

comments. Comments must be submitted on or before August 23, 2022.

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## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Chapter I

#### Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination From the Financial Services Agency of Japan

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Proposed order and request for comment.

**SUMMARY:** The Commodity Futures Trading Commission is soliciting public comment on an application submitted by the Financial Services Agency of Japan requesting that the Commission determine that registered swap dealers organized and domiciled in Japan that are subject to, and comply with, certain capital and financial reporting requirements in Japan may comply with certain capital and financial