDs and MSPs are members within 17 business days of the end of each calendar quarter. The financial reports and specific position information that would be required under this requirement was set forth in a separate Appendix B to proposed Regulation 23.105(p). The information required on Appendix B was intended to be identical to that required by the SEC for SBSDs subject to the capital rules of a prudential regulator.[423] These quarterly unaudited reports filed with the Commission were largely based on existing ''call reports'' that the bank SDs and bank MSPs are required to file with their respective prudential regulator.[424]

In addition, proposed regulation 23.105(p) required bank SDs and bank MSPs to file certain notices with the Commission and their RFA following the occurrence of certain events. Proposed regulation 23.105 (p)(3)(i) required a bank SD or bank MSP to file a notice with the Commission and with an RFA if the SD or MSP filed a notice of change of its reported capital category with the Federal Reserve Board, the OCC, or the FDIC. Proposed regulation 23.105(p)(3) also required a bank SD that is a foreign bank to notify the Commission if the SD files a notice of a change in its capital category or a notice of falling below its minimum capital requirement with a prudential regulator or with its home country supervisor.[425] Proposed regulation 23.105(p)(3) also required a bank SD or bank MSP to file notices in the event the SD or MSP fails to post or collect initial margin for uncleared swap transactions

[419] *See* Commission regulation § 1.12 (17 CFR 1.12), which requires FCMs to file notices with the Commission and with the FCMs' designated self-regulatory organizations of certain events, including a firm being undercapitalized or failing to maintain current books and records.

[420] *See* Commission regulations §§ 23.152 and 23.153 (17 CFR 23.152 and 23.153).

[421] The term 'regulatory capital'' is defined in proposed Commission regulation § 23.100 and means the relevant capital approach applicable to the SD under proposed Commission regulation § 23.101. *See 2016 Capital Proposal,* 81 FR 91252 at 91309–11.

[422] *See* 17 CFR 240.18a–8.

[423] *See* 2016 *Capital Proposal,* 81 FR 91252 at 91279.

[424] *See* proposed Commission regulation § 23.105(p) and Appendix B; 2016 *Capital Proposal,* 81 FR 91252 at 91321–22 and 91329–32. *See also,* Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices (''call reports''); 12 U.S.C. 324; 12 U.S.C. 1817; 12 U.S.C. 161; and 12 U.S.C. 1464. The proposed financial reporting requirement was consistent with the SEC proposed filing requirement for SBSDs that are subject to the capital rule of a prudential regulator. *See* proposed SEC rule 17 CFR 240.18a–8. Specifically, the Commission proposed that the SDs and MSPs submit to the Commission Appendix B of proposed Commission regulation § 23.105, which is largely based on the SEC's proposed Form SBS part 2 and part 5.

[425] These notices are identical to those finalized for SBSDs by the SEC in 17 CFR 240.18a–8(c).

or post or collect uncleared swap variation margin as required under the respective prudential regulators' rules subject to certain thresholds.[426] Finally, proposed regulation 23.105(p) also included an identical oath and affirmation provisions and electronic filing requirements for bank SDs and bank MSPs as the Commission proposed under paragraphs (f) and (n) of regulation 23.105 for covered SDs and covered MSPs.

The *2019 Capital Reopening* noted that the SEC finalized its recordkeeping, reporting and notification requirements for SBSDs and MSBSPs, which include requiring SBSDs and MSBSPs subject to the capital rules of a prudential regulator to report quarterly unaudited financial information and provide notices of change in its capital category or falling below its minimum capital requirement with the a prudential regulator.[427] The *2019 Capital Reopening* asked whether it was appropriate to make specific changes to proposed regulation 23.105(p) Appendix B in this regard, and to make such schedule align with that finalized by the SEC under Form X–17a–5 FOCUS Part IIC.[428]

Several commenters noted that the 17 business day timeline for the quarterly unaudited financial reporting requirement for bank SDs and bank MSPs was inconsistent with existing banking requirements which permit between a 30-day or 45 calendar day timeline depending on size. In addition, the SEC amended their requirements for SBSDs subject to the capital rules of a prudential regulator to 30 calendar days, making slight adjustments to the schedules in order to make them more consistent with existing call reports.

As noted previously, the Commission wishes to harmonize the reporting requirements for bank SDs and bank MSPs to the maximum extent practicable. The Commission is modifying final regulation 23.105(p) to require a 30 calendar day reporting timeline comparable to that required by SBSD subject to the capital rules of a prudential regulator. The Commission is also adopting the notification requirements relating to the notices of change in capital category or failing below its minimum capital requirement with a prudential regulator. The Commission, however, is not adopting the additional requirements relating to posting and collecting of initial and variation margin under certain thresholds as these notices are not required for SBSDs subject to the rules of a prudential regulator. The Commission further notes in this regard that bank SDs and bank MSPs are also not subject to the Commission's rules for uncleared margin. The Commission is making technical amendments to the Appendix B to align the schedule with that required of SBSD subject to the capital requirements of a prudential regulator under FORM x–17a–5 FOCUS Part IIC, which have been aligned primarily with FFIEC Form 031.

4. Public Disclosures

The Commission proposed to require covered SDs and covered MSPs to provide public disclosure on their website of required financial reporting, including a statement of financial condition and of the amount of minimum regulatory capital required and the amount of regulatory capital of the SD or MSP no less than quarterly, with the same information provided from an audited financial statement no less than annually.[429] The Commission also proposed to require bank SDs and bank MSPs to make publically available no less than quarterly similar financial information.[430] In both instances, the proposed public disclosures were required to be posted to the SD's or MSP's website within ten business days after the SD or MSP is required to file the financial information with the Commission.

The Commission noted in the *2016 Capital Proposal* that its approach was consistent with the financial reporting information the Commission had previously determined should not qualify as exempt from the Freedom of Information Act for FCMs.[431] For bank SDs and bank MSPs, the Commission noted the Proposal was consistent with publically available information provided by bank entities in call reports.[432]

Several covered SDs that are subsidiaries of public companies requested that the posting period on firm's website be extended from ten days to 20 days for the quarterly information, noting that additional timeframe would be necessary to allow for internal and external auditors to review the information.[433] One commenter stated that public disclosure of financial reports will be onerous for commercial covered SDs, while others requested elimination of public disclosures by bank SDs.[434]

In the *2019 Capital Reopening,* the Commission asked questions regarding the practicality of moving the posting deadline from ten business days to 30 calendar days to be consistent with the final requirements adopted by the SEC for SBSDs. Further, the Commission asked whether it was appropriate to remove the public disclosure requirement for bank SDs and bank MSPs under the rationale that this information is already provided to the public on a timely basis as a result of separate disclosure requirements imposed by the prudential regulators.[435] In response, commenters confirmed that a longer period for public disclosure would be preferred and that imposing an additional Commission requirement for bank SDs is duplicative and would override existing balances that were struck.[436] One commenter suggested harmonizing the public disclosure requirement for stand-alone SDs with the biannual requirement required by the SEC for stand-alone SBSD.[437] Another commenter recommended that an exemption be provided for commercial firms which meet a certain threshold of minimum capital.[438]

The Commission believes that is best to harmonize public disclosure requirements to the maximum extent practicable with that required of SBSDs by the SEC. Thus, the Commission is not adopting public disclosure requirements for bank SDs and bank MSPs as these SDs and MSPs will already be providing public disclosures of key financial information as part of the ''call report'' process. Covered SDs and covered MSPs will be required to bi-annually make available on its website basic financial information 30 calendar days following when such information is filed with the Commission. This approach will harmonize the Commission's public disclosure requirements with those required of the stand-alone SBSDs under 17 CFR 240.18a–7(b). Therefore, the Commission is not adopting proposed regulation 23.105(p)(7)

[426] These notices are identical to those required for SDs and MSPs subject to the capital rules of the Commission and proposed under 23.105(c). *See* 2016 *Capital Proposal,* 81 FR 91252 at 91318.

[427] *See* 17 CFR 240.18a–7(a)(2) and 240.18a–8(c).

[428] *2019 Capital Reopening,* 84 FR 69664 at 69680.

[429] *See* Proposed Commission regulation § 23.105(i)(3); *2016 Capital Proposal,* 81 FR 91252 at 91320.

[430] *See* Proposed Commission regulation § 23.105(p)(7); *2016 Capital Proposal,* 81 FR 91252 at 91322.

[431] *See 2016 Capital Proposal,* 81 FR 91252 at 91277.

[432] *Id.*

[433] *See* Shell 5/15/17 Letter; NCGA/NGSA 5/15/2017 Letter; CEWG 5/15/2017 Letter.

[434] *See* Shell 5/15/17 Letter; SIFMA 5/15/17 Letter; MS 5/15/17 Letter.

[435] *See 2019 Capital Reopening,* 84 FR 69664 at 69680, questions 13–a and 13–b.

[436] *See* NCGA/NGSA 3/3/2020 Letter at 6; IIB/ISDA/SIFMA 3/3/2020 Letter at 52.

[437] *See* Shell 3/3/2020 Letter at 4.

[438] *See* Cargill 3/3/2020 Letter at 3.

regarding public disclosures requirements for bank SDs and bank MSPs. The Commission is adopting regulation 23.105(i) as proposed with modification to the timelines as discussed above.

5. Electronic Filing Requirements for Financial Reports and Regulatory Notices

Proposed regulation 23.105(n) required all notifications and financial statement filings submitted to the Commission pursuant to regulation 23.105 to be filed in an electronic manner using a user authentication process approved by the Commission. Proposed regulation 23.105(f) and (p) required each filing made pursuant to Regulation 23.105 include an oath or affirmation signed by an appropriate SD or MSP personnel that the information provided in the filing was true and correct. The Commission notes that many SDs and MSPs are already familiar with the Commission approved WinJammer filing system maintained jointly by NFA and Chicago Mercantile Exchange. WinJammer currently allows Commission registrants that are authorized to use the electronic system to file financial reports and notices with the Commission and NFA simultaneously. The Commission views this system, as well as other future Commission approved systems, as the most effective way to ensure that the filings required under proposed regulation 23.105 would be submitted promptly and directly to the Commission.

One commenter to the 2016 Proposal asked that the Commission provide clarity with the requirements of the oath or affirmation.[439] Another commenter, while generally supportive of the proposed requirements, encouraged the Commission to either adopt standard forms or mandate that the financial filings be accomplished in a form and manner prescribed by an RFA.[440] This commenter further suggested that the Commission consider the SEC's final adopted forms as a starting point for the Commission's forms and encouraged the Commission to parallel any financial reporting requirements for prudentially regulated SDs and those relying on substituted compliance with the SEC's filing requirements for these firms.[441]

As with other requirements regarding financial reporting for SDs and MSPs, the Commission wishes to harmonize these rules to the maximum extent practicable with that adopted by the SEC. The Commission expects that those registrants that are dually-registered with the SEC as either BDs or SBSDs, including those that are also subject to the capital rules of a prudential regulator, would fully comply with the Commission's reporting requirements by filing forms adopted by the SEC. Accordingly, to ensure that bank SD or bank MSP duly registered with the SEC will not be subject to two separate filing requirements, the Commission is amending 23.105(p) by including a provision that a bank SD or bank MSP may file a Form X–17A–5 FOCUS Part IIC in lieu of the forms required under 23.105(p).

The Commission wishes to add clarity that while it is adopting specific schedules in Appendix A and B with regard to swap position information, it is not adopting a standard form for the other routine monthly or annual filing requirements as discussed above.[442] Nonetheless, the Commission may approve additional procedures developed by an RFA, which could include standard forms or procedures necessary to carry out the Commission's filing requirements. The Commission notes that an RFA is required to adopt minimum capital, segregation, and other financial requirements applicable to its members, in accordance with section 17(p)(2) of the CEA. In this regard, each self-regulatory organization, which includes an RFA, must have minimum financial and related reporting requirements that are the same as or more stringent than the Commission's requirements.[443] The Commission is not modifying the proposed language related to the oath or affirmation that financial reports be true and correct. This language is identical to that required in regulation 1.10(d)(4) and that is required by the SEC in 240.17a–5(e)(2) and 240.18a–7(d)(1). In order to ensure that the oath and affirmation is harmonized with SEC for duly registered SBSDs, the Commission is modifying the application of the oath or affirmation to only apply to financial reports, and not to notice or other filings as proposed. For the same reasons, the Commission is modifying the language that for corporations, the oath and affirmation must be signed by the duly authorized officer. The Commission is adopting all other aspects of regulation 23.105(f) and (p) as proposed.

6. Swap Dealer and Major Swap Participant Reporting of Position Information

Proposed regulation 23.105(l) required each covered SD or covered MSP to file monthly swap and security-based swap position information with the Commission and with the RFA of which the SD or MSP is a member. This information was proposed to be reported using Appendix A to regulation 23.105, and was based upon the information proposed to be filed with the SEC by SBSDs.[444] Accordingly, covered SDs or covered MSPs that are dually-registered as SBSDs would be subject to file the same position information with both regulators. In this regard, all covered SDs or covered MSPs were permitted under proposed 23.105(d)(3) to file SEC forms in lieu of the Commission's financial reporting requirements.

The position information that was proposed in regulation 23.105(l) would include a covered SD's or covered MSP's: (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; and, (iii) the internal credit rating, gross replacement value, net replacement value, current net exposure, total exposure, and margin collected for the top 36 counterparties. The covered SD or covered MSP would also have to provide current exposure and net exposure by country for the top 10 countries. The Commission also proposed in 23.105(m) to require covered SDs and MSPs to file with the Commission information about their custodians that hold margin for uncleared swaps pursuant to regulations 23.152 and 23.153 and the aggregate amounts of margin held at such custodians, as well as, the aggregate amount required to be posted and collected pursuant to such rules. The Commission indicated this information will be necessary component of its financial surveillance program to monitor the financial condition and positions of SDs and MSPs.

In the *2019 Capital Reopening,* the Commission noted that a commenter had raised issue with the fact that the proposed appendices did not contain accompanying form instructions, despite having defined terms in both

[439] SIFMA 5/15/17 Letter at 28.

[440] NFA 3/2/2020 Letter at 6, 7.

[441] *Id.*

[442] Please note that due to changes in **Federal Register** publication requirements, the appendices that had been referred to as Appendix A to section 23.105 and Appendix B to section 23.105 in previous documents are being published in this final rule as Appendix B to Subpart E of Part 23 and Appendix C to Subpart E of Part 23, respectively.

[443] *See* also Commission regulation § 1.52 (17 CFR 1.52).

[444] *See* SEC proposed Form SBS part 4.

column headings and rows.[445] In this regard, the Commission asked whether it would be appropriate to incorporate by reference the form instructions published alongside of finalized SEC form X–17a–5 FOCUS Part II and IIC on the proposed appendices to regulation 23.105. Further, the Commission asked whether it was appropriate to modify the proposed Appendices to align certain column headings and rows to that finalized by the SEC in their aforementioned forms.

The Commission received one comment in support of adding the explanatory note incorporating by reference the form instructions published by the SEC.[446] Therefore, the Commission is making technical modifications to the Appendix A to align the schedules with that required of SBSDs under Form X–17a–5 FOCUS Report Part II and incorporate by reference their form instructions. In this regard, the headings of Schedules 2, 3, and 4 of Appendix A have been modified to indicate that these will be required to be completed by Covered SDs authorized to use models. Much of the information on these schedules is required under regulation 23.105(k), and is consistent with that required by the SEC under their form schedules. In addition, Schedule 1 of Appendix A contains general position information and utilizes identical column and row headings as the comparable SEC schedule and applies generally to all covered SDs. All other aspects of regulation 23.105(l) and the incorporated Appendix A are being adopted as proposed. The Commission did not receive comment on the monthly custodian reporting in regulation 23.105(m) and is adopting as proposed.

7. Reporting Requirements for Swap Dealers and Major Swap Participants Approved To Use Internal Capital Models

The Commission proposed reporting requirements for covered SDs that have received approval from the Commission or from an RFA under proposed regulation 23.102(d) to use internal models to compute market risk capital charges or credit risk capital charges. The Commission's proposed requirements for the collection of model information are largely based on existing requirements for ANC Firms under regulation 1.17 and the rules of the SEC, and on SEC rules for SBSDs and BDs.

Regulation 23.105(k) required a covered SD to file, on a monthly basis, a listing of each product category for which the covered SD does not use an internal model to compute market risk deductions, and the amount of the market risk deduction; a graph reflecting, for each business line, the daily intra-month VaR; the aggregate VaR for the SD; for each product for which the SD uses scenario analysis, the product category and the deduction for market risk; and, credit risk information on swap, mixed swap, and security-based swap 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.

Regulation 23.105(k) also required each covered SD approved to use internal capital models to submit a report identifying the number of business days for which the actual daily net trading loss exceeded the corresponding daily VaR and the results of back-testing of all internal models used to compute allowable capital, including VaR, and credit risk models, indicating the number of back-testing exceptions. All of the information required to be submitted to the Commission or RFA under proposed regulation 23.105(k) would be required to be filed within 17 days of the close of each month, with the exception of the report identifying the number of business days for which the actual daily net trading loss exceeded the corresponding daily VaR, which would be required on a quarterly basis.

The Commission did not receive comment on the proposed reporting requirements for covered SDs and MSPs who have been approved to use models under regulation 23.102(d). The Commission also notes that such reporting requirements are identical to that finalized by the SEC for SBSDs and MSBSDs who have been approved to use models to calculate their market and credit risk charges under the SEC's rules. As such, the Commission is adopting regulation 23.105(k) with slight technical amendments to align such requirements with that finalized by the SEC.

8. Weekly Position and Margin Reporting

The Commission proposed weekly reporting of position and margin information for the purposes of conducting risk surveillance of SDs and MSPs. This requirement would apply to SDs and MSPs subject to the capital and margin rules of either the Commission or a prudential regulator. Similar reporting is currently provided on a daily basis by DCOs for cleared swaps.[447]

Proposed regulation 23.105(q)(1) would require SDs and MSPs to report position information, in a format specified by the Commission, (i) by counterparty, and (ii) for each counterparty, by the following asset classes—commodity, credit, equity, and foreign exchange or interest rate. Under the uncleared margin rules, these are asset classes within which margin offsets may be taken.[448]

Proposed regulation 23.105(q)(2) would require SDs and MSPs to report margin information, in a format specified by the Commission, showing: (i) The total initial margin posted by the SD or MSP with each counterparty; (ii) the total initial margin collected by the SD or MSP from each counterparty; and (iii) the net variation margin paid or collected over the previous week with each counterparty.

Several commenters noted that the weekly position requirement was duplicative of information provided as part of the Commission's Part 45 program.[449] Other commenters noted ambiguities in the Commission's proposed requirements and indicated that any weekly reporting requirement would likely be very costly to implement.[450]

As noted in the Proposal, the Commission currently uses positon and margin information filed by DCOs to identify and to take steps to mitigate the risks posed to the financial system by participants in cleared markets including DCOs, clearing members, and large traders.[451] In addition, the Commission has collected specific transactional swap data as part of its Part 45 program and uses such data in various surveillance and oversight

[445] *See 2019 Capital Reopening,* 84 FR 69664 at 69680 footnote 121, citing to SIFMA 5/17/17 Letter.

[446] IIB/ISDA/SIFMA 3/3/2020 Letter at 50, fn. 108.

[447] Commission regulation § 39.19(c)(1) (17 CFR 39.19(c)(1)).

[448] 17 CFR 23.154(b)(2)(v).

[449] *See* ISDA 5/15/2017 Letter; Cargill 5/15/2017 Letter.

[450] *See* INTL FCStone 5/15/2017 Letter; CEWG 5/15/2017 Letter; BPE 5/15/2017 Letter; SIFMA 5/15/2017 Letter.

[451] *See 2016 Capital Proposal,* 81 FR 91252 at 91279–80.

functions.[452] The Commission has recently proposed revisions to the Part 45 data collection, including several additional fields, such as initial and variation margin.[453] Therefore, the Commission at this time believes that imposing an additional weekly position reporting requirement for SDs and MSPs would be duplicative of these efforts. The Commission will revisit the need for a separate weekly position and margin reporting requirement once the routine financial reporting requirements of SDs and MSPs are effective. Accordingly, the Commission is not adopting the weekly position and margin reporting requirements in proposed regulation 23.105(q) at this time.

E. Comparability Determinations for Eligible Covered SDs and Covered MSPs

The Commission proposed a substituted compliance framework that would permit covered SDs and covered MSPs that were organized and domiciled in a foreign jurisdiction to rely on compliance with their applicable home country regulator's capital and financial reporting requirements in lieu of meeting all or parts of the Commission's capital adequacy and financial reporting requirements.[454] The availability of substituted compliance was conditioned upon the Commission issuing a determination that the relevant foreign jurisdiction's capital adequacy and financial reporting requirements are comparable with the Commission's corresponding capital adequacy and financial reporting requirements (*i.e.,* a ''Capital Comparability Determination''). Furthermore, FCM–SDs and dually-registered FCM/MSPs (''FCM–MSPs'') were not eligible for substituted compliance as FCMs are required to comply with the capital and financial reporting requirements in part 1 of the Commission's regulations.[455]

The proposed Capital Comparability Determination framework established a standard of review for determining whether some or all of the relevant foreign jurisdiction's capital adequacy and financial reporting requirements are comparable with the Commission's corresponding capital adequacy and financial reporting requirements. This framework, as detailed below, is generally consistent with the approach adopted by the Commission in assessing substituted compliance of the margin rules for covered SDs engaging in cross-border uncleared swap transactions.

Proposed regulation 23.106 provided that any eligible covered SD or covered MSP, and any foreign regulatory authority that has direct supervisory authority with respect to capital and financial reporting over one or more eligible covered SDs or covered MSPs, is permitted to request a Capital Comparability Determination. The Commission further proposed that eligible covered SDs and covered MSPs may coordinate with their home country regulators in order to simplify and streamline the process for obtaining a Capital Comparability Determination.[456]

Persons requesting a Capital Comparability Determination are required to submit to the Commission: (i) Copies of the relevant foreign jurisdiction's capital and financial reporting requirements (including English translations of any foreign language documents); (ii) descriptions of the objectives of the relevant capital and financial reporting requirements and how such requirements are comparable to, or different from, the Commission's capital and financial reporting requirements (*e.g.,* the Net Liquid Assets Capital Approach and Bank-Based Capital Approach), international standards such as Basel bank capital requirements, if applicable; and, (iii) descriptions of how such requirements address the elements of the Commission's capital and financial reporting rules. A person requesting a Capital Comparability Determination is further required to identify the regulatory provisions that correspond to the Commission's capital and financial reporting requirements (and, if necessary, identify whether the foreign jurisdiction's capital requirements do not address a particular element). A person requesting the determination is also required to provide a description of the ability of the relevant foreign regulatory authority or authorities to supervise and enforce compliance with the applicable capital and financial reporting requirements, and to provide any other information and documentation the Commission deems appropriate.

The proposal identified certain key factors that the Commission would consider in making a Capital Comparability Determination. Specifically, the Commission would consider: (i) The scope and objectives of the relevant foreign jurisdiction's capital requirements; (ii) how and whether the relevant foreign jurisdiction's capital adequacy requirements compare to international Basel capital standards for banking institutions or to other standards such as those used for securities brokers or dealers; (iii) whether the relevant foreign jurisdiction's capital requirements achieve comparable outcomes to the Commission's corresponding capital requirements; (iv) the ability of the relevant regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's capital adequacy and financial reporting requirements; and (v) any other facts or circumstances the Commission deems relevant. The Commission further stated that a foreign capital regime may be deemed comparable in some, but not all, elements of the Commission's capital and financial reporting requirements.

Proposed regulation 23.106 further provided that any covered SD or covered MSP that, in accordance with a Capital Comparability Determination, complies with a foreign jurisdiction's capital and financial reporting requirements, would be deemed in compliance with the Commission's corresponding capital adequacy and financial reporting requirements. Accordingly, the failure of such an SD or MSP to comply with the relevant foreign capital and financial reporting requirements may constitute a violation of the Commission's capital adequacy and financial reporting requirements. In addition, all covered SDs and covered MSPs relying on substituted compliance would remain subject to the Commission's examination and enforcement authority regardless of the Commission issuing a Capital Comparability Determination.

The Commission also retained the authority to impose any terms and conditions it deems appropriate in issuing a Capital Comparability Determination and to further condition, modify, suspend, terminate or otherwise restrict any Capital Comparability Determination it had issued in its discretion. Such revisions or termination of the Capital Comparability Determination could result from, for example, changes in foreign laws or regulatory oversight. In this regard, the Capital Comparability Determinations issued by the Commission would require that the Commission be notified of any material changes to information submitted in support of a Capital

[452] *See* 85 FR 21578 at 21579, 21584.

[453] *See* 85 FR 21578 at 21649–51.

[454] *See 2016 Capital Proposal,* 81 FR 91252 at 91280–81.

[455] Two FCMs currently are organized and domiciled outside of the U.S., and neither is provisionally-registered as an SD or MSP. Accordingly, the Commission does not view the inability of an FCM–SD or an FCM–MSP to avail itself of substituted compliance to present any issues to registrants.

[456] The Commission also confirms that a trade association or similar organization may submit a Capital Comparability Determination on behalf of one or more eligible covered SDs or covered MSPs.

Comparability Determination, including, but not limited to, changes in the relevant foreign jurisdiction's supervisory or regulatory regime.

Commenters generally supported the Commission's proposed substituted compliance framework.[457] One commenter stated that less than full acceptance of foreign regulation by the Commission would result in substantially increased costs to non-U.S. covered SDs and to U.S. covered SDs with non-U.S. parent entities.[458]

Several commenters stated that the Commission should streamline or simplify the proposed substituted compliance process for certain non-U.S. covered SDs. In this regard, one commenter requested that the Commission grant automatic qualification for substituted compliance with the Commission's capital rules for any non-U.S. covered SD that is subject to Basel-compliant home country capital requirements administered by a regulatory authority that is either in a G20 jurisdiction or is a member of the BCBS or IOSCO.[459] Another commenter requested that the Commission exempt non-US covered SDs from the substituted compliance approval process in cases where the covered SDs are subject to capital standards in their home countries that the Federal Reserve Board has determined in the context of foreign banking organizations to be consistent with the Basel III standards.[460] One commenter stated that the Commission should clarify that a non-U.S. SD that qualifies for substituted compliance with the Commission's capital requirements can also meet any relevant Commission notification requirements in proposed regulation 23.105(c) by meeting comparable home country notice requirements.[461]

One commenter also requested that the Commission's assessment of the capital framework of a foreign jurisdiction be performed in a holistic manner, as opposed to narrowly focusing on a line-by-line comparison of regulatory requirements.[462] In addition, one commenter stated that the Commission issue Capital Comparability Determinations well in advance of the compliance date, which will help alleviate potential issues with eligible covered SDs having to seek capital model approval.[463]

NFA also requested that the Commission revise proposed regulation 23.106(a)(4), which provides that a covered SD that intends to comply with the capital adequacy and financial reporting requirements of a foreign jurisdiction that has received a Capital Comparability Determination to file a notice to that effect with NFA, and further requires NFA to confirm that the covered SD may comply with some or all of the requirements of the foreign jurisdiction in lieu of the Commission's requirements.[464] NFA suggested that the requirement be revised to require that a non-U.S. covered SD make only a notice filing similar to the substituted compliance process for margin and entity-level requirements.[465]

The Commission has reviewed the proposed substituted compliance framework and considered the comments received and is adopting the framework with several modifications as discussed below. There currently are 24 non-U.S. covered SDs provisionally registered with the Commission. These 24 non-U.S. covered SDs are located in a total of 7 foreign jurisdictions, with 12 SDs located in the United Kingdom. The Commission also understands that many, if not all, of the 24 non-U.S. covered SDs are subject to regulatory requirements in their respective home country jurisdictions, including capital and financial reporting requirements.

The Commission's approach to substituted compliance is a principles-based, holistic approach that focuses on whether the foreign regulations are designed with the objective of ensuring overall safety and soundness of the non-U.S. covered SD in a manner that is comparable with the Commission's overall capital and financial reporting requirements and is not based on a line-by-line assessment or comparison of a foreign jurisdiction's regulatory requirements with the Commission's requirements. The Commission also will seek to address applications for Capital Comparability Determinations in as expeditious manner, which should provide adequate notice to market participants of its determination prior to the compliance date of these rules.

The Commission is retaining the requirement in proposed regulation 23.106(a)(2) that requires a person to submit a written request to Commission for a Capital Comparability Determination. The Commission is not revising the framework to permit certain non-U.S. covered SDs to satisfy their CFTC regulatory requirements through a process of automatic qualification of substituted compliance with the capital or financial reporting requirements of a foreign jurisdiction, including foreign jurisdictions that are compliant with Basel capital standards. The Commission believes that appropriate capital and financial reporting are fundamental to the Commission's statutory mandate of promoting the safety and soundness of covered SDs, and helping to ensure that such firms meet their financial obligations to swap counterparties. Accordingly, the Commission believes that a non-U.S. covered SD seeking to comply with the Commission's capital and financial reporting requirements must submit information that demonstrates how the foreign regulatory requirements achieve comparable outcomes to the Commission' requirements. The Commission believes that the proposal provides sufficient flexibility for persons seeking Capital Comparability Determinations in that it permits regulatory authorities as well as non-U.S. covered SDs to submit the required materials for the Commission's consideration.

Proposed regulation 23.106(a)(1) provided that a covered SD, covered MSP, or a foreign regulatory authority that has direct supervisory authority over one or more covered SDs or covered MSPs that are eligible for substituted compliance may request a Capital Comparability Determination. The Commission is modifying regulation 23.106(a)(1) by providing that a trade association or other similar group also may request a Capital Comparability Determination on behalf of its member covered SDs and covered MSPs. The purpose of this modification is to provide greater flexibility and efficiencies in the substituted compliance framework by allowing trade associations to request Capital Comparability Determinations for multiple covered SDs or covered MSPs that may be in a particular jurisdiction. This modification potentially allows the Commission to focus its limited resources on a smaller number of requests and will allow covered SDs and covered MSPs to reduce costs by not having to submit individual Capital Comparability Determination requests.

The Commission also is modifying proposed regulation 23.106(a)(3), which provided that the Commission would consider all relevant factors in assessing whether a foreign jurisdiction's capital

[457] *See, e.g.,* ISDA 5/15/2017 Letter; SIFMA 5/15/2017 Letter; MS 5/15/2017 Letter; JBA 3/14/2017 Letter; Letter from Sarah Miller, Institute of International Bankers (May 15, 2017) (IIB 5/15/2017 Letter); IIB/ISDA/SIFMA 3/3/2020 Letter; MS 3/3/2020 Letter; Letter from Atsushi Hirayama, International Bankers Association of Japan (February 27, 2020) (IBAJ 2/27/2020 Letter); and NFA 3/2/2020 Letter.

[458] *See* SIFMA 5/15/2017 Letter.

[459] *See* IIB 5/15/2017 Letter.

[460] *See* JBA 3/14/2017 Letter.

[461] *See* IIB/ISDA/SIFMA 3/3/2020 Letter.

[462] *See* IBAJ 2/27/2020 Letter.

[463] *See* NFA 3/2/2020 Letter.

[464] *Id.*

[465] *Id.*

and financial reporting requirements are comparable to the Commission's, including whether or how the foreign jurisdiction's capital adequacy requirements compare to the capital standards issued by the BCBS for banking institutions or to other standards used for securities brokers or dealers. The Commission is removing this specific reference to BCBS capital standards and to broker-dealer standards in the final rule. As noted above, the Commission's approach to substituted compliance is a principles-based, holistic approach that focuses on whether the foreign regulations are designed with the objective of ensuring overall safety and soundness of the non-U.S. covered SD or MSP in a manner that is comparable with the Commission's overall capital and financial reporting requirements. While a foreign jurisdiction's incorporation of BCBS standards or broker-dealer standards are approaches that the Commission would consider for substituted compliance, it was not the Commission's intent to limit the regulatory approaches, or to appear to limit the regulatory approaches, that it would deem acceptable for substituted compliance. To clarify the rule, and to avoid any potential confusion, the Commission is removing the references to BCBS and broker-dealer standards from the rule. This modification, however, does not represent any change in the Commission's stated approach to substituted compliance.

Proposed regulation 23.106(a)(4) required a non-U.S. covered SD or a non-U.S. covered MSP to file with an RFA a notice of the SD's or MSP's intent to comply with the requirements of a foreign jurisdiction that had received a Capital Comparability Determination. Regulation 23.106(a)(4) further provided that the RFA would determine the information that was necessary to be included in the notice and would provide a confirmation to the non-U.S. covered SD or non-U.S. MSP of its ability to meet the Commission's requirements through substituted compliance. The Commission is modifying the notice and confirmation provisions in final regulation 23.106(a)(4) to require a non-U.S. covered SD or non-U.S. covered MSP to file a notice of its intent to avail itself of a Capital Comparability Determination with the Commission. As the capital and financial reporting requirements are entity-level requirements, it is necessary for the Commission to assess whether each non-U.S. covered SD or non-U.S. covered MSP that files a notice of its intent to meet the Commission's capital and reporting requirements through substituted compliance satisfies any conditions set forth in the applicable Capital Comparability Determination issued to applicable foreign jurisdiction. Upon receipt of a notice, Commission staff will engage with the non-U.S. covered SD or non-U.S. covered MSP to determine the extent to which the foreign regulation that it is subject to is consistent with the Commission's Capital Comparability Determination. As part of the determination, the Commission will review the foreign jurisdiction's regulations, process, and/or procedures, as applicable, for assessing the ongoing financial condition of a covered SD or a covered MSP in determining whether it is appropriate to extend substituted compliance to the notice provisions contained in regulation 23.105(c).

Regulation 23.106(a)(4) also provided that the failure of a non-U.S. covered SD or non-non-U.S. covered MSP operating under substituted compliance to comply with the capital adequacy or financial reporting requirements of the relevant foreign jurisdiction may constitute a violation of the Commission's capital adequacy and financial reporting requirements. The Commission is modifying this provision in final regulation 23.106(a)(4)(ii) to explicitly provide that the Commission may initiate an action for a violation of the Commission's rules when a covered SD or covered MSP subject to a capital comparability determination has failed to comply with a foreign jurisdiction's corresponding capital adequacy and financial reporting requirements. This modification is intended to provide clarity to the final rule by providing that the Commission may initiate an action against a non-U.S. covered SD or non-U.S. covered MSP for failure to comply with the relevant Commission capital and financial reporting requirements when it violates the corresponding foreign jurisdiction's requirements.

F. Additional Amendments to Existing Regulations

1. Financial Reporting Requirements for FCMs or IBs That Are Also Registered SBSDs

The Commission is amending regulation 1.10 to authorize dually-registered FCM/SBSDs and IB/SBSDs to file SEC Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part II C (''FOCUS Report''), as applicable, in in lieu of CFTC Form 1–FR–FCM or Form 1–FR–IB.

Regulation 1.10 requires each FCM to file an unaudited monthly financial report with the Commission and with the FCM's designated self-regulatory organization (''DSRO'') within 17 business days of the close of each month.[466] An FCM's monthly financial reports must be submitted on CFTC Form 1–FR–FCM. FCMs also are required to file an audited annual financial report with the Commission and with the firm's DSRO within 60 days of the end of the FCM's fiscal year end. An FCM's annual financial report may be submitted on Form 1–FR–FCM or, subject to certain conditions, presented in a manner consistent with U.S. GAAP.[467]

Regulation 1.10 requires each IB to file with NFA an unaudited financial report on a semi-annual basis, and an audited annual financial report.[468] The IB unaudited reports must be submitted on Form 1–FR–IB within 17 business days of the date of the report. IB annual reports may be filed on Form 1–FR–IB or, subject to certain conditions, presented in a manner consistent with U.S. GAAP. IB annual financial reports must be filed within 90 days of the IB's fiscal year end.[469]

Regulation 1.10(h) currently streamlines the financial reporting requirements imposed on FCMs and IBs that are dually-registered as BDs. Such dual-registrants are permitted to file with the Commission and with the firms' DSRO the SEC's FOCUS Reports, in lieu of a Form 1–FR–FCM or Form 1–FR–IB. The *2016 Capital Proposal* proposed amending regulation 1.10(h) to permit an FCM or IB that is dually-registered as a SBSD or MSBSP to file an SEC FOCUS Report in lieu of a CFTC Form 1–FR–FCM or CFTC Form 1–FR–IB.[470] The proposed amendment is consistent, as noted above, with the current provisions that authorize dually-registered FCMs/BDs and IBs/BDs to file FOCUS Reports in lieu of the CFTC financial forms. Furthermore, the Commission's experience with

[466] The term ''self-regulatory organization'' (''SRO'') is defined in Commission regulation § 1.3 (17 CFR 1.3) as a contract market, a swap execution facility (all as further defined under§ 1.3), or an RFA under section 17 of the CEA. The term ''designated self-regulatory organization'' is also defined in Commission regulation § 1.3 and generally means the SRO that has primary financial surveillance responsibilities over a registrant.

[467] *See* Commission regulation § 1.10(d)(3) (17 CFR 1.10(d)(3)).

[468] *See* Commission regulation § 1.10(b)(2)(i) (17 CFR 1.10(b)(2)(i)). An IB is required to file its unaudited financial report as of the middle and the end of its fiscal year end.

[469] Commission regulation § 1.10(b)(2)(ii)(A) (17 CFR 1.10(b)(2)(ii)(A)).

[470] *See 2016 Capital Proposal,* 81 FR 91252 at 91281–82.

regulation 1.10(h) has been that the FOCUS Reports include information that is substantially comparable to the Forms 1–FR and provide the information necessary for the Commission to conduct financial surveillance of the registrants.

Regulations 1.10(f) and 1.16(f) also currently provide that a dually-registered FCM/BD or IB/BD may automatically obtain an extension of time to file its unaudited and audited financial reports required under regulation 1.10 by submitting a copy of the written approval for the extension issued by the BD's securities designated examining authority (''DEA'').[471] The *2016 Capital Proposal* proposed amending regulations 1.10(f) and 1.16 to provide that an FCM or IB that is also registered with the SEC as an SBSD or an MSBSP may obtain an automatic extension of time to file its unaudited or audited FOCUS Report with the Commission and with the firm's DSRO, as applicable, by submitting a copy of the SEC's or the DEA's approval of the extension request. The proposed amendment maintains the intent of the current regulations by retaining a consistent approach to the granting to dual registrants extensions of time to file financial reports. The Commission also proposed a technical amendment to regulation 1.16 to correct a cross reference to SEC rule 17a–5 (17 CFR 240.17a–5) for extensions of time to file audited financial statements.

The Commission did not receive any comments related to the proposed amendments to the provisions of regulations 1.10 and 1.16 noted above. After further consideration and for the reasons stated in the *2016 Capital Proposal,* the Commission is adopting these amendments substantially as proposed.

2. *Amendments to the FCM and IB Notice Provisions in Regulation 1.12*

Regulation 1.12 requires an FCM or IB to file a notice with the Commission and with the registrant's DSRO when certain prescribed events occur that trigger a notice filing requirement.[472] Such events include the registrant: (i) Failing to maintain compliance with the Commission's capital requirements or the capital rules of a SRO; (ii) failing to hold sufficient funds in segregated or secured amount accounts to meet its regulatory requirements; (iii) failing to maintain current books and records; and (iv) experiencing a significant reduction in capital from the previous month-end.

The Commission proposed amending regulation 1.12(a) to require an FCM or IB that is a dual registrant with the SEC to file a notice if the FCM or IB fails to meet any applicable SEC's minimum capital requirements. The Commission stated that such notice is appropriate as it provides Commission staff with the opportunity to assess the potential impact of the dually-registered FCM's or IB's failure to meet SEC minimum capital requirements on the respective firm's CFTC regulated activities, and to initiate discussions with the SEC regarding the capital deficiency.[473]

Commission regulation 1.12(b) requires an FCM or IB to file notice with the Commission and with the firm's DSRO if a firm's adjusted net capital falls below the applicable ''early warning level'' set forth in the regulation.[474] The Commission proposed amending regulation 1.12(b) to require an FCM or IB that is also registered with the SEC as a SBSD or a MSBSP to file a notice if the SBSD's or MSBSP's capital falls below the ''early warning level'' established in the rules of the SEC. The proposal was intended to provide additional information to the Commission in its efforts to monitor the financial condition of its registrants.

The Commission did not receive any comments related to the above proposed amendments to regulation 1.12. For the reasons stated in the *2016 Capital Proposal,* the Commission is adopting the amendments as proposed.

3. *FCM and IB Unsecured Receivables From Swap Transactions*

Regulation 1.17 provides that an FCM or IB, in computing its net capital, must exclude unsecured receivables except for certain specified unsecured receivables, including interest receivable, floor broker receivable, commissions receivable from other brokers or dealers, mutual fund concessions receivable and management receivable from registered investment companies and commodity pools. The regulation further provides that an FCM or IB must exclude these otherwise permitted unsecured receivables from current assets in computing its net capital if the receivable is outstanding longer than 30 days from the payable date.[475] The operation of the regulation effectively allowed an FCM or IB to reflect commissions due from FCMs that carried customer accounts introduced by the FCM or IB as a current asset in computing its net capital, as the FCMs generally paid these commissions within 30 days from the payable date.

The Commission proposed to amend regulation 1.17(c)(2)(ii)(B) to codify several staff no-action letters that provided that staff would not recommend an enforcement action against an IB that reflect certain commissions receivable balances from swap transactions that are outstanding no more than 60 days from the month-end accrual date as current assets in computing its net capital, provided that the commissions are promptly billed.[476] The staff no-action letters were issued to accommodate the long-standing commission billing practices in the swaps market that differed from the futures markets. Commissions for swaps transactions are often billed and paid in a process that exceeds 30 days. The final rule adopted by the Commission would allow both FCMs and IBs to recognize unsecured commissions receivable resulting from swap transactions in computing their net capital, provided that the unsecured receivables are not outstanding more than 60 days from the month end accrual date and the commissions are billed promptly after the close of the month.

The Commission also proposed amending regulation 1.17(c)(2)(ii)(B) by adding a new provision that allows FCMs and IBs to recognize dividends receivable that are not outstanding more than 30 days. This proposed amendment was to further align the Commission's capital rules with the SEC's capital, which specifically addressed the capital treatment of dividends.

The Commission received no comments on the proposed amendments to regulation 1.17(c)(2)(ii)(B). After considering the issue, and for the reasons stated in the *2016 Capital Proposal,* the Commission has determined to adopt the amendments to regulation 1.17(c)(2)(ii)(B) as proposed.

4. Amendments to FCM and IB Notice and Disclosure Requirements for Bulk Transfers

Regulation 1.65 provides that an FCM or IB must obtain a customer's specific consent prior to transferring the customer's account to another FCM or

[471] Commission regulations §§ 1.10(f) and 1.16(f) (17 CFR 1.10(f) and 1.16(f)).

[472] Commission regulation § 1.12 (17 CFR 1.12).

[473] *See 2016 Capital Proposal,* 81 FR 91252 at 91282.

[474] If an FCM's or IB's adjusted net capital falls below a certain threshold, such as 120 percent of its minimum adjusted net capital requirement, the firm is deemed to be maintaining adjusted net capital at a level below its ''early warning level.''

[475] Commission regulation § 1.17(c)(2)(ii) (17 CFR 1.17(c)(2)(ii)).

[476] *See 2016 Capital Proposal,* 81 FR 91252 at 91282.

IB, except if the account is transferred at the customer's request.[477] Regulation 1.65 further provides that an FCM or IB may transfer a customer's account without the customer's specific consent if the FCM's or IB's account agreement with the customer contains a valid consent by the customer to a prospective transfer of the account; the customer is provided with written notice of, and a reasonable opportunity to object to, the transfer; and, the customer has not objected to the transfer or given other instructions as to the disposition of the account. The written notice provided to the customers is required to contain certain prescribed information including, the reason for the transfer, a statement that the customer is not required to accept the proposed transfer and may direct that the account be liquidated or transferred to an FCM or IB of the customer's choosing, and a clear statement of how the customer is to provide notice that it does not consent to the proposed transfer.[478]

An FCM or IB is also required to file with the Commission notice of a transfer of customer accounts at least five business days prior to the transfer if the transfer involves more than 25 percent of the FCM's or IB's total accounts (or 50 percent if the FCM or IB has less than 100 accounts).[479] The notice must be submitted to the Commission by mail, addressed to the Deputy Director, Compliance and Registration Section, Division of Swap Dealer and Intermediary Oversight.[480] Finally, the notice must be filed with the Commission as soon as practicable and no later than the day of the transfer if the FCM or IB cannot file the notice at least five business days prior to the transfer.[481] The FCM or IB is required to file a brief statement explaining the circumstances necessitating the delay in filing.

The Commission proposed to amend regulation 1.65 noting that it had found that five days' notice, when given, often is not a sufficient amount of time to allow the Commission to effectively monitor the bulk transfer of customer accounts.[482] Specifically, the Commission proposed to amend regulation 1.65(b) to require that the notice of a bulk transfer of customer accounts must be filed with the Commission at least ten business days in advance of a transfer. The Commission noted that the bulk transfers of customer accounts are generally planned well in advance such that the FCM or IB should be able to provide the Commission ten days advance notice of such a transfer. The Commission also proposed to amend regulation 1.65(d) to require the notice to be filed by the FCM or IB electronically, which is consistent with the filing requirements of other notices and financial forms filed by FCMs or IBs with the Commission. The Commission noted that the electronic system to file such notices already exists and has been used by FCMs and IBs for many years. Accordingly, the Commission believed that the proposed electronic filing of notices of bulk transfers would not result in any additional costs either to the Commission or to FCMs and IBs.

The Commission also proposed to amend regulation 1.65(d) to provide that the notices shall be considered filed with the Commission when submitted to the Director of the Division of Swap Dealer and Intermediary Oversight. The Commission proposed to require the notices of bulk transfer to be addressed to the Director of the Division of Swap Dealer and Intermediary Oversight to reflect organizational changes since the rule was last revised, and to ensure that such notices are reviewed promptly upon receipt.

The Commission further proposed to amend regulation 1.65(e) to delegate to the Director of the Division of Swap Dealer and Intermediary Oversight the authority to accept a lesser time period for the notification provided for in regulation 1.65(b). However, the notice must be filed as soon as practicable and in no event later than the day of the transfer. This provision is deemed necessary as certain transfers may be performed under exigent circumstances where 10 days advance notice is not possible, such as situations where the FCM or IB becomes insolvent and is required to terminate its business.

The Commission did not receive any comments regarding the proposed amendments to the bulk transfer provisions of regulation 1.65. The Commission has considered the proposed amendments and, for the reasons stated in the *2016 Capital Proposal,* has determined to adopt the amendments as proposed.

5. Conforming Amendments to Delegated Authority Provisions in Regulation 140.91

Commission regulations 1.10, 1.12, and 1.17 reserve certain functions to the Commission, the greater part of which the Commission has delegated to the Director of the Division of Swap Dealer and Intermediary Oversight through the provisions of regulation 140.91.[483] The Commission proposed to amend regulation 140.91 to provide similar delegations with respect to functions reserved to the Commission in part 23.

Regulation 23.101(c), as adopted, requires a covered SD or covered MSP to be in compliance with the minimum regulatory capital requirements at all times and to be able to demonstrate such compliance to the Commission at any time. Regulation 23.103(d), as adopted, requires a covered SD or covered MSP, upon request, to provide the Commission with additional information regarding its internal models used to compute its market risk exposure requirement and OTC derivatives credit risk requirement. Regulation 23.105(a)(2), as adopted, requires a covered SD or covered MSP to provide the Commission with immediate notification if the SD or MSP fails to maintain compliance with the minimum regulatory capital requirements, and further authorizes the Commission to request financial condition reporting and other financial information from the covered SD or covered MSP. Regulation 23.105(d), as adopted, authorizes the Commission to direct a bank SD or bank MSP that is subject to capital rules established by a prudential regulator, or has been designated a systemically important financial institution by the Financial Stability Oversight Council and is subject to capital requirements imposed by the Board of Governors of the Federal Reserve System, to file with the Commission copies of its capital computations for any periods of time specified by the Commission.

The Commission proposed to amend regulation 140.91 to delegate to the Director of the Division of Swap Dealer and Intermediary Oversight, or the Director's designee, the authority reserved to the Commission under regulations 23.101(c), 23.103(d), and 23.105(a)(2) and (d).[484] The Commission did not receive any comments regarding the proposed amendments to regulation 140.91 to delegate the functions noted above to DSIO staff and has determined

[477] Commission regulation § 1.65(a)(1) (17 CFR 1.65(a)(1)).

[478] Commission regulation § 1.65(a)(2) (17 CFR 1.65(a)(2)).

[479] Commission regulation § 1.65(b) (17 CFR 1.65(b)).

[480] Commission regulation § 1.65(d) (17 CFR 1.65(d)).

[481] Commission regulation § 1.65(e) (17 CFR 1.65(e)).

[482] *See 2016 Capital Proposal,* 81 FR 91252 at 91282.

[483] Commission regulation § 140.91 (17 CFR 140.91).

[484] *See 2016 Capital Proposal,* 81 FR 91252 at 91282–83.

to adopt the amendments substantially as proposed. The delegation of such functions to staff of the Division of Swap Dealer and Intermediary Oversight is necessary for the effective oversight of SDs and MSPs compliance with minimum financial and related reporting requirements. The delegation of authority is also comparable to the authorities currently delegated to staff under regulation 140.91 regarding the supervision of FCMs compliance with minimum financial requirements.

G. Effective Date and Compliance Date

The proposed amendments and new regulations adopted by the Commission shall be effective 60 days after publication in the **Federal Register**. Several commenters requested that timeline for implementation be extended to allow for approval of capital models.[485] Specific concerns included comments that the implementation timeline should not create competitive disparities between SDs utilizing models approved by other regulators and SDs seeking model approval for the first time from the Commission and NFA.[486] Another commenter stated SDs that did not have model approval at the compliance date would be at a significant competitive disadvantage relative to covered SDs and FCM–SDs that had the approval to use models at the compliance date because such SDs would be required to use the proposed standardized capital charges while awaiting model approval at the compliance date.[487] Several commenters further stated that the Commission should automatically approve market risk models and credit risk models of covered SDs or FCM–SDs that have already been approved by a prudential regulator, the SEC, or certain foreign regulators.[488] In view of these concerns, the Commission is extending the compliance date for the amended regulations and the new regulations until October 6, 2021. Additionally, the Commission has provided for the ability of SDs to use capital models pending Commission/NFA approval, provided the SD files the certification required under Commission regulation 23.102(f) and the model has been approved by the SEC, prudential regulators, or qualified foreign regulators. Further, the Commission has provided for a substituted compliance program. By setting the compliance date as October 6, 2021, the Commission has addressed commenters' concerns by allowing SDs a sufficient period of time to develop policies, procedures, and systems, to implement new financial reporting regimes and to develop capital models, as applicable, to meet the new regulatory requirements while also maintaining consistency with the SEC's compliance date for rules imposing capital, margin, segregation, and financial reporting obligations for SBSDs, and amending existing rules for BDs. The coordination of the compliance date will assist dually-registered entities with meeting their CFTC and SEC regulatory requirements.

III. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RF Act'') requires that agencies consider whether the regulations they propose will have a significant economic impact on a substantial number of small entities.[489] This rulemaking would affect the obligations of SDs, MSPs, FCMs, and IBs. The Commission has previously determined that SDs, MSPs, and FCMs are not small entities for purposes of the RF Act.[490] Therefore, the requirements of the RF Act do not apply to those entities. The Commission has found it appropriate to consider whether IBs should be deemed small entities for purposes of the RF Act on a case-by-case basis, in the context of the particular Commission regulation at issue.[491] As certain IBs may be small entities for purposes of the RF Act, the Commission considered whether this rulemaking would have a significant economic impact on such registrants.

Only a few of the regulations included in this rulemaking, the amendment of Commission regulations 1.10, 1.12, 1.16 and 1.17, will impact the obligations of IBs. These amendments will permit the filing and harmonization of financial reporting and notification rules as adopted by the SEC for dual registered SBSD and MSBSPs and accommodate common billing practices in the swap industry surrounding the collection of commission receivables. The Commission believes that these amendments will have a minimal effect on IBs, and are not expected to impose any new burdens or costs on them. The Commission does not, therefore, expect small entities to incur any additional costs as a result of this proposed rulemaking.

Accordingly, for the reasons stated above, the Commission believes that this rulemaking will not have a significant economic impact on a substantial number of small entities. Therefore, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the regulations being published today by this **Federal Register** release will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

1. Background

The Paperwork Reduction Act of 1995 (''PRA'')[492] imposes certain requirements on Federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. The rule amendments adopted herein results in an amendment to existing collection of information ''Regulations and Forms Pertaining to Financial Integrity of the Market Place; Margin Requirements for SDs/MSPs''[493] as discussed below. The responses to this collection of information are mandatory. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number issued by the Office of Management and Budget (''OMB'').

The Commission did not receive any comments regarding its PRA burden analysis in the preamble to the Proposal. The Commission is revising collection number 3038–0024 to reflect the adoption of amendments to Parts 1 and 23 of its regulations, as discussed below, with changes to reflect adjustments that were made to the final rules in response to comments on the Proposal. The Commission does not believe the rule amendments as adopted impose any other new collections of information that require approval of OMB under the PRA.

[485] *See* Citadel 5/15/2017 Letter; SIFMA 5/15/2017 Letter; FIA 5/15/2017 Letter; FIA–PTG 5/24/2017 Letter.

[486] *See* Citadel 5/15/2017 Letter.

[487] *See* ISDA 5/15/17 Letter.

[488] *See, e.g.,* FIA 5/15/17 Letter; SIFMA 5/15/17 Letter. *See also,* ABN/ING/Mizuho/Nomura 1/29/2018 Letter.

[489] 5 U.S.C. 601 *et seq.*

[490] *See* Policy Statement and Establishment of Definitions of ''Small Entities'' for Purposes of the Regulatory Flexibility Act, 47 FR 18618 (Apr. 30, 1982) (FCMs) and Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, 2620 (Jan. 19, 2012) (SDs and MSPs).

[491] *See* Introducing Brokers and Associated Persons of Introducing Brokers, Commodity Trading Advisors and Commodity Pool Operators; Registration and Other Regulatory Requirements, 48 FR 35248, 35276 (Aug. 3, 1983).

[492] 44 U.S.C. 3501 *et seq.*

[493] *See* OMB Control No. 3038–0024, *http://www.reginfo.gov/public/do/PRAOMBHistory?ombControlNumber=3038-0024.*

2. New Information Collection Requirements and Related Burden Estimates [494]

Currently, there are approximately 108 SDs and no MSPs provisionally registered with the Commission that may be impacted by this rulemaking and, in particular, the collection of information contained herein and discussed below.

i. FOCUS Report

The amendments to Commission regulation 1.10(h) allow an FCM or IB that is also an SEC-registered securities BD to file, subject to certain conditions, its FOCUS Form X–17a–5–Part II in lieu of its Form 1–FR. Because these amendments provide an alternative to filing Form 1–FR, the Commission believes that the amendments would not cause FCMs or IBs to incur any additional burden. Rather, to the extent that the rule provides an alternative to filing a Form 1–FR and is elected by FCMs or IBs, it is reasonable for the Commission to infer that the alternative is less burdensome to such FCMs and IBs.

The amendments to Commission regulation 1.10(f) allow an FCM or IB that is dually-registered with the SEC as either a SBSD or MSBSP to request an extension of time to file its uncertified FOCUS Report. The Commission is unable to estimate with precision how many requests it would receive from registrants under § 1.10(f) in relation to FOCUS Report annually. The Commission anticipates that it will receive one such request in the aggregate annually, and that preparing such a request will consume five burden hours, resulting in an annual increase in burden of five hours in the aggregate.

ii. Notice of Failure To Maintain Minimum Financial Requirements

Commission regulations 1.12(a) and (b) currently require FCMs and IBs, to file notices if they know or should have known that certain specified minimum financial thresholds have been exceeded. The amendments to Commission regulation 1.12(a) and (b) add as an additional threshold for such notices certain financial requirements of the SEC if the applicant or registrant is registered with the SEC as an SBSD or MSBSD. The Commission is unable to estimate with precision how many additional notices it would receive from such entities as a result of the additional minimum threshold. In an attempt to provide conservative estimates, the Commission anticipates receiving 10 such notices in the aggregate annually, and that preparing such a notice will consume five burden hours, resulting in an annual increase in burden of 50 hours in the aggregate.

iii. Requests for Extensions of Time To File Financial Statements

The amendments to Commission regulation 1.16(f) allow an FCM or IB that is registered with the SEC as an SBSD or MSBSP to request an extension of time to file its audited annual financial statements.[495] The Commission is unable to estimate with precision how many of such requests it would receive from such entities. The Commission anticipates receiving one such request in the aggregate annually, and that preparing the request will consume five burden hours, resulting in an annual increase in burden of five hours in the aggregate.

iv. Capital Requirement Elections

Amended Commission regulation 23.101(a)(7) requires that certain SDs that wish to change their capital election submit a written request to the Commission and provide any additional information and documentation requested by the Commission. The Commission is unable to estimate with precision how many of such requests it would receive from such entities. The Commission anticipates that it would receive one such request in the aggregate annually, and that preparing such a request would consume five burden hours, resulting in an annual increase in burden of five hours in the aggregate.

v. Application for Use of Models

Commission regulation 23.102(a) allow an SD to apply to the Commission or a RFA of which it is a member for approval to use internal models when calculating its market risk exposure and credit risk exposure under Commission regulations 23.101(a)(1)(i)(B), 23.101(a)(1)(ii)(A), or 23.101(a)(2)(ii)(A), by sending to the Commission and such RFA an application, including the information set forth in Appendix A to Commission regulation 23.102 and meeting certain other requirements. Amended Commission regulation 1.17(c)(6)(v) relatedly allows an FCM that is also an SD to apply in writing to the Commission or an RFA of which it is a member for approval to compute deductions for market risk and credit risk using internal models in lieu of the standardized deductions otherwise required under Commission regulation 1.17.[496]

Appendices A and B to Commission regulation 23.102 contain further related information collection requirements, including that the SD: (i) Provide notice to the Commission and RFA and/or update its application and related materials for certain inaccuracies and amendments; (ii) notify the Commission or RFA before it ceases to use such internal models to compute deductions; (iii) if a VaR model is used, have an annual review of such model conducted by a qualified third party service, (iv) conduct stress-testing, retain and make available to the Commission and the RFA records of the results and all assumptions and parameters thereof, and notify the Commission and RFA promptly of instances where such tests indicate any material deficiencies in the comprehensive risk model; (v) demonstrate to the Commission or the RFA that certain additional conditions have been satisfied and retain and make available to the Commission or the RFA records related thereto; and (vi) comply with additional conditions that may be imposed on the SD by the Commission or the RFA.

As discussed above, there are currently 108 SDs and 0 MSPs provisionally registered with the Commission. Of these, the Commission estimates that approximately 56 SDs and no MSPs would be subject to the Commission's capital rules as they are not subject to the capital rules of a prudential regulator. The Commission further estimates conservatively that 32 of these SDs would seek to obtain Commission approval to use models for computing their market and credit risk capital charges.

The Commission staff estimates that an SD approved to use internal models would spend approximately 5,600 hours per year to review and update the models and approximately 640 hours per year to back-test the models for the aggregate of 6,240 annual burden hours for each SD. Consequently, Commission staff estimates that reviewing and backtesting the models for the 32 SDs will result in an aggregate annual hour burden of approximately 199,680 hours.

[494] This discussion does not include information collection requirements that are included under other Commission regulations and related OMB control numbers.

[495] The registrant would also be required to promptly file with the DSRO and the Commission copies of any notice it receives from its designated examining authority to approve or deny the requested extension of time.

[496] Note that the changes to Commission regulation § 1.17(c)(6)(i) (17 CFR 1.17(c)(6)(i)), which permit any dual registered FCM Broker-Dealer who has received approval by the SEC under § 240.15c3–1(a)(7) (17 CFR 240.15c3–1(a)(7)) to use models to calculate its market and credit risk charges, do not add an additional collection of information and therefore are not considered in this analysis.

vi. Equity Withdrawal Requirements.

Commission regulation 23.104 adds equity withdrawal restrictions on certain SDs. Commission regulation 23.104(a) allows an SD to apply in writing for relief from restrictions on certain equity withdrawals. Commission staff estimates that 28 of the 107 currently provisionally registered SDs would be subject to this regulation. Commission staff estimates that each of these 28 SDs would file approximately two notices annually with the Commission and that it would take approximately 30 minutes to file each of these notices. This results in an aggregate annual hour burden estimate of approximately 28 hours.

vii. Financial Recordkeeping, Reporting and Notification Requirements for SDs and MSPs

Commission regulation 23.105 requires that each SD and MSP maintain certain specified records, report certain financial information and notify or request permission from the Commission under certain specified circumstances, in each case, as provided in the proposed regulation. For example, the regulation requires generally that SDs and MSPs maintain current books and records, provide notice to the Commission of regulatory capital deficiencies and related documentation, provide notice of certain other events specified in the rule, and file financial reports and related materials with the Commission (including the information in Appendix A and B to the regulation, as applicable). Regulation 23.105 also requires the SD or MSP to furnish information about its custodians that hold margin for uncleared swap transactions and the amounts of margin so held, and for SDs approved to use models (as discussed above), provide additional information regarding such models, as further described in regulation 23.105(k).

The Commission estimates that there are 28 SD firms which will be required to fulfill their financial reporting, recordkeeping and notification obligations under regulation 23.105(a)–23.105(n) because they are not subject to a prudential regulator, not already registered as an FCM, and not dually registered as a SBSD. The Commission expects these 28 firms will apply to use models. Commission staff estimates that the preparation of monthly and annual financial reports for these SDs, including the recordkeeping, related notification and preparation of the specific information required in Appendix A to 23.105, would impose an on-going burden of 250 hour per firm annually. The Commission further estimates it will cost each SD $300,000 to retain an independent public accountant to audit its financial statements each year. Thus, the total burden hours estimated for compliance with 23.105(a)–23.105(n) for these 28 SD firms would be 7,000 hours annually.

Regulation 23.105(p) and its accompanying Appendix B impose a quarterly financial reporting and notification obligations on SDs which are subject to a prudential regulator. The Commission expects that approximately 52 of the 108 currently provisionally registered SDs are subject to a prudential regulator. The Commission estimates that these reporting and notification requirements will impose a burden of 33 hours on-going annually. This results in a total aggregate burden of 1,716 hours annually.

viii. Capital Comparability Determinations

Commission regulation 23.106 allows certain SDs, MSPs, and foreign regulatory authorities to request a Capital Comparability Determination with respect to capital adequacy and financial reporting requirements for SDs or MSPs, as discussed above. As part of this request, persons are required to submit to the Commission certain specified supporting information and further information, as requested by the Commission. Further, if such a determination was made by the Commission, an SD or MSP would be required to file a notice with the RFA of which it is a member of its intent to comply with the capital adequacy and financial reporting requirements of the foreign jurisdiction. Moreover, in issuing a Capital Comparability Determination, the Commission would be able to impose any terms and conditions it deems appropriate, including additional capital and financial reporting requirements.

The Commission expects that 43 firms out of the 108 currently provisionally registered SDs would seek Capital Comparability Determinations. These 24 firms are located in five different jurisdictions, all of which appear to have adopted some level of Basel compliant capital rule or another capital rule that would apply to SDs. As such, Commission staff estimates that it will take approximately ten hours per firm annually to prepare and submit requests for Capital Comparability Determinations and otherwise comply with the requirements of proposed regulation 23.106, resulting in aggregate annual burden of 240 hours.

IV. Cost Benefit Considerations

A. Background

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its discretionary actions before promulgating a regulation under the CEA or issuing certain orders.[497] Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. In this cost benefit section, the Commission discusses the costs and benefits resulting from its discretionary determinations with respect to the section 15(a) factors.[498] In addition, in Attachment A to this section, the Commission, using available data, estimates the cost of the final rule to each type of SD or MSP.

This rulemaking implements the new statutory framework of Section 4s(e) of the CEA, added by Section 731 of the Dodd-Frank Act, which requires the Commission to adopt capital requirements for SDs and MSPs that do not have a prudential regulator (*i.e.,* ''covered swap entities'' or ''CSEs'') and amends Commission regulation 1.17 to impose specific market risk and credit risk capital charges for uncleared swap and security-based swap positions held by an FCM.[499] Section 4s(e) of the CEA requires the Commission to adopt minimum capital requirements for CSEs that are designed to help ensure the CSE's safety and soundness and be appropriate for the risk associated with the uncleared swaps held by a CSE. In addition, section 4s(e)(2)(C) of the CEA, requires the Commission to set capital requirements for CSEs that account for the risks associated with the CSE's entire swaps portfolio and all other activities conducted by the CSE. Lastly, section 4s(e)(3)(D) of the CEA provides that the Commission, the prudential regulators, and the SEC, must ''to the maximum extent practicable'' establish and maintain comparable capital rules. The rulemaking also includes certain financial reporting requirements related to an SDs and MSPs financial condition and capital requirements.

In the following cost-benefit considerations, the Commission has

[497] 7 U.S.C. 19(a).

[498] The Commission notes that the costs and benefits in this rulemaking, and highlighted below, have informed the policy choices described throughout this release.

[499] *See* section 4s(e)(2)(B).

evaluated the costs and benefits of this rulemaking. In this section the Commission will: (i) Discuss the general benefits and costs of regulatory capital; (ii) summarize the rulemaking; (iii) describe the baseline for which the cost and benefits of this rulemaking were considered; (iv) provide an overview of the different capital approaches set out in this rulemaking and the rationale for each approach; (v) describe the costs and benefits to each type of SD and MSP under their corresponding capital approaches; (vi) discuss the reporting requirements; and (vii) an analyze the rulemaking as it relates to each of the 15(a) factors.

Where reasonably feasible, the Commission has endeavored to estimate quantifiable costs and benefits. Where quantification is not feasible, the Commission identifies and describes costs and benefits qualitatively. The Commission acknowledges that it is limited in estimating the actual cost of its final capital rule. First, the initial and recurring costs for any particular registrant will depend on, among other things, its size, organizational structure, swap dealing activity, other business activities, modelling capacities, practices, and cost structure. In the 2016's proposal's cost-benefit considerations, the Commission estimated the cost of its capital proposal using SDR data on interest rate swaps for the purposes of extrapolating certain possible ranges regarding the possible cost of capital at Commission registered SDs. Interest rate swaps served as a proxy for all covered swap positions held by all covered SDs and then estimated the initial margin based on that portfolio. Interest rate swaps were selected because they represented a majority of the swaps notional reported to swap data repositories. The Commission did not receive any data or comments specifically addressing this analysis. Upon further review, the Commission has concluded that because this approach considered only one type of swap, the Commission does not believe that this estimate was helpful in understanding the range of possible cost outcomes that could have flowed from the proposal.

In order for the Commission to be able to develop a credible estimate, it would need access to proprietary information for each swap dealer. Among some of the information that the Commission currently lacks and would be relevant are: (i) Position level data, sufficient to estimate risk margins; (ii) for the Bank-Based Capital Approach, data about the registrant's Risk-Weighted Assets (RWAs); and (iii) for the Net Liquid Assets Capital Approach and the tangible net worth approach, data about market risk and credit risk charges. For these reasons, the Commission has not quantified the costs of the rule in terms of the level of capital charges the rule may require. Instead, the Commission has attempted to quantify costs in terms of how implementation of the rule may affect registrants' capital requirements in comparison to their existing capital levels and other circumstances. As detailed in Attachment A, the Commission has compiled available capital data and considered whether additional capital would be required to meet the Commission's capital requirements.

In considering the effects of the final rule and the resulting costs and benefits, the Commission acknowledges that the swaps markets have many types of market participants including SDs and their clients (who could be professional investors, public and non-public operating firms) and function internationally with: (i) Transactions that involve U.S. firms occurring across different international jurisdictions; (ii) some entities organized outside of the United States that are prospective Commission registrants; and (iii) some entities that typically operate both within and outside the United States. Where the Commission does not specifically refer to matters of location, the discussion of costs and benefits below refers to the effects of the amendments on all relevant swaps activities, whether based on their actual occurrence in the United States or on their connection with, or effect on U.S. commerce pursuant to, section 2(i) of the CEA.[500]

B. Regulatory Capital

Regulatory capital is designed to ensure that a firm will have enough capital, in times of financial stress, to cover the risk inherent of the activities in the firm. Regulatory capital's framework can be designed differently, but its primary purpose remains the same—to meet this objective. Although a firm may mitigate its risks through other methods, including risk management techniques (*e.g.,* netting, credit limits, margin), capital is viewed as the last line of defense of an entity, ensuring its viability in times of financial stress. In adopting this rulemaking, the Commission was cognizant of the purpose of capital and the potential trade-off between the costs of requiring additional capital and the Commission's statutory mandate of helping to ensure the safety and soundness of SDs and MSPs thereby promoting the stability of the U.S. financial system.

C. General Summary of Rulemaking

The Commission designed this rulemaking on well-established existing capital regimes. The framework, which draws upon the principles and structures of bank-based capital, broker-dealer capital, and FCM capital, provides CSEs, operating under a current capital regime, with the ability to continue to comply with that regime, with minor adjustments to account for the inherent risk of swap dealing and to mitigate regulatory arbitrage. The Commission, in developing its capital framework, provides CSEs with the flexibility to continue operating under a similar capital framework, which should mitigate disruptions to the markets and mitigate the possibility of duplicative or even conflicting rules, while helping to ensure the safety and soundness of the CSE and the stability of the U.S. financial system.

The final rule detail minimum capital requirements for different ''types'' or ''categories'' of CSEs and further define the capital computations, including various market risk and credit risk charges, whether using models or a standardized rules-based or table-based approach, to determine whether a CSE satisfies the minimum capital requirements. The Commission's final rules permit SDs that are neither registered as FCMs nor subject to the capital rules of a prudential regulator to elect a capital requirement that is based on existing bank holding company (''BHC'') capital rules adopted by the Federal Reserve Board or a capital requirement that is based on the existing FCM/BD net capital rules. The Commission's final rule also permits certain SDs that meet defined conditions designed to ensure that they are ''predominantly engaged in non-financial activities'' to compute their minimum regulatory capital based upon the firms' tangible net worth. Further, the Commission is allowing SDs to obtain approval from the Commission, or from an RFA of which the SDs are members, to use internal models to compute certain market risk and credit

[500] Pursuant to section 2(i) of the CEA, activities outside of the United States are not subject to the swap provisions of the CEA, including any rules prescribed or regulations promulgated thereunder, unless those activities either have a direct and significant connection with activities in, or effect on, commerce of the United States; or contravene any rule or regulation established to prevent evasion of a CEA provision enacted under the Dodd-Frank Act, Public Law 111–203, 124 Stat. 1376. 7 U.S.C. 2(i).

risk capital charges when calculating their capital.[501]

The Commission is also imposing certain restrictions on the withdrawal of capital from SDs if certain defined triggers are breached.

The final rules also establish a program of ''substituted compliance'' that will allow a CSE that is organized and domiciled in a non-U.S. jurisdiction (''non-U.S. CSE'') (or an appropriate regulatory authority in the non-U.S. CSE's home country jurisdiction) to petition the Commission for a determination that the home country jurisdiction's capital and financial reporting requirements are comparable to the CFTC's capital and financial reporting requirements for such CSE, such that the CSE may satisfy its home country jurisdiction's capital and financial reporting requirements (subject to any conditions imposed by the Commission) in lieu of the Commission's capital and financial reporting requirements (*i.e.,* ''Comparability Determination'').

Consistent with section 4s(f), the Commission is requiring SDs and MSPs to satisfy current books and records requirements, ''early warning'' and other notification filing requirements, and periodic and annual financial report filing requirements with the Commission and with any RFA of which the SDs and MSPs are members.

D. Baseline

In determining the costs and benefits of this rulemaking, the Commission's benchmark from which this rulemaking was evaluated was the market's status quo, *i.e.,* the swap market as it exists today. As this final rule will implement capital and financial reporting on CSEs and recordkeeping requirements on SDs and MSPs, the Commission will discuss the incremental costs and benefits to each type or category of SD and MSP, as to their current capital and financial reporting and recordkeeping requirements. As each CSE or its parent holding company may be complying with current capital requirements, based on capital requirements that are a result of the entity or its parent entity registering with a financial agency, as a result of it being a financial intermediary (*e.g.,* as an BD, FCM or BHC), the Commission has set different baselines for each type or category of entity. In the case that a CSE does not have current capital requirements, the Commission considered the full cost and benefit of its amendments on the entity. The following is a list of types or categories of registered entities and their corresponding capital regimes that the CSE currently complies with, if there is any, and their corresponding financial reporting and capital requirements. [502] Therefore, the Commission is using the status quo or baseline to evaluate the costs and benefits of these final rules for the following types or categories of CSEs:

SDs That Are Bank Subsidiaries

- *Capital.* Currently U.S. CSEs that are bank subsidiaries and are not a BD or an FCM are not subject to capital requirements; however, as part of a BHC or a subsidiary of a bank, the CSE's parent entity must comply with the prudential regulators' capital requirements. In addition, certain non-U.S. CSEs that are subsidiaries within a bank holding company and are not BDs or FCMs are currently complying with a foreign jurisdiction's capital, liquidity and financial reporting requirements and these CSEs are covered below, in the Substituted Compliance section.
- *Reporting.* These SDs do have reporting requirements, but not for the information that is requested in this rulemaking; however, a BHC must report the requested information to the Federal Reserve Board, which includes certain swap and security-based swap positions held at its SD subsidiary.

SDs That Are BDs (Including, OTC Derivatives Dealers) (With and Without Models)

- *Capital.* If a CSE is also registered as a BD with the SEC, the CSE is already meeting the SEC's BD capital requirements.
- The SEC currently imposes the Net Liquid Assets Capital Approach on BDs. However, the SEC has modified certain parts of this approach to address certain types of BDs (*i.e.,* ANC Firms and OTC derivatives dealers). As discussed below, an ANC Firm is currently approved by the SEC to use capital models to calculate certain market and credit risk charges. In addition, OTC derivatives dealers may be approved by the SEC to use capital models provided that they maintain a minimum of $100 million in tentative net capital and at least $20 million in net capital. Certain non-U.S. SDs are already complying with capital, liquidity and reporting requirements in other jurisdictions. Therefore, the Commission will cover these SDs in the Substituted Compliance section.
- *Reporting.* As a BD, these SDs must comply with the SEC's BD reporting requirements (the Commission's amended reporting requirements are based on the SEC reporting requirements).

SDs That are FCMs and not BDs (With and Without Models)

- *Capital.* For CSEs that are also registered with the Commission as FCMs, the Commission's Net Liquid Assets Capital Approach that is similar to the capital requirements of a registered BD.
- *Reporting.* As an FCM, these SDs must comply with the Commission's FCM reporting requirements (the Commission's amended reporting requirements are based on these).

SDs That Are BDs and/or FCMs (ANC Firms With Models and One Other SD)

- *Capital.* For CSEs that are also registered as BDs/FCMs (using approved models), a significant percentage of these SDs are currently using the ANC capital approach, as discussed below. There is currently one other SD that is not an ANC Firm, but meets the requirements set out above for SD/BDs and FCM–SDs.
- *Reporting.* As an ANC firm, these SDs must comply with the SEC's and the CFTC's ANC firm reporting requirements.

Stand-Alone SDs and Commercial SDs (With and Without Models)

- *Capital.* Currently a CSE that is a stand-alone SD has no capital requirements; however, certain non-US Stand-alone SDs are complying with a foreign jurisdiction's capital, liquidity and reporting requirements and, therefore, will be included in the Substituted Compliance benchmark below.
- *Reporting.* As CSEs, these entities have reporting requirements, but not for the information required requested in this rulemaking.

[501] Section 17 of the CEA sets forth the registration requirements for RFAs. RFAs are defined as self-regulatory organizations under Commission regulation § 1.3 (17 CFR 1.3). The Commission recognizes that SDs that seek model approval from the Commission or from an RFA will be required to submit documentation addressing several capital models including value at risk, stressed value at risk, specific risk, comprehensive risk and incremental risk. To the extent that models are reviewed and approved by an RFA, additional costs may be incurred by the RFA which may be passed on to the SDs.

[502] The baseline of this CBC doesn't include those SDs that are also registered with the SEC as Security-based Swap Dealers (SD–SBSDs), as the SEC's rule will become effective at the same time as the Commission's Final rule. Therefore, unless SD–SBSDs are registered as another category of registered entities that impose capital requirements, this CBC will treat these entities as currently having no current capital requirements. However, the Commission recognizes that to the extent that the SEC's capital requirements for these dual registered SD–SBSDs require greater minimum capital than the Commission's Final Rule, the costs discussed below with be mitigated.

MSPs

• *Capital.* Although there are no MSPs at this time, it is possible that an MSP in the future may have existing capital requirements. For example, if a bank is determined to be an MSP or an insurance company, these entities may have existing capital requirements.

• *Reporting.* As MSPs, these entities have reporting requirements, but not for the information required in this rulemaking.

Substituted Compliance [503]

• *Capital.* As discussed above, there are certain non-U.S. CSEs that comply with a foreign jurisdiction's capital and financial reporting requirements. Commission staff understands that generally these foreign capital requirements are either a bank-based capital regime or a dealer-based regime, which, as the Commission has been informed by these foreign regulators, are similar to the Net Liquid Assets Capital Approach.

• *Reporting.* The Commission understands that some of these non-U.S. CSEs are currently complying with a foreign jurisdiction's financial reporting requirements; however, these financial reporting requirements may not be the same as the Commission is requiring in this rulemaking.

Prudentially Regulated SDs [504]

• *Reporting.* These SDs comply with their applicable prudential regulator's reporting requirements.

E. Overview of Approaches

In developing the capital approaches required herein, the Commission selected from well-established frameworks. As a result of the financial crisis and over the years after the crisis, each of the approaches has undergone significant analysis and changes.

The Commission is providing certain CSEs with an option to choose between a Bank-Based Capital Approach (similar to the prudential regulators' capital approach) and a net Liquid Assets Capital Approach (similar to the SEC's and CFTC's capital approach). As detailed below, the Bank-Based Capital Approach is designed to require an SD to have enough equity, including common equity tier 1 capital (as defined above), to absorb losses in a time of stress, while the net liquid assets method is designed to require an SD to hold at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities.

The following table summarizes the Commission's capital rules followed by a summary of each approach:

Approaches	SD entities	Equity type	The greatest of the following:
Net Liquid Assets Capital, Regulation 1.17, FCM Approach.	*SD–FCM*	Net Liquid Assets (Assets – Liabilities – Market Risk – Credit Risk).	$20 million or $100 million if approved to use capital models. 8% of the total customer and non-customer cleared margin, plus an additional 2% of the total amount of a swap dealer's initial margin on uncleared swaps. RFA.
ANC, Regulation 1.17 and SEC Rule 15c3–1.	*SD–FCM–ANC Approved Firm*	Net Liquid Assets (Assets – Liabilities – Market Risk – Credit Risk).	$5 billion tentative net capital (not discounted). $6 billion early warning net capital (not discounted). $1 billion Net Discounted Assets. 8% of the total customer and non-customer cleared margin, plus an additional 2% of the total amount of a swap dealer's initial margin on uncleared swaps. RFA.
Net Liquid Assets Capital, SEC Rule 15c3–1 or 18a–1.	*SD–BDs, SD–BDs (OTC Derivatives Dealers), SD–Non-Bank Subsidiaries of BHC, SD.*	Net Liquid Assets (Assets – Liabilities – Market Risk – Credit Risk).	$20 million. 2% of the total amount of a swap dealer's initial margin on uncleared swaps. RFA.
Bank-Based Capital	*SD–Non-Bank Subsidiaries of BHC, SD.*	Common Tier 1 Equity, Tier 1 or Tier 2, subject to limits [505].	$20 million. 8% of RWA. 8% of the total amount of a swap dealer's initial margin on uncleared swaps. RFA.
Tangible Net Worth Capital Approach.	*SDs–Non-financial Entities (15% test).*	Basic Equity (Assets – Liabilities – Goodwill).	$20 million plus market and credit risk charges. 8% of the total amount of a swap dealer's initial margin on uncleared swaps. RFA.
MSPs	*MSP*	Equity	≥$0. RFA.

[503] The Commission estimates that there are 24 SDs that may be eligible for substituted compliance under this rulemaking.

[504] The Commission notes that under section 4s(e) of the CEA, these SDs must comply with the prudential regulators' capital requirements, but must also comply with the Commission's reporting and recordkeeping requirements.

[505] Under the final rule, 6.5% of RWA must be met using CET1, the remaining amount is permitted to be met with capital in the form of Tier 1 or Tier 2, provided that subordinated debt meets the conditions in Commission regulation 18a–1d (17 CFR 240.18a–1d). In addition, $20 million must be comprised of CET1, and 8% of total amount of swap dealer's initial margin on uncleared swaps must be comprised of CET1, Tier 1 or Tier 2 capital as defined under banking rules.

1. Bank-Based Capital Approach

Under the Bank-Based Capital Approach a CSE would need to maintain regulatory capital that meets the following:

- $20 million of common equity tier 1;
- Six point five percent (6.5%) of common equity tier 1 capital equal to the sum of the following: (i) The amount of its risk-weighted assets (''RWA''), which is the market risk capital charge under a VaR computation or a standardized formula table (Reg. 1.17); (ii) the amount of current counterparty credit risk (''CCR''), which is the sum of the default risk capital charge and a credit value adjustment (''CVA'') risk capital charge, which is under either a standardized formula table or a VaR method, provided that an additional one point five percent (1.5%) of capital may be met with common equity tier 1 capital, additional tier 1 capital, or tier 2 capital (including subordinated debt subject to the conditions in SEC rule 18a–1d;
- Eight percent (8%) of the total amount of a swap dealer's uncleared swap initial margin comprised of common equity tier 1, additional tier 1, or tier 2 capital; and
- The amount required by its RFA.

As noted above, the Commission is requiring a $20 million fixed-dollar floor, as this is the minimum amount of required capital under all approaches. The Commission is requiring this minimum level as it believes that this is the minimum amount of capital that should be required for a CSE, without regard to the volume of swaps the CSE engages in, to conduct its dealing activity. As noted above, this amount is based on the Commission's experience with other registered entities that are currently subject to capital requirements. The Commission is also adopting, an eight percent (8%) of uncleared swap initial margin requirement, as through its experience in supervising FCMs, it recognizes that this capital computation is a determinative condition in computing their required capital and requires an SD to maintain a higher level of capital as the operational and other risks associated with its dealing activity base increases, as measured by the initial margin requirements on the swaps positions. As discussed above, under the Bank-Based Capital Approach, the Commission is maintaining the 8% level of initial margin requirement. The Commission believes that the 8% level is properly calibrated for the Bank-Based Capital Approach method in determining capital. Unlike the Net Liquid Assets Capital Approach, which leaves higher quality assets in determining the required level of capital, the Bank-Based Capital Approach uses its entire balance sheet in determining the amount of required capital. As a result of including all of its assets (*e.g.,* property, plant and equipment (''PP&E'')) in determining the capital requirement under the Bank-Based Capital Approach, the Commission believes that the 8% requirement is properly set, ensuring that the Commission meets its statutory requirements for harmonization. In addition, the Commission has determined to include only a SD's initial margin amount on its uncleared swaps in calculating its capital requirement under this prong of the Bank-Based Capital Approach. As discussed above in section II.C.3., the Commission did not include other instruments that require initial margin because it believes that these other instruments either do not contain the same level of risk to the SD as uncleared swaps (*e.g.,* cleared swaps) or are not within the products or markets for which the Commission typically regulates. The Commission recognizes that by not including these margined instruments in the minimum calculation, it may be decreasing the amount of required capital; however, these instruments are not removed from the required amount of capital component, which includes these positions net of applied market and credit risk charges. The Commission believes this approach better harmonizes the minimum calculation across the different elective approaches under the Commission's framework and in comparison to other regulators (namely, the SEC and the Federal Reserve Board and OCC).

In addition, the Commission has included a standardized table for market risk that is currently not part of the BCBS or prudential regulator capital framework. The Commission included the standardized table in calculating an SD's market risk charges to address SDs that do not use approved models in computing market risk charges. The Commission included the regulation 1.17 standardized market risk charges, as it believes these charges result in adequate capital computations for the level of market risk inherent in these financial instruments. In addition, the Commission is currently using these standardized charges in computing an FCM's market risk charges on the same financial instruments for an FCM's required capital.

2. Net Liquid Assets Capital Approach

Under this approach, an SD is required to maintain minimum net capital equal to or exceeding the greatest of:

- $20 million; or
- Two percent (2%) of the total amount of a swap dealer's uncleared swap initial margin.

Net capital is generally defined as an SD's current and liquid assets minus its liabilities (excluding certain qualifying subordinated debt), with the remainder discounted according to either a CFTC or RFA approved VaR-based model or a standardized rules-based approach set out in regulation 1.17.

As noted and discussed above, under this approach, the Commission requires a $20 million fixed-dollar floor. In addition, the Commission is adopting, under this approach, a net liquid assets test that is designed to allow an SD to engage in activities that are part of its swaps business (*e.g.,* holding risk inherent in swaps into its dealing inventory), but in a manner that places the SD in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (*e.g.,* money owed to customers, counterparties, and creditors). The Commission believes that the Net Liquid Assets Capital Approach, although structurally different than the Bank-Based Capital Approach, ensures the safety and soundness of the SD, while providing the same protections to the financial system.

As discussed above, under the Net Liquid Assets Capital Approach, the Commission is changing the proposed 8% level of initial margin requirement to 2%. The Commission believes that, under this approach, the 2% level is properly calibrated in determining an SD's capital requirement. As discussed above in section II.C.1., as a concept an 8% risk margin amount capital minimum component was originally proposed by the Commission in 2003, and subsequently adopted in 2004, to apply to FCMs. At the time, the Commission justified this minimum amount component based on an analysis and comparison of the amount to then existing FCM capital regime, which used a percentage of the customer funds held by an FCM as the minimum.[506]

[506] *See Minimum Financial and Related Reporting Requirements for Futures Commission Merchants and Introducing Brokers, 68 FR 40835 (July 9, 2003) and 69 FR 49784 (Aug. 12, 2004). See also, CFTC Division of Trading and Markets, Review of Standard Portfolio Analysis of Risk Margining System Implemented by the Chicago Mercantile Exchange, Board of Trade Clearing Corporation,*

Continued

The Commission originally proposed to use this same concept and percentage for use in determining SD minimum capital as means to harmonize the SD approach with Commission's experience and familiarity with its use in the existing FCM approach. Yet, the Commission recognizes that the Commission's margin requirements for uncleared swap positions generally impose a higher initial margin requirement relative to cleared futures positions, which justify using a different multiplied in the Net Liquid Assets Capital Approach.

Minimum initial margin requirements for cleared futures transactions are generally set by clearing organizations and typically have a different margin period of risk. In this regard, the FCM minimum capital requirement of 8% of the risk margin amount on futures is based upon margin calculations using clearing organization models that require a 99% one-tailed confidence interval over a minimum liquidation period of one day for futures.[507] In contrast, initial margin for uncleared swaps is required to be calculated at a 99% one-tailed confidence interval over minimum liquidation period of 10 business days (or the maturity of the swap if shorter).[508] The greater margin period of risk for uncleared swaps generally requires a higher level of initial margin, which when used in determining minimum capital results in a higher level of required capital relative to if cleared futures margin was alternative used. The modification of the final rule to set the risk margin amount multiplier at 2% for uncleared swap positions is therefore appropriate given the generally higher initial margin requirements imposed on such positions under the Commission's regulations relative to cleared positions.

As noted above, a 2% multiplier using uncleared swap margin is also justified under the Net Liquid Assets Capital Approach as compared to a 8% multiplier in Bank-Based Capital Approach and Tangible Net Worth Approach because of differences in the composition of capital under the approaches. Bank-Based Capital Approach and Tangible Net Worth Capital Approach do not account for illiquid assets when determining the amount of capital, thereby including a much greater composition of assets as compared to that under the Net Liquid Assets Capital Approach. Applying a higher more comparable multiplier percentage under Net Liquid Assets Capital Approach would result in much more stringent capital requirement and could make competition among SDs utilizing this approach exponentially more difficult, especially for SDs which may be required to use this approach as a result of dual-registration with the SEC as either a BD or SBSD.

3. Alternative Net Capital (''ANC'')

Under the ANC approach, an SD/BD or FCM would need to maintain its net capital in accordance with the following requirements:

- $1 billion net capital;[509]
- $5 billion tentative net capital;[510] and
- $6 billion early warning net capital.[511]

An SD that is registered with the SEC as a BD and is approved by the SEC to use internal models to compute certain market risk and credit risk capital charges (an ''ANC Firm'') will be able to continue to use the ANC approach in calculating its SD capital; however, with enhancements to the minimum capital requirements as adopted by the SEC.

An ANC Firm must maintain, at all times, tentative net capital, which is the net capital of an ANC Firm before deductions for market and credit risk, of $5 billion. In addition, an ANC Firm must maintain, at all times, early warning tentative net capital, which is the net capital of an ANC Firm before deductions for market and credit risk, of $6 billion. Lastly, an ANC Firm must maintain, at all times, $1 billion of net capital, which is net discounted assets (discounted by VaR models for market and credit risk).

In adopting this approach, the Commission recognizes that ANC Firms are dual registrants with the Commission and SEC that offer a wide-range of financial services and act as different types of intermediaries (*e.g.,* BD, FCM, SD). As a result of the additional complexity and risk inherent in these entities, and the Commission's experience with these ANC Firms, the Commission is increasing their minimum capital requirements consistent with the SEC.

The Commission expects that SDs that are ANC Firms will elect to use this capital approach for their swaps transactions. The Commission believes that since this approach has been in effect for more than 10 years and it properly accounts for the inherent risk and complexity of these firms, including their swap dealing activities, that it is appropriate to permit ANC Firms to continue using this approach, but with some enhancements based on the Commission's experience. As discussed above, the Commission is increasing the minimum capital requirements for ANC Firms in a manner consistent with the SEC's increases for ANC Firms. The Commission believes that the increases are appropriate to reflect the potential increase in swaps activities that ANC Firms may engage in, particularly if affiliates move their swaps activities into the ANC Firms to more efficiently use the capital held by the ANC Firms.

4. Tangible Net Worth

The Commission is adopting a Tangible Net Worth Capital Approach for both SDs and MSPs. With respect to SDs, the Commission is requiring an SD to maintain minimum net capital equal to or in excess of the greater of:

- $20 million plus market and credit risk charges;
- Eight percent (8%) of the total amount of a swap dealer's uncleared swap initial margin; or
- The amount required by its RFA.

The term tangible net worth is defined to mean an SD's net worth as determined in accordance with generally accepted accounting principles in the United States, excluding goodwill and other intangible assets.

As noted above, the Commission is adopting this approach as it recognizes that certain SD's that are primarily engaged in non-financial activities may engage in a diverse range of business activities different from, and broader than, the dealing activities conducted by a financial entity. An SD, availing itself of this approach, must meet the Commission's 15% revenue test and 15% asset test as discussed in section II.C.4. to demonstrate that entity or its parent/consolidated entity is primarily engaged in non-financial activities.

As discussed below, the Commission believes that the Tangible Net Worth Capital Approach meets statutory mandate, as it is designed to help ensure the safety and soundness of the SD, while calibrated to the inherent risk of the uncleared swaps held by the SD and the overall activity of the SD. As the Tangible Net Worth Capital Approach would only be available to SDs that are primarily engaged in non-financial activities, the Commission believes that this approach has proper controls to ensure that it is only able to be utilized by SDs which could not likely meet the other tests due to their unique position

and the Chicago Board of Trade (Apr. 2001) (''T&M 2001 Report''). *See,* IIB/ISDA/SIFMA 3/3/2020 Letter.

[507] *See* Commission regulation § 39.13(g) (17 CFR 39.13(g)).

[508] *See* Commission regulation § 23.154 (b)(2) (17 CFR 23.154(b)(2)).

[509] *See* SEC rule 15c3–1(a)(7) (17 CFR 240.15c3–1(a)(7)).

[510] *See Id.*

[511] *See Id.*

in commercial markets as well as the swap dealing markets.

With respect to MSPs, the Commission is requiring an MSP to maintain net tangible net worth in the amount equal to or in excess of the greater of the MSP's positive net worth or the amount of capital required by an RFA of which the MSP is a member. There are currently no MSPs and the only previously registered MSP were required to register as a result of their legacy swaps and not any current swap activity. The Commission believes that the capital requirements for MSPs are appropriate given that no entities are currently registered and the Commission is uncertain of the types of entities that may register in the future. As noted above, the Commission has taken this uncertainty into consideration by proposing to allow an RFA to establish an MSP's minimum capital requirements. Such RFA's are required under section 17 of the CEA to establish capital requirements for all members that are subject to a Commission minimum capital requirement. Accordingly, RFAs may adjust their rules going forward depending on the nature of any entities that may seek to register as MSPs, and adopt minimum capital requirements as appropriate. Such RFA rules must be submitted to the Commission for review prior to the rules becoming effective.

As discussed above, the Commission is maintaining the 8% level of initial margin requirement under the Tangible Net Worth Capital Approach. Similar to the discussion above in the Bank-Based Capital Approach, the Commission believes that the 8% level is properly calibrated. Unlike the Net Liquid Assets Capital Approach, which leaves higher quality assets in determining the required level of capital, the Tangible Net Worth Capital Approach uses a SD's entire balance sheet in determining the amount of required capital. As a result of including all assets, including illiquid assets (*e.g.,* PP&E) in determining the capital requirements, the Commission believes that the 8% requirement is properly set, ensuring that the Commission meets its statutory requirements. For the same reasons discussed above with the other approaches, the Commission also decided to include only a SD's initial margin amount on its uncleared swaps in calculating its capital requirement under this prong.

5. Substituted Compliance

As described above, the Commission is providing certain non-U.S. CSEs with the ability to petition the Commission for approval to comply with comparable foreign capital and financial reporting requirements in lieu of some or all of the Commission's requirements. The Commission recognizes that this may provide these CSEs with cost advantages by avoiding the costs of potentially duplicative or conflicting regulation.

In limiting the scope of substituted compliance, the Commission does not believe it should make available substituted compliance to all CSEs. The Commission is adopting substituted compliance only to non-U.S. CSEs, as it believes that it is necessary that its capital requirements apply to U.S. CSEs, as they are integral to the U.S. swaps market and critical in ensuring the stability of the U.S. financial system.

Additionally, the Commission recognizes that substituted compliance, to the extent that it puts conditions on its comparability determination, may result in additional costs to these CSEs; however, the Commission believes that providing a substituted compliance regime that allows for conditions instead of an all-or-nothing approach will benefit these CSEs and provide for a more competitive swaps market. Moreover, to the extent that a non-U.S. CSE must comply with a foreign regime and the Commission does not find that regime comparable, the Commission recognizes that these non-U.S. CSE may be burdened with additional costs and subject to conflicting and/or duplicative costs.

F. Entities

The following section discusses the related incremental costs and benefits of the rulemaking's capital approaches and reporting requirements on each type or category of SDs and MSPs. The Commission understands that certain SDs and MSPs organized and domiciled outside of the U.S. would be included in these types or categories of entities. These non-U.S. SDs and MSPs are discussed in the Substituted Compliance section below.

1. Bank Subsidiaries

Currently, all U.S. CSEs that are subsidiaries in a BHC and are not a BD or FCM currently are not subject to capital requirements;[512] however, their parent BHC complies with the Federal Reserve's capital requirements. Under the Federal Reserve Board's capital requirements, which are based on Basel III requirements, a BHC must maintain adequate capital for the entire consolidated entity.[513] That is, all the assets and liabilities of the BHC's consolidated subsidiaries are consolidated into the holding company. The Federal Reserve Board's capital requirements are then imposed on the BHC, requiring the BHC to maintain capital levels according to those requirements.

As these CSEs are not currently required to be separately capitalized, the Commission understands that this may add incremental cost to the consolidated entity and/or the CSE as they may have to retain earnings or further capitalize the CSE to the required capital levels. However, the Commission recognizes that a consolidated entity may capitalize one of its subsidiaries in many different ways, including retaining earnings from the CSE or from within the consolidated group. Even with this requirement imposing capital on the subsidiaries, as noted above, the BHC must maintain capital levels in accordance with the Federal Reserve Board's capital requirements, which are calculated on a consolidated basis; therefore, incremental costs may be mitigated, as it may be possible for the consolidated entity to keep the same level of capital within the BHC, but reallocated among its subsidiaries.[514] In addition, the Commission recognizes that earnings may now have to be retained in the CSE and may no longer be available to be reallocated to fund other more profitable activities within the consolidated group or to be returned to shareholders; however, the Commission believes that by providing these CSEs with the option of differing capital approaches, these CSEs will select the capital approach this is optimal for its operations, financial structure and which will reduce duplicative or conflicting rules and the administrative costs of calculating and maintaining additional sets of books and records.

[512] The Commission acknowledges that some subsidiaries in a BHC may be an insurance company and, therefore, may have capital requirements set by its insurance regulator. Such entities are outside the scope of the Commission's rulemaking as these entities are currently not registered with the CFTC as an SD or MSP. The Commission further acknowledges that there are some non-U.S. subsidiaries that are part of a bank and those subsidiaries and/or their parent may be subject to the capital regime of a foreign regulator. The Commission believes that in such a case, the capital regime that is likely to be applicable would be either the Basel III-based approach or a version of the net liquid assets approach.

[513] *See Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule;* Final Rule, 78 FR 62018 (Oct. 11, 2013).

[514] The Commission notes that the bank or an insurance company in a BHC must maintain certain capital and as such, may not be able available to capitalize the CSE.

The Commission believes that although the capital approaches adopted herein may be structurally different, they each require a CSE to maintain adequate capital levels commensurate to its regulated swap dealing activities, which should help ensure the safety and soundness of the CSE and the stability of the U.S. financial system.

In requiring capital for a bank subsidiary that is an SD, as discussed above, the SD may incur additional costs. As a result of the additional costs, some SDs may be put at a competitive disadvantage, when compared to those dealers with lesser capital requirements or with no capital requirements. As a result of this additional cost, some swap dealing activity may become too costly—becoming a low margin activity—and, therefore, some SDs may limit their dealing activity or exit the swaps market. Additional costs may also be passed on to customers in the form of higher prices; however, if these SDs are to remain competitive in the swaps market, they must compete by matching or beating prices of their competitors or provide other additional services to their customers. In addition, as most of the largest swap dealers are part of a BHC, these SDs are already incurring capital charges at the consolidated level, and, therefore, the incremental cost and the effect on competition and pricing of swaps may be mitigated. Because these SDs have the option to select the most optimal capital approach for them, they can control some of the burdens placed on them by the rules and thereby, mitigate the rulemaking's effect on pricing.

2. SD/BD (Without Models)

An SD that is also a BD that does not use SEC/CFTC-approved models to calculate its market and credit risk charges has the option to use either the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach, but with standardized capital charges for market risk and credit risk. The Commission recognizes that although it is giving an option to these SDs to comply with either approach, these SDs must still meet the SEC's BD capital requirement.

The standardized capital charges impose significant capital requirements for uncleared swaps primarily in the form of rules-based market risk charges and credit risk charges. The Commission does not anticipate that many SD/BDs engaging in significant swaps activity will do so using the standardized capital charges for market and credit risk.

3. SD/BD/OTC Derivatives Dealers (Without Models)

An SD that is registered with the SEC as an OTC derivatives dealer will have the option to comply with either the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach. As OTC derivatives dealers, these SDs already comply with the SEC's net liquid assets capital requirements. OTC derivative dealers also may be approved by the SEC to use internal models to calculate market and credit risk charges in lieu of standardized, rules and table-based capital charges for swaps, security-based swaps and other financial instruments.

The Commission believes that since SDs that are registered OTC derivatives dealers are already complying with the SEC's Net Liquid Assets Capital Approach, they will select this approach in meeting with the Commission SD's proposed capital requirements. The Commission believes that allowing these entities to continue using current capital requirements will reduce the possibility of duplicative or conflicting rules and administrative costs of calculating and maintaining additional sets of books and records. The Commission believes that this will result in only a small incremental cost to OTC derivative dealers.

The Commission recognizes that OTC derivatives dealers already have received approval from the SEC to use models in computing their current capital requirements and, therefore, will not incur any additional costs in developing and implementing this model-based approach in computing capital charges.

4. FCM–SD (Without Models)

An SD that is also registered with the Commission as an FCM that does not use models to calculate market and credit risk charges, must compute its capital in accordance with the standardized market and credit risk charges set forth in regulation 1.17. The Commission is amending certain provisions of regulation 1.17 to reduce the burden on an FCM engaging in swaps. The amendments align the FCM capital requirements with that of the Net Liquid Assets Capital Approach for SDs in regulation 23.101. In amending the requirements, the Commission believes that it is reducing the burden placed on SDs/FCMs, as the amount of capital on uncleared swaps would have been significantly higher under the current requirements and would have placed FCM–SDs at a competitive disadvantage. Specifically, regulation 1.17 currently does not allow an FCM to recognize collateral held at a third-party custodian as capital. Therefore, under regulation 1.17 an FCM–SD would have to take a 100 percent capital charge for margin posted with third-party custodians even though the Commission's uncleared margin rules require initial margin to be held at a third-party custodian. This is true even though the custodian has no ability to rehypothecate the initial margin and the SD has the ability to retrieve the initial margin back from the custodian with no encumbrance. Therefore, the Commission believes that its amendments to regulation 1.17 to allow an FCM–SD to recognize margin posted with third-party custodians in accordance with the Commission's margin rules allows an FCM–SD to meet its minimum level of required capital while also requiring an FCM–SD to maintain adequate capital levels, when considering the amount of initial margin that the SD has at its disposal in the event of a counterparty default.

As a result of the amendments, FCM–SDs should benefit from lower capital charges and should allow these FCM–SDs to continue to comply with one capital rule, which should mitigate some of the administrative costs and reduce the possibility of duplicative or conflicting rules. The Commission is not providing these SDs with an option to use the Bank-Based Capital Approach, as the Commission believes that this option is unnecessary and costly, and the current FCM capital approach reflects that the firm is not only a SD, but acts as an intermediary for customers on futures markets. The Commission has made amendments to account for FCM–SDs' swap activities and in allowing these FCMs to change their current capital method, the Commission believes that this would add an additional layer of complexity and costs to the FCMs, as the FCMs would have to change, modify or migrate all of their current systems to a new capital regime. In addition, the Commission believes that requiring the same capital regime, with beneficial amendments, is more appropriate in transitioning the Commission's capital requirements to these entities, as it should result in fewer burdens and a simple transition in implementing the Commission's amended capital requirements. Further, the Commission believes that this would simplify the Commission's ability to supervise these entities, as the Commission will be able to seamlessly transition from its current capital regime to these new requirements; however, the Commission recognizes that by not providing these

SDs with the option to use the Bank-Based Capital Approach it may be foreclosing the ability of these SDs to use a capital approach that may be more cost effective.

The Commission recognizes that by amending regulation 1.17 capital charges it is reducing the burden currently placed on FCM–SDs' swaps activities, which may result in greater liquidity in the swaps market, as this activity will be less costly and may incentivize these entities to engage in more swap dealing activity.

As a result of the amendments to regulation 1.17, these FCM–SDs may be able to realize some of the cost saving of the amendments when competing with other dealers for counterparties. This cost savings may also result in more efficient pricing for their counterparties. However, the Commission notes, as stated above, that as a result of the Commission's margin requirements for uncleared swaps these benefits may be limited.

5. ANC Firms (SD/BDs and/or FCMs That Use Models)

An SD that is an ANC Firm (*i.e.,* also a BD and/or FCM, with approval by the SEC/CFTC to use models in computing market risk and credit risk charges), will incur minimal additional capital charges, as a result of the amendments. The Commission is retaining this approach for these firms, but with an increase in the capital thresholds, as noted above. The Commission is making these amendments based on market experience in supervising ANC Firms, and in recognition that the amendments are consistent with the SEC's capital increases for ANC Firms. The Commission notes that the current ANC Firms are already maintaining more than the amended thresholds; however, by increasing these capital requirements the Commission recognizes that this may have an additional cost, as ANC Firms will now be required to maintain these capital levels, as under the current capital thresholds, these were held at their discretion.

The Commission recognizes that ANC firms already have received approval from the to use models in computing their current capital requirements and, therefore, they will not incur any additional costs in developing and implementing this model-based approach in computing capital charges.

6. Stand-Alone SD (With and Without Models)

A stand-alone SD is provided with an option to comply with either the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach. In providing this option, the Commission, as discussed above, believes that both options provide adequate capital requirements and account for the financial activities of an SD. Therefore, the Commission believes that these SDs will benefit, as these SDs will have the ability to select the most optimal approach, based on their organizational and operational structure and the composition of their assets. In addition, this option will also reduce the possibility of duplicative or conflicting rules and administrative costs of calculating and maintaining additional sets of books and records.

A stand-alone SD that does not use models must compute their market risk and credit risk charges in accordance with rules-based requirements and standardized tables. The Commission recognizes that under the Bank-Based Capital Approach, market risk charges are calculated with a prudential regulator's approved model; however, to allow stand-alone SDs to use the Bank-Based Capital Approach without a model, the Commission is incorporating regulation 1.17 market risk charges into the framework. In providing this alternative, the Commission is providing an option to those stand-alone SDs that do not have Commission-approved models. In doing so, the Commission is providing these SDs with a benefit, as they are still able to choose the most efficient capital approach. The Commission incorporated regulation 1.17 market risk charges, as amended, as it believes that this is a well-established method that properly accounts for market risk charges.

However, the Commission recognizes that many of these entities are not currently subject to minimum capital requirements, and as such, will incur additional costs on all of their financial activities, including their swap activities, which may result in possible increases in costs and pricing. In addition, a stand-alone SD selecting to use models in computing its market and credit risk charges may incur additional costs in developing and implementing these models.

The Commission recognizes that by requiring capital for SDs this may put these SDs at a competitive disadvantage, when compared to those dealers with a lesser capital requirement or with no additional capital requirements as a result of these rules. As a result of this additional cost, some swap activities may become too costly and, therefore, some SDs may limit their activity or exit the swaps market. This additional cost may in turn be passed on to customers in the form of higher prices; however, if these SDs are to remain competitive in the swaps market, they must compete by matching or beating prices of their competitors or provide other additional services to their customers. If an SD decides to limit its activity or withdraw from the swaps market, this may result in a reduced level of liquidity in the swaps market.

In requiring minimum capital requirements, the Commission believes that it is complying with its statutory mandate, as these standards are calibrated to the level of risk in an SD and are designed to help ensure safety and soundness of the SD and the stability of the U.S. financial system. In addition, the Commission's proposal is modeled after two well-established capital regimes, which should help ensure safety and soundness of the SD and competition among all registered SDs.

7. Non-Financial SD (With and Without Models)

An SD or an SD that has a parent that is predominantly engaged in non-financial activities, as defined in regulation 23.100 (85% non-financial threshold), may use the Tangible Net Worth Capital Approach. This approach is designed after GAAP's tangible net worth computation and excludes intangibles and goodwill.[515] The Commission is also requiring that the non-financial SD include in its capital requirement its market risk and credit risk charges.

The Commission believes that this approach, which is tailored to non-financial entities that are SDs or have a SD in its corporate family, provides these entities with the flexibility to meet an appropriate capital requirement, without requiring the firms to engage in costly restructuring of their operations and business. The Commission recognizes that these SDs deal in swaps, but the Commission also recognizes that these entities or their parent entity are primarily engaged in commercial activities and these SDs primarily transact with commercial clients. BCBS and the Commission did not fully consider this type of business model when developing the Bank-Based Capital Approach and the Net Liquid Assets Capital Approach. In allowing these entities to maintain their current structure, the Commission believes that its approach will allow for less disruption to these SDs and in the markets, as these SDs may serve smaller clients that would not otherwise be able to participate in the swaps market

[515] Under GAAP, tangible net equity is determined by subtracting a firm's liabilities from its tangible assets.

without these SDs. However, the Commission, in helping to ensure the safety and soundness of these SDs, is requiring that these entities maintain a level of tangible net worth equal to or greater than the greatest of (i) $20 million plus the SD's market and credit risk charges, (ii) eight percent of its uncleared swaps initial margin amount or (iii) the amount of capital required by an RFA, as this would account for the SD's exposure (market and credit risk) to the swaps markets, without penalty to the SD's or the SD's parent's commercial activities.

In developing this approach, the Commission also recognizes that the commercial activities of a commercial SD could affect the overall financial health of the SD. That is, in the event of a substantial loss emanating from its commercial activities, this loss may have a substantial negative affect on the SD, which may find itself in financial distress. As the Commission is not accounting for the risk in the commercial activities, it is possible that the amount and type of capital that a commercial SD is required to maintain may not be adequate to prevent the failure of the SD, which then will affect all of its swap counterparties. However, in tailoring this method to these commercial SDs, the Commission is taking a position that is consistent with the Commission's prior positions on commercial entities, as it believes these commercial entities and their corresponding activities present less default and systemic risk than a financial entity.[516]

The Commission recognizes that these entities are not currently subject to minimum capital requirements, and as such, will incur additional costs due to the imposition of a capital requirement on all of their swap dealing activities, which may result in possible increases in pricing; however, as the Commission has developed its capital requirements to better account for activities in these commercial SDs, it believes that the additional cost should be mitigated by this approach.

In addition, as the Commission expects that many of these SDs will use models in computing its market and credit risk charges, this may also result in additional costs in developing and implementing these models; however, this cost should be mitigated by the savings that may be realized by using such models.

8. MSP

An MSP must maintain capital (*i.e.,* tangible net worth) of the greater of positive tangible net worth or the amount of capital required by a RFA of which the MSP is a member. This approach is designed after GAAP's tangible net worth computation and excludes intangible assets and goodwill. Currently there are no MSPs. The Commission cannot determine if other entities will register in the future as MSPs, however, the Commission is required to adopt a capital requirement to address potential future registrants.

In adopting the Tangible Net Worth Capital Approach for MSPs, the Commission is allowing these entities to continue their operations if they become registered as MSPs with little to no changes to the entities' structures. In providing for this, the Commission believes that these entities if they become registered as MSPs will incur minimal additional costs to comply with the proposed requirements.

The Commission believes that the adopted capital requirements will help ensure the safety and soundness of MSPs, as these entities will typically be posting and collecting margin on all of their new uncleared swaps and, therefore, as these MSPs are registered only as a result of being an end user of swaps and not a swap dealer, the margin requirements satisfy most of the safety risk for these entities, which is on a $1 for $1 basis, than through more burdensome capital requirements. Therefore, the Commission is only requiring MSPs to maintain solvency, while noting that the entity may be subject to other capital requirements and hence required to comply with those capital requirements.

As the Commission's capital requirements will result in minimal additional costs to these MSPs, there should be little to no effect on competition, as they are end users (*i.e.,* price takers) and little to no incremental effect on pricing.

9. Substituted Compliance

A non-U.S. CSE that is already complying with a comparable foreign jurisdiction's capital or financial reporting regime is provided with the ability to meet the Commission's capital requirements by meeting the foreign jurisdiction's capital requirements. In providing these CSEs with the ability to continue to comply with their current capital and financial reporting regimes the Commission believes that it is limiting the potential for conflicting and duplicate capital requirements. In addition, as each foreign jurisdiction must be determined to be of comparable effect, which mitigate the possible negative impacts on the U.S. financial system.

The Commission further recognizes that non-U.S. CSEs that use conditional substituted compliance may incur additional costs; however, the Commission believes that conditional substituted compliance provides an offsetting benefit to these CSEs as it allows for a conditional substituted compliance determination instead of an all-or-nothing approach, which may result in the Commission not recognizing a foreign jurisdictions capital requirements, resulting in more substantial additional cost, including possible conflicting and/or duplicative requirements.

G. Liquidity Requirements

The Commission proposed to require FCM–SDs and covered SDs electing the Bank-Based Capital Approach or the Net Liquid Assets Capital Approach to satisfy specific liquidity requirements.[517] The proposal required covered SD electing the Bank-Based Capital Approach to meet the liquidity coverage ratio requirements set forth in 12 CFR part 249.[518] In addition, the proposal required covered SDs electing the Net Liquid Assets Capital Approach and FCM–SDs to adopt a liquidity stress test requirement that was similar to those undertaken by SEC ANC Firms.[519]

The Commission proposed these requirements to address the potential risk that a covered SD or FCM–SD may not be able to meet both expected and unexpected current and future cash flows, including collateral needs. As noted above, the Commission is not adopting these requirements. Therefore, by not including these requirements, the Commission recognizes that it may be increasing risk to the financial system. The Commission realizes that it is possible for a firm to have enough capital, but not enough liquidity to continue its operations as an ongoing business. These requirements were intended to ensure that SDs would have enough liquid assets to meet liabilities, which would help it during a liquidity crisis—ensuring the short-term continuing operations of the SD. However, the Commission believes this increased risk to the financial system is mitigated by the Commission's regulation 23.600, which imposes liquidity requirements on covered SDs. Regulation 23.600 requires each SD to establish, document, maintain, and enforce a system of written risk management policy and procedures designed to monitor and manage the

[516] *See e.g.,* 17 CFR 39.6.

[517] *See 2016 Capital Proposal,* 81 FR 91252 at 91273–75.

[518] *Id.*

[519] *Id.*

risk associated with the covered SD's swaps activities, including liquidity risk. In addition, for those SDs that are part of a bank holding company, the bank holding company must comply with high quality liquid asset requirements, which should mitigate this increased risk at these SD. Finally, this risk is greatly reduced for firms electing the Net Liquid Assets Capital Approach, which already incorporates a liquidity component into its primary determination of the capital amount.

In not adopting these requirements, the Commission believes that SDs will be provided with greater flexibility in meeting its current liquidity needs. This should allow SDs to allocate their funds in a more efficient manner, which may result in a greater return on capital, as they will no longer need to set aside funds in low-returning assets.

H. Equity Withdrawal Restrictions

In the Final Rule, the Commission is prohibiting certain withdrawals of equity capital from covered SDs.[520] The equity withdrawal restriction generally provides that the capital of a covered SD, or any subsidiary or affiliate of the covered SD that has any of its liabilities or obligations guaranteed by the covered SD, may not be withdrawn by action of the covered SD or by its equity holders if the withdrawal would result in the covered SD holding less than 120 percent of the minimum regulatory capital that the covered SD is required to hold pursuant to proposed regulation 23.101. As discussed above in section II. C. 9., the Commission adopted these requirements to ensure the safety and soundness of the covered SD and the integrity of the financial system, because the Commission believes that the withdrawal, loan or advance may be detrimental to the financial integrity of the covered SD. In addition, these transactions may unduly jeopardize the covered SD's ability to meet its financial obligations to counterparties or to pay other liabilities which may cause a significant impact on the markets or expose the counterparties and creditors of the covered SD to loss. However, the Commission notes that in adopting these requirements, the Commission may be limiting the consolidated entity's, including the covered SDs and their affiliates, financial flexibility. That is, these requirements may limit the ability of the consolidate entity to allocate capital, at a critical time, to an entity that may need funding or an entity with a greater rate of return. The Commission recognizes this, but, as stated above, believes that if it permitted this activity, it may cause significant impact on the financial system.

I. Reporting and Recordkeeping Requirements

The recordkeeping, reporting and notification requirements set out in this rulemaking are intended to facilitate effective oversight and improve internal risk management, via requiring robust internal procedures for creating and retaining records central to the conduct of business as an SD or MSP. Requiring registered SDs and MSPs to comply with recordkeeping and reporting rules should help ensure more effective regulatory oversight. The amendments will help the Commission determine whether an SD or MSP is operating in compliance with the Commission's capital requirements and allow the Commission to assess the risks and exposures that these entities are managing.

As detailed above in Section II.D., the Commission is requiring all SDs to file certain financial information pertaining to their capital requirements. Those SDs that are prudentially regulated are provided with the option to submit their financial information that is reported to their prudential regulator to the Commission. In addition, those SDs that are also FCMs may file their financial information pertaining to their capital requirements with the Commission, including notices, in the same manner as they currently report. For those SDs that are also registered with the SEC as a BD or a SBSD, these SDs may file the same financial information to the Commission, as they file with the SEC. In filing the required financial information with the Commission, these entities must file through the Winjammer electronic filing system. Alternatively, these same SDs have the option to report their financial information like stand-alone SDs, commercial SDs and MSPs report their financial information to the Commission. The Commission is providing this option, as the information reported to the Commission under this proposal and that is filed with the Commission or other financial regulatory agencies are similar, as the information provides the Commission with the ability to assess and monitor an SD's financial condition and whether the SD is currently meeting the Commission's capital requirements. In permitting these SDs to use their current required information, the Commission believes that this should mitigate some additional costs to prepare and report this information to the Commission. In addition, these SDs should already have developed policies, procedures and systems to aggregate, monitor, and track their swap dealing activities and risks. As such, this should also mitigate some of the costs incurred under the rulemaking.

Those SDs and MSPs that are not subject to current capital requirements will have to develop and establish policies, procedures and systems to monitor, track, calculate and report the required information. In developing these policies, procedures and systems, these SDs will incur costs; however, as these entities are registered with the Commission as SDs, the Commission believes that they should already have developed policies, procedures and systems to aggregate, monitor, and track their swap activities and risks, as is required under the Commission's swap dealer framework. This should mitigate some of the burdens of the reporting and recordkeeping requirements. In addition, as the information that the Commission is requiring is based on GAAP or another accounting method, this information is already being prepared for other purposes and therefore, should again mitigate the costs in meeting these requirements.

The Commission also believes that as a result of the reporting and recordkeeping requirements, SDs should be able to more effectively track their trading and risk exposure in swaps and other financial activities. To the extent that these SDs can better monitor and track their risks, this should help them better manage risk.

As noted in the section F.9., the Commission is providing substituted compliance to certain non-U.S. CSEs. As discussed above and for the same reasons, the Commission believes that, in regards its reporting requirements, providing substitute compliance to these non-U.S. CSEs it should reduce the possibility of additional costs and duplicative or conflicting requirements.

J. Section 15(a) Factors

The following is a discussion of the cost and benefit considerations as it relates to the five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.

1. Protection of Market Participants and the Public

The rules are intended to strengthen the swaps market by requiring all CSEs to maintain a minimum level of capital. These minimum capital requirements should enhance the loss absorbing

[520] *See* 23.104(a) and (b).

capacity of CSEs and reduce the probability of financial contagion in the event of a counterparty default or a financial crisis. In addition, capital functions as a risk management tool by limiting the amount of leverage that a CSE can incur. Financial reporting requirements for CSEs should help the Commission and investors monitor and assess the financial condition of these CSEs. As this rulemaking is designed to protect financial entities from default, this should have a direct benefit to the public, as the failure of these CSEs could result in a financial contagion, which could negatively impact the general public. On the other hand, the capital rules may require additional capital to be raised and will increase the cost of swaps for all market participants, as described above.

2. Efficiency, Competitiveness, and Financial Integrity of Swaps Markets

The Commission seeks to promote efficiency and financial integrity of the swaps market, and where possible, mitigate undue competitive disparities. Most notably, the Commission aligned the regulations with that of the prudential regulators', SEC's and the Commission's current capital frameworks to the greatest extent possible. Doing so should promote greater operational efficiencies for those SDs that are part of a BHC or are also registered with the SEC as a BD or the Commission as an FCM, as they may be able to avoid creating duplicative compliance and operational infrastructures and instead, rely on the infrastructure supporting the other registered entities. In addition, this approach should also enhance efficiency and limit conflicting rules, as these entities can continue to operate under their current regimes. Moreover, the amendments permit CSEs to calculate credit and market risk charges under a standardized or model-based approach, which allows them to choose the methodology that is the most suitable for their asset composition.

The Commission notes that the capital rule, like other requirements under the Dodd-Frank Act, could have a substantial impact on competition in the swaps market. As the Commission's capital rule will result in additional costs to certain CSEs that do not have current capital requirements, these CSEs may either limit their swap activities or withdraw from the swaps market. In this event, it is possible that this may result in less competition and increases in prices of swaps. Depending on the relative cost of the Commission's capital requirements compared with corresponding requirements under prudential regulators' regime, SEC's regime or in other jurisdictions, certain CSEs may have a competitive advantage or disadvantage; however, the Commission, in developing the capital rule, harmonized it with those of the prudential regulators and the SEC to the maximum extent practicable.

As noted above, the Commission, recognizing that SDs are critical to the financial integrity of the financial markets, designed their capital requirements to help ensure the safety and soundness of these SDs. In doing so, this should protect an SD in the event of a default by its counterparty or a financial crisis, which the Commission determines should reduce the probability of financial contagion.

3. Price Discovery

As noted above, the capital rule may have a negative effect on competition, as a result of increasing costs, which may result in some SDs limiting or withdrawing from the swaps markets. In that event, this negative effect on competition could result in a less liquid swaps market, which will have a negative effect on price discovery. However, as discussed above, most of the larger SDs or their parent entities are already subject to capital requirements that impose capital charges for their swap activities and, therefore, the rule's negative impact on competition, liquidity and price discovery should be limited, and in any event is outweighed by the increased benefit of the longer term safety and soundness of the entities that provide price discovery.

4. Sound Risk Management Practices

A well-designed risk management system helps to identify, evaluate, address, and monitor the risks associated with a firm's business. As discussed above, capital plays an important risk management function and limits the amount of leverage an entity can incur. In addition, capital serves as the last line of defense in the event of a counterparty default or severe losses at a firm. The Commission's capital rule is developed from two well-established capital regimes. Therefore, the Commission's capital rule should promote increase risk management practices within a CSE. Moreover, the Commission believes that as a result of the reporting and recordkeeping requirements, SDs may more effectively track their trading and risk exposure in swaps and other financial activities. To the extent that these SDs can better monitor and track their risks, this should help them better manage risk within the entity.

5. Other Public Interest Considerations

The Commission has not identified any additional public interest considerations related to the costs and benefits of the proposed rule.

K. Attachment A to Cost Benefit Considerations

i. Minimum Capital Requirement

Due to data availability, the Commission's analysis is focused on cost arising from minimum capital requirements. As discussed above, this rulemaking would prescribe capital requirements for SDs and MSPs that are not subject to a prudential regulator, and amendments to existing capital rules for FCMs would prescribe capital requirement for FCMs that are also registered as SDs and increase capital requirement for FCMs to account for risk arising from their swaps and security-based swaps. The Commission discusses cost at the entity level. The analysis below makes many assumptions that assume away complex details and the marginal cost resulting from the final rule would be much larger and proportionally larger for smaller entities. Please note that the true magnitude of cost is unknown.

As of June 3, 2020, there are approximately 108 SDs and no MSPs provisionally registered with the Commission. The Commission estimates that out of the 108 provisionally registered SDs, 15 U.S. Prudential Regulated Registrants SDs are exempt from the Commission's capital requirement; 38 SDs which are Non-U.S. Registrants Overseen by the FRB are also exempt from the Commission's capital requirement. For the rest of the 56 provisionally registered SDs, 4 SDs are also registered with the Commission as FCMs, while the other 52 SDs are not FCMs.

The cost benefit considerations noted in the *2016 Capital Proposal* included an analysis of interest rate swap position data for the purposes of extrapolating certain possible ranges regarding the possible cost of capital at Commission registered SDs. The Commission noted at the time that this was because interest rate swaps represent a majority of the swaps notional reported to swap data repositories. The Commission received no comments specifically addressing this analysis and upon further review has concluded that utilizing Part 45 data for this exercise could be problematic; drawing conclusions of estimated capital costs from the one particular type of swap data does not adequately reflect the variety of SDs and their respective dealing books under the

Commission's jurisdiction. The Commission has updated other tables that were included to reflect current registrations. The quantitative data noted herein reflect data either reported on existing Commission filings from these registrants or is readily available to the public as part of the bank or financial holding company public disclosure process.

Discussing Capital Requirement Cost at Entity Level

The Commission collects monthly financial and capital information from FCMs. There are currently four SDs that are also registered as FCMs. For the purpose of discussing cost of complying with these minimum capital requirements, the Commission further separates these SDs that are also FCMs into two categories: SDs that are also SEC registered ANC firms, and FCMs that are not ANC firms registered with the SEC.

1. SDs That Are FCMs and ANC Firms With the SEC

TABLE 1—CAPITAL FOR SDS THAT ARE ALSO FCMS AND ANC FIRMS AS OF APRIL 30, 2020

Name of swap dealers	Registered as	Adjusted net capital	Net capital requirement	Excess net capital
CITIGROUP GLOBAL MARKETS INC	FCM BD SD	$9,448,443,343	$ 4,041,143,110	$5,407,300,233
GOLDMAN SACHS & CO	FCM BD SD	19,731,764,252	4,116,348,831	15,615,415,421
JP MORGAN SECURITIES LLC	FCM BD SD	23,422,668,118	5,808,368,054	17,614,300,064
MORGAN STANLEY & CO LLC	FCM BD SD	12,993,998,405	4,109,846,691	8,884,151,714

Source: FCM financial data as of April 30, 2020.

The Commission estimates that four SDs are already registered as ANC BDs with the SEC. Under the *2019 SEC Final Capital Rule,* ANC firms registered with the SEC are required to maintain a minimum of five billion dollars of tentative net capital and a minimum of one billion dollars of net capital. In addition, all ANC firms use models for risk charge computations. These minimum capital requirements for ANC firms by the SEC are much higher than the minimum capital requirements adopted by the Commission, thus are more likely the binding constraints for these firms. Based on financial information reported by these SDs in their monthly reports filed with the Commission, these four SDs maintain a significant amount of net capital in excess of SEC's requirement and the Commission's capital requirement. Therefore, the Commission expects that the likelihood of these entities needing to raise additional capital due to this rule might be low; however, there may be other significant costs for these entities to comply with this capital requirement. The true magnitude of these costs is hard to predict due to the complexities of these rules.

2. SDs That Are FCMs but Currently Are Not ANC Firms Registered With SEC

There are currently no provisionally registered swap dealers which are registered as FCMs but not ANC firms registered with the SEC. As noted in the 2016 Proposal, there were four previously provisionally registered SDs in this category, but withdrew their registration. The Commission understands that a majority of these SDs engaged in forex dealing business exited swaps dealing as result of the adoption of other regulatory requirements, namely the uncleared margin rules. Accordingly, the Commission does not expect there to be any other type of FCM registered as a SD and thus is not further considering the costs of capital for these entities.

For SDs that are not FCMs, the Commission prescribes the following minimum capital requirements depending on whether SDs are financial entities or commercial entities. Standardized approach to calculate credit and market risk may not be tailored to specific business models of SDs. Developing risk models for capital purposes and going through model approval process might be much more costly for SDs that currently do not have a formal model approval process in place. For the purpose of discussing the cost of complying with minimum capital requirement, the Commission separated stand-alone SDs into following categories.

3. Nonbank U.S. Subsidiaries of Bank Holding Companies (BHCs) or Financial Holding Companies Subject to Basel III Capital Regime

These SDs currently do not have any capital requirement, and the capital requirement resulting from this final rule may increase cost to these SDs as it may have to raise capital to the required level. However, U.S. parents of the SDs in this category are currently subject to the Federal Reserve's capital requirements on a consolidated basis, including U.S. Basel III capital requirement and also are participants of the Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act Stress Test (DFAST). CCAR evaluates the capital planning process and capital adequacy of the largest U.S.-based BHCs, including the firms' planned capital actions. The Dodd-Frank Act stress tests are a forward-looking component to help assess whether firms have sufficient capital to absorb losses and have the ability to lend to households and businesses even in times of financial and economic stress. Similarly, other SDs in this category are subsidiaries of foreign BHCs or a foreign financial holding company (FHC), which already comply with Basel III risk-based capital requirements and having common equity tier 1 capital ratio at consolidated level exceeding eight percent. The parent BHCs of these nonbank SDs, set out in the table below, are well capitalized due to these requirements, as indicated by their common equity tier 1 capital ratio at the consolidated level, which is much higher than eight percent.

Therefore, assuming that these SDs would use the Bank-Based Capital Approach, the final rule requires common equity tier 1 capital, additional tier 1 capital, or tier 2 capital to be equal or greater than the minimum requirement, that is, max [$20mm, 8%* RWA,[521] 8% * Risk Margin, RFA requirement] to be considered well-capitalized. Assuming risk margin based requirement is not the binding constraint, and CET1 qualified instruments are the same across jurisdictions, the additional CET1 capital required from the Commission's capital requirement may not be significant, as it may be possible for the consolidated entity to keep the same

[521] Under the final rule, 6.5% of RWA must be met using CET1, the remaining amount is permitted to be met with capital in the form of Tier 1 or Tier 2, provided that subordinated debt meets the conditions in Commission regulation 1.17(h) (17 CFR 1.17(h)).

level of capital within the BHC, but just reallocate among its subsidiaries.[522] In addition, the Commission recognizes that earnings will now have to retain in the SD and will no longer be available to be reallocated to fund other more profitable activities within the consolidated group or to be returned to shareholders. The Commission understands that capital is not additive, *i.e.,* the sum of capital at individual subsidiary level may be more than the amount of capital required at the parent level for all its subsidiaries, due to the loss of netting benefits.

TABLE 2—SD'S PARENT BHC'S COMMON EQUITY TIER 1 CAPITAL RATIO AS OF FIRST QUARTER 2020

Name of swap dealers	Common equity tier 1 capital ratio of parent BHC	SEC registered BD
CITIGROUP ENERGY INC	Citigroup Inc. 11.1%[523]	N
CREDIT SUISSE CAPITAL LLC	Credit Suisse 12.1%[524]	Y
GOLDMAN SACHS FINANCIAL MARKETS LP	Goldman Sachs 12.3%[525]	Y
GOLDMAN SACHS MITSUI MARINE DERIVATIVE PRODUCTS LP.	Goldman Sachs 12.3%	N
ING CAPITAL MARKETS LLC	ING Group 13.97%[526]	N
J ARON & COMPANY	Goldman Sachs 12.3%	N
MERRILL LYNCH CAPITAL SERVICES INC	Bank of America 10.8%[527]	N
MERRILL LYNCH COMMODITIES INC	Bank of America 10.8%	N
MIZUHO CAPITAL MARKETS LLC	Mizuho Financial Group 11.65%[528]	N
MACQUARIE ENERGY LLC	Macquarie Bank 12.2%[529]	N
MORGAN STANLEY CAPITAL GROUP INC	Morgan Stanley 15.3%[530]	N
MORGAN STANLEY CAPITAL SERVICES LLC	Morgan Stanley 15.3%	N
MORGAN STANLEY CAPITAL PRODUCTS LLC	Morgan Stanley 15.3%	N
NOMURA DERIVATIVE PRODUCTS INC	Nomura Holdings 18.06%[531]	N
NOMURA GLOBAL FINANCIAL PRODUCTS INC	Nomura Holdings 18.06%	Y
SMBC CAPITAL MARKETS INC	SMFG 15.55%[532]	N

As discussed above, the Commission expects these SDs would use models to calculate market risk and credit risk charges. Their parents BHCs most likely are already using their risk models to calculate capital for the positions of these wholly owned subsidiaries (including uncleared swaps) to measure the credit and market risk exposures of these positions.

4. U.S. SDs That Are Not Part of BHCs

The Commission estimates that there are approximately 8 U.S. SDs not part of BHCs or financial holding companies that comply with Basel III capital requirements. These SDs currently do not have any capital requirement. However, these SDs are part of groups that are already subject to the CFTC's or the SEC's net capital requirements. These SDs' consolidated group has excess net capital ranging from $32 million to $1.3 billion.[533] As it is possible for the consolidated entity to keep the same level of capital within the group, by reallocating it among subsidiaries, the additional cost of complying with the Commission's capital requirement may not be too burdensome. However, for those SDs or their consolidated groups that currently have smaller amount of excess net capital, they might need to raise additional capital and thus might incur significant cost to comply with the Commission's capital requirement. However, given the complexities of the final rule, the compliance cost to some SDs might be significant, particularly for certain business models.

TABLE 3—CURRENT CAPITAL REQUIREMENT (EXCESS NET CAPITAL) AT THE SD OR ITS PARENT LEVEL

Name of swap dealers	Excess net capital at entity or its parent level	SEC Registered BD
BTIG LLC	[534] 85,162,256	Y
GAIN GTX LLC	[535] 32,628,137	N

[522] For purposes of this analysis, the Commission is only using CET1 as a comparison since this represents the majority of eligible capital under the approach. The Commission expects firms to use permitted subordinated debt to comprise the remaining amount of capital.

[523] *https://www.citigroup.com/citi/investor/data/p200423a.pdf?ieNocache=743.*

[524] *https://www.credit-suisse.com/about-us-news/en/articles/media-releases/1q20-financial-report-202005.html.*

[525] *https://www.goldmansachs.com/investor-relations/financials/current/other-information/1q-pillar3-2020.pdf.*

[526] *https://www.ing.com/web/file?uuid=e0fcbfe7-f4a7-4746-af3b-b112c5e9b302&owner=b03bc017-e0db-4b5d-abbf-003b12934429&contentid=49857&elementid=2138555.*

[527] *https://mms.businesswire.com/media/20200415005331/en/785157/1/Q1_2020_Bank_of_America_Financial_Results_Press_Release.pdf?download=1.*

[528] *https://www.mizuho-fg.com/investors/financial/basel/capital/data2003/pdf/fg_fy01.pdf.*

[529] *https://www.macquarie.com/assets/macq/investor/regulatory-disclosures/2020/MBL-Basel-III-Pillar-3-capital-disclosures-032020.pdf.*

[530] *https://www.morganstanley.com/about-us-ir/shareholder/1q2020.pdf.*

[531] *https://www.nomuraholdings.com/company/group/holdings/pdf/basel_201912.pdf.*

[532] *https://www.smfg.co.jp/english/investor/library/basel_3/2020/2020_fg_e_cc1.pdf.*

[533] Selected FCM Financial Data as of April 30, 2020.

[534] At December 31, 2019, BTIG LLC's net capital was $85,412,256 which was $85,162,256 in excess of its minimum requirement.

[535] GAIN GTX LLC is a wholly owned subsidiary of GAIN Capital Holdings, Inc., a global provider of online trading services. GAIN Capital Group LLC (a CFTC registered FCM and RFD) is also subsidiary of GAIN Capital Holdings, Inc. and has excess net capital of 14,821,951.

[536] Excess net capital of INTL FCSTONE FINANCIAL INC (FCM and BD) as of Apr. 30, 2020.

[537] Excess net capital of Jefferies LLC, parent of Jefferies Derivative Products LLC, Jefferies Financial Products LLC, and Jefferies Financial Services LLC.

[538] Excess net capital at Cantor Fitzgerald & CO. (FCM and Broker-Dealer), which is owned by Cantor Fitzgerald Securities (94% ownership).

[539] Excess net capital of E D & F MAN CAPITAL MARKETS INC (FCM and BD) as of Apr. 30, 2020.

[540] At December 31, 2018, excess net capital was $1 .09 billion for Citadel Securities LLC, a registered BD.

TABLE 3—CURRENT CAPITAL REQUIREMENT (EXCESS NET CAPITAL) AT THE SD OR ITS PARENT LEVEL—Continued

Name of swap dealers	Excess net capital at entity or its parent level	SEC Registered BD
INTL FCSTONE MARKETS LLC	[536] 72,247,715	Y
JEFFERIES FINANCIAL PRODUCTS LLC	[537] 1,334,356,732	N
JEFFERIES FINANCIAL SERVICES INC	1,334,356,732	N
CANTOR FITZGERALD SECURITIES	[538] 365,105,535	N
ED&F MAN DERIVATIVE PRODUCTS INC	[539] 95,389,978	N
CITADEL SECURITIES SWAP DEALER LLC	[540] 1,090,000,000	N

5. Non-Financial/Commercial SDs

The capital rule would require Non-Financial/Commercial SDs to maintain tangible net worth in an amount equal to or in excess of the minimum capital level that is, max ($20 million plus market risk charges and credit risk charges, 8% of risk margin, RFA requirement). Currently, there is no capital requirement for commercial SDs. The Commission estimates that currently three to four SD would be in this category, and believes that their tangible net worth greatly exceeds the Commission's requirement. Although these SDs may not need to raise additional capital, the cost of complying with the final rule might still be significant, particularly if these SDs choose to develop models for capital purposes.

6. Non-U.S. SDs Not Subject to a Prudential Regulator

The Commission is allowing a ''substituted compliance'' program for capital requirements for SDs that are: (1) Not organized under the laws of the U.S., and (2) not domiciled in the U.S. The Commission estimates that there are about 24 non-U.S. provisionally registered SDs not subject to U.S. prudential regulators that would be eligible to apply for substituted compliance. The Commission would permit these non-U.S. SDs (or regulatory authorities in the non-U.S. SD's home country jurisdictions) to petition the Commission to satisfy the Commission's capital requirements through a program of substituted compliance with the SD's home country capital requirements. These SDs are domiciled in U.K., Germany, France, Japan, Mexico, Singapore, and Australia; which are members of Basel Committee on Banking Supervision and have adopted Basel III risk-based capital.[541] Thus, the Commission expects that these SDs or their parents may not need to raise significant additional capital to comply with the Commission's capital requirements. However, these SDs may incur significant cost to obtain approval for substituted compliance.

ii. Margin vs. Capital

The Commission's capital rule also requires an SD to include the initial margin for all swaps that would otherwise fall below the $50 million initial margin threshold amount or the $500,000 minimum transfer amount, as defined in regulation 23.151, for purposes of computing the uncleared swap initial margin amount. As such, the uncleared swap initial margin amount would be the amount that an SD would have to collect from a counterparty, assuming that the exclusions and exemptions for collecting initial margin for uncleared swaps set forth in regulations 23.150–161 would not apply, and also assuming that the thresholds under which initial margin would not need to be exchanged would not apply. Accordingly, swaps that are not subject to the Commission's margin requirements such as those executed prior to the compliance date for margin requirements (''legacy swaps''), inter-affiliate swaps, and swaps with counterparties that would qualify for the exception or exemption under section 2(h)(7)(A) would have to be taken into account in determining the capital requirement.

The Commission believes that it would be appropriate to require an SD to maintain capital for uncollateralized swap exposures to counterparties to cover the ''residual'' risk of a counterparty's uncleared swaps positions. The Commission's approach regarding including uncollateralized swap exposures in the SD's capital requirements is consistent with the approach adopted by the prudential regulators in setting capital requirements for SDs subject to their jurisdiction and is consistent with the approach proposed by the SEC for SBSDs.

The Commission provides certain exemptions from initial margin requirements for uncleared trades between affiliates. However, inter-affiliate swaps would require capital to be held against them. The Commission understands that SDs may have different organizational structures due to various reasons. These reasons include, among others, centralized risk management for consolidation of balance-sheet, asset-liability and liquidity risk management; taxation benefits; funds transfer pricing; merger and acquisition; trading centers; and subsidiaries in different jurisdictions. An arms-length swap may be offset by swap transaction with an affiliated SD because of any of the reasons listed above and possibly others. Centralization of risk within different entities of a firm in the same jurisdiction provides risk reduction benefits somewhat similar to the CCP and is encouraged.

Both parties to a swap transaction may be required to hold capital even if they both are part of the same parent institution. In that sense, there may be double (or more) counting of capital at the parent level for a given outward facing swap based on the legal structure of the entity. This may lead to an uneven playing field between SDs if for a given swap, different swap dealers are required to hold different amount of capital based on the number of inter-affiliate trades that they execute for the same client facing trade.

iii. Model vs. Table

The capital rule allows an SD to apply to the Commission or an RFA of which it is a member for approval to use internal models when calculating its market risk exposure and credit risk exposure. The capital rule also allows an FCM that is also an SD to apply in writing to the Commission or an RFA of which it is a member for approval to compute deductions for market risk and credit risk using internal models in lieu of the standardized deductions otherwise required.

As discussed above, there are approximately 108 SDs and no MSPs provisionally registered with the Commission. Of these, the Commission estimates that approximately 55 SDs and no MSPs would be subject to the Commission's capital rules as they are

[541] *http://www.bis.org/bcbs/publ/d338.pdf.*

not subject to those of a prudential regulator. The Commission further estimates conservatively that most of these SDs would seek to obtain Commission approval to use models for computing their market and credit risk capital charges. These entities would incur cost to develop, maintain, document, audit models, and seek model approval. The possibility of using models to calculate credit risk and market risk charges may allow SDs to more efficiently deploy capital in other parts of its operations, because models could reduce capital charges and thereby could make additional capital available. This reduced capital requirement due to model use could improve returns of SDs and make them more competitive. However, if models developed for capital purposes deviate significantly from models used for pricing and risk management, and regulatory capital deviates significantly from economic capital, this could reduce the discussed benefits of capital rule.

Although the Commission expects that SDs would use models for calculating market risk and credit risk charges, it is possible that some entities, particularly potential new entrants, may not have the risk management capabilities of which the models are an integral part, and, therefore, have to rely on the standardized haircut approach. The benefit of the standardized haircut approach for measuring market risk is its inherent simplicity. Therefore, this approach may improve customer protections and reduce systemic risk. In addition, a standardized haircut approach may reduce costs for the SD related to the risk of failing to observe or correct a problem with the use of models that could adversely impact the firm's financial conditions, because the use of models would require the allocation by the SD of additional firm resources and personnel. Conversely, if the standardized haircuts are too conservative and netting benefits are very limited, they could make conducting swap business too costly, preventing or impairing the ability of the firms to engage in swaps, increasing transaction costs, reducing liquidity, and reducing the availability of swaps for risk mitigation by end users.

iv. Other Considerations

The capital rule requirements should reduce the risk of a failure of any major market participant in the swap market, which in turn reduces the possibility of a general market failure, and thus promotes confidence for market participants to transact in swaps for investment and hedging purposes. The capital requirements are designed to promote confidence in SDs among customers, counterparties, and the entities that provide financing to SDs, thereby, lessen the potential that these market participants may seek to rapidly withdraw assets and financing from SDs during a time of market stress. This heightened confidence is expected to increase swap transactions and promote competition among dealers. A more competitive swap market may promote a more efficient capital allocation.

However, to the extent that costs associated with the rules are high, they may negatively affect competition within the swap markets. This may, for example, lead smaller dealers or entities for whom dealing is not a core business to exit the market because compliance with the minimum capital and reporting requirements is too costly. These same costs may result in increased barriers of entry, as they may prevent new dealers from entering the market. The combination of these two events may lead to a concentration of SD in the market, which could lead to market inefficiencies.

The capital rule could have a substantial impact on domestic and international commerce and the relative competitive position of SDs operating under different requirements of various jurisdictions. Specifically, SDs subject to a particular regulatory regime may be advantaged or disadvantaged if corresponding requirements in other regimes are substantially more or less stringent. This could affect the ability of U.S. SDs to compete in the domestic and global markets and, the ability of non-U.S. SDs to compete in U.S. markets. Substantial differences between the U.S. and foreign jurisdictions in the costs of complying with these requirements for swaps between U.S. and foreign jurisdictions could reduce cross-border capital flows and hinder the ability of global firms to efficiently allocate capital among legal entities to meet the demands of their customers/counterparties.

The willingness of end users to trade with an SD dealer will depend on their evaluation of the counterparty credit risks of trading with that particular SD compared to alternative SDs, and their ability to negotiate favorable price and other terms. The capital and risk management requirements would in general reduce the likelihood of SDs' defaulting or failing, and therefore may increase the willingness of end users to trade with more SDs that have strong capital reserves. End users of covered swaps are mostly made up of sophisticated participants such as hedge fund, asset management, other financial firms, and large commercial corporations. Many of these entities trade substantial volume of swaps and are relatively well-positioned to negotiate price and other terms with competing dealers. To the extent that the capital rule results in increased competition, participants should be able to take advantage of this increased competition and negotiate improved terms. On the other hand, SDs may pass on additional capital, operational and compliance costs resulting from the final rule to end users in the form of higher fees or wider spreads. Thus end users may experience increased cost of using swaps for hedging and investing purposes.

In addition, benefits may arise when SDs consolidate with other affiliated SDs, FCMs, and/or BDs. This may yield efficiencies for clients conducting business in swaps, including netting benefits, reduced number of account relationships, and reduced number of governing agreements. These potential benefits, however, may be offset by reduced competition from a smaller number of competing SDs. Further, the capital rule will permit conducting swap business in an entity jointly registered as an FCM, or SBSD, or broker-dealer, which may offer the potential for these firms to offer portfolio margining for a variety of positions. From a holding company's perspective, aggregating swap business in a single entity, could help simplify and streamline risk management, allow more efficient use of capital, as well as operational efficiencies, and avoid the need for multiple netting and other agreements.

The rules may create the potential for regulatory arbitrage to the extent that they differ from corresponding rules other regulators adopt. Also, to the extent that the requirements are overly stringent, they may prevent or discourage new entrants into swap markets and thereby may either increase spreads and trading costs or even reduce the availability of swaps. In these cases, end users would face higher cost or be forced to use less effective financial instruments to meet their business needs.

List of Subjects

17 CFR Part 1

Brokers, Commodity futures, Reporting and recordkeeping requirements.

17 CFR Part 23

Capital and margin requirements, Major swap participants, Swap dealers, Swaps.

17 CFR Part 140

Authority delegations (Government agencies).

For the reasons stated in the Preamble, the Commodity Futures Trading Commission amends 17 CFR parts 1, 23, and 140 as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

■ 1. The authority citation for part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 6s, 7, 7a–1, 7a–2, 7b, 7b–3, 8, 9, 10a, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24 (2012).

■ 2. Amend § 1.10 by:

■ a. Revising the paragraph (f)(1) introductory text; and

■ b. Revising paragraph (h)

The revisions read as follows:

§ 1.10 Financial reports of futures commission merchants and introducing brokers.

* * * * *

(f) * * * (1) In the event a registrant finds that it cannot file its Form 1–FR, or, in accordance with paragraph (h) of this section, its Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part IIC (FOCUS report), for any period within the time specified in paragraphs (b)(1)(i) or (b)(2)(i) of this section without substantial undue hardship, it may request approval for an extension of time, as follows:

* * * * *

(h) *Filing option available to a futures commission merchant or an introducing broker that is also a securities broker or dealer.* Any applicant or registrant which is registered with the Securities and Exchange Commission as a securities broker or dealer, a security-based swap dealer, or a major security-based market participant may comply with the requirements of this section by filing (in accordance with paragraphs (a), (b), (c), and (j) of this section) a copy, as applicable, of its Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, Part IIC, or Part II CSE (FOCUS Report), in lieu of Form 1–FR; *Provided, however,* That all information which is required to be furnished on and submitted with Form 1–FR is provided with such FOCUS Report; and *Provided, further,* That a certified FOCUS Report filed by an introducing broker or applicant for registration as an introducing broker in lieu of a certified Form 1–FR–IB must be filed according to National Futures Association rules, either in paper form or electronically, in accordance with procedures established by the National Futures Association, and if filed electronically, a paper copy of such filing with the original manually signed certification must be maintained by such introducing broker or applicant in accordance with § 1.31.

* * * * *

■ 3. Amend § 1.12 by:

■ a. Revising paragraph (a) introductory text;

■ b. Revising paragraphs (a)(1), (b)(3) and (b)(4); and

■ c. Adding paragraph (b)(5).

The revisions and additions read as follows:

§ 1.12 Maintenance of minimum financial requirements by futures commission merchants and introducing brokers.

(a) Each person registered as a futures commission merchant or who files an application for registration as a futures commission merchant, and each person registered as an introducing broker or who files an application for registration as an introducing broker (except for an introducing broker or applicant for registration as an introducing broker operating pursuant to, or who has filed concurrently with its application for registration, a guarantee agreement and who is not also a securities broker or dealer), who knows or should have known that its adjusted net capital at any time is less than the minimum required by § 1.17 or by the capital rule of any self-regulatory organization to which such person is subject, or the minimum net capital requirements of the Securities and Exchange Commission if the applicant or registrant is registered with the Securities and Exchange Commission, must:

(1) Give notice, as set forth in paragraph (n) of this section that the applicant's or registrant's capital is below the applicable minimum requirement. Such notice must be given immediately after the applicant or registrant knows or should have known that its adjusted net capital or net capital, as applicable, is less than minimum required amount; and

* * * * *

(b) * * *

(3) 150 percent of the amount of adjusted net capital required by a registered futures association of which it is a member, unless such amount has been determined by a margin-based capital computation set forth in the rules of the registered futures association, and such amount meets or exceeds the amount of adjusted net capital required under the margin-based capital computation set forth in § 1.17(a)(1)(i)(B), in which case the required percentage is 110 percent;

(4) For securities brokers or dealers, the amount of net capital specified in Rule 17a–11(b) of the Securities and Exchange Commission (17 CFR 240.17a–11(b)); or

(5) For security-based swap dealers or major security-based swap participants, the amount of net capital specified in Rule 18a–8(b) of the Securities and Exchange Commission (17 CFR 240.18a–8(b)), must file notice to that effect, as soon as possible and no later than twenty-four (24) hours of such event.

* * * * *

■ 4. Amend § 1.16 by revising paragraphs (f)(1)(i)(B) and (f)(1)(ii)(B) to read as follows:

§ 1.16 Qualifications and reports of accountants.

* * * * *

(f)(1) * * *

(i) * * *

(B) A futures commission merchant that is registered with the Securities and Exchange Commission as a securities broker or dealer may file with its designated self-regulatory organization a copy of any application that the registrant has filed with its designated examining authority, pursuant to § 240.17a–5(m) of this title, for an extension of time to file annual reports. The registrant must also promptly file with the designated self-regulatory organization and the Commission copies of any notice it receives from its designated examining authority to approve or deny the requested extension of time. Upon receipt by the designated self-regulatory organization and the Commission of copies of any such notice of approval, the requested extension of time referenced in the notice shall be deemed approved under this paragraph (f)(1)(i).

* * * * *

(ii) * * *

(B) An introducing broker that is registered with the Securities and Exchange Commission as a securities broker or dealer may file with the National Futures Association copies of any application that the registrant has filed with its designated examining authority, pursuant to § 240.17a–5(m) of this title, for an extension of time to file annual reports. The registrant must also file promptly with the National Futures Association copies of any notice it receives from its designated examining

authority to approve or deny the requested extension of time. Upon the receipt by the National Futures Association of a copy of any such notice of approval, the requested extension of time referenced in the notice shall be deemed approved under this paragraph (f)(1)(ii).

* * * * *

■ 5. Amend § 1.17 by:
■ a. Revising paragraphs (a)(1)(i)(A) and (B);
■ b. Adding paragraph (a)(1)(ii);
■ c. Revising paragraphs (b)(9) and (10) and adding paragraph (b)(11) ;
■ d. Revising paragraph (c)(1)(i);
■ e. Revising paragraph (c)(2)(i);
■ f. Revising paragraphs (c)(2)(ii)(B) and (D) and adding paragraph (c)(2)(ii)(G);
■ g. Adding paragraphs (c)(5)(iii), (iv), (xv), and (xvi);
■ h. Revising paragraphs (c)(5)(viii), (x), (ix) and (xiv);
■ i. Revising paragraph (c)(6)(i) and (iv)(A), and adding paragraph (c)(6)(v); and
■ j. Revising paragraph (g)(1).

The revisions and additions read as follows:

§ 1.17 Minimum financial requirements for futures commission merchants and introducing brokers.

(a)(1)(i) * * *

(A) $1,000,000, *Provided, however,* that if the futures commission merchant also is a swap dealer, the minimum amount shall be $20,000,000;

(B) The futures commission merchant's risk-based capital requirement, computed as the sum of:

(*1*) Eight percent of the total risk margin requirement (as defined in § 1.17(b)(8) of this section) for positions carried by the futures commission merchant in customer accounts and noncustomer accounts; and

(*2*) For a futures commission merchant that is also a registered swap dealer, two percent of the total uncleared swap margin, as that term is defined in paragraph (b)(11) of this section.

* * * * *

(ii) A futures commission merchant that is registered as a swap dealer and has received approval to use internal models to compute market risk and credit risk charges for uncleared swaps must maintain net capital equal to or in excess of $100 million and adjusted net capital equal to or in excess of $20 million.

* * * * *

(b) * * *

(9) *Cleared over the counter derivative positions* means a swap cleared by a derivatives clearing organization or a clearing organization exempted by the Commission from registering as a derivatives clearing organization, and further includes positions cleared by any organization permitted to clear such positions under the laws of the relevant jurisdiction.

(10) *Cleared over the counter customer* means any person for whom the futures commission merchant carries on its books one or more accounts for the cleared over the counter derivative positions of such person, and such account or accounts are not proprietary accounts as defined in § 1.3 of this part.

(11) *Uncleared swap margin:* This term means the amount of initial margin, computed in accordance with § 23.154 of this chapter, that a dually-registered futures commission merchant and swap dealer would be required to collect from each counterparty for each outstanding swap position of the dually-registered futures commission merchant and swap dealer. A dually-registered futures commission merchant and swap dealer must include all swap positions in the calculation of the uncleared swap margin amount, including swaps that are exempt or excluded from the scope of the Commission's margin regulations for uncleared swaps pursuant to § 23.150 of this chapter, exempt foreign exchange swaps or foreign exchange forwards, or netting set of swaps or foreign exchange swaps, for each counterparty, as if the counterparty was an unaffiliated swap dealer. Furthermore, in computing the uncleared swap margin amount, a dually-registered futures commission merchant and swap dealer may not exclude the *initial margin threshold amount* or the *minimum transfer amount* as such terms are defined in § 23.151 of this chapter.

(c) * * *

(1) * * *

(i) Unrealized profits shall be added and unrealized losses shall be deducted in the accounts of the applicant or registrant, including unrealized profits and losses on fixed price commitments, uncleared swaps, uncleared security-based swaps, and forward contracts;

* * * * *

(2) * * *

(i) Exclude any unsecured commodity futures, options, cleared swaps, or other Commission regulated account containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only: *Provided, however,* deficits or debit ledger balances in unsecured customers', noncustomers', and proprietary accounts, which are the subject of calls for margin or other required deposits may be included in current assets until the close of business on the business day following the date on which such deficit or debit ledger balance originated providing that the account had timely satisfied, through the deposit of new funds, the previous day's debit or deficits, if any, in its entirety.

(ii) * * *

(B)(*1*) Interest receivable, floor brokerage receivable, commissions receivable from other brokers or dealers (other than syndicate profits), mutual fund concessions receivable and management fees receivable from registered investment companies and commodity pools that are not outstanding more than thirty (30) days from the date they are due;

(*2*) Dividends receivable that are not outstanding more than thirty (30) days from the payable date; and

(*3*) Commissions or fees receivable, including from other brokers or dealers, resulting from swap transactions that are not outstanding more than sixty (60) days from the month end accrual date provided they are billed promptly after the close of the month of their inception;

* * * * *

(D) Receivables from registered futures commission merchants or brokers, resulting from commodity futures, options, cleared swaps, foreign futures or foreign options transactions, except those specifically excluded under paragraph (c)(2)(i) of this section;

* * * * *

(G) Receivables from third-party custodians that maintain the futures commission merchant's initial margin deposits associated with uncleared swap and security-based swap transactions pursuant to the margin rules of the Commission, the Securities and Exchange Commission, a prudential regulator, as defined in section 1a(39) of the Act, or a foreign jurisdiction that has received a Comparability Determination under § 23.160 of this chapter.

* * * * *

(5) * * *

(iii) Swaps:

(A) *Uncleared swaps that are credit-default swaps referencing broad-based securities indices.*(*1*) *Short positions (selling protection).* In the case of an uncleared short credit default swap that references a broad-based securities index, deducting the percentage of the notional amount based upon the current basis point spread of the credit default swap and the maturity of the credit default swap in accordance with the following table:

TABLE TO § 1.17(C)(5)(III)(A)(*1*)—MARKET RISK CHARGES FOR UNCLEARED CREDIT DEFAULT SWAPS

Length of time to maturity of CDS contract	Basis point spread (%)					
	100 or less	101–300	301–400	401–500	501–699	700 or more
Less than 12 months	0.67	1.33	3.33	5.00	6.67	10.00
12 months but less than 24 months	1.00	2.33	5.00	6.67	8.33	11.67
24 months but less than 36 months	1.33	3.33	6.67	8.33	10.00	13.33
36 months but less than 48 months	2.00	4.00	8.33	10.00	11.67	15.00
48 months but less than 60 months	2.67	4.67	10.00	11.67	13.33	16.67
60 months but less than 72 months	3.67	5.67	11.67	13.33	15.00	18.33
72 months but less than 84 months	4.67	6.67	13.33	15.00	16.67	20.00
84 months but less than 120 months	5.67	10.00	15.00	16.67	18.33	26.67
120 months and longer	6.67	13.33	16.67	18.33	20.00	33.33

(*2*) *Long positions (purchasing protection).* In the case of an uncleared swap that is a long credit default swap referencing a broad-based security index, deducting 50 percent of the deduction that would be required by paragraph (c)(5)(iii)(A)(*1*) of this section if the swap was a short credit default swap, each such deduction not to exceed the current market value of the long position.

(*3*) *Long and short positions.* (*i*) *Long and short uncleared credit default swaps referencing the same broad-based security index.* In the case of uncleared swaps that are long and short credit default swaps referencing the same broad-based security index, have the same credit events which would trigger payment by the seller of protection, have the same basket of obligations which would determine the amount of payment by the seller of protection upon the occurrence of a credit event, that are in the same or adjacent spread category and have a maturity date within three months of the other maturity category, deducting the percentage of the notional amounts specified in the higher maturity category under paragraph (c)(5)(iii)(A)(*1*) or (c)(5)(iii)(A)(*2*) of this section on the excess of the long or short position.

(*ii*) *Long basket of obligors and uncleared long credit default swap referencing a broad-based securities index.* In the case of an uncleared swap that is a long credit default swap referencing a broad-based security index and the futures commission merchant is long a basket of debt securities comprising all of the components of the security index, deducting 50 percent of the amount specified in § 240.15c3–1(c)(2)(vi) of this title for the component of securities, provided the futures commission merchant can deliver the component securities to satisfy the obligation of the futures commission merchant on the credit default swap.

(*iii*) *Short basket of obligors and uncleared short credit default swap referencing a broad-based securities index.* In the case of an uncleared swap that is a short credit default swap referencing a broad-based security index and the futures commission merchant is short a basket of debt securities comprising all of the components of the security index, deducting the amount specified in § 240.15c3–1(c)(2)(vi) of this title for the component securities.

(B) *Interest rate swaps.* In the case of an uncleared interest rate swap, deducting the percentage deduction specified in § 240.15c3–1(c)(2)(vi)(A) of this title based on the maturity of the interest rate swap, provided that the percentage deduction must be no less than one eighth of 1 percent of the amount of a long position that is netted against a short position in the case of an uncleared interest rate swap with a maturity of three months or more;

(C) *All other uncleared swaps.* (*1*) In the case of any uncleared swap that is not a credit default swap or interest rate swap, deducting the amount calculated by multiplying the notional value of the uncleared swap by:

(*i*) The percentage specified in § 240.15c3–1 of this title applicable to the reference asset if § 240.15c3–1 of this title specifies a percentage deduction for the type of asset and this section does not specify a percentage deduction;

(*ii*) Six percent in the case of a currency swap that references euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs, and twenty percent in the case of currency swaps that reference any other foreign currencies; or

(*iii*) In the case of over-the-counter swap transactions involving commodities, 20 percent of the market value of the amount of the underlying commodities.

(D) *Netting of Swap Market Risk Charges.* The deductions under paragraphs (c)(5)(iii)(B) and (C) of this section may be reduced by an amount equal to any reduction recognized for a comparable long or short position in the reference asset or interest rate under this section or in § 240.15c3–1 of this title.

(iv) Security-based Swaps: In the case of security-based swaps as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)), the percentage as specified in § 240.15c3–1 of this title.

* * * * *

(viii) In the case of a futures commission merchant, for undermargined customer accounts, the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin or other required deposits which are outstanding no more than one business day. If there are no such maintenance margin requirements or clearing organization margin requirements, then the amount of funds required to provide margin equal to the amount necessary, after application of calls for margin or other required deposits outstanding no more than one business day, to restore original margin when the original margin has been depleted by 50 percent or more: *Provided,* to the extent a deficit is excluded from current assets in accordance with paragraph (c)(2)(i) of this section such amount shall not also be deducted under this paragraph. In the event that an owner of a customer account has deposited an asset other than cash to margin, guarantee or secure his account, the value attributable to such asset for purposes of this subparagraph shall be the lesser of:

(A) The value attributable to the asset pursuant to the margin rules of the applicable board of trade, or

(B) The market value of the asset after application of the percentage deductions specified in paragraph (c)(5) of this section;

(ix) In the case of a futures commission merchant, for undermargined noncustomer and omnibus accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin or other required deposits which are outstanding no more than one business day. If there are no such maintenance margin requirements or clearing organization margin requirements, then the amount of funds required to provide margin equal to the amount necessary after application of calls for margin or other required deposits outstanding no more than one business day to restore original margin when the original margin has been depleted by 50 percent or more: *Provided,* to the extent a deficit is excluded from current assets in accordance with paragraph (c)(2)(i) of this section such amount shall not also be deducted under this paragraph. In the event that an owner of a noncustomer or omnibus account has deposited an asset other than cash to margin, guarantee or secure his account the value attributable to such asset for purposes of this paragraph shall be the lesser of the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or the market value of such asset after application of the percentage deductions specified in paragraph (c)(5) of this section;

(x) In the case of open futures contracts, cleared swaps, and granted (sold) commodity options held in proprietary accounts carried by the applicant or registrant which are not covered by a position held by the applicant or registrant or which are not the result of a ''changer trade'' made in accordance with the rules of a contract market:

(A) For an applicant or registrant which is a clearing member of a clearing organization for the positions cleared by such member, the applicable margin requirement of the applicable clearing organization;

(B) For an applicant or registrant which is a member of a self-regulatory organization, 150 percent of the applicable maintenance margin requirement of the applicable board of trade, or clearing organization, whichever is greater;

(C) For all other applicants or registrants, 200 percent of the applicable maintenance margin requirements of the applicable board of trade or clearing organization, whichever is greater; or

(D) For open contracts or granted (sold) commodity options for which there are no applicable maintenance margin requirements, 200 percent of the applicable initial margin requirement: *Provided,* the equity in any such proprietary account shall reduce the deduction required by this paragraph (c)(5)(x) if such equity is not otherwise includable in adjusted net capital;

* * * * *

(xiv) For securities brokers and dealers, all other deductions specified in § 240.15c3–1 of this title;

(xv) In the case of a futures commission merchant that is also a registered swap dealer, the amount of funds required from each swap counterparty and security-based swap counterparty to meet initial margin requirements of the Commission or Securities and Exchange Commission, as applicable, after application of calls for margin or other required deposits which are outstanding within the required time frame to collect margin or other required deposits;

(xvi) In the case of a futures commission merchant that is also a registered swap dealer, the amount of initial margin calculated pursuant to § 23.154 of this chapter for the account of a swap counterparty that is subject to a margin exception or exemption under § 23.150 of this chapter, less any margin posted on such account, and the amount of initial margin calculated pursuant to § 240.18a–3(c)(1)(i)(B) of this title for the account of a security-based swap counterparty that is subject to a margin exception or exemption under the rules of the Securities and Exchange Commission, less any margin posted on such account.

(6)(i) *Election of alternative capital deductions that have received approval of Securities and Exchange Commission pursuant to § 240.15c3–1(a)(7) of this title.* Any futures commission merchant that is also registered with the Securities and Exchange Commission as a securities broker or dealer, and who also satisfies the other requirements of this paragraph (c)(6), may elect to compute its adjusted net capital using the alternative capital deductions that, under § 240.15c3–1(a)(7) of this title, the Securities and Exchange Commission has approved by written order in lieu of the deductions that would otherwise be required under this section.

* * * * *

(iv) * * *

(A) Information that the futures commission merchant files on a monthly basis with its designated examining authority or the Securities and Exchange Commission, whether by way of schedules to its FOCUS reports or by other filings, in satisfaction of § 240.17a–5(a)(5) of this title;

* * * * *

(v) *Election of alternative market risk and credit risk capital deductions for a futures commission merchant that is registered as a swap dealer and has received approval of the Commission or a registered futures association for which the futures commission merchant is a member.* For purposes of this paragraph (c)(6)(v) only, all references to futures commission merchant means a futures commission merchant that is also registered as a swap dealer.

(A) A futures commission merchant may apply in writing to the Commission or a registered futures association of which it is a member for approval to compute deductions for market risk and credit risk using internal models in lieu of the standardized deductions otherwise required under this section; *Provided however,* that the Commission must issue a determination that the registered futures association's model requirements and review process are comparable to the Commission's requirements and review process in order for the registered futures association's model approval to be accepted as an alternative means of compliance with this section. The futures commission merchant must file the application in accordance with instructions approved by the Commission and specified on the website of the registered futures association.

(B) A futures commission merchant's application must include the information set forth in Appendix A to Subpart E of Part 23 and the market risk and credit risk charges must be computed in accordance with § 23.102 of this chapter.

(C) The Commission or registered futures association upon obtaining the Commission's determination that its requirements and model approval process are comparable to the Commission's requirements and process, may approve or deny the application, in whole or in part, or approve or deny an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission or registered futures association may require, if the Commission or registered futures association finds the approval to be appropriate in the public interest, after determining, among other things, whether the applicant has met the requirements of § 23.102 of this chapter.

* * * * *

(g)(1) The Commission may by order restrict, for a period of up to twenty business days, any withdrawal by a futures commission merchant of equity capital, or any unsecured advance or loan to a stockholder, partner, limited liability company member, sole proprietor, employee or affiliate if the Commission, based on the facts and information available, concludes that any such withdrawal, advance or loan may be detrimental to the financial integrity of the futures commission merchant, or may unduly jeopardize its ability to meet customer obligations or other liabilities that may cause a significant impact on the markets.

* * * * *

■ 6. Amend § 1.65 by revising paragraph (b) introductory text, paragraphs (d) and (e) to read as follows:

§ 1.65 Notice of bulk transfers and disclosure obligations to customers.

* * * * *

(b) *Notice to the Commission.* Each futures commission merchant or introducing broker shall file with the Commission, at least ten business days in advance of the transfer, notice of any transfer of customer accounts carried or introduced by such futures commission merchant or introducing broker that is not initiated at the request of the customer, where the transfer involves the lesser of:

* * * * *

(d) The notice required by paragraph (b) of this section shall be considered filed when submitted to the Director of the Division of Swap Dealer and Intermediary Oversight, in electronic form using a form of user authentication assigned in accordance with procedures established by or approved by the Commission, and otherwise in accordance with instructions issued by or approved by the Commission.

(e) In the event that the notice required by paragraph (b) of this section cannot be filed with the Commission at least ten days prior to the account transfer, the Commission hereby delegates to the Director of the Division of Swap Dealer and Intermediary Oversight, or such other employee or employees as the Director may designate from time to time, the authority to accept a lesser time period for such notification at the Director's or designee's discretion. In any event, however, the transferee futures commission merchant or introducing broker shall file such notice as soon as practicable and no later than the day of the transfer. Such notice shall include a brief statement explaining the circumstances necessitating the delay in filing.

* * * * *

PART 23—SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

■ 7. The authority citation for part 23 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 6, 6a, 6b, 6b–1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.

■ 8. Add section 23.100 to subpart E to read as follows:

§ 23.100 Definitions applicable to capital requirements.

For purposes of §§ 23.101 through 23.106 of subpart E, the following terms are defined as follows:

Actual daily net trading profit and loss. This term is used in assessing the performance of a swap dealer's VaR measure and refers to changes in the swap dealer's portfolio value that would have occurred were end-of-day positions to remain unchanged (therefore, excluding fees, commissions, reserves, net interest income, and intraday trading).

Advanced approaches Board-regulated institution. The term shall have the meaning ascribed to it in 12 CFR part 217.

BHC equivalent risk-weighted assets. This term means the risk-weighted assets of a swap dealer that elects to meet the capital requirements in § 23.101(a)(1)(i) calculated as follows:

(1) If the swap dealer is not approved to use internal models to calculate credit risk exposure under § 23.102, it shall calculate its credit risk-weighted assets using the bank holding company regulations in subpart D of 12 CFR part 217, as if the swap dealer itself were a bank holding company, with the swap dealer permitted to calculate its exposure amount for OTC derivative contracts using either the current exposure method or the standardized approach for counterparty credit risk, without regard to the status of any affiliate of the swap dealer as an advanced approaches Board-regulated institution;

(2) If the swap dealer is approved to use internal models to calculate credit risk exposure under § 23.102, it shall calculate its credit risk-weighted assets using the bank holding company regulations in subpart E of 12 CFR part 217, as if the swap dealer itself were a bank holding company, with the swap dealer permitted to calculate its exposure amount for OTC derivative contracts using either the internal models methodology or the standardized approach for counterparty credit risk, without regard to the status of any affiliate of the swap dealer as an advanced approaches Board-regulated institution;

(3) If the swap dealer is not approved to use internal models to calculate market risk exposure under § 23.102, it shall compute a market risk capital charge for the positions that the swap dealer holds in its proprietary accounts using the applicable standardized market risk charges set forth in § 240.18a–1 of this title and § 1.17 of this chapter for such positions, and multiplying that amount by a factor of 12.5;

(4) If the swap dealer is approved to use internal models to calculate market risk exposure under § 23.102, it shall calculate its market risk-weighted assets using subpart F of 12 CFR part 217; *Provided, however,* that the swap dealer may elect to apply either the provisions of such sections that are applicable to advanced approaches Board-regulated institutions or those that are applicable to Board-regulated institutions that are not advanced approaches Board-regulated institutions.

Credit risk. This term refers to the risk that the counterparty to an uncleared swap transaction could default before the final settlement of the transaction's cash flows.

Credit risk exposure requirement. This term refers to the amount that the swap dealer (other than a swap dealer subject to the minimum capital requirements of § 23.101(a)(1)(i)) is required to compute under § 23.102 if approved to use internal credit risk models, or to compute under § 23.103 if not approved to use internal credit risk models.

Exempt foreign exchange swaps and foreign exchange forwards are those foreign exchange swaps and foreign exchange forwards that were exempted from the definition of a swap by the U.S. Department of the Treasury.

Market risk exposure. This term means the risk of loss in a position or portfolio of positions resulting from movements in market prices and other factors. Market risk exposure is the sum of:

(1) General market risks including changes in the market value of a particular assets that result from broad market movements, such as a changes in market interest rates, foreign exchange rates, equity prices, and commodity prices;

(2) Specific risk, which includes risks that affect the market value of a specific instrument, such as the credit risk of the issuer of the particular instrument, but do not materially alter broad market conditions;

(3) Incremental risk, which means the risk of loss on a position that could result from the failure of an obligor to make timely payments of principal and interest; and

(4) Comprehensive risk, which is the measure of all material price risks of one or more portfolios of correlation trading positions.

Market risk exposure requirement. This term refers to the amount that the swap dealer (other than a swap dealer subject to the minimum capital requirements of § 23.101(a)(1)(i)) is required to compute under § 23.102 if approved to use internal market risk models, or § 23.103 if not approved to use internal market risk models.

OTC derivative contract. This term shall have the meaning ascribed to it in 12 CFR part 217.

Predominantly engaged in non-financial activities. A swap dealer is predominantly engaged in non-financial activities if: (1) The swap dealer's consolidated annual gross financial revenues, or if the swap dealer is a wholly owned subsidiary, then the swap dealer's consolidated parent's annual gross financial revenues, in either of its two most recently completed fiscal years represents less than 15 percent of the swap dealer's consolidated gross revenue in that fiscal year (''15% revenue test''), and (2) the consolidated total financial assets of the swap dealer, or if the swap dealer is wholly owned subsidiary, the consolidated total financial assets of the swap dealer's parent, at the end of its two most recently completed fiscal years represents less than 15 percent of the swap dealer's consolidated total assets as of the end of the fiscal year (''15% asset test''). For purpose of computing the 15% revenue test or the 15% asset test, a swap dealer's activities or swap dealer's parent's activities shall be deemed financial activities if such activities are defined as financial activities under 12 CFR 242.3 and Appendix A to 12 CFR 242, including 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; *Provided, however,* a swap dealer may exclude from its financial activities accounts receivable resulting from non-financial activities.

Prudential regulator. This term has the same meaning as set forth in section 1a(39) of the Act, and includes the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency, as applicable to a swap dealer or major swap participant.

Regulatory capital. This term shall mean:

(1) With respect to the capital requirement under § 23.101(a)(1)(i), the amount of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital maintained by a covered SD, computed in accordance with § 23.101(a)(1)(i);

(2) With respect to the capital requirement under § 23.101(a)(1)(ii), the amount of tentative net capital and net capital maintained by a covered SD, computed in accordance with § 23.101(a)(1)(ii);

(3) With respect to the capital requirement under § 23.101(a)(2)(i), the amount of tangible net worth as defined in this section and maintained by a covered SD; and

(4) With respect to the capital requirement under 23.101(b), the amount of tangible net worth as defined in this section and maintained by a major swap participant.

Regulatory capital requirement. This term refers to each of the capital requirements that § 23.101 applies to a swap dealer or major swap participant.

Tangible net worth. This term means the net worth of a swap dealer or major swap participant as determined in accordance with generally accepted accounting principles in the United States, excluding goodwill and other intangible assets. In determining net worth, all long and short positions in swaps, security-based swaps and related positions must be marked to their market value. A swap dealer or major swap participant must include in its computation of tangible net worth all liabilities or obligations of a subsidiary or affiliate that the swap dealer or major swap participant guarantees, endorses, or assumes either directly or indirectly.

Uncleared swap margin. This term means the amount of initial margin, computed in accordance with § 23.154, that a swap dealer would be required to collect from each counterparty for each outstanding swap position of the swap dealer. A swap dealer must include all swap positions in the calculation of the uncleared swap margin amount, including swaps that are exempt or excluded from the scope of the Commission's margin regulations for uncleared swaps pursuant to § 23.150, exempt foreign exchange swaps or foreign exchange forwards, or netting set of swaps or foreign exchange swaps, for each counterparty, as if that counterparty was an unaffiliated swap dealer. Furthermore, in computing the uncleared swap margin amount, a swap dealer may not exclude the *initial margin threshold amount* or *minimum transfer amount* as such terms are defined in § 23.151.

■ 9. Add section 23.101 to subpart E to read as follows:

§ 23.101 Minimum financial requirements for swap dealers and major swap participants.

(a)(1) Except as provided in paragraphs (a)(2) through (a)(5) of this section, each swap dealer must elect to be subject to the minimum capital requirements set forth in either paragraphs (a)(1)(i) or (a)(1)(ii) of this section:

(i) A swap dealer that elects to meet the capital requirements in this paragraph (a)(1)(i) must at all times maintain regulatory capital that meets the following:

(A) $20 million of common equity tier 1 capital, as defined under the bank holding company regulations in 12 CFR 217.20, as if the swap dealer itself were a bank holding company subject to 12 CFR part 217;

(B) An aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital, all as defined under the bank holding company regulations in 12 CFR 217.20, equal to or greater than eight percent of the swap dealer's BHC equivalent risk-weighted assets; *provided, however,* that the swap dealer must maintain a minimum of common equity tier 1 capital equal to six point five percent of its BHC equivalent risk-weighted assets; *provided further,* that any capital that is subordinated debt under 12 CFR 217.20 and that is included in the swap dealer's capital for purposes of this paragraph (a)(1)(i)(B) must qualify as subordinated debt under § 240.18a–1d of this title;

(C) An aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital, all as defined under the bank holding company regulations in 12 CFR 217.20, equal to or greater than eight percent of the amount of uncleared swap margin, as that term is defined in § 23.100 of this part, for each uncleared swap position open on the books of the swap dealer, computed on a counterparty by counterparty basis pursuant to § 23.154 of this part; and

(D) The amount of capital required by a registered futures association of which the swap dealer is a member.

(ii)(A) A swap dealer that elects to meet the capital requirements in this paragraph (a)(1)(ii) must at all times maintain net capital, as defined and computed in accordance with

§ 240.18a–1 of this title as if the swap dealer were a security-based swap dealer registered with the Securities and Exchange Commission and subject to § 240.18a–1 of this title, that equals or exceeds the greater of:

(*1*) $20 million; *provided however,* that if the swap dealer is approved under § 23.102 of this part to use internal models to compute market risk capital charges or credit risk capital charges it must maintain tentative net capital, as defined and computed in accordance with § 240.18a–1 of this title as if the swap dealer were a security-based swap dealer registered with the Securities and Exchange Commission and subject to § 240.18a–1 of this title, of not less than $100 million and net capital of $20 million;

(*2*) Two percent of the uncleared swap margin, as defined in § 23.100 of this part; or

(*3*) The amount of capital required by a registered futures association of which the swap dealer is a member.

(B) A swap dealer that uses internal models to compute market risk for its proprietary positions under § 240.18a–1(d) of this title must calculate the total market risk as the sum of the VaR measure, stressed VaR measure, specific risk measure, comprehensive risk measure, and incremental risk measure of the portfolio of proprietary positions in accordance with § 23.102 of this part and Appendix A to Subpart E of Part 23; and

(C) A swap dealer may recognize as a current asset, receivables from third-party custodians that maintain the swap dealer's initial margin deposits associated with uncleared swap and security-based swap transactions pursuant to the margin rules of the Commission, the Securities and Exchange Commission, a prudential regulator, as defined in section 1a(39) of the Act, or a foreign jurisdiction that has received a margin Comparability Determination under § 23.160 of this chapter.

(2)(i) A swap dealer that is ''predominantly engaged in non-financial activities'' as defined in § 23.100 of this part may elect to meet the minimum capital requirements in this paragraph (a)(2) in lieu of the capital requirements in paragraph (a)(1) of this section.

(ii) A swap dealer that satisfies the requirements of paragraph (a)(2)(i) of this section and elects to meet the requirements of this paragraph (a)(2) must maintain tangible net worth, as defined in § 23.100 of this part, equal to or in excess of the greatest of the following:

(A) $20 million plus the amount of the swap dealer's market risk exposure requirement (as defined in § 23.100 of this part) and its credit risk exposure requirement (as defined in § 23.100 of this part) associated with the swap dealer's swap and related hedge positions that are part of the swap dealer's swap dealing activities. The swap dealer shall compute its market risk exposure requirement and credit risk exposure requirement for its swap positions in accordance with § 23.102 of this part if the swap dealer has obtained approval to use internal capital models. The swap dealer shall compute its market risk exposure requirement and credit risk exposure requirement in accordance with the standardized approach of paragraphs (b)(1) and (c)(1) of § 23.103 of this part if it has not been approved to use internal capital models;

(B) Eight percent of the amount of uncleared swap margin, as that term is defined in § 23.100 of this part, for each uncleared swap positions open on the books of the swap dealer, computed on a counterparty by counterparty basis pursuant to § 23.154 of this part; or

(C) The amount of capital required by a registered futures association of which the swap dealer is a member.

(3) A swap dealer that is subject to minimum capital requirements established by the rules or regulations of a prudential regulator pursuant to section 4s(e) of the Act is not subject to the regulatory capital requirements set forth in paragraph (a)(1) or (2) of this section.

(4) A swap dealer that is a futures commission merchant is subject to the minimum capital requirements of § 1.17 of this title, and is not subject to the regulatory capital requirements set forth in paragraph (a)(1) or (2) of this section.

(5) A swap dealer that is organized and domiciled outside of the United States, including a swap dealer that is an affiliate of a person organized and domiciled in the United States, may satisfy its requirements for capital adequacy under paragraphs (a)(1) or (2) of this section by substituted compliance with the capital adequacy requirement of its home country jurisdiction. In order to qualify for substituted compliance, a swap dealer's home country jurisdiction must receive from the Commission a Capital Comparability Determination under § 23.106 of this part. A swap dealer that is a registered futures commission merchant may not apply for a Capital Comparability Determination and must comply with the minimum capital requirements set forth in § 1.17 of this chapter.

(6) A swap dealer that elects to meet the capital requirements of paragraph (a)(1)(i), (a)(1)(ii), or (a)(2) of this section may not subsequently change its election without the prior written approval of the Commission. A swap dealer that wishes to change its election must submit a written request to the Commission and must provide any additional information and documentation requested by the Commission.

(b)(1) Every major swap participant for which there is not a prudential regulator must at all time have and maintain positive tangible net worth.

(2) Notwithstanding paragraph (b)(1) of this section, each major swap participant for which there is no prudential regulator must meet the minimum capital requirements established by a registered futures association of which the major swap participant is a member.

(3) Notwithstanding paragraphs (b)(1) and (2) of this section, a major swap participant that is a futures commission merchant is subject to the minimum capital requirements of § 1.17 of this chapter, and is not subject to the regulatory capital requirements set forth in paragraph (b)(1) and (2) of this section.

(4) A major swap participant that is organized and domiciled outside of the United States, including a major swap participant that is an affiliate of a person organized and domiciled in the United States, may satisfy its requirements for capital adequacy under paragraphs (b)(1) and (2) of this section by substituted compliance with the capital adequacy requirement of its home country jurisdiction. In order to qualify for substituted compliance, a major swap participant's home country jurisdiction must receive from the Commission a Capital Comparability Determination under § 23.106 of this part. A major swap participant that is a registered futures commission merchant may not apply for a Capital Comparability Determination and must comply with the minimum capital requirements set forth in § 1.17 of this chapter.

(c)(1) Before any applicant may be registered as a swap dealer or major swap participant, the applicant must demonstrate to the satisfaction of a registered futures association of which it is a member, or applying for membership, one of the following:

(i) That the applicant complies with the applicable regulatory capital requirements in paragraphs (a)(1), (a)(2), (b)(1), or (b)(2) of this section;

(ii) That the applicant is a futures commission merchant that complies with § 1.17 of this chapter;

(iii) That the applicant is subject to minimum capital requirements established by the rules or regulations of a prudential regulator under paragraph (a)(3) of this section;

(iv) That the applicant is organized and domiciled in a non-U.S. jurisdiction and is regulated in a jurisdiction for which the Commission has issued a Capital Comparability Determination under § 23.106 of this part, and the non-U.S. person has obtained confirmation from the Commission that it may rely upon the Commission's Comparability Determination under § 23.106 of this part.

(2) Each swap dealer and major swap participant subject to the minimum capital requirements set forth in paragraphs (a) and (b) of this section must be in compliance with such requirements at all times, and must be able to demonstrate such compliance to the satisfaction of the Commission and to the registered futures association of which the swap dealer or major swap participant is a member.

■ 10. Add section 23.102 to subpart E to read as follows:

§ 23.102 Calculation of market risk exposure requirement and credit risk exposure requirement using internal models

(a) A swap dealer may apply to the Commission or to a registered futures association of which the swap dealer is a member to obtain approval to use internal models under terms and conditions required by the Commission or the registered futures association and by these regulations, when calculating the swap dealer's market risk exposure and credit risk exposure under §§ 23.101(a)(1)(i)(B), 23.101(a)(1)(ii)(A), or 23.101(a)(2)(ii)(A); *Provided however,* that the Commission must issue a determination that the registered futures association's model requirements and review process are comparable to the Commission's requirements and review process in order for the registered futures association's model approval to be accepted as an alternative means of compliance with this section.

(b) The swap dealer's application to use internal models to compute market risk exposure and credit risk exposure must be in writing and must be filed with the Commission and with a registered futures association of which the swap dealer is a member. The swap dealer must file the application in accordance with instructions established by the Commission and the registered futures association.

(c) A swap dealer's application must include the following:

(1) In the case of a swap dealer subject to the minimum capital requirements in § 23.101(a)(1)(i) applying to use internal models to compute market risk exposure, the information required under subpart F of 12 CFR part 217, as if the swap dealer were itself a bank holding company subject to 12 CFR part 217.

(2) In the case of a swap dealer subject to the minimum capital requirements in § 23.101(a)(1)(i) applying to use internal models to compute credit risk exposure, the information required under subpart E of 12 CFR part 217 in order to calculate credit risk-weighted assets in accordance with sections 217.131 through 217.155 of that subpart, as if the swap dealer were itself a bank holding company subject to 12 CFR part 217.

(3) In the case of a swap dealer subject to the minimum capital requirements in § 23.101(a)(ii) or § 23.101(a)(2), the information set forth in Appendix A to Subpart E of Part 23.

(d) The Commission, or registered futures association upon obtaining the Commission's determination that its requirements and model approval process are comparable to the Commission's requirements and process, may approve or deny the application, or approve or deny an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission or registered futures association may require, if the Commission or registered futures association finds the approval to be appropriate in the public interest, after determining, among other things, whether the applicant has met the requirements of this section. A swap dealer that has received Commission or registered futures association approval to compute market risk exposure requirements and credit risk exposure requirements pursuant to internal models must compute such charges in accordance with Appendix A to Subpart E of Part 23.

(e) A swap dealer must cease using internal models to compute its market risk exposure requirement and credit risk exposure requirement, upon the occurrence of any of the following:

(1) The swap dealer has materially changed a mathematical model described in the application or materially changed its internal risk management control system without first submitting amendments identifying such changes and obtaining the approval of the Commission or the registered futures association for such changes;

(2) The Commission or the registered futures association of which the swap dealer is a member determines that the internal models are no longer sufficient for purposes of the capital calculations of the swap dealer as a result of changes in the operations of the swap dealer;

(3) The swap dealer fails to come into compliance with its requirements under this section, after having received from the Director of the Commission's Division of Swap Dealer and Intermediary Oversight, or from the registered futures association of which the swap dealer is a member, written notification that the swap dealer is not in compliance with its requirements, and must come into compliance by a date specified in the notice; or

(4) The Commission by written order finds that permitting the swap dealer to continue to use the internal models is no longer appropriate.

(f)(1) Notwithstanding paragraphs (a) through (d) of this section, a swap dealer may use internal market risk or credit risk models upon the submission to the Commission and the registered futures association of which the swap dealer is a member a certification, signed by the Chief Executive Officer, Chief Financial Officer, or other appropriate official with knowledge of the swap dealer's capital requirements and the capital models, that such models are in substantial compliance with Commission's model requirements and have been approved for use in computing capital by the swap dealer, or an affiliate of the swap dealer, by the Securities and Exchange Commission, a prudential regulator (as defined in § 1.3 of this chapter), a foreign regulatory authority in a jurisdiction that the Commission has found to be eligible for substituted compliance under § 23.106, or a foreign regulatory authority whose capital adequacy requirements are consistent with the capital requirements issued by the Basel Committee on Banking Supervision. A swap dealer also must file an application containing the information required under paragraph (c) of this section with the Commission with its certification. A swap dealer may use such models pending the subsequent approval or denial of the swap dealer's capital model application by the Commission or the registered futures association of which the swap dealer is a member.

(2) A swap dealer shall revise the certification required under paragraph (f)(1) of this section to address any material changes or revisions to the models, or to reflect any regulatory restrictions placed on the models since the certification was submitted.

(3) A swap dealer shall cease using capital models subject to the certification under paragraph (f)(1) of this section if the regulatory authority that previously approved the models for use by the swap dealer, or by the swap dealer's affiliate, has withdrawn its approval and the Commission or a registered futures association has not approved the models.

■ 11. Add section 23.103 to subpart E to read as follows:

§ 23.103 Calculation of market risk exposure requirement and credit risk requirement when models are not approved.

(a) *Non-model approach.* A swap dealer that:

(1) Does not compute its regulatory capital requirements under § 23.101(a)(1)(i), and

(2) Either:

(A) has not received approval from the Commission or from a registered futures association of which the swap dealer is a member to compute its market risk exposure requirement and/or credit risk exposure requirement pursuant to internal models under § 23.102, or

(B) has had its approval to compute its market risk exposure requirement and/or credit risk exposure requirement pursuant to internal models under § 23.102 revoked by the Commission or registered futures association must compute its market risk exposure requirement and/or credit risk exposure requirement pursuant to paragraphs (b) and/or (c) of this section.

(b) *Market risk exposure requirements.* (1) A swap dealer that computes its regulatory capital under § 23.101(a)(1)(ii) or (a)(2) shall compute a market risk capital charge for the positions that the swap dealer holds in its proprietary accounts using the applicable standardized market risk charges set forth in § 240.18a–1 of this title and § 1.17 of this chapter for such positions.

(2) In computing its net capital under § 23.101(a)(1)(ii), a swap dealer shall deduct from its tentative net capital the sum of the market risk capital charges computed under paragraph (b)(1) of this section.

(3) In computing its minimum capital requirement under § 23.101(a)(2), a swap dealer must add the amount of the market risk capital charge computed under this section to the $20 million minimum capital requirement.

(c) *Credit risk charges.* (1) A swap dealer that computes regulatory capital under § 23.101(a)(1)(ii) shall compute counterparty credit risk charges using the applicable standardized credit risk charges set forth in § 240.18a–1 of this title and § 1.17 of this chapter for such positions.

(2) In computing its net capital under § 23.101(a)(1)(ii), a swap dealer shall reduce its tentative net capital by the sum of the counterparty credit risk charges computed under paragraph (c)(1) of this section.

(3) In computing its minimum capital requirement under § 23.101(a)(2), a swap dealer must add the amount of the credit risk charge computed under this section to the $20 million minimum capital requirement.

■ 12. Add section 23.104 to subpart E to read as follows:

§ 23.104 Equity Withdrawal Restrictions.

(a) *Equity withdrawal restrictions.* The capital of a swap dealer, including the capital of any affiliate or subsidiary whose liabilities or obligations are guaranteed, endorsed, or assumed by the swap dealer may not be withdrawn by action of the swap dealer or its equity holders, or by redemption of shares of stock by the swap dealer or by such affiliates or subsidiaries, or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to an equity holder or employee if, after giving effect thereto and to any other such withdrawals, advances, or loans which are scheduled to occur within six months following such withdrawal, advance or loan, the swap dealer's regulatory capital is less than 120 percent of the minimum regulatory capital required under § 23.101 of this part. The equity withdrawal restrictions, however, do not preclude a swap dealer from making required tax payments or from paying reasonable compensation to equity holders. The Commission may, upon application by the swap dealer, grant relief from this paragraph (a) if the Commission deems such relief to be in the public interest.

(b) *Temporary equity withdrawal restrictions by Commission order.* (1) The Commission may by order restrict, for a period of up to twenty business days, any withdrawal by a swap dealer of capital or any unsecured loan or advance to a stockholder, partner, member, employee or affiliate under such terms and conditions as the Commission deems appropriate in the public interest if the Commission, based on the information available, concludes that such withdrawal, loan or advance may be detrimental to the financial integrity of the swap dealer, or may unduly jeopardize the swap dealer's ability to meet its financial obligations to counterparties or to pay other liabilities which may cause a significant impact on the markets or expose the counterparties and creditors of the swap dealer to loss.

(2) An order temporarily prohibiting the withdrawal of capital shall be rescinded if the Commission determines that the restriction on capital withdrawal should not remain in effect. A hearing on an order temporarily prohibiting withdrawal of capital will be held within two business days from the date of the request in writing by the swap dealer.

■ 13. Add section 23.105 to subpart E to read as follows:

§ 23.105 Financial recordkeeping, reporting and notification requirements for swap dealers and major swap participants.

(a) *Scope.* (1) Except as provided in paragraphs (a)(2) and (a)(3) of this section, a swap dealer or major swap participant must comply with the applicable requirements set forth in paragraphs (b) through (p) of this section.

(2) The requirements in paragraphs (b) through (o) of this section do not apply to any swap dealer or major swap participant that is subject to the capital requirements of a prudential regulator.

(3) The requirements in paragraph (p) of this section do not apply to any swap dealer or major swap participant that is subject to the capital requirements of the Commission.

(b) *Current books and records.* A swap dealer or major swap participant shall prepare and keep current ledgers or other similar records which show or summarize, with appropriate references to supporting documents, each transaction affecting its asset, liability, income, expense, and capital accounts, and in which all its asset, liability, and capital accounts are classified in accordance with U.S. generally accepted accounting principles, and as otherwise may be necessary for the capital calculations required under § 23.101 of this part: *Provided, however,* that a swap dealer or major swap participant that is not otherwise required to prepare financial statements in accordance with U.S. generally accepted accounting principles, may prepare and keep records required by this section in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board. Such records must be maintained in accordance with § 1.31 of this chapter.

(c) *Notices.* (1) A swap dealer or major swap participant who knows or should have known that its regulatory capital at any time is less than the minimum required by § 23.101 of this part, must:

(i) Provide immediate written notice to the Commission and to the registered futures association of which it is a member that the swap dealer's or major swap participant's regulatory capital is less than that required by § 23.101 of this part; and

(ii) Provide together with such notice, documentation in such form as necessary to adequately reflect the swap dealer's or major swap participant's regulatory capital condition as of any date such person's regulatory capital is less than the minimum required. The swap dealer or major swap participant must provide similar documentation for other days as the Commission or registered futures association may request.

(2) A swap dealer or major swap participant who knows or should have known that its regulatory capital at any time is less than 120 percent of its minimum regulatory capital requirement as determined under § 23.101 of this part, must provide written notice to the Commission and to the registered futures association of which it is a member to that effect within 24 hours of such event.

(3) If a swap dealer or major swap participant at any time fails to make or to keep current the books and records required by these regulations, such swap dealer or major swap participant must, on the same day such event occurs, provide written notice to the Commission and to the registered futures association of which it is a member of such fact, specifying the books and records which have not been made or which are not current, and within 48 hours after giving such notice file a written report stating what steps have been and are being taken to correct the situation.

(4) A swap dealer or major swap participant must provide written notice to the Commission and to the registered futures association of which it is a member of a substantial reduction in capital as compared to that last reported in a financial report filed with the Commission pursuant to this section. The notice shall be provided if the swap dealer or major swap participant experiences a 30 percent or more decrease in the amount of capital that the swap dealer or major swap participant holds in excess of its regulatory capital requirement as computed under § 23.101 of this part.

(5) A swap dealer or major swap participant must provide written notice to the Commission and to the registered futures association of which it is a member two business days prior to the withdrawal of capital by action of the equity holders of the swap dealer or major swap participant where the withdrawal exceeds 30 percent of the swap dealer's or major swap participant's excess regulatory capital as computed under § 23.101 of this part.

(6) A swap dealer or major swap participant that is registered with the Securities and Exchange Commission as a security-based swap dealer or as a major security-based swap participant and files a notice with the Securities and Exchange Commission under 17 CFR 240.18a–8 or 17 CFR 240.17a–11, as applicable, must file a copy of such notice with the Commission and with the registered futures association of which it is a member at the time the security-based swap dealer or major security-based swap participant files the notice with the Securities and Exchange Commission.

(7) A swap dealer or major swap participant must submit a written notice to the Commission and to the registered futures association of which it is a member within 24 hours of the occurrence of any of the following events:

(i) A single counterparty, or group of counterparties that are under common ownership or control, fails to post initial margin or pay variation margin to the swap dealer or major swap participant for swap positions in compliance with § 23.152 and § 23.153 of this part and security-based swap positions in compliance with 17 CFR 240.18a–3(c)(1)(ii) and 17 CFR 240.18a–3(c)(2)(ii), and such initial margin and variation margin, in the aggregate, is equal to or greater than 25 percent of the swap dealer's minimum capital requirement or 25 percent of the major swap participant's tangible net worth;

(ii) Counterparties fail to post initial margin or pay variation margin to the swap dealer or major swap participant for swap positions in compliance with § 23.152 and § 23.153 of this part and security-based swap positions in compliance with 17 CFR 240.18a–3(c)(1)(ii) and 17 CFR 240.18a–3(c)(2)(ii) in an amount that, in the aggregate, exceeds 50 percent of the swap dealer's minimum capital requirement or 50 percent of the major swap participant's tangible net worth;

(iii) A swap dealer or major swap participant fails to post initial margin or pay variation margin to a single counterparty or group of counterparties under common ownership and control for swap positions in compliance with § 23.152 and § 23.153 of this part and security-based swap positions in compliance with 17 CFR 240.18a–3(c)(1)(ii) and 17 CFR 240.18a–3(c)(2)(ii), and such initial margin and variation margin, in the aggregate, exceeds 25 percent of the swap dealer's minimum capital requirement or 25 percent of the major swap participant's tangible net worth; or

(iv) A swap dealer or major swap participant fails to post initial margin or pay variation margin to counterparties for swap positions in compliance with § 23.152 and § 23.153 of this part and security-based swap positions in compliance with 17 CFR 240.18a–3(c)(1)(ii) and 17 CFR 240.18a–3(c)(2)(ii) in an amount that, in the aggregate, exceeds 50 percent of the swap dealer's s minimum capital requirement or 50 percent of the major swap participants tangible net worth.

(d) *Unaudited financial reports.* (1) A swap dealer or major swap participant shall file with the Commission and with a registered futures association of which it is a member monthly financial reports meeting the requirements in paragraph (d)(2) of this section as of the close of business each month; *Provided, however,* that a swap dealer or major swap participant who is subject to the minimum capital requirements of § 23.101(a)(2) or (b), respectively, may file quarterly financial reports meeting the requirements of paragraph (d)(2) of this section as of the close of business each quarter end. Such financial reports must be filed no later than 17 business days after the date for which the report is made.

(2) The financial reports required by this section must be prepared in the English language and be denominated in United States dollars. The financial reports shall include a statement of financial condition, a statement of income/loss, a statement of changes in liabilities subordinated to the claims of general creditors, a statement of changes in ownership equity, a statement demonstrating compliance with and calculation of the applicable regulatory capital requirement under § 23.101, and such further material information as may be necessary to make the required statements not misleading. The monthly report and schedules must be prepared in accordance with generally accepted accounting principles as established in the United States*; Provided, however,* that a swap dealer or major swap participant that is not otherwise required to prepare financial statements in accordance with U.S. generally accepted accounting principles, may prepare the monthly report and schedules required by this section in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board.

(3) A swap dealer or major swap participant that is also registered with

the Securities and Exchange Commission as a broker or dealer, security-based swap dealer, or a major security-based swap participant and files a monthly Form X–17A–5 FOCUS Report Part II with the Securities and Exchange Commission pursuant to 17 CFR 240.18a–7 or 17 CFR 240.17a–5, as applicable, may file such Form X–17A–5 FOCUS Report Part II with the Commission and with the registered futures association in lieu of the financial reports required under paragraphs (d)(1) and (2) of the section. The swap dealer or major swap participant must file the form with the Commission and registered futures association when it files the Form X–17A–5 FOCUS Report Part II with the Securities and Exchange Commission, *provided, however,* that the swap dealer or major swap participant must file the Form X–17A–5 FOCUS Report Part II with the Commission and registered futures association no later than 17 business days after the end of each month.

(4) A swap dealer or major swap participant that is also registered with the Commission as a futures commission merchant may file a Form 1–FR–FCM in lieu of the monthly financial reports required under paragraphs (d)(1) and (2) of the section.

(e) *Annual audited financial report.* (1) A swap dealer or major swap participant shall file with the Commission and with a registered futures association of which it is a member an annual financial report as of the close of its fiscal year, certified in accordance with paragraph (e)(2) of this section, and including the information specified in paragraph (e)(3) of this section no later than 60 days after the close of the swap dealer's or major swap participant's fiscal year-end: *Provided, however,* that a swap dealer or major swap participant who is subject to the minimum capital requirements of § 23.101(a)(2) or (b), respectively, of this part may file an annual financial report no later than 90 days after the close of the swap dealer's and major swap participant's fiscal year-end.

(2) The annual financial report shall be audited and reported upon with an opinion expressed by an independent certified public accountant or independent licensed accountant that is in good standing in the accountant's home jurisdiction.

(3) The annual financial reports shall be prepared in accordance with generally accepted accounting principles as established in the United States, be prepared in the English language, and denominated in United States dollars: *Provided, however,* that a swap dealer or major swap participant that does not otherwise prepare financial statements in accordance with U.S. generally accepted accounting principles, may prepare the annual financial report required by this section in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board.

(4) The annual financial report must include the following:

(i) A statement of financial condition as of the date for which the report is made;

(ii) Statements of income (loss), cash flows, changes in ownership equity for the period between the date of the most recent certified statement of financial condition filed with the Commission and registered futures association and the date for which the report is made, and changes in liabilities subordinated to claims of general creditors;

(iii) Appropriate footnote disclosures;

(iv) A statement demonstrating the swap dealer's or major swap participant's compliance with and calculation of the applicable regulatory capital requirement under § 23.101 of this part;

(v) A reconciliation of any material differences from the unaudited financial report prepared as of the swap dealer's or major swap participant's year-end date under paragraph (d) of this section and the swap dealer's or major swap participant's annual financial report prepared under this paragraph (e); and

(vi) Such further material information as may be necessary to make the required statements not misleading.

(5) A swap dealer or major swap participant that is also registered with the Securities and Exchange Commission as a broker or dealer, security-based swap dealer, or a major security-based swap participant and files an annual financial report with the Securities and Exchange Commission pursuant to 17 CFR 240.18a–7 or 17 CFR 240.17a–5, as applicable, may file such annual financial report with the Commission and the registered futures association in lieu of the annual financial report required under this paragraph (e). The swap dealer or major swap participant must file its annual financial report with the Commission and the registered futures association at the same time that it files the annual financial report with the Securities and Exchange Commission, provided that the annual financial report is filed with the Commission and registered futures association no later than 60 days from the swap dealer's or major swap participant's fiscal year-end date.

(6) A swap dealer or major swap participant that is also registered with the Commission as a futures commission merchant may file an audited Form 1–FR–FCM in lieu of the annual financial report required under this paragraph (e).

(f) *Oath or affirmation.* Attached to each unaudited and audited financial report must be an oath or affirmation that to the best knowledge and belief of the individual making such oath or affirmation the information contained in the financial report is true and correct. The individual making such oath or affirmation must be: If the swap dealer or major swap participant is a sole proprietorship, the proprietor; if a partnership, any general partner; if a corporation, the duly authorized officer; and, if a limited liability company or limited liability partnership, the chief executive officer, the chief financial officer, the manager, the managing member, or those members vested with the management authority for the limited liability company or limited liability partnership.

(g) *Change of fiscal year-end.* A swap dealer or major swap participant may not change the date of its fiscal year-end from that used in its most recent annual financial report filed under paragraph (e) of this section unless the swap dealer or major swap participant has requested and received written approval for the change from a registered futures association of which it is a member.

(h) *Additional information requirements.* From time to time the Commission or a registered futures association, may, by written notice, require any swap dealer or major swap participant to file financial or operational information on a daily basis or at such other times as may be specified by the Commission or registered futures association. Such information must be furnished in accordance with the requirements included in the written Commission or registered futures association notice.

(i) *Public disclosure and nonpublic treatment of reports.* (1) A swap dealer or major swap participant must no less than six months after the date of the most recent annual audited financial report make publicly available on its website the following unaudited information:

(i) The statement of financial condition; and

(ii) A statement disclosing the amount of the swap dealer's or major swap participant's regulatory capital as of the end of the quarter and the amount of its minimum regulatory capital requirement, computed in accordance with § 23.101.

(2) A swap dealer or major swap participant must no less than annually make publicly available on its website the following information:

(i) The statement of financial condition from the swap dealer or major swap participant's audited annual financial report including applicable footnotes; and

(ii) A statement disclosing the amount of the swap dealer's or major swap participant's regulatory capital as of the fiscal year end and its minimum regulatory capital requirement, computed in accordance with § 23.101.

(3) Financial information required to be made publicly available pursuant to paragraph (i)(2) of this section must be posted within 10 business days after the firm is required to file with the Commission the reports required under paragraph (e)(1).

(4) Financial information required to be made publicly available pursuant to paragraph (i)(1) of this section must be posted within 30 calendar days of the date of the statements required under paragraph (d)(1).

(5) Financial information required to be filed with the Commission pursuant to this section, and not otherwise publicly available, will be treated as exempt from mandatory public disclosure for purposes of the Freedom of Information Act and the Government in the Sunshine Act and parts 145 and 147 of this chapter; *Provided, however,* that all information that is exempt from mandatory public disclosure will be available for official use by any official or employee of the United States or any State, by the National Futures Association and by any other person to whom the Commission believes disclosure of such information is in the public interest.

(j) *Extension of time to file financial reports.* A swap dealer or major swap participant may file a request with the registered futures association of which it is a member for an extension of time to file a monthly unaudited financial report or an annual audited financial report required under paragraphs (d) and (e) of this section. Such request will be approved, conditionally or unconditionally, or disapproved by the registered futures association.

(k) *Additional reporting requirements for swap dealers approved to use models to calculate market risk and credit risk for computing capital requirements.* (1) A swap dealer that has received approval or filed an application for provisional approval under § 23.102(d) from the Commission, or from a registered futures association of which the swap dealer is a member, to use internal models to compute its market risk exposure requirement and credit risk exposure requirement in computing its regulatory capital under § 23.101 must file with the Commission and with the registered futures association of which the swap dealer is a member the following information within 17 business days of the end of each month:

(i) For each product for which the swap dealer calculates a deduction for market risk other than in accordance with a model approved or for which an application of provisional approval has been filed pursuant to § 23.102(d), the product category and the amount of the deduction for market risk;

(ii) A graph reflecting, for each business line, the daily intra-month VaR;

(iii) The aggregate VaR for the swap dealer;

(iv) For each product for which the swap dealer uses scenario analysis, the product category and the deduction for market risk;

(v) Credit risk information on swap, mixed swap and security-based swap exposures including:

(A) Overall current exposure;

(B) Current exposure (including commitments) listed by counterparty for the 15 largest exposures;

(C) The 10 largest commitments listed by counterparty;

(D) The swap dealer's maximum potential exposure listed by counterparty for the 15 largest exposures;

(E) The swap dealer's aggregate maximum potential exposure;

(F) A summary report reflecting the swap dealer's current and maximum potential exposures by credit rating category; and

(G) A summary report reflecting the swap dealer's current exposure for each of the top ten countries to which the swap dealer is exposed (by residence of the main operating group of the counterparty).

(2) A swap dealer that has received approval or filed an application of provisional approval under § 23.102(d) from the Commission or from a registered futures association of which the swap dealer is a member to use internal models to compute its market risk exposure requirement and credit risk exposure requirement in computing its regulatory capital under § 23.101 must file with the Commission and with the registered futures association of which the swap dealer is member the following information within 17 business days of the end of each calendar quarter:

(i) A report identifying the number of business days for which the actual daily net trading loss exceeded the corresponding daily VaR; and

(ii) The results of back-testing of all internal models used to compute allowable capital, including VaR, and credit risk models, indicating the number of back-testing exceptions.

(l) *Additional position and counterparty reporting requirements.* A swap dealer or major swap participant must provide on a monthly basis to the Commission and to the registered futures association of which the swap dealer or major swap participant is a member the specific information required in Appendix B to Subpart E of this part.

(m) *Margin reporting.* A swap dealer or major swap participant must file with the Commission and with the registered futures association of which the swap dealer or major swap participant is a member the following information as of the end of each month within 17 business days of the end of each month:

(1) The name and address of each custodian holding initial margin or variation margin collected by the swap dealer or major swap participant for uncleared swap transactions pursuant to §§ 23.152 and 23.153;

(2) The amount of initial margin and variation margin collected by the swap dealer or major swap participant that is held by each custodian listed in paragraph (m)(1) of this section;

(3) The aggregate amount of initial margin that the swap dealer or major swap participant is required to collect from swap counterparties pursuant to § 23.152(a);

(4) The name and address of each custodian holding initial margin or variation margin posted by the swap dealer or major swap participant for uncleared swap transaction pursuant to §§ 23.152 and 23.153;

(5) The amount of initial margin and variation margin posted by the swap dealer or major swap participant that is held by each custodian listed in paragraph (m)(4) of this section; and

(6) The aggregate amount of initial margin that the swap dealer or majors swap participant is required to post to its swap counterparties pursuant to § 23.152(b).

(n) *Electronic filing.* All filings of financial reports, notices and other information required to be submitted to the Commission or registered futures association under paragraphs (b) through (m) of this section must be filed in electronic form using a form of user authentication assigned in accordance with procedures established by or approved by the Commission or registered futures association, and otherwise in accordance with

instructions issued by or approved by the Commission or registered futures association.

A swap dealer or major swap participant must provide the Commission or registered futures association with the means necessary to read and to process the information contained in such report. Any such electronic submission must clearly indicate the swap dealer or major swap participant on whose behalf such filing is made and the use of such user authentication in submitting such filing will constitute and become a substitute for the manual signature of the authorized signer. In the case of a financial report required under paragraphs (d), (e), or (h) of this section and filed via electronic transmission in accordance with procedures established by or approved by the Commission or registered futures association, such transmission must be accompanied by the user authentication assigned to the authorized signer under such procedures, and the use of such user authentication will constitute and become a substitute for the manual signature of the authorized signer for the purpose of making the oath or affirmation referred to in paragraph (f) of this section.

(o) *Comparability determination for certain financial reporting.* A swap dealer or major swap participant that is subject to the monthly financial reporting requirements of paragraph (d) of this section and the annual financial reporting requirements of paragraph (e) of this section may petition the Commission for a Capital Comparability Determination under § 23.106 to file monthly financial reports and/or annual financial reports prepared in accordance with the rules a foreign regulatory authority in lieu of the requirements contained in this section.

(p) *Quarterly financial reporting and notification provisions for swap dealers and major swap participants that are subject to the capital requirements of a prudential regulator.* (1) *Scope.* A swap dealer or major swap participant that is subject to the capital requirements of a prudential regulator must comply with the requirements of this paragraph.

(2) *Financial report and position information.* A swap dealer or major swap participant that is subject to the capital requirements of a prudential regulator shall file on a quarterly basis with the Commission the financial reports and specific position information set forth in Appendix C to subpart E of this part. The swap dealer or major swap participant must file Appendix B to subpart E of this part with the Commission within 30 calendar days of the date of the end of the swap dealer's or major swap participant's fiscal quarter.

(3) *Notices.* A swap dealer or major swap participant that is subject to the capital requirements of a prudential regulator must comply with the following written notice provisions:

(i) A swap dealer or major swap participant that files a notice of adjustment of its reported capital category with the Federal Reserve Board, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation, or files a similar notice with its home country supervisor(s), must give written notice of this fact that same day by transmitting a copy of the notice of the adjustment of reported capital category, or the similar notice provided to its home country supervisor(s), to the Commission and with a registered futures association of which it is a member.

(ii) A swap dealer or major swap participant must provide immediate written notice to the Commission and with a registered futures association of which it is a member that the swap dealer's or major swap participant's regulatory capital is less than the applicable minimum capital requirements set forth in 12 CFR 217.10, 12 CFR 3.10, or 12 CFR 324.10, or the minimum capital requirements established by its home country supervisor(s).

(iii) If a swap dealer or major swap participant at any time fails to make or to keep current the books and records necessary to produce reports required under paragraph (p)(2) of this section, such swap dealer or major swap participant must, on the same day such event occurs, provide written notice to the Commission and with a registered futures association of which it is a member of such fact, specifying the books and records which have not been made or which are not current, and within 48 hours after giving such notice file a written report stating what steps have been and are being taken to correct the situation.

(4) *Additional information.* From time to time the Commission may, by written notice, require a swap dealer or major swap participant that is subject to the capital rules of a prudential regulator to file financial or operational information on a daily basis or at such other times as may be specified by the Commission. Such information must be furnished in accordance with the requirements included in the written Commission notice.

(5) *Oath or affirmation.* Attached to each financial report, must be an oath or affirmation that to the best knowledge and belief of the individual making such oath or affirmation the information contained in the filing is true and correct. The individual making such oath or affirmation must be: If the swap dealer or major swap participant is a sole proprietorship, the proprietor; if a partnership, any general partner; if a corporation, the duly authorized officer; and, if a limited liability company or limited liability partnership, the chief executive officer, the chief financial officer, the manager, the managing member, or those members vested with the management authority for the limited liability company or limited liability partnership.

(6) *Electronic filing.* All filings of financial reports, notices, and other information made pursuant to this paragraph (p) must be submitted to the Commission in electronic form using a form of user authentication assigned in accordance with procedures established by or approved by the Commission, and otherwise in accordance with instructions issued by or approved by the Commission. Each swap dealer and major swap participant must provide the Commission with the means necessary to read and to process the information contained in such report. Any such electronic submission must clearly indicate the swap dealer or major swap participant on whose behalf such filing is made and the use of such user authentication in submitting such filing will constitute and become a substitute for the manual signature of the authorized signer. In the case of a financial report required under this paragraph (p) and filed via electronic transmission in accordance with procedures established by or approved by the Commission, such transmission must be accompanied by the user authentication assigned to the authorized signer under such procedures, and the use of such user authentication will constitute and become a substitute for the manual signature of the authorized signer for the purpose of making the oath or affirmation referred to in paragraph (p)(5) of this paragraph. Every notice or report required to be transmitted to the Commission pursuant to this paragraph (p) must also be filed with the Securities and Exchange Commission if the swap dealer or major swap participant also is registered with the Securities and Exchange Commission.

(7) A swap dealer or major swap participant that is subject to rules of a prudential regulator and is also registered with the Securities and Exchange Commission as a security-based swap dealer or a major security-

based swap participant and files a quarterly Form X–17A–5 FOCUS Report Part IIC with the Securities and Exchange Commission pursuant to 17 CFR 240.18a–7, may file such Form X–17A–5 FOCUS Report Part IIC with the Commission in lieu of the financial reports required under paragraphs (p)(2) of this section. The swap dealer or major swap participant must file the form with the Commission when it files the Form X–17A–5 FOCUS Report Part IIC with the Securities and Exchange Commission, *provided, however,* that the swap dealer or major swap participant must file the Form X–17A–5 FOCUS Report Part IIC with the Commission no later than 30 calendar days from the date the report is made.

■ 14. Add section 23.106 to subpart E to read as follows:

§ 23.106 Substituted compliance for swap dealer's and major swap participant's capital and financial reporting.

(a)(1) *Eligibility requirements.* The following persons may, either individually or collectively, request a Capital Comparability Determination with respect to the Commission's capital adequacy and financial reporting requirements for swap dealers or major swap participants:

(i) A swap dealer or major swap participant that is eligible for substituted compliance under § 23.101 or a trade association or other similar group on behalf of its members who are swap dealers or major swap participants; or

(ii) A foreign regulatory authority that has direct supervisory authority over one or more swap dealers or major swap participants that are eligible for substituted compliance under § 23.101, and such foreign regulatory authority is responsible for administering the relevant foreign jurisdiction's capital adequacy and financial reporting requirements over the swap dealer or major swap participant.

(2) *Submission requirements.* A person requesting a Capital Comparability Determination must electronically submit to the Commission:

(i) A description of the objectives of the relevant foreign jurisdiction's capital adequacy and financial reporting requirements over entities that are subject to the Commission's capital adequacy and financial reporting requirements in this part;

(ii) A description (including specific legal and regulatory provisions) of how the relevant foreign jurisdiction's capital adequacy and financial reporting requirements address the elements of the Commission's capital adequacy and financial reporting requirements for swap dealers and major swap participants, including, at a minimum, the methodologies for establishing and calculating capital adequacy requirements and whether such methodologies comport with any international standards, including Basel-based capital requirements for banking institutions; and

(iii) A description of the ability of the relevant foreign regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's capital adequacy and financial reporting requirements. Such description should discuss the powers of the foreign regulatory authority or authorities to supervise, investigate, and discipline entities for compliance with capital adequacy and financial reporting requirements, and the ongoing efforts of the regulatory authority or authorities to detect and deter violations, and ensure compliance with capital adequacy and financial reporting requirements. The description should address how foreign authorities and foreign laws and regulations address situations where a swap dealer or major swap participant is unable to comply with the foreign jurisdictions capital adequacy or financial reporting requirements.

(iv) Upon request, such other information and documentation that the Commission deems necessary to evaluate the comparability of the capital adequacy and financial reporting requirements of the foreign jurisdiction.

(v) All supplied documents shall be provided in English, or provided translated to the English language, with currency amounts stated in or converted to USD (conversions to be noted with applicable date).

(3) *Standard of Review.* The Commission will issue a Capital Comparability Determination to the extent that it determines that some or all of the relevant foreign jurisdiction's capital adequacy and financial reporting requirements and related financial recordkeeping and reporting requirements for swap dealing financial intermediaries are comparable to the Commission's corresponding capital adequacy and financial recordkeeping and reporting requirements. In determining whether the requirements are comparable, the Commission may consider all relevant factors, including:

(i) The scope and objectives of the foreign jurisdiction's capital adequacy and financial reporting requirements;

(ii) Whether the relevant foreign jurisdiction's capital adequacy and financial reporting requirements achieve comparable outcomes to the Commission's corresponding capital adequacy and financial reporting requirements for swap dealers and major swap participants;

(iii) The ability of the relevant regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's capital adequacy and financial reporting requirements; and

(iv) Any other facts or circumstances the Commission deems relevant.

(4) *Reliance.* (i) A swap dealer or major swap participant that is subject to the supervision of a foreign jurisdiction that has received a Capital Comparability Determination from the Commission must file a notice of its intent to comply with the capital adequacy and financial reporting requirements of the foreign jurisdiction with the Commission.

(ii) Any swap dealer or major swap participant that has filed the notice set forth in paragraph (a)(4)(i) of this section and has received confirmation from the Commission that it may comply with a foreign jurisdiction's capital adequacy and financial reporting requirements will be deemed to be in compliance with the Commission's corresponding capital adequacy and financial reporting requirements. Accordingly, if a swap dealer or major swap participant has failed to comply with the foreign jurisdiction's capital adequacy and financial reporting requirements, the Commission may initiate an action for a violation of the Commission's corresponding requirements. All swap dealers and major swap participants, regardless of whether they rely on a Capital Comparability Determination, remain subject to the Commission's examination and enforcement authority.

(5) *Conditions.* In issuing a Capital Comparability Determination, the Commission may impose any terms and conditions it deems appropriate, including certain capital adequacy and financial reporting requirements on swap dealers or major swap participants. The violation of such terms and conditions may constitute a violation of the Commission's capital adequacy or financial reporting requirements and/or result in the modification or revocation of the Capital Comparability Determination.

(6) *Modifications.* The Commission reserves the right to further condition, modify, suspend or terminate or otherwise restrict a Capital Comparability Determination in the Commission's discretion.

■ 15. Add Appendix A to subpart E of part 23 to read as follows:

Appendix A to Subpart E of Part 23—Application for Internal Models To Compute Market Risk Exposure Requirement and Credit Risk Exposure Requirement

(a) A swap dealer that is requesting the approval of the Commission or the approval of a registered futures association of which the swap dealer is a member to use internal models to compute its market risk exposure requirement and credit risk exposure requirement under § 23.102 must include the following information as part of its application:

(1) An executive summary of the information within its application and, if applicable, an identification of the ultimate holding company of the swap dealer;

(2) A list of the categories of positions that the swap dealer holds in its proprietary accounts and a brief description of the methods that the swap dealer will use to calculate deductions for market risk and credit risk on those categories of positions;

(3) A description of the mathematical models used by the swap dealer under this Appendix A to compute the VaR of the swap dealer's positions; the stressed VaR of the swap dealer's positions; the specific risk of the swap dealer's positions subject to specific risk; comprehensive risk of the swap dealer's positions; and the incremental risk of the swap dealer's positions, and deductions for credit risk exposure. The description should encompass the creation, use, and maintenance of the mathematical models; a description of the swap dealer's internal risk management controls over the models, including a description of each category of persons who may input data into the models; if a mathematical model incorporates empirical correlations across risk categories, a description of the process for measuring correlations; a description of the back-testing procedures the swap dealer will use to back-test the mathematical models; a description of how each mathematical model satisfies the applicable qualitative and quantitative requirements set forth in this Appendix A and a statement describing the extent to which each mathematical model used to compute deductions for market risk exposures and credit risk exposures will be used as part of the risk analyses and reports presented to senior management;

(4) If the swap dealer is applying to the Commission for approval or a registered futures association to use scenario analysis to calculate deductions for market risk for certain positions, a list of those types of positions, a description of how those deductions will be calculated using scenario analysis, and an explanation of why each scenario analysis is appropriate to calculate deductions for market risk on those types of positions;

(5) A description of how the swap dealer will calculate current exposure;

(6) A description of how the swap dealer will determine internal credit ratings of counterparties and internal credit risk-weights of counterparties, if applicable;

(7) For each instance in which a mathematical model to be used by the swap dealer to calculate a deduction for market risk exposure or to calculate maximum potential exposure for a particular product or counterparty differs from the mathematical model used by the swap dealer's ultimate holding company or the swap dealer's affiliates (if applicable) to calculate an allowance for market risk exposure or to calculate maximum potential exposure for that same product or counterparty, a description of the difference(s) between the mathematical models;

(8) A description of the swap dealer's process of re-estimating, re-evaluating, and updating internal models to ensure continued applicability and relevance; and

(9) Sample risk reports that are provided to management at the swap dealer who are responsible for managing the swap dealer's risk.

(b) The application of the swap dealer shall be supplemented by other information relating to the internal risk management control system, mathematical models, and financial position of the swap dealer that the Commission or a registered futures association may request to complete its review of the application.

(c) A person who files an application with the Commission pursuant to this appendix for which it seeks confidential treatment may clearly mark each page or segregable portion of each page with the words ''Confidential Treatment Requested.'' All information submitted in connection with the application will be accorded confidential treatment by the Commission, to the extent permitted by law.

(d) If any of the information filed with the Commission or a registered futures association as part of the application of the swap dealer is found to be or becomes inaccurate before the Commission or a registered futures association approves the application, the swap dealer must notify the Commission or the registered futures association promptly and provide the Commission or the registered futures association with a description of the circumstances in which the information was found to be or has become inaccurate along with updated, accurate information.

(e) The Commission or the registered futures association may approve the application or an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission or the registered futures association may require if the Commission or the registered futures association finds the approval to be appropriate in the public interest, after determining, among other things, whether the swap dealer has met all the requirements of this Appendix A.

(f) A swap dealer shall amend its application under this Appendix A and submit the amendment to the Commission and the registered futures association for approval before it may materially change a mathematical model used to calculate market risk exposure requirements or credit risk exposure requirements or before it may materially change its internal risk management control system with respect to such model.

(g) As a condition for a swap dealer to use internal models to compute deductions for market risk exposure and credit risk exposure under this Appendix A, the swap dealer agrees that:

(1) It will notify the Commission and the registered futures association 45 days before it ceases to use internal models to compute deductions for market risk exposure and credit risk exposure under this Appendix A; and

(2) The Commission or the registered futures association may determine that the notice will become effective after a shorter or longer period of time if the swap dealer consents or if the Commission determines that a shorter or longer period of time is appropriate in the public interest.

(h) The Commission or the registered futures association may by written order revoke a swap dealer's approval to use internal models to compute market risk exposures and credit risk exposures on certain credit exposures arising from transactions in derivatives instruments if the Commission or the registered futures association finds that such approval is no longer appropriate in the public interest. In making its finding, the Commission or the registered futures association will consider the compliance history of the swap dealer related to its use of models and the swap dealer's compliance with its internal risk management controls. If the Commission or the registered futures association withdraws all or part of a swap dealer's approval to use internal models, the swap dealer shall compute market risk exposure requirements and credit risk exposure requirements in accordance with § 23.103.

(i) *VaR models.* A value-at-risk (''VaR'') model must meet the following minimum requirements in order to be approved:

(1) *Qualitative requirements.* (i) The VaR model used to calculate market risk exposure or credit risk exposure for a position must be integrated into the daily internal risk management system of the swap dealer;

(ii) The VaR model must be reviewed both periodically and annually. The periodic review may be conducted by personnel of the swap dealer that are independent from the personnel that perform the VaR model calculations. The annual review must be conducted by a qualified third party service. The review must include:

(A) An evaluation of the conceptual soundness of, and empirical support for, the internal models;

(B) An ongoing monitoring process that includes verification of processes and the comparison of the swap dealer's model outputs with relevant internal and external data sources or estimation techniques; and

(C) An outcomes analysis process that includes back-testing. This process must include a comparison of the changes in the swap dealer's portfolio value that would have occurred were end-of-day positions to remain unchanged (therefore, excluding fees, commissions, reserves, net interest income, and intraday trading) with VaR-based measures during a sample period not used in model development.

(iii) For purposes of computing market risk, the swap dealer must determine the appropriate multiplication factor as follows:

(A) Beginning three months after the swap dealer begins using the VaR model to

calculate the market risk exposure, the swap dealer must conduct monthly back-testing of the model by comparing its actual daily net trading profit or loss with the corresponding VaR measure generated by the VaR model, using a 99 percent, one-tailed confidence level with price changes equivalent to a one business-day movement in rates and prices, for each of the past 250 business days, or other period as may be appropriate for the first year of its use;

(B) On the last business day of each quarter, the swap dealer must identify the number of back-testing exceptions of the VaR model using actual daily net trading profit and loss, as that term is defined in §§ 23.100. An exception has occurred when for a business day the actual net trading loss, if any, exceeds the corresponding VaR measure. The counting period shall be for the prior 250 business days except that during the first year of use of the model another appropriate period may be used; and

(C) The swap dealer must use the multiplication factor indicated in Table 1 of this Appendix A in determining its market risk until it obtains the next quarter's back-testing results;

TABLE 1—MULTIPLICATION FACTOR BASED ON THE NUMBER OF BACK-TESTING EXCEPTIONS OF THE VAR MODEL

Number of exceptions	Multiplication factor
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

(iv) For purposes of computing the credit equivalent amount of the swap dealer's exposures to a counterparty, the swap dealer must determine the appropriate multiplication factor as follows:

(A) Beginning three months after it begins using the VaR model to calculate maximum potential exposure, the swap dealer must conduct back-testing of the model by comparing, for at least 80 counterparties (or the actual number of counterparties if the swap dealer does not have 80 counterparties) with widely varying types and sizes of positions with the firm, the ten business day change in its current exposure to the counterparty based on its positions held at the beginning of the ten-business day period with the corresponding ten-business day maximum potential exposure for the counterparty generated by the VaR model;

(B) As of the last business day of each quarter, the swap dealer must identify the number of back-testing exceptions of the VaR model, that is, the number of ten-business day periods in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the change in current exposure to a counterparty, assuming the portfolio remains static for the ten-business day period, exceeds the corresponding maximum potential exposure; and

(C) The swap dealer will propose, as part of its application, a schedule of multiplication factors, which must be approved by the Commission, or a registered futures association of which the swap dealer is a member, based on the number of back-testing exceptions of the VaR model. The swap dealer must use the multiplication factor indicated in the approved schedule in determining the credit equivalent amount of its exposures to a counterparty until it obtains the next quarter's back-testing results, unless the Commission or the registered futures association determines, based on, among other relevant factors, a review of the swap dealer's internal risk management control system, including a review of the VaR model, that a different adjustment or other action is appropriate.

(2) *Quantitative requirements.* (i) For purposes of determining market risk exposure, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices;

(ii) For purposes of determining maximum potential exposure, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a one-year movement in rates and prices; or based on a review of the swap dealer's procedures for managing collateral and if the collateral is marked to market daily and the swap dealer has the ability to call for additional collateral daily, the Commission, or the registered futures association of which the swap dealer is a member, may approve a time horizon of not less than ten business days;

(iii) The VaR model must use an effective historical observation period of at least one year. The swap dealer must consider the effects of market stress in its construction of the model. Historical data sets must be updated at least monthly and reassessed whenever market prices or volatilities change significantly or portfolio composition warrant; and

(iv) The VaR model must take into account and incorporate all significant, identifiable market risk factors applicable to positions in the accounts of the swap dealer, including:

(A) Risks arising from the non-linear price characteristics of derivatives and the sensitivity of the fair value of those positions to changes in the volatility of the derivatives' underlying rates, prices, or other material risk factors. A swap dealer with a large or complex portfolio with non-linear derivatives (such as options or positions with embedded optionality) must measure the volatility of these positions at different maturities and/or strike prices, where material;

(B) Empirical correlations within and across risk factors provided that the swap dealer validates and demonstrates the reasonableness of its process for measuring correlations, if the VaR-based measure does not incorporate empirical correlations across risk categories, the swap dealer must add the separate measures from its internal models used to calculate the VaR-based measure for the appropriate risk categories (interest rate risk, credit spread risk, equity price risk, foreign exchange rate risk, and/or commodity price risk) to determine its aggregate VaR-based measure, or, alternatively, risk factors sufficient to cover all the market risk inherent in the positions in the proprietary or other trading accounts of the swap dealer, including interest rate risk, equity price risk, foreign exchange risk, and commodity price risk; and

(C) Spread risk, where applicable, and segments of the yield curve sufficient to capture differences in volatility and imperfect correlation of rates along the yield curve for securities and derivatives that are sensitive to different interest rates. For material positions in major currencies and markets, modeling techniques must incorporate enough segments of the yield curve—in no case less than six—to capture differences in volatility and less than perfect correlation of rates along the yield curve.

(j) *Stressed VaR-based Measure.* A stressed VaR model must meet the following minimum requirements in order to be approved:

(1) *Requirements for stressed VaR-based measure.* (i) A swap dealer must calculate a stressed VaR-based measure for its positions using the same model(s) used to calculate the VaR-based measure under paragraph (i) of this appendix, subject to the same confidence level and holding period applicable to the VaR-based measure, but with model inputs calibrated to historical data from a continuous 12-month period that reflects a period of significant financial stress appropriate to the swap dealer's current portfolio.

(ii) The stressed VaR-based measure must be calculated at least weekly and be no less than the swap dealer's VaR-based measure.

(iii) A swap dealer must have policies and procedures that describe how it determines the period of significant financial stress used to calculate the swap dealer's stressed VaR-based measure under this appendix and must be able to provide empirical support for the period used. The swap dealer must obtain the prior approval of the Commission, or a registered futures association of which the swap dealer is a member, if the swap dealer makes any material changes to these policies and procedures. The policies and procedures must address:

(A) How the swap dealer links the period of significant financial stress used to calculate the stressed VaR-based measure to the composition and directional bias of its current portfolio; and

(B) The swap dealer's process for selecting, reviewing, and updating the period of significant financial stress used to calculate the stressed VaR-based measure and for monitoring the appropriateness of the period to the swap dealer's current portfolio.

(iv) Nothing in this appendix prevents the Commission or the registered futures association of which the swap dealer is a member from requiring a swap dealer to use a different period of significant financial stress in the calculation of the stressed VaR-based measure.

(k) *Specific Risk.* A specific risk model must meet the following minimum requirements in order to be approved:

(1) *General requirement.* A swap dealer must use one of the methods in this

paragraph (k) to measure the specific risk for each of its debt, equity, and securitization positions with specific risk.

(2) *Modeled specific risk.* A swap dealer may use models to measure the specific risk of its proprietary positions. A swap dealer must use models to measure the specific risk of correlation trading positions that are modeled under paragraph (m) of this appendix.

(i) *Requirements for specific risk modeling.* (A) If a swap dealer uses internal models to measure the specific risk of a portfolio, the internal models must:

(*1*) Explain the historical price variation in the portfolio;

(*2*) Be responsive to changes in market conditions;

(*3*) Be robust to an adverse environment, including signaling rising risk in an adverse environment; and

(*4*) Capture all material components of specific risk for the debt and equity positions in the portfolio. Specifically, the internal models must:

(*i*) Capture name-related basis risk;

(*ii*) Capture event risk and idiosyncratic risk; and

(*iii*) Capture and demonstrate sensitivity to material differences between positions that are similar but not identical and to changes in portfolio composition and concentrations.

(B) If a swap dealer calculates an incremental risk measure for a portfolio of debt or equity positions under paragraph (l) of this appendix, the swap dealer is not required to capture default and credit migration risks in its internal models used to measure the specific risk of those portfolios.

(C) A swap dealer shall validate a specific risk model through back-testing.

(ii) *Specific risk fully modeled for one or more portfolios.* If the swap dealer's VaR-based measure captures all material aspects of specific risk for one or more of its portfolios of debt, equity, or correlation trading positions, the swap dealer has no specific risk add-on for those portfolios.

(3) *Specific risk not modeled.* (i) If the swap dealer's VaR-based measure does not capture all material aspects of specific risk for a portfolio of debt, equity, or correlation trading positions, the swap dealer must calculate a specific-risk add-on for the portfolio under the standardized measurement method as described in 12 CFR 217.210.

(ii) A swap dealer must calculate a specific risk add-on under the standardized measurement method as described in 12 CFR 217.200 for all of its securitization positions that are not modeled under this paragraph (k).

(l) *Incremental Risk.* An incremental risk model must meet the following minimum requirements in order to be approved:

(1) *General requirement.* A swap dealer that measures the specific risk of a portfolio of debt positions under paragraph (k) of this appendix using internal models must calculate at least weekly an incremental risk measure for that portfolio according to the requirements in this appendix. The incremental risk measure is the swap dealer's measure of potential losses due to incremental risk over a one-year time horizon at a one-tail, 99.9 percent confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions. With the prior approval of the Commission or a registered futures association of which the swap dealer is a member, a swap dealer may choose to include portfolios of equity positions in its incremental risk model, provided that it consistently includes such equity positions in a manner that is consistent with how the swap dealer internally measures and manages the incremental risk of such positions at the portfolio level. If equity positions are included in the model, for modeling purposes default is considered to have occurred upon the default of any debt of the issuer of the equity position. A swap dealer may not include correlation trading positions or securitization positions in its incremental risk measure.

(2) *Requirements for incremental risk modeling.* For purposes of calculating the incremental risk measure, the incremental risk model must:

(i) Measure incremental risk over a one-year time horizon and at a one-tail, 99.9 percent confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions.

(A) A constant level of risk assumption means that the swap dealer rebalances, or rolls over, the swap dealer's trading positions at the beginning of each liquidity horizon over the one-year horizon in a manner that maintains the swap dealer's initial risk level. The swap dealer must determine the frequency of rebalancing in a manner consistent with the liquidity horizons of the positions in the portfolio. The liquidity horizon of a position or set of positions is the time required for a swap dealer to reduce its exposure to, or hedge all of its material risks of, the position(s) in a stressed market. The liquidity horizon for a position or set of positions may not be less than the shorter of three months or the contractual maturity of the position.

(B) A constant position assumption means that the swap dealer maintains the same set of positions throughout the one-year horizon. If a swap dealer uses this assumption, it must do so consistently across all portfolios.

(C) A swap dealer's selection of a constant position or a constant risk assumption must be consistent between the swap dealer's incremental risk model and its comprehensive risk model described in paragraph (m) of this appendix, if applicable.

(D) A swap dealer's treatment of liquidity horizons must be consistent between the swap dealer's incremental risk model and its comprehensive risk model described in paragraph (m) of this appendix, if applicable.

(ii) Recognize the impact of correlations between default and migration events among obligors.

(iii) Reflect the effect of issuer and market concentrations, as well as concentrations that can arise within and across product classes during stressed conditions.

(iv) Reflect netting only of long and short positions that reference the same financial instrument.

(v) Reflect any material mismatch between a position and its hedge.

(vi) Recognize the effect that liquidity horizons have on dynamic hedging strategies. In such cases, a swap dealer must:

(A) Choose to model the rebalancing of the hedge consistently over the relevant set of trading positions;

(B) Demonstrate that including rebalancing results in a more appropriate risk measurement;

(C) Demonstrate that the market for the hedge is sufficiently liquid to permit rebalancing during periods of stress; and

(D) Capture in the incremental risk model any residual risks arising from such hedging strategies.

(vii) Reflect the nonlinear impact of options and other positions with material nonlinear behavior with respect to default and migration changes.

(viii) Maintain consistency with the swap dealer's internal risk management methodologies for identifying, measuring, and managing risk.

(m) *Comprehensive Risk.* A comprehensive risk model must meet the following minimum requirements in order to be approved:

(1) *General requirement.* (i) Subject to the prior approval of the Commission or a registered futures association of which the swap dealer is a member, a swap dealer may use the method in this paragraph to measure comprehensive risk, that is, all price risk, for one or more portfolios of correlation trading positions.

(ii) A swap dealer that measures the price risk of a portfolio of correlation trading positions using internal models must calculate at least weekly a comprehensive risk measure that captures all price risk according to the requirements of this paragraph (m). The comprehensive risk measure is either:

(A) The sum of:

(*1*) The swap dealer's modeled measure of all price risk determined according to the requirements in paragraph (m)(2) of this appendix; and

(*2*) A surcharge for the swap dealer's modeled correlation trading positions equal to the total specific risk add-on for such positions as calculated under paragraph (k) of this appendix multiplied by 8.0 percent; or

(B) With approval of the Commission, or the registered futures association of which the swap dealer is a member, and provided the swap dealer has met the requirements of this paragraph (m) for a period of at least one year and can demonstrate the effectiveness of the model through the results of ongoing model validation efforts including robust benchmarking, the greater of:

(*1*) The swap dealer's modeled measure of all price risk determined according to the requirements in paragraph (b) of this appendix; or

(*2*) The total specific risk add-on that would apply to the swap dealer's modeled correlation trading positions as calculated under paragraph (k) of this appendix multiplied by 8.0 percent.

(2) *Requirements for modeling all price risk.* If a swap dealer uses an internal model to measure the price risk of a portfolio of correlation trading positions:

(i) The internal model must measure comprehensive risk over a one-year time

horizon at a one-tail, 99.9 percent confidence level, either under the assumption of a constant level of risk, or under the assumption of constant positions.

(ii) The model must capture all material price risk, including but not limited to the following:

(A) The risks associated with the contractual structure of cash flows of the position, its issuer, and its underlying exposures;

(B) Credit spread risk, including nonlinear price risks;

(C) The volatility of implied correlations, including nonlinear price risks such as the cross-effect between spreads and correlations;

(D) Basis risk;

(E) Recovery rate volatility as it relates to the propensity for recovery rates to affect tranche prices; and

(F) To the extent the comprehensive risk measure incorporates the benefits of dynamic hedging, the static nature of the hedge over the liquidity horizon must be recognized. In such cases, a swap dealer must:

(*1*) Choose to model the rebalancing of the hedge consistently over the relevant set of trading positions;

(*2*) Demonstrate that including rebalancing results in a more appropriate risk measurement;

(*3*) Demonstrate that the market for the hedge is sufficiently liquid to permit rebalancing during periods of stress; and

(*4*) Capture in the comprehensive risk model any residual risks arising from such hedging strategies;

(iii) The swap dealer must use market data that are relevant in representing the risk profile of the swap dealer's correlation trading positions in order to ensure that the swap dealer fully captures the material risks of the correlation trading positions in its comprehensive risk measure in accordance with this appendix; and

(iv) The swap dealer must be able to demonstrate that its model is an appropriate representation of comprehensive risk in light of the historical price variation of its correlation trading positions.

(3) *Requirements for stress testing.* (i) A swap dealer must at least weekly apply specific, supervisory stress scenarios to its portfolio of correlation trading positions that capture changes in:

(A) Default rates;

(B) Recovery rates;

(C) Credit spreads;

(D) Correlations of underlying exposures; and

(E) Correlations of a correlation trading position and its hedge.

(ii) *Other requirements.* (A) A swap dealer must retain and make available to the Commission and to the registered futures association of which the swap dealer is a member the results and all assumptions and parameters of the supervisory stress testing, including comparisons with the capital requirements generated by the swap dealer's comprehensive risk model.

(B) A swap dealer must report promptly to the Commission and to the registered futures association of which it is a member any instances where the stress tests indicate any material deficiencies in the comprehensive risk model.

(n) *Securitization Exposures.* (1) To use the simplified supervisory formula approach (SSFA) to determine the specific risk-weighting factor for a securitization position, a swap dealer must have data that enables it to assign accurately the parameters described in paragraph (n)(2) of this appendix. Data used to assign the parameters described in paragraph (n)(2) of this appendix must be the most currently available data; if the contracts governing the underlying exposures of the securitization require payments on a monthly or quarterly basis, the data used to assign the parameters described in paragraph (n)(2) of this appendix must be no more than 91 calendar days old. A swap dealer that does not have the appropriate data to assign the parameters described in paragraph (n)(2) of this appendix must assign a specific risk-weighting of 100 percent to the position.

(2) *SSFA parameters.* To calculate the specific risk-weighting factor for a securitization position using the SSFA, a swap dealer must have accurate information on the five inputs to the SSFA calculation described in paragraphs (n)(2)(i) through (n)(2)(v) of this appendix.

(i) K_G is the weighted-average (with unpaid principal used as the weight for each exposure) total capital requirement of the underlying exposures calculated for a swap dealer's credit risk. K_G is expressed as a decimal value between zero and one (that is, an average risk weight of 100 percent presents a value of K_G equal to 0.08).

(ii) Parameter W is expressed as a decimal value between zero and one. Parameter W is the ratio of the sum of the dollar amounts of any underlying exposures of the securitization that meet any of the criteria as set forth in paragraphs (n)(2)(ii)(A) through (F) of this appendix to the balance, measured in dollars, of underlying exposures:

(A) Ninety days or more past due;

(B) Subject to a bankruptcy or insolvency proceeding;

(C) In the process of foreclosure;

(D) Held as real estate owned;

(E) Has contractually deferred payments for 90 days or more, other than principal or interest payments deferred on;

(*1*) Federally-guaranteed student loans, in accordance with the terms of those guarantee programs; or

(*2*) Consumer loans, including non-federally guaranteed student loans, provided that such payments are deferred pursuant to provisions included in the contract at the time funds are disbursed that provide for period(s) of deferral that are not initiated based on changes in the creditworthiness of the borrower; or

(F) Is in default.

(iii) Parameter A is the attachment point for the position, which represents the threshold at which credit losses will first be allocated to the position. Except as provided in 12 CFR 217.210(b)(2)(vii)(D) for nth to default derivatives, parameter A equals the ratio of the current dollar amount of underlying exposures that are subordinated to the position of the swap dealer to the current dollar amount of underlying exposures. Any reserve account funded by the accumulated cash flows from the underlying exposures that is subordinated to the position that contains the swap dealer's securitization exposure may be included in the calculation of parameter A to the extent that cash is present in the account. Parameter A is expressed as a decimal value between zero and one.

(iv) Parameter D is the detachment point for the position, which represents the threshold at which credit losses of principal allocated to the position would result in a total loss of principal. Except as provided in 12 CFR 210(b)(2)(vii)(D) for nth-to-default credit derivatives, parameter D equals parameter A plus the ratio of the current dollar amount of the securitization positions that are pari passu with the position (that is, have equal seniority with respect to credit risk) to the current dollar amount of the underlying exposures. Parameter D is expressed as a decimal value between zero and one.

(v) A supervisory calibration parameter, p, is equal to 0.5 for securitization positions that are not resecuritization positions and equal to 1.5 for resecuritization positions.

(3) *Mechanics of the SSFA.* K_G and W are used to calculate K_A, the augmented value of K_G, which reflects the observed credit quality of the underlying exposures. K_A is defined in paragraph (n)(4) of this appendix. The values of parameters A and D, relative to K_A determine the specific risk-weighting factor assigned to a securitization position, or portion of a position, as appropriate, is the larger of the specific risk-weighting factor determined in accordance with this paragraph (n)(3), paragraph (n)(4) of this appendix, and a specific risk-weighting factor of 1.6 percent.

(i) When the detachment point, parameter D, for a securitization position is less than or equal to K_A, the position must be assigned a specific risk-weighting factor of 100 percent.

(ii) When the attachment point, parameter A, for a securitization position is greater than or equal to K_A, the swap dealer must calculate the specific risk-weighting factor in accordance with paragraph (n)(4) of this appendix.

(iii) When A is less than K_A and D is greater than K_A, the specific risk-weighting factor is a weighted-average of 1.00 and K_{SSFA} calculated under paragraphs (n)(3)(iii)(A) and (3)(iii)(B) of this appendix. For the purpose of this calculation:

(A) The weight assigned to 1.00 equals

(B) The weight assigned to K_{SSFA} equals $\frac{D-K_A}{D-A}$. The specific risk-weighting factor is equal to: SRWF = $100 \cdot [(\frac{K_A-A}{D-A}) \cdot 1.00] + [(\frac{D-K_A}{D-A}) \cdot K_{SSFA}]$

(4) *SSFA equation.* (i) The swap dealer must define the following parameters:

$$K_A = (1 - W) \cdot K_G + (0.5 \cdot W)$$

$$a = -\frac{1}{p \cdot K_A}$$

$$u = D - K_A$$

$$l = \max(A - K_A, 0)$$

$e = 2.71828$, the base of the natural logarithms

(ii) Then the swap dealer must calculate K_{SSFA} according to the following formula:

$$K_{SSFA} = \frac{e^{a \cdot u} - e^{a \cdot l}}{a \cdot (u - l)}$$

(iii) The specific risk-weighting factor for the position (expressed as a percent) is equal to $K_{SSFA} \times 100$.

(o) *Additional conditions.* As a condition for the swap dealer to use this Appendix A to calculate certain of its capital charges, the Commission, or registered futures association of which the swap dealer is a member, may impose additional conditions on the swap dealer, which may include, but are not limited to restricting the swap dealer's business on a product-specific, category-specific, or general basis; submitting to the Commission or the registered futures association a plan to increase the swap dealer's regulatory capital; filing more frequent reports with the Commission or the registered futures association; modifying the swap dealer's internal risk management control procedures; or computing the swap dealer's deductions for market and credit risk in accordance with §§ 23.102 as appropriate. If the Commission or registered futures association finds it is necessary or appropriate in the public interest, the Commission or registered futures association may impose additional conditions on the swap dealer, if:

(1) The swap dealer is required to provide notice to the Commission or the registered futures association that the swap dealer's regulatory capital is less than $100 million;

(2) The swap dealer fails to meet the reporting requirements set forth in § 23.105;

(3) Any event specified in § 23.105 occurs;

(4) There is a material deficiency in the internal risk management control system or in the mathematical models used to price securities or to calculate deductions for market and credit risk or allowances for market and credit risk, as applicable, of the swap dealer;

(5) The swap dealer fails to comply with this Appendix A; or

(6) The Commission finds that imposition of other conditions is necessary or appropriate in the public interest.

■ 16. Add Appendix B to Subpart E of Part 23 to read as follows:

Appendix B to Subpart E of Part 23—Swap Dealer and Major Swap Participant Position Information

BILLING CODE 6351–01–P

Reg. 23.105 (l)
Appendix
B

SCHEDULE 1 – AGGREGATE SECURITIES, COMMODITIES, AND SWAPS POSITIONS

Items on this page to be reported by: Swap Dealers
Major Swap Participants

Aggregate Securities, Commodities, and Swaps Positions	LONG/BOUGHT		SHORT/SOLD	
1. U.S. treasury securities	$	8200	$	8201
2. U.S. government agency and U.S. government-sponsored enterprises	$	8210	$	8211
A. Mortgage-backed securities issued by U.S. government agency and U.S. government-sponsored enterprises	$	18001	$	18002
B. Debt securities issued by U.S. government agency and U.S. government-sponsored enterprises	$	18003	$	18004
3. Securities issued by states and political subdivisions in the U.S	$	8220	$	8221
4. Foreign securities				
A. Debt securities	$	8230	$	8231
B. Equity securities	$	8235	$	8236
5. Money market instruments	$	8240	$	8241
6. Private label mortgage backed securities	$	8250	$	8251
7. Other asset-backed securities	$	8260	$	8261
8. Corporate obligations	$	8270	$	8271
9. Stocks and warrants (other than arbitrage positions)	$	8280	$	8281
10. Arbitrage	$	8290	$	8291
11. Spot commodities	$	8330	$	8331
12. Other securities and commodities	$	8360	$	8361
13. Securities with no ready market				
A. Equity	$	8340	$	8341
B. Debt	$	8345	$	8346
C. Other	$	8350	$	8351
D. Total securities with no ready market	$	12777	$	12782
14. Total net securities and spot commodities (sum of Lines 1-12 and 13D)	$	12778	$	12783
15. Security-based swaps				
A. Cleared	$	12106	$	12114
B. Non-cleared	$	12107	$	12115
16. Mixed swaps				
A. Cleared	$	12108	$	12116
B. Non-cleared	$	12109	$	12117
17. Swaps				
A. Cleared	$	12110	$	12118
B. Non-cleared	$	12111	$	12119
18. Other derivatives and options	$	8295	$	8296
19. Counterparty netting	$	12779	$	12784
20. Cash collateral netting	$	12780	$	12785
21. Total derivative receivables and payables (sum of Lines 15-20)	$	12781	$	12786
22. Total net securities, commodities, and swaps positions (sum of Lines 14 and 21)	$	8370	$	8371

Name of firm: _____
As of: _____

NOTE: The information required to be reported within this form is intended to be identical to that required to be reported by Security Based Swap Dealers and Major Security Based Swap Participants under SEC FORM X-17a-5 FOCUS Report Part II. Please refer to FOCUS REPORT II INSTRUCTIONS and related interpretations published by the SEC in the preparation of this form.

Reg. 23.105 (l)
Appendix
B

SCHEDULE 2 – CREDIT CONCENTRATION REPORT FOR FIFTEEN LARGEST EXPOSURES IN DERIVATIVES

Items on this page to be reported by: Swap Dealers (Authorized to use models)
Major Swap Participants

I. By Current Net Exposure

Counterparty Identifier		Gross Replacement Value Receivable (Gross Gain)	Gross Replacement Value Payable (Gross Loss)	Net Replacement Value	Current Net Exposure	Current Net and Potential Exposure	Margin Collected
1.	12120	$ 12135	$ 12151	$ 12167	$ 12183	$ 12199	$ 12215
2.	12121	$ 12136	$ 12152	$ 12168	$ 12184	$ 12200	$ 12216
3.	12122	$ 12137	$ 12153	$ 12169	$ 12185	$ 12201	$ 12217
4.	12123	$ 12138	$ 12154	$ 12170	$ 12186	$ 12202	$ 12218
5.	12124	$ 12139	$ 12155	$ 12171	$ 12187	$ 12203	$ 12219
6.	12125	$ 12140	$ 12156	$ 12172	$ 12188	$ 12204	$ 12220
7.	12126	$ 12141	$ 12157	$ 12173	$ 12189	$ 12205	$ 12221
8.	12127	$ 12142	$ 12158	$ 12174	$ 12190	$ 12206	$ 12222
9.	12128	$ 12143	$ 12159	$ 12175	$ 12191	$ 12207	$ 12223
10.	12129	$ 12144	$ 12160	$ 12176	$ 12192	$ 12208	$ 12224
11.	12130	$ 12145	$ 12161	$ 12177	$ 12193	$ 12209	$ 12225
12.	12131	$ 12146	$ 12162	$ 12178	$ 12194	$ 12210	$ 12226
13.	12132	$ 12147	$ 12163	$ 12179	$ 12195	$ 12211	$ 12227
14.	12133	$ 12148	$ 12164	$ 12180	$ 12196	$ 12212	$ 12228
15.	12134	$ 12149	$ 12165	$ 12181	$ 12197	$ 12213	$ 12229
All other counterparties		$ 12150	$ 12166	$ 12182	$ 12198	$ 12214	$ 12230
Totals:		$ 7810	$ 7811	$ 7812	$ 7813	$ 7814	$ 12231

II. By Current Net and Potential Exposure

Counterparty Identifier		Gross Replacement Value Receivable (Gross Gain)	Gross Replacement Value Payable (Gross Loss)	Net Replacement Value	Current Net Exposure	Current Net and Potential Exposure	Margin Collected
1.	12232	$ 12247	$ 12264	$ 12281	$ 12298	$ 12315	$ 12332
2.	12233	$ 12248	$ 12265	$ 12282	$ 12299	$ 12316	$ 12333
3.	12234	$ 12249	$ 12266	$ 12283	$ 12300	$ 12317	$ 12334
4.	12235	$ 12250	$ 12267	$ 12284	$ 12301	$ 12318	$ 12335
5.	12236	$ 12251	$ 12268	$ 12285	$ 12302	$ 12319	$ 12336
6.	12237	$ 12252	$ 12269	$ 12286	$ 12303	$ 12320	$ 12337
7.	12238	$ 12253	$ 12270	$ 12287	$ 12304	$ 12321	$ 12338
8.	12239	$ 12254	$ 12271	$ 12288	$ 12305	$ 12322	$ 12339
9.	12240	$ 12255	$ 12272	$ 12289	$ 12306	$ 12323	$ 12340
10.	12241	$ 12256	$ 12273	$ 12290	$ 12307	$ 12324	$ 12341
11.	12242	$ 12257	$ 12274	$ 12291	$ 12308	$ 12325	$ 12342
12.	12243	$ 12258	$ 12275	$ 12292	$ 12309	$ 12326	$ 12343
13.	12244	$ 12259	$ 12276	$ 12293	$ 12310	$ 12327	$ 12344
14.	12245	$ 12260	$ 12277	$ 12294	$ 12311	$ 12328	$ 12345
15.	12246	$ 12261	$ 12278	$ 12295	$ 12312	$ 12329	$ 12346
All other counterparties		$ 12262	$ 12279	$ 12296	$ 12313	$ 12330	$ 12347
Totals:		$ 12263	$ 12280	$ 12297	$ 12314	$ 12331	$ 12348

Name of firm: _____
As of: _____

NOTE: The information required to be reported within this form is intended to be identical to that required to be reported by Security Based Swap Dealers and Major Security Based Swap Participants under SEC FORM X-17a-5 FOCUS Report Part II. Please refer to FOCUS REPORT II INSTRUCTIONS and related interpretations published by the SEC in the preparation of this form.

Reg. 23.105 (l)
Appendix
B

SCHEDULE 3 – PORTFOLIO SUMMARY OF DERIVATIVES EXPOSURES BY INTERNAL CREDIT RATING

Items on this page to be reported by: Swap Dealers (Authorized to use models)
Major Swap Participants

Internal Credit Rating		Gross Replacement Value Receivable		Gross Replacement Value Payable		Net Replacement Value		Current Net Exposure		Current Net and Potential Exposure		Margin Collected	
1.	12349	$	12386	$	12423	$	12460	$	12497	$	12534	$	12572
2.	12350	$	12387	$	12424	$	12461	$	12498	$	12535	$	12573
3.	12351	$	12388	$	12425	$	12462	$	12499	$	12536	$	12574
4.	12352	$	12389	$	12426	$	12463	$	12500	$	12537	$	12575
5.	12353	$	12390	$	12427	$	12464	$	12501	$	12538	$	12576
6.	12354	$	12391	$	12428	$	12465	$	12502	$	12539	$	12577
7.	12355	$	12392	$	12429	$	12466	$	12503	$	12540	$	12578
8.	12356	$	12393	$	12430	$	12467	$	12504	$	12541	$	12579
9.	12357	$	12394	$	12431	$	12468	$	12505	$	12542	$	12580
10.	12358	$	12395	$	12432	$	12469	$	12506	$	12543	$	12581
11.	12359	$	12396	$	12433	$	12470	$	12507	$	12544	$	12582
12.	12360	$	12397	$	12434	$	12471	$	12508	$	12545	$	12583
13.	12361	$	12398	$	12435	$	12472	$	12509	$	12546	$	12584
14.	12362	$	12399	$	12436	$	12473	$	12510	$	12547	$	12585
15.	12363	$	12400	$	12437	$	12474	$	12511	$	12548	$	12586
16.	12364	$	12401	$	12438	$	12475	$	12512	$	12549	$	12587
17.	12365	$	12402	$	12439	$	12476	$	12513	$	12550	$	12588
18.	12366	$	12403	$	12440	$	12477	$	12514	$	12551	$	12589
19.	12367	$	12404	$	12441	$	12478	$	12515	$	12552	$	12590
20.	12368	$	12405	$	12442	$	12479	$	12516	$	12553	$	12591
21.	12369	$	12406	$	12443	$	12480	$	12517	$	12554	$	12592
22.	12370	$	12407	$	12444	$	12481	$	12518	$	12555	$	12593
23.	12371	$	12408	$	12445	$	12482	$	12519	$	12556	$	12594
24.	12372	$	12409	$	12446	$	12483	$	12520	$	12557	$	12595
25.	12373	$	12410	$	12447	$	12484	$	12521	$	12558	$	12596
26.	12374	$	12411	$	12448	$	12485	$	12522	$	12559	$	12597
27.	12375	$	12412	$	12449	$	12486	$	12523	$	12560	$	12598
28.	12376	$	12413	$	12450	$	12487	$	12524	$	12561	$	12599
29.	12377	$	12414	$	12451	$	12488	$	12525	$	12562	$	12600
30.	12378	$	12415	$	12452	$	12489	$	12526	$	12563	$	12601
31.	12379	$	12416	$	12453	$	12490	$	12527	$	12564	$	12602
32.	12380	$	12417	$	12454	$	12491	$	12528	$	12565	$	12603
33.	12381	$	12418	$	12455	$	12492	$	12529	$	12566	$	12604
34.	12382	$	12419	$	12456	$	12493	$	12530	$	12567	$	12605
35.	12383	$	12420	$	12457	$	12494	$	12531	$	12568	$	12606
36.	12384	$	12421	$	12458	$	12495	$	12532	$	12569	$	12607
Unrated	12385	$	12422	$	12459	$	12496	$	12533	$	12570	$	12608
Totals:		$	7822	$	7823	$	7821	$	7820	$	12571	$	12609

Name of firm: _____
As of: _____

NOTE: The information required to be reported within this form is intended to be identical to that required to be reported by Security Based Swap Dealers and Major Security Based Swap Participants under SEC FORM X-17a-5 FOCUS Report Part II. Please refer to FOCUS REPORT II INSTRUCTIONS and related interpretations published by the SEC in the preparation of this form.

Reg. 23.105 (l) Appendix B	SCHEDULE 4 – GEOGRAPHIC DISTRIBUTION OF DERIVATIVES EXPOSURES FOR TEN LARGEST COUNTRIES
	Items on this page to be reported by: Swap Dealers (Authorized to use models) Major Swap Participants

I. By Current Net Exposure

Country		Gross Replacement Value Receivable	Gross Replacement Value Payable	Net Replacement Value	Current Net Exposure	Current Net and Potential Exposure	Margin Collected
1.	12610	$ 12620	$ 12630	$ 12640	$ 12650	$ 12661	$ 12671
2.	12611	$ 12621	$ 12631	$ 12641	$ 12651	$ 12662	$ 12672
3.	12612	$ 12622	$ 12632	$ 12642	$ 12652	$ 12663	$ 12673
4.	12613	$ 12623	$ 12633	$ 12643	$ 12653	$ 12664	$ 12674
5.	12614	$ 12624	$ 12634	$ 12644	$ 12654	$ 12665	$ 12675
6.	12615	$ 12625	$ 12635	$ 12645	$ 12655	$ 12666	$ 12676
7.	12616	$ 12626	$ 12636	$ 12646	$ 12656	$ 12667	$ 12677
8.	12617	$ 12627	$ 12637	$ 12647	$ 12657	$ 12668	$ 12678
9.	12618	$ 12628	$ 12638	$ 12648	$ 12658	$ 12669	$ 12679
10.	12619	$ 12629	$ 12639	$ 12649	$ 12659	$ 12670	$ 12680
Totals:		$ 7803	$ 7804	$ 7802	$ 12660	$ 7801	$ 12681

II. By Current Net and Potential Exposure

Country		Gross Replacement Value Receivable	Gross Replacement Value Payable	Net Replacement Value	Current Net Exposure	Current Net and Potential Exposure	Margin Collected
1.	12682	$ 12692	$ 12703	$ 12714	$ 12725	$ 12736	$ 12747
2.	12683	$ 12693	$ 12704	$ 12715	$ 12726	$ 12737	$ 12748
3.	12684	$ 12694	$ 12705	$ 12716	$ 12727	$ 12738	$ 12749
4.	12685	$ 12695	$ 12706	$ 12717	$ 12728	$ 12739	$ 12750
5.	12686	$ 12696	$ 12707	$ 12718	$ 12729	$ 12740	$ 12751
6.	12687	$ 12697	$ 12708	$ 12719	$ 12730	$ 12741	$ 12752
7.	12688	$ 12698	$ 12709	$ 12720	$ 12731	$ 12742	$ 12753
8.	12689	$ 12699	$ 12710	$ 12721	$ 12732	$ 12743	$ 12754
9.	12690	$ 12700	$ 12711	$ 12722	$ 12733	$ 12744	$ 12755
10.	12691	$ 12701	$ 12712	$ 12723	$ 12734	$ 12745	$ 12756
Totals:		$ 12702	$ 12713	$ 12724	$ 12735	$ 12746	$ 12757

Name of firm: _____
As of: _____

NOTE: The information required to be reported within this form is intended to be identical to that required to be reported by Security Based Swap Dealers and Major Security Based Swap Participants under SEC FORM X-17a-5 FOCUS Report Part II. Please refer to FOCUS REPORT II INSTRUCTIONS and related interpretations published by the SEC in the preparation of this form.

■ 17. Add Appendix C to Subpart E of Part 23 to read as follows:

Appendix C to Subpart E of Part 23—Financial Reports and Specific Position Information for Swap Dealers and Major Swap Participants Subject to the Capital Requirements of a Prudential Regulator

Reg. 23.105 (p) Appendix C	BALANCE SHEET (INFORMATION AS REPORTED ON FFIEC FORM 031 – SCHEDULE RC)
	Items on this page to be reported by a: Bank SD Bank MSP

Assets		Totals	
1. Cash and balances due from depository institutions (from FFIEC Form 031's Schedule RC-A)			
A. Noninterest-bearing balances and currency and coin		$ _____	0081b
B. Interest-bearing balances		$ _____	0071b
2. Securities			
A. Held-to-maturity securities		$ _____	1754b
B. Available-for-sale securities		$ _____	1773b
3. Federal funds sold and securities purchased under agreements to resell			
A. Federal funds sold in domestic offices		$ _____	B987b
B. Securities purchased under agreements to resell		$ _____	B989b
4. Loans and lease financing receivables (from FFIEC Form 031's Schedule RC-C)			
A. Loans and leases held for sale		$ _____	5369b
B. Loans and leases, net of unearned income	$ _____ B528b		
C. LESS: Allowance for loan and lease losses	$ _____ 3123b		
D. Loans and leases, net of unearned income and allowance (Line 4B minus Line 4C)		$ _____	B529b
5. Trading assets (from FFIEC Form 031's Schedule RC-D)		$ _____	3545b
6. Premises and fixed assets (including capitalized leases)		$ _____	2145b
7. Other real estate owned (from FFIEC Form 031's Schedule RC-M)		$ _____	2150b
8. Investments in unconsolidated subsidiaries and associated companies		$ _____	2130b
9. Direct and indirect investments in real estate ventures		$ _____	3656b
10. Intangible assets			
A. Goodwill		$ _____	3163b
B. Other intangible assets (from FFIEC Form 031's Schedule RC-M)		$ _____	0426b
11. Other assets (from FFIEC Form 031's Schedule RC-F)		$ _____	2160b
12. Total assets (sum of Lines 1 through 11)		$ _____	2170b

Name of firm: _____
As of: _____

NOTE: The information required to be reported within this form is intended to be identical to that required to be reported by Security Based Swap Dealers and Major Security Based Swap Participants under SEC FORM X-17a-5 FOCUS Report Part II. Please refer to FOCUS REPORT II INSTRUCTIONS and related interpretations published by the SEC in the preparation of this form.

Reg. 23.105 (p) Appendix C	BALANCE SHEET (INFORMATION AS REPORTED ON FFIEC FORM 031 – SCHEDULE RC)
	Items on this page to be reported by a: Bank SD Bank MSP

Liabilities			Totals	
13. Deposits				
A. In domestic offices (sum of totals of Columns A and C from FFIEC Form 031's Schedule RC-E, part I)			$	2200b
1. Noninterest-bearing	$	6631b		
2. Interest-bearing	$	6636b		
B. In foreign offices, Edge and Agreement subsidiaries, and IBFs (from FFIEC Form 031's Schedule RC-E, part II)			$	2200b
1. Noninterest-bearing	$	6631b		
2. Interest-bearing	$	6636b		
14. Federal funds purchased and securities sold under agreements to repurchase				
A. Federal funds purchased in domestic offices			$	B993b
B. Securities sold under agreements to repurchase			$	B995b
15. Trading liabilities			$	3548b
16. Other borrowed money (includes mortgage indebtedness and obligations under capitalized leases) (from FFIEC Form 031's Schedule RC-M)			$	3190b
17. Not applicable.				
18. Not applicable.				
19. Subordinated notes and debentures			$	3200b
20. Other liabilities (from FFIEC Form 031's Schedule RC-G)			$	2930b
21. Total liabilities (sum of Lines 13 through 20)			$	2948b
22. Not applicable.				
Equity Capital				
23. Perpetual preferred stock and related surplus			$	3838b
24. Common stock			$	3230b
25. Surplus (exclude all surplus related to preferred stock)			$	3839b
26 A. Retained earnings			$	3632b
B. Accumulated other comprehensive income			$	B530b
C. Other equity capital components			$	A130b
27A. Total bank equity capital (sum of Lines 23 through 26.C)			$	3210b
B. Non-controlling (minority) interests in consolidated subsidiaries			$	3000b
28. Total equity capital (sum of Lines 27A and 27B)			$	G105b
29. Total liabilities and equity capital (sum of Lines 21 and 28)			$	3300b

Name of firm: _____
As of: _____

NOTE: The information required to be reported within this form is intended to be identical to that required to be reported by Security Based Swap Dealers and Major Security Based Swap Participants under SEC FORM X-17a-5 FOCUS Report Part II. Please refer to FOCUS REPORT II INSTRUCTIONS and related interpretations published by the SEC in the preparation of this form.

Reg. 23.105 (p) Appendix C	REGULATORY CAPITAL (INFORMATION AS REPORTED ON FFIEC FORM 031 – SCHEDULE RC-R)
	Items on this page to be reported by a: Bank SD

Capital	**Totals**
1. Total bank equity capital (from FFIEC Form 031's Schedule RC, Line 27A)	$ _____ 3210b
2. Tier 1 capital	$ _____ 8274b
3. Tier 2 capital	$ _____ 5311b
4. Tier 3 capital allocated for market risk	$ _____ 1395b
5. Total risk-based capital	$ _____ 3792b
6. Total risk-weighted assets	$ _____ A223b
7. Total assets for the leverage ratio	$ _____ A224b

Capital Ratios (Column B is to be completed by all banks. Column A is to be completed by banks with financial subsidiaries.)	**Column A**	**Column B**
8. Tier 1 leverage ratio	$ _____ 7204b	
9. Tier 1 risk-based capital ratio	_____ 7206b	$ _____ 7206b
10. Total risk-based capital ratio	_____ 7205b	$ _____ 7205b

Name of firm: _____
As of: _____

NOTE: The information required to be reported within this form is intended to be identical to that required to be reported by Security Based Swap Dealers and Major Security Based Swap Participants under SEC FORM X-17a-5 FOCUS Report Part II. Please refer to FOCUS REPORT II INSTRUCTIONS and related interpretations published by the SEC in the preparation of this form.

Reg. 23.105 (p) Appendix C	SCHEDULE 1 - AGGREGATE SECURITY-BASED SWAP AND SWAP POSITIONS
	Items on this page to be reported by a: Bank SDs Bank MSPs

Aggregate Positions	LONG/BOUGHT		SHORT/SOLD	
1. Security-based swaps				
A. Cleared	$ _____	12801	$ _____	12809
B. Non-cleared	$ _____	12802	$ _____	12810
2. Mixed swaps				
A. Cleared	$ _____	12803	$ _____	12811
B. Non-cleared	$ _____	12804	$ _____	12812
3. Swaps				
A. Cleared	$ _____	12805	$ _____	12813
B. Non-cleared	$ _____	12806	$ _____	12814
4. Other derivatives	$ _____	12807	$ _____	12815
5. Total (sum of Lines 1-4)	$ _____	12808	$ _____	12816

Name of firm: _____
As of: _____

NOTE: The information required to be reported within this form is intended to be identical to that required to be reported by Security Based Swap Dealers and Major Security Based Swap Participants under SEC FORM X-17a-5 FOCUS Report Part II. Please refer to FOCUS REPORT II INSTRUCTIONS and related interpretations published by the SEC in the preparation of this form.

BILLING CODE 6351–01–C

PART 140—ORGANIZATION, FUNCTIONS, AND PROCEDURES OF THE COMMISSION

■ 18. The authority citation for part 140 continues to read as follows:

Authority: 7 U.S.C. 2(a)(12), 12a, 13(c), 13(d), 13(e), and 16(b).

■ 19. In § 140.91, redesignate paragraphs (a)(11) and (12) as paragraphs (a)(12) and (13), and add a new paragraph (a)(11) to read as follows:

§ 140.91 Delegation of authority to the Director of the Division of Clearing and Risk and to the Director of the Division of Swap Dealer and Intermediary Oversight.

(a) * * *

(11) All functions reserved to the Commission in § 23.100–106 of this chapter, except for those related to the revocation of a swap dealer's or major swap participant's approval to use internal models to compute capital requirements under § 23.102 of this chapter, those related to the Commission's order under § 23.104 of this chapter, and the issuance of Capital Comparability Determinations under § 23.106 of this chapter.

* * * * *

Issued in Washington, DC, on July 24, 2020, by the Commission.

Robert Sidman,

Deputy Secretary of the Commission.

Note: The following appendices will not appear in the Code of Federal Regulations.

Appendices to Capital Requirements of Swap Dealers and Major Swap Participants—Commission Voting Summary, Chairman's Statement, and Commissioners' Statements

Appendix 1—Commission Voting Summary

On this matter, Chairman Tarbert and Commissioners Quintenz and Stump voted in the affirmative. Commissioners Behnam and Berkovitz voted in the negative.

Appendix 2—Supporting Statement of Chairman Heath P. Tarbert

Today marks 10 years and a day since the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act'') was signed into law. Much has changed during the past decade—our derivatives markets today are faster, increasingly digital, and more deeply connected to the global economy than they were in 2010. Yet amidst these changes, there has been at least one constant: The absence of capital requirements for swap dealers and major swap participants for which the CFTC is responsible.[1] As a response to the credit crisis of 2008, Section 731 of the Dodd-Frank Act amended the Commodity Exchange Act (''CEA''), providing that the CFTC ''shall adopt'' capital and financial reporting requirements for these entities.[2] It is high time to fulfill this mandate and close the book on our Dodd-Frank Act responsibilities.[3] After all, ''late'' is always better than ''too late.''

There is another compelling reason to finalize a capital rule that is more than a decade in the making:[4] Certainty. One of our strategic goals as an agency is to enhance the regulatory experience for market participants at home and abroad.[5] Certainty is the bedrock of this goal. Our swap dealers cannot effectively plan for compliance without clarity from us about what their capital obligations will look like. Today we lift this cloud of uncertainty by finalizing a capital rule that carefully accounts for the differences among our swap dealers.

The final capital rule is designed to enhance customer protection and reduce systemic risk in the financial system. Capital requirements are the ultimate backstop, ensuring that customers are protected and the financial system remains sound in the event that all other measures fail. While our uncleared margin rules have effectively absorbed the shocks of recent pandemic-driven volatility,[6] a capital regime will provide further assurances that our markets and their participants can weather new storms.

Determining Capital

The final capital rule requires swap dealers and major swap participants to maintain a level of minimum capital based on one of three basic approaches. Each approach incorporates minimum amounts of capital based on various criteria, including a $20 million floor, a level of capital required by the National Futures Association, and the amount of margin on uncleared swap transactions. The three basic approaches will be the focus of my remarks because they are effectively tailored to the distinctive type of swap dealer involved.

Regulatory Flexibility

Our derivatives markets are vibrant in large part because of the diversity of swap dealers and other market participants. Of the 108 provisionally registered swap dealers, 56 will be subject to the capital requirements. Of those, four are futures commission merchants that are dually registered with the SEC as broker-dealers and 12 are non-bank subsidiaries of bank holding companies. Others are non-banks that deal in financial swaps involving interest rates, foreign currency, credit, and the like; still more are primarily engaged in agricultural and energy businesses; and several are subject to the laws and regulations of other countries.

The final capital rule applies to entities with a variety of business structures, asset profiles, and risk levels. For example, a swap dealer primarily involved in the energy business is fundamentally different from a large bank involved in financial swaps. A ''one-size-fits-all'' approach would be incompatible with the rich gradations in our derivatives markets. As a result, the final capital requirements offer regulatory flexibility by accounting for key differences among covered entities. This flexible approach is designed to enhance the regulatory experience for our market participants[7] while safeguarding the markets, as more fully discussed below.

1. Capital Requirements for FCM Swap Dealers

The CFTC has longstanding capital requirements for Futures Commission Merchants (''FCMs'') to ensure customer funds are protected in the event of an FCM failure.[8] The final rule preserves existing FCM capital rules for swap dealers that are also registered as FCMs, but makes a few key adjustments to better address risk and customer protection associated with dealing in swaps.

The final rule requires FCM swap dealers to maintain minimum capital equal to or greater than the sum of: (i) The current FCM risk margin amount of 8% of customer and noncustomer cleared futures, cleared foreign futures, and cleared swaps positions; and (ii) 2% of the total margin amount associated with uncleared swaps. Security-based swaps are excluded from both margin amounts. In addition, the final rule increases the $1 million minimum capital ''floor'' for FCMs to $20 million for FCM swap dealers.

These changes reflect sound policy. In particular, excluding security-based swaps comports with the CFTC's longstanding respect for the SEC's jurisdiction over those products. Moreover, excluding cleared swaps from the 2% risk margin amount brings our capital requirements in line with the lower credit risk posed by cleared products. This approach is also consistent with the CFTC's net capital requirement for Registered

[1] The CFTC does not have jurisdiction to establish capital requirements for swap dealers subject to the jurisdiction of a federal banking regulator as identified in Section 1a(39) of the CEA, 7 U.S.C. 1(a)(39) (2018).

[2] *See* Section 4s(e) and 4s(f)(2) of the CEA, 7 U.S.C. 6s(e), 6s(f)(2) (2018).

[3] Section 731 of the Dodd-Frank Act also required the CFTC to establish initial and variation margin requirements for uncleared swaps, which are being implemented on a phased schedule that currently extends to all but the smallest swap market participants. *See* Statement of Chairman Heath P. Tarbert in Support of Extending the Phase 5 Initial Margin Compliance Deadline (May 28, 2020), *https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement052820c.*

[4] The capital rule was first proposed in 2011 and re-proposed in 2016. *See Capital Requirements of Swap Dealers and Major Swap Participants,* 76 FR 27802 (May 12, 2011); *see also Capital Requirements of Swap Dealers and Major Swap Participants,* 81 FR 91252 (Dec. 16, 2016). The comment period was re-opened in December 2019, allowing the Commission to glean additional insights from market participants prior to presenting today's final rule. *See Capital Requirements of Swap Dealers and Major Swap Participants,* 84 FR 69664 (Dec. 16, 2019).

[5] *See* CFTC Strategic Plan 2020–2024, at 4 (discussing Strategic Goal 3), *https://www.cftc.gov/media/3871/CFTC2020_2024StrategicPlan/download.*

[6] Heath Tarbert, *Volatility Ain't What it Used to Be,* Wall Street Journal (Mar. 23, 2020), *https://www.wsj.com/articles/volatility-aint-what-it-used-to-be-11585004897.*

[7] *See* CFTC Strategic Plan, *supra* note 5, at 4.

[8] *See* Regulation 1.17, 17 CFR 1.17 (2019).

Foreign Exchange Dealers,[9] as well as the SEC's capital rules for broker dealers.[10]

2. Capital Requirements for Non-FCM Swap Dealers

Well-crafted rules must account for the differences among our market participants. For swap dealers that are not FCMs, the final rule provides three methods of determining minimum capital that respond to their different business models, risk profiles, and capital structures.[11]

a. The Net Liquid Assets Approach

Some swap dealers have responsibility for customer funds, such as those that are dually registered with the SEC as broker dealers. For these swap dealers, capital requirements can advance customer protection where all else has failed, by providing a ''cushion'' for orderly liquidation.[12] An effective cushion requires liquidity, which can be analogized to the readily available cash in one's wallet. Consistent with this analogy, swap dealers may select the Net Liquid Assets approach in the final rule—requiring them to maintain 2% of the margin amount associated with uncleared swaps—which we believe is sufficient to protect customer funds in the event of a liquidation.

The Net Liquid Assets approach is not only about customer protection: It also facilitates sensible harmonization with SEC capital requirements for dual registrants. In doing so, the Net Liquid Assets approach supports the CFTC's strategic goal of improving the regulatory experience for market participants.[13]

b. The Bank-Based Approach

Banks are the backbone of our financial system, and are subject to a specific statutory regime managed by the Federal Reserve Board and other federal banking regulators. Banks—and by extension their non-bank swap dealer subsidiaries—naturally raise greater systemic risk concerns than other types of swap dealers.

While the cash in one's wallet is the appropriate analogy when thinking about capital as a measure of customer protection, the central role banks play in our financial system requires us to consider a much bigger picture. For banks, capital must facilitate safety and soundness, ensuring that they act prudently.[14] The personal finance analogy for assessing bank capital, therefore, is not just cash-in-wallet, but also savings accounts, checking accounts, retirement funds, and other assets.

This broad view of bank capital as a window into solvency is designed to reduce overall risk in the financial system, advancing a strategic goal of the CFTC.[15] As stated in the agency's 2020–2024 Strategic Plan, ''[t]aking steps to avoid systemic risk will not only protect market participants, but increase confidence in the soundness of U.S. derivatives markets.'' [16] Our bank-based capital approach is designed to meet this goal.

Accordingly, swap dealers selecting the Bank-Based Approach may satisfy their capital requirements by retaining (i) 8% of risk-weighted assets (''RWA''), composed of at least 6.5% of tier 1 common equity (''CET1''), and (ii) 8% of their uncleared swap margin amount. Requiring at least 6.5% of a swap dealer's RWA to be composed of CET1—the highest-quality regulatory capital—addresses potential systemic risk by ensuring that available capital can immediately stem losses, avoiding financial contagion. Second, the requirement that swap dealers electing the Bank-Based Approach must retain 8% of margin for uncleared swaps reflects the uniquely critical role they play in the financial system.

c. The Tangible Net Worth Approach

Finally, some swap dealers are not financial entities, but rather commercial businesses engaged in the agriculture and energy sectors. These swap dealers help American families put food on the table and gas in the car. Unlike financial entities, their balance sheets often contain significant physical assets, such as oil refineries, grain warehouses, and even railroad rolling stock. Net worth—inclusive of physical assets—is the appropriate measure to assess minimum capital for these commercial entities. In extending our analogy, capital for these swap dealers must be inclusive not just of cash or retirement account holdings, but one's house and car—the assets that could be pledged as collateral in borrowing.

The final capital rule recognizes that commercial entities are fundamentally different from other swap dealers. This is reflected in the Tangible Net Worth (''TNW'') approach, which sets minimum capital at 8% of the margin amount for uncleared swaps. Eligibility for the TNW approach is determined at the consolidated parent level, which allows a financial subsidiary of a commercial entity that is registered as a swap dealer to elect the approach.

3. Market and Credit Risk Models

In addition to capital requirements, today's final rule makes important adjustments to the requirements that swap dealers must satisfy to rely on internal market and credit risk models rather than the standardized models provided in Regulation 1.17. Like minimum capital requirements, market and credit risk models will be most effective when they reflect a swap dealer's unique business and risk profile. In addition, internal models specific to a swap dealer's portfolio can provide a more nuanced view of risk than standardized models.

That said, the final rule provides a certification process for swap dealers relying on internal market and credit risk models, ensuring flexibility while retaining oversight through the National Futures Association. Permitting swap dealers to rely on bespoke models that best account for their particular situations is good governance and enhances the regulatory experience.[17] At the same time, by subjecting those models to objective validation by the National Futures Association (and potentially other domestic and foreign regulators), there is a check on that flexibility. Further, this approach makes the CFTC's model approval process more closely aligned with the SEC and federal banking regulators.[18]

Allowing swap dealers to rely on internal risk models is also an appropriate instance of principles-based regulation,[19] as prescriptive requirements that do not account for differences among firms simply cannot measure risk as accurately as internal models that account for key differences among swap dealers.

4. Financial Reporting

Today's final rule also adopts financial reporting, recordkeeping, and notification requirements for swap dealers and major swap participants. These requirements include the obligation to provide financial statements and reports to the CFTC and the National Futures Association. Most importantly, covered entities must alert us when there is undercapitalization, a books and records problem, and/or a specified triggering event, such as the failure to post required margin. The rule also includes public reporting requirements for those swap dealers not subject to the jurisdiction of a banking regulator.

These reporting requirements should serve as early warning systems for systemic risk, allowing the CFTC to react quickly to emerging threats to financial stability. At the same time, the reporting requirements are designed to harmonize, as appropriate, with existing financial reporting requirements for FCMs, bank swap dealers, and SEC-registered entities. The final rule also eliminates weekly position reporting, which does not materially advance our ability to monitor systemic risk. In short, balance is the touchstone of the financial reporting rules, allowing us to achieve greater insight into potential systemic risk without placing undue burdens on market participants.

5. Substituted Compliance

Last, our final rule today accounts for non-U.S. domiciled swap dealers by allowing them to petition the CFTC for substituted compliance in satisfaction of their capital and financial reporting requirements. These swap dealers may seek a comparability determination based on the capital and

[9] *See* Section 2(c)(2)(C) of the CEA, 7 U.S.C. 2(c)(2)(C) (2018), and Regulation 5.7(a), 17 CFR 5.7(a) (2019).

[10] *See* SEC Rule 240.15c3–1, 17 CFR 240.15C3–1 (2019).

[11] *See* Regulation 23.101.

[12] Former SEC Commissioner Dan Gallagher, ''The Philosophies of Capital Requirements'' (speech in Washington, DC, Jan. 15, 2014) at 1, *https://www.sec.gov/news/speech/2014-spch011514dmg.*

[13] *See* CFTC Strategic Plan, *supra* note 5 at 4 (discussing Strategic Goal 3).

[14] *See* Gallagher, *supra* note 12, at 1.

[15] *See* CFTC Strategic Plan, *supra* note 5, at 5 (discussing Strategic Goal 1, which is to strengthen the resilience and integrity of our derivatives markets while fostering their vibrancy).

[16] *Id.*

[17] *See* CFTC Strategic Plan, *supra* note 5, at 7.

[18] The market and credit risk model approval process in the final rule is similar to the requirements established by the Federal Reserve Board for bank holding companies, as well as the SEC's requirements for security-based swap dealers.

[19] For a discussion of the circumstances in which to apply principles vs. rules, *see* Heath P. Tarbert, *Rules for Principles and Principles for Rules: Tools for Crafting Sound Financial Regulation,* 10 Harvard Business Law Review (2020).

financial reporting rules of their home jurisdictions, provided certain conditions are met. In providing this option, the final rule supports international comity while enhancing the regulatory experience for market participants abroad.[20]

Conclusion

Today we mark a decade and a day following the enactment of the Dodd-Frank Act by completing the CFTC's required rulemakings under Section 731. The final capital rule is flexible and tailored, to accommodate the wide array of swap dealers that touch every corner of our markets. The final rule is also long on customer protection and systemic risk mitigation, advancing the CFTC's mission of promoting the integrity, resilience, and vibrancy of the U.S. derivatives markets through sound regulation. After 10 years of hard work by CFTC staff, I am pleased to support the final rule and the long-awaited certainty it brings to our markets. Given the current economic crisis the world faces in light of the continuing COVID–19 pandemic, we are fortunate to have a final rule that has come late, but not too late.

Appendix 3—Supporting Statement of Commissioner Brian D. Quintenz

Ten years and one day ago, the Dodd-Frank Act Wall Street Reform and Consumer Protection Act was enacted. I am proud to vote for today's final rule which, in my view, is the capstone of the Commodity Futures Trading Commission's (CFTC or Commission) work to appropriately calibrate the post-crisis reforms. Capital ensures that firms are able to continue to operate during times of economic and financial stress by providing an adequate cushion to protect them from losses. Just as important as the safety and soundness of individual firms, capital is designed to give the marketplace confidence that any given firm has a high probability of surviving the next crisis.

But, capital requirements also create important incentives that drive market behavior. The cost of capital may be the most determinative factor in a firm's decision to remain, or become, a swap dealer (SD), or to continue to provide clearing services to clients, in the case of a futures commission merchant (FCM). If capital costs are too expensive, firms will restrict certain business activities, end unprofitable business lines, or, in some cases, exit the swaps or futures markets altogether. As a result, over time, the swaps and futures markets will become less liquid, less accessible to end users, more heavily concentrated, and less competitive. These are not the hallmarks of a healthy financial system. This is why I have always regarded the finalization of capital requirements for SDs and FCMs to be the most consequential rulemaking of the post-crisis reforms.

I believe the final capital regulations for SDs and FCMs adopted today establish minimum capital requirements that will ensure the safety and soundness of these firms for years to come, through periods of economic growth and stability and through periods of market contraction and extreme volatility. They are appropriately calibrated to the true risks posed by an SD's or FCM's business and ensure these firms have the capital necessary to support their active participation in the markets and servicing of clients. They are also largely harmonized with the capital approaches of the prudential regulators and the Securities and Exchange Commission (SEC), which should reduce unnecessary burdens and facilitate compliance.

No rule is perfect. I expect there will be aspects of this rule that need to be revised or recalibrated in the future—and I specifically discuss some areas below which I would like to see revisited. Nevertheless, it is a common saying that you cannot build a great house without a solid foundation. I am confident that today's capital regulations provide that foundation and will support vibrant, healthy derivatives markets, with future Commissions able to build upon this progress in the years to come. I would like to highlight a few aspects of the final rule below.

The risk margin amount. We heard from many commenters that, of all the alternatives, the proposed eight percent risk margin amount would act not as a capital floor as intended, but rather as the primary driver of firms' capital requirements and as a potential binding constraint on their businesses. The final rule appropriately recalibrates the scope of products included in this calculation, while also adopting a risk margin amount percentage that is appropriately tailored to the capital approach elected by the firm. Specifically, the final rule maintains the existing minimum capital requirements for standalone FCMs, with those firms continuing to maintain minimum capital equal to or greater than 8% of the risk margin amount for customer futures and cleared swaps. For FCM–SDs, the final rule establishes a minimum capital requirement equal to or greater than (i) 8% of the risk margin amount for customer futures and cleared swaps, plus (ii) 2% of the risk margin amount for the FCM–SD's uncleared swaps. For non-FCM SDs that elect the Net Liquid Assets Approach, the Final Rule requires the firm to maintain minimum capital equal to or greater than 2% of the SD's uncleared swap margin. For non-FCM SDs electing either the Bank-Based Approach or the Tentative Net Worth Approach, the final rule establishes a minimum capital requirement equal to or greater than 8% of the firm's uncleared swap margin. For the reasons discussed below, I believe each of these adjustments from the proposal represents an improvement that more precisely tailors the capital requirements of a firm to its particular business and its selected capital approach.

I support the removal of a firm's cleared and uncleared security-based swaps (SBS) from the risk margin amount calculation. It is appropriate that the Commission maintain its historical approach and establish minimum capital requirements for registrants that are based upon products within the CFTC's jurisdiction. I am also very pleased that proprietary cleared futures and swaps were removed from the risk margin amount. FCMs, FCM–SDs, and SDs electing the Net Liquid Assets Approach are all subject to rigorous market and credit risk capital charges on these proprietary cleared positions. I believe these capital charges adequately account for the risk of these positions and there is no reason to account for them yet again in the firm's minimum capital requirement. Moreover, for SDs that elect one of the other capital approaches, I also believe it is appropriate to exclude proprietary cleared positions given that the SD's credit exposure on such positions is limited to either a clearing organization or to the FCM that carries the SD's account.

Finally, I also support the reduced 2% risk margin multiplier amount on uncleared swap margin for FCMs, FCM–SDs, and SDs electing the Net Liquid Assets Approach, while maintaining the 8% multiplier for other types of standalone SDs. Under the FCM capital rules and the Net Liquid Assets Capital Approach for standalone SDs, the types of capital that may be used to meet a firm's minimum capital requirement are significantly more conservative than the types of capital that may be used under the Bank-Based Capital Approach and the Tangible Net Worth Capital Approach. The Net Liquid Assets Approach is liquidity-focused and generally requires the firm to hold at least one dollar of highly liquid assets for each dollar of the firm's liabilities. As a result, when computing what qualifies as eligible capital under this approach, firms must subtract all illiquid assets, such as fixed assets and intangible assets. In contrast, the other capital approaches focus on the solvency of the firm and require the firms to maintain positive balance sheet equity. Under these approaches, firms are not required to subtract illiquid assets or fixed assets from their balance sheet equity. Given the significantly more restrictive standard for qualifying eligible capital under the Net Liquid Assets Approach, I think it is appropriate to lower the risk margin multiplier to 2% in order to minimize competitive disparities across the other two capital approaches.

The final rule also expresses the Commission's ongoing commitment to monitor, and if necessary, adjust, the risk margin percentage. This should only be done, however, with a wealth of data and a highly robust economic analysis. With the benefit of the financial reporting the Commission will soon receive from SDs, the Commission may be able to further refine this metric to promote consistency across the possible SD capital approaches.

Bank-based capital approach. In response to commenters, the final rule now permits firms to use a combination of common equity tier 1, additional tier 1, and tier 2 capital to meet its minimum capital requirements under both the 8% of risk-weighted assets and 8% of uncleared swap margin alternatives. In particular, with respect to the 8% of uncleared swap margin alternative, the rule does not limit the amounts of additional tier 1 or tier 2 capital the firm can use to meet the requirement. Because of this additional flexibility, the final rule requires firms electing this approach to satisfy *all* of the four possible minimum capital alternatives.

[20] *See* CFTC Strategic Plan, *supra* note 5, at 4 (discussing Strategic Goal 3).

The Commission will need to closely observe the impact of this change to ensure it does not create any competitive disadvantages for firms electing this approach. I anticipate that if additional data and analysis shows this outcome creates unintended consequences, the Commission will take action to address them.

Model approval process. I am also pleased with the model approval process established in the final rule, which allows the Commission to realize the benefits of the NFA's considerable expertise and resources. Once the Commission, or the Director of the Division of Swap Dealer and Intermediary Oversight (DSIO) pursuant to delegated authority, makes a determination that the NFA's model review process is comparable to the Commission's process, the NFA's approval of a model will satisfy the Commission's model approval requirement. In addition, for a firm utilizing a model that has already been approved by its relevant regulator, the final rule provides a process whereby, upon making certain representations, the firm can continue to use the model pending approval by the Commission or NFA. These steps help ensure that firms seeking to use models will be able to do so by the rule's compliance date.

Areas for further improvement. As I noted above, no rule is perfect. I would like to briefly highlight three areas not addressed in this final rule that I hope the Commission will address in the future.

Standardized market risk capital charges. First, this final rule does not adjust any of the standardized market risk charges under Regulation 1.17. I believe that many of these standardized charges are too high given the liquidity and actual risks of the product. For example, the final rule applies a 20% notional standardized market risk charge on uncleared foreign exchange non-deliverable forwards. In contrast, the Commission's uncleared margin rules apply a 6% notional charge on these products for purposes of the standardized initial margin calculation. I hope that in the future the Commission can work with the SEC to recalibrate and update these charges to better reflect the risks of the underlying products.

Alternative forms of collateral. Second, I hope that with the benefit of experience and information received from financial reporting, the Commission will consider modifying its rules to recognize alternative forms of collateral, such as letters of credit or liens, provided by commercial end users that are exempt from clearing and margin requirements when computing credit risk charges. Alternative collateral arrangements are frequently used by SDs in commodity derivatives transactions with end users to create ''right way'' risk and can be effective means of managing the credit risk of certain derivatives transactions. I think it would be beneficial for the Commission's capital regime to recognize, as appropriate, the risk-reducing nature of these arrangements.

Net liquid assets approach. Third, I am also interested in continuing to explore commenters' suggestion that firms electing the Net Liquid Assets Approach be required to maintain tentative net capital in excess of the risk margin amount, as opposed to the current net capital requirement. I continue to have concerns that in periods of high volatility, the procyclicality of increasing margin requirements may cause unnecessary stress on these firms, as their capital charges for positions increase at the same time as their minimum capital requirement. I am interested in looking at possible adjustments that could be made to address this issue.

In closing, I believe the capital regime adopted today strikes the necessary balance between capital levels that protect firms from losses on certain products, and levels that allow firms to earn an economic benefit from servicing their customers' risk management needs through those products. There is a direct tradeoff between the amount of capital regulators require firms to hold to ensure firms' resilience and viability, and the amount of available capital firms have to deploy in financial markets to support the market's ongoing liquidity and health. The capital standards adopted today protect the safety and soundness of firms, while ensuring they can continue to service their clients and make markets.

I would also like to thank DSIO, in particular Tom Smith, for their thoughtfulness and tireless dedication to getting this rule right. It has truly been a pleasure to work with and learn from you throughout this process.

Appendix 4—Dissenting Statement of Commissioner Rostin Behnam

I respectfully dissent from the Commodity Futures Trading Commission's (the ''Commission'' or ''CFTC'') rulemaking today regarding Capital Requirements of Swap Dealers and Major Swap Participants (the ''Final Capital Rule'').

Ten Years of Dodd-Frank

Yesterday marked ten years since Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] Congress passed Dodd-Frank as a targeted legislative response to the 2008 financial crisis and the near obsolescence of the U.S. financial regulatory framework. The Great Recession wreaked havoc on Main Street Americans and the global economy. Undercapitalization was at the heart of the 2008 crisis, and the swift response to require financial institutions to hold additional capital mitigated both the blunt economic shock we endured this past March, and the substantial weight we continue to shoulder as a result of the Covid-19 pandemic.

Section 731 of the Dodd-Frank Act[2] requires the CFTC to establish capital rules for all registered Swap Dealers (''SDs'') and Major Swap Participants (''MSPs'') that are not banks, as well as associated financial recordkeeping and reporting requirements. The capital requirements in Section 731, which established Section 4s(e) of the Commodity Exchange Act (''the Act''), are clear: ''. . . [t]o offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared,'' the Commission's capital requirements shall ''help ensure the safety and soundness of the swap dealer or major swap participant'' and ''be appropriate to the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.''[3] There can be no doubt that Congress intended to impose significant new requirements that would contribute to the protection from another financial crisis.

Congress's 2010 response largely incorporated the international financial reform initiatives for over-the-counter derivatives laid out at the 2009 G20 Pittsburgh Summit aimed at improving transparency, mitigating systemic risk, and protecting against market abuse.[4] One of the core initiatives in the G20 statement was the imposition of higher capital requirements. Paragraph 16 of the statement provides the purpose the G20 leaders agreed to aim for: ''*To make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis.*''[5] Paragraph 17 then lays out what the G20 leaders agreed to do to rein in the excesses, and the first item is this: ''We committed to act together to raise capital standards.''[6] The G20 leaders said unequivocally that, for over-the-counter derivatives markets, ''[n]on-centrally cleared contracts should be subject to higher capital requirements.''[7] Congress had this same goal in mind when enacting the Dodd-Frank Act a decade ago.[8]

Three and a Half Years of the Capital Proposal

In 2016, the Commission issued a bipartisan proposal to implement capital requirements as directed by Congress through Section 731 of the Dodd-Frank Act.[9] The Commission now jumps from a proposal issued in 2016 to a significantly different final rule nearly four years later, without any intervening *reproposal* to provide interested market participants clear proposed capital requirements to meaningfully comment upon. In so doing, the Commission undermines the spirit of the Dodd-Frank Act and violates the letter of the Administrative Procedure Act (''APA'').[10]

The preamble to the Final Capital Rule asserts that all of the actions taken today are

[1] *See* The Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203 124 Stat. 1376 (2010) (the ''Dodd-Frank Act'').

[2] *Id.*at section 731(e), 124 Stat. at 1704–6.

[3] Section 4s(e)(3) of the Commodity Exchange Act (''the Act''), 7 U.S.C. 6s(e)(3).

[4] G20, *Leaders' Statement, The Pittsburgh Summit* (Sept. 24–25, 2009), *available at https://www.oecd.org/g20/summits/pittsburgh/.*

[5] *Id.* at 2.

[6] *Id.*

[7] *Id.* at 9.

[8] *See* Statement of Sen. Christopher Dodd, Cong. Rec., Vol. 156, Issue 104, S5828, S5832 (July 14, 2010) (''Derivatives are vitally important if utilized properly in terms of wealth creation and growing an economy. But what was once a way for companies to hedge against sudden price shocks has become a profit center in and of itself, and it can be a dangerous one as well, when dealers and other large market participants don't hold enough capital to back up their risky bets and regulators don't have information about where the risks lie.'').

[9] Capital Requirements of Swap Dealers and Major Swap Participants, 81 FR 91252 (proposed Dec. 16, 2016) (the ''2016 Proposal'').

[10] 5 U.S.C. 551 *et seq.*

a ''logical outgrowth'' from the 2016 Proposal.[11] The preamble even goes a step further, arguing that ''modifications described in the *2019 Capital Reopening,* including a discussion and specific inclusion of potential rule language, were logical outgrowths'' of the 2016 Proposal.[12] This simply cannot be true if the requirement that a final rule is a logical outgrowth of an agency's proposed rule is to have any meaning at all.[13]

The changes in the Final Capital Rule to the amount of capital that a futures commission merchant SD (FCM–SD) must maintain are illustrative of the point. The 2016 Proposal would have required an FCM–SD to maintain regulatory capital equal to or greater than 8% of the initial margin associated with the FCM–SD's proprietary cleared and uncleared futures, foreign futures, swap, and security-based swap positions. In 2019, the Commission reopened the comment period on the 2016 Proposal.[14] In the **Federal Register** release announcing the 2019 reopening, the Commission sought additional public input based on an initial review of comments received from the 2016 Proposal on myriad alternatives, seeking comment ''on all aspects of the proposed risk margin amount, including comments regarding the possible increase or decrease of the risk margin percentage in coordination with the inclusion or exclusion of certain products in order to establish the most optimal capital requirement.'' [15] This, in many respects, is a blank check. Not only does it allow for any conceivable percentage of risk margin, it simultaneously opens up multiple combinations of inputs. The Commission now states that any of the possible outcomes along this sliding scale would have been a logical outgrowth. It is the equivalent of saying that the Final Capital Rule is a logical outgrowth because it imposes any capital requirements at all, and that simply cannot be the case under the legal intent and plain reading of the principle of logical outgrowth.

A Final Capital Rule (and Five Years of Review)

Where did the Commission end up? The Commission decides today to set the multiplier for the uncleared swaps of FCM–SDs at 2%, rather than the 8% originally proposed. The Commission also is modifying the final rule from the proposal to *remove* security-based swaps, proprietary futures, foreign futures, and cleared swaps from the risk margin amount calculation. These are significant changes from the 2016 proposal, and they are just one of the possible outcomes suggested in the reopening of the comment period.

I am not sure if 2% is the appropriate landing spot to insulate our markets from outsize risk. And based on the preamble to this Final Capital Rule, I do not think the Commission is certain either. The preamble states that the Commission does not have the data to determine whether or not 2% is the optimal or even adequate percentage.[16] Instead, the Commission chooses 2% with the intent that ''the Commission's decision to modify the final rule by removing cleared and uncleared security-based swaps, as well as proprietary futures, foreign futures, and cleared swaps positions from the risk margin amount calculation, and to set the multiplier at 2% should mitigate many of the commenters' concerns that the proposed 8% risk margin amount calculation was over inclusive of the types of positions included in the calculation and was set at a percentage that was too high.'' [17] Due to this lack of data, the Commission will need to conduct a *5-year* post implementation review ''to assess whether the minimum capital requirements for FCM–SDs are adequately calibrated to ensure their safety and soundness.'' [18] And I applaud the Commission for including this critical regulatory component of the capital regime's implementation. However, this information is exactly the type of data that the Commission would have benefited from during the notice and comment process. By failing to issue a reproposal in 2019, allowing just a few additional months of concrete, data driven deliberation, which could have clearly stated a specific approach, we lost the opportunity to find out whether the minimum capital requirements that we selected are adequately calibrated to ensure safety and soundness.

Because of the lack of clarity in the reopening of the comment period, we again received more general comments that 8% was too high. In justifying the selection of 2%, the preamble states that ''2% should mitigate many of the commenters' concerns that the proposed 8% risk margin amount calculation was over inclusive of the types of positions included in the calculation and was set at a percentage that was too high.'' [19] Because we did not provide a clear alternative, we again received comments on 8% rather than comments on 2%, or on some alternative.

Ultimately, this lack of information gathering impacts the CFTC and results in a Final Capital Rule that has not benefited from fulsome public comment. However, the impacts on our market participants are greater. They have been denied the ability to comment meaningfully. This is particularly true of the cost benefit analysis. Broadly asking stakeholders to comment on any variation results in a situation where no one had an opportunity to comment on anything approximating what the Commission has done in its Final Capital Rule. As a result, this rule ultimately derived from a process that is, in many respects, equivalent to not soliciting comments from the public and market participants at all.[20]

I note that, less than a month ago, the Commission voted to withdraw the Regulation Automated Trading proposal (''Regulation AT''),[21] the most recent iteration of which had been issued in November 2016, a couple of weeks before the 2016 Proposal.[22] At the same time that Regulation AT was withdrawn, the Commission issued a rebranded Electronic Trading Risk Principles proposal intended to ''*accomplish a similar goal*'' to the original Regulation AT.[23] Following the logic set forth today for the Final Capital Rule, the Commission could have simply issued a final rule for Electronic Trading Risk Principles last month, arguing that it was merely a *logical outgrowth* of the latest iteration of Regulation AT. While I disagreed with last month's policy decision, procedurally the Commission did the right thing under the APA. We should have followed the same procedure for capital, and issued a reproposal.[24] If we had done so last December, we could have received meaningful comments from market participants on a clearly stated reproposal, and we could well have been in position to finalize a stronger, more carefully considered Final Capital Rule today that addresses current market conditions in a manner that is more data driven.

Conclusion

Before I conclude, I would like to thank staff from the Division of Swap Dealer and Intermediary Oversight for their excellent work on this highly technical and complex rulemaking, and willingness to answer my questions and take feedback.

While I would have liked to stand with my fellow Commissioners today, I cannot justify it under these circumstances. I truly wish that I could support today's Commission action as we mark the tenth anniversary of the Dodd-Frank Act this week. To reiterate sentiments made in my first speech as a CFTC Commissioner,[25] capital is a

[11] Final Capital Rule at 1.B.

[12] *Id.;* Capital Requirements for Swap Dealers and Major Swap Participants, 84 FR 69664 (Dec. 19, 2019).

[13] *See Small Refiner Lead Phase-Down Task Force* v. *United States Envtl. Prot. Agency,* 705 F.2d 506, 548–49 (D.C. Cir. 1983) (''Agency notice must describe the range of alternatives being considered with reasonable specificity. Otherwise, interested parties will not know what to comment on, and notice will not lead to better-informed agency decisionmaking.'').

[14] 84 FR 69664.

[15] *Id.* at 69668.

[16] Final Capital Rule at II.B.2.b. (''The Commission does not have the benefit of . . . comprehensive data regarding the multiplier for the uncleared swaps risk margin amount at this time.'')

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *See Texas* v. *United States EPA,* 389 F.Supp. 3d. 497, 505 (S.D. Tex. 2019) (''The APA does not envision requiring interested parties to parse through such vague references like tea leaves to discern an agency's regulatory intent regarding such significant changes to a final rule'').

[21] Press Release Number 8188–20, CFTC, CFTC Approves Two Final Rules and Two Proposed Rules at June 25 Open Meeting (June 25, 2020), *https://www.cftc.gov/PressRoom/PressReleases/8188-20.*

[22] Regulation Automated Trading, 81 FR 85333 (proposed Nov. 25, 2016).

[23] Electronic Trading Risk Principles (proposed Jun. 25, 2020), at I.B.

[24] Statement of Dissent of Commissioner Rostin Behnam, Capital Requirements of Swap Dealers and Major Swap Participants (Dec. 10, 2019), available at *https://www.cftc.gov/PressRoom/Speeches Testimony/behnamstatement121019.*

[25] *See* Rostin Behnam, Commissioner, CFTC, The Dodd-Frank Inflection Point: Building on Derivatives Reform, Remarks of CFTC Commissioner Rostin Behnam at the Georgetown Center for Financial Markets and Policy (Nov. 14, 2017), *https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam.*

cornerstone financial crisis reform [26] that is critical to protecting our financial institutions and our financial system as a whole from systemic risk and contagion. But it is also critical to protection from unintended consequences if capital (and margin) levels are applied and set without due regard to the uniqueness of our financial markets and market participants.

I appreciate that in moving forward, we must fulfill our directive to establish capital standards appropriately, and in consideration of other activities engaged in by SDs and MSPs such that we ensure that we do not penalize commercial end-users who need choices and benefit from competition in our markets. At the same time, we must heed Congressional intent without any compromise, regardless of what *we* think is best, remaining cognizant of the impact that capital requirements have on market stability, and follow APA rulemaking requirements when we do so.

Shortly before the Commission voted on the reopening in December, 2019, Chairman Tarbert gave remarks about *transparency* [27], making many very powerful and important points about the incredible importance of being mindful—as regulators—of ''. . . not only what we do, but how we do it.'' [28] The Chairman ended that particular statement with a wonderful quote from Aristotle. Among many profound lessons from the Greek philosopher, he is also sometimes credited with the statement that ''[p]atience is bitter, but its fruit is sweet.'' In that vein, I simply wish the Commission had devoted a little bit more time to how we fulfill this foundational Dodd-Frank requirement.

The road has been long, far too long in many respects. But, unsure of what deadlines we are racing to meet at this point, or targets we are aiming to hit, I feel strongly the Commission and our markets, would have stood on sturdier ground, and perhaps even have landed at the same conclusion voted on today, if we had practiced a little patience.

Appendix 5—Dissenting Statement of Commissioner Dan M. Berkovitz

Today, for the first time, the Commission adopts capital requirements for non-bank swap dealers (''Final Rule''). This is the last major swap dealer regulation required under the Dodd-Frank Act. The Dodd-Frank Act specified that the swap dealer capital requirement ''shall—(i) help ensure the safety and soundness of the swap dealer or major swap participant; and (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.'' [1]

Unfortunately, there is no rational basis to conclude that the minimum capital requirements in the Final Rule meet those standards and serve their intended purpose. The Final Rule is not based on quantitative analysis of data or the appropriate level of capital for the risks presented by a swap dealer. Rather, it appears to be designed with the objective of ensuring that most dealers will not need to raise more capital. In its consideration of costs and benefits, the Commission concludes that, depending on the type of swap dealer, ''the likelihood of . . . needing to raise additional capital due to this rule might be low,'' ''may not be significant,'' or ''that their tangible net worth greatly exceeds the Commission's requirement.'' [2] For this reason, I dissent.

No Rational Basis To Conclude That Minimum Capital Levels Are Appropriate

The Final Rule permits swap dealers, depending on their characteristics, to select one of three different approaches to calculate their minimum capital requirements. The approaches are identified as the: (1) ''Net Liquid Assets Capital Approach,'' (2) ''Bank-Based Capital Approach,'' and (3) ''Tangible Net Worth Capital Approach.'' The first two approaches are based on existing CFTC, Securities and Exchange Commission (''SEC''), and Federal Reserve capital requirements for futures commission merchants (''FCMs''), securities broker-dealers (''BDs''), and banks. The third approach is designed to accommodate commercial swap dealers whose capital is normally in the form of physical assets.

These methods are based on existing holistic, all-enterprise capital approaches that take into account a broad spectrum of risks. They are not necessarily suited to the swap dealers subject to the CFTC capital requirements, which are mostly stand-alone legal entities for swap dealing. Accordingly, it is not clear that these methodologies will generate capital requirements that are ''appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.'' [3] However, using those precedents has some advantages in that it allows the different types of swap dealers to manage capital using known structures. While these historical approaches were not specifically designed to be able to meet the statutory standard, it may be possible to achieve the intended outcome using these structures if the specific methods, limits, and other factors had been developed based on the swap dealer specific standard. Unfortunately, this did not happen.

In December 2016, the Commission issued a re-proposal of the previously proposed capital regulations (''2016 Re-Proposal'') [4] that contained minimum capital requirements in each approach that were largely based on existing levels for FCM capital requirements. The 2016 Re-Proposal included cleared and uncleared swaps and uncleared security-based swaps in the calculation of the minimum requirements.

Commenters objected that the 2016 Re-Proposal was too costly and burdensome. At the end of last year the Commission, by a 3–2 vote, issued a second re-proposal (''2019 Second Re-Proposal'') consisting of over 140 mostly open-ended questions designed to invite comments supporting reduced minimum capital requirements or otherwise lower the costs for swap dealers to comply.[5]

Not surprisingly, the Final Rule adopts numerous provisions that are weaker than the 2016 Re-Proposal. The preamble to the Final Rule identifies ''lower capital charges,'' ''harmonization,'' and consistency with ''historical'' precedent as rationales for these provisions.

While the Commission makes conclusory statements that the rule helps ''ensure the safety and soundness'' of the swap dealers, there is little or no analysis supporting these assertions. Similarly, there is no analysis as to how or why these capital levels are ''appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.''

The capital requirements for dually-registered FCM/BDs that are also swap dealers illustrate how this approach leads to arbitrary results from a risk-based perspective. Under the 2016 Re-Proposal, in addition to capital required to be held for non-swap activity, the FCM/BD swap dealer would be required to hold capital equal to a minimum of 8% of initial margin for uncleared swaps, security-based swaps, and certain futures positions of the swap dealer. As explained in the 2016 Re-Proposal, the 8% multiplier level is drawn from the Commission's experience with its risk-based capital requirements for FCMs.[6]

Based on comments received on the prior proposals, and on the desire to ''harmonize'' with the SEC, the Final Rule lowers the capital add-on multiplier level to 2%, and only applies the multiplier to uncleared swaps initial margin.[7] Security-based swaps are not included in the calculation based on the rationale that only swaps are within the CFTC's jurisdiction. If the entity is also registered with the SEC and the SEC's capital requirements are greater than the CFTC's, then the entity can use the SEC's requirement with no add-on for uncleared swaps. The Commission makes these changes not based on any analysis of the risk to the registrant,

[26] G20, Leaders' Statement, Framework for Strong, Sustainable and Balanced Growth, The Pittsburgh Summit (September 24–25 2009), *http://www.g20.utoronto.ca/2009/2009communique0925.html* (''We committed to act together to raise capital standards . . .'').

[27] Heath P. Tarbert, Chairman, CFTC, Statement of Chairman Heath P. Tarbert Before the December 10, 2019 Open Meeting (Dec. 10, 2019), *https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement121019.*

[28] *Id.*

[1] CEA section 4s(e)(3)(A).

[2] Final Capital Rule release, Cost Benefit Considerations, Attachment A. The analysis also notes that a few non-bank financial swap dealers ''might need to raise additional capital and thus might incur significant cost to comply with the Commission's capital requirement.''

[3] CEA section 4s(e)(3)(A).

[4] Proposed Rule, Capital Requirements of Swap Dealers and Major Swap Participants, 81 FR 91252 (Dec. 16, 2016).

[5] For a more in-depth discussion of the procedural and substantive problems inherent in the 2019 Second Re-Proposal, *see* Dissenting Statement of Commissioner Dan M. Berkovitz, ''Proposed'' Rule and ''Request for Additional Comment'' on Capital Requirements of Swap Dealers and Major Swap Participants (Dec. 10, 2019), available at *https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatment121019b.*

[6] *See* 17 CFR 1.17(a)(1)(i)(B).

[7] While the Final Capital Rule selectively picks the 2% level purportedly to ''harmonize'' with the SEC's security-based swap dealer capital rule, the final rule uses different formulas and positions for the calculation. Furthermore, the SEC's rule has a built-in increase in the multiplier from 2% to 8% over time. The CFTC Final Capital Rule expressly choses to deviate from that SEC approach and has no such increases.

but because this approach ''maintains a consistency with the long-standing historical approach that the Commission and SEC have followed with respect to dually-registered FCM/BDs.'' [8]

The following example shows how this approach can result in an arbitrary outcome from a risk perspective. Under the Final Rule, if the amount of uncleared swap margin for an FCM that is not a BD is $1 billion, multiplying that amount by 2% yields a minimum capital add-on of $20 million. Similarly, under the SEC's capital rule, for a securities-based swap dealer that is not an FCM with $1 billion of required margin for uncleared security-based swaps, a 2% add-on would be $20 million.[9] Now, let's consider the add-on for a dually-registered FCM/BD. Each of the CFTC and SEC capital rules individually require that the minimum capital requirements include capital based on either the uncleared swap positions or the uncleared security-based swap positions, respectively, but not the aggregate of both types of positions. A dually-registered firm with the same aggregate risk margin amount of $1 billion, but split half to swaps and half to security-based swaps, would be required to reserve $10 million ($500 million * 2%). Thus, the dually-registered firm with a total initial margin requirement of $1 billion held for a portfolio split evenly between swaps and security-based swaps would be required to reserve only half the capital required for the same amount of initial margin held for a portfolio that was either all swaps or all security-based swaps. For such dually-registered firms, the amount of capital required to be held may ultimately be based on irrelevant and arbitrary considerations of ''historical precedent'' and agency jurisdiction rather than swap risk-based calculations.

Financial Data and Monitoring Capital Sufficiency

The capital requirements for swap dealers are one of the most complex and highly technical areas in our regulations. The swap dealers subject to the CFTC capital requirements vary significantly and include (i) very large FCMs and/or BDs registered with the CFTC and the SEC; (ii) U.S. and foreign affiliates of banking organizations; (iii) large commercial enterprises and affiliates thereof; and (iv) other financial companies that are not affiliated with banks. Each grouping has unique capital structures. Furthermore, there was little available quantitative financial accounting data for the swap activities of these entities to calibrate the appropriate levels of capital. Given this complex and technical backdrop, the Final Rule notes in several places that the Commission will gather and analyze the new financial reporting data now required under the rule and may reassess components of the rule to determine whether it needs to be amended to be better fit for purpose. I strongly support that effort and will follow this monitoring and analysis closely.

Substituted Compliance for Capital Requirements

Under the Final Rule, swap dealers organized and domiciled outside of the United States, including many subsidiaries of U.S. firms, can satisfy the capital requirements by complying with the capital requirements of the country of their domicile if the Commission grants substituted compliance. The methods and standards for such a determination are similar to those to be established in the final cross-border swap regulations scheduled for consideration by the Commission tomorrow. Unfortunately, those methods and standards are substantively weaker than the standards currently used by the Commission and may result in outsourcing swap dealer capital oversight to other jurisdictions where not appropriate.

Conclusion

Notwithstanding my dissent, I want to once again acknowledge the complexity and highly technical nature of the capital requirements. Given these difficulties, I would like to recognize the hard-working staff of the CFTC for their efforts in fashioning the Final Rule. Some of you spent many a late night addressing comments and questions and revising the rule release. While I cannot support the outcome, I nonetheless appreciate and thank you for the dedication you bring to your work here at the CFTC.

Unfortunately, the rule the Commission will be adopting today is simply an affirmation of the status quo. This is not what Congress intended when it directed the CFTC to adopt capital requirements ''appropriate for the risk'' presented by uncleared swap activities of swap dealers. For this reason, I dissent.

[FR Doc. 2020–16492 Filed 9–14–20; 8:45 am]

BILLING CODE 6351–01–P

[8] Final Rule release, section II.C.2.

[9] While it is acknowledged that this example is somewhat simplified from the calculations and absolute minimum amounts specified in both the CFTC and SEC capital rules, the example illustrates a possible outcome of the rules.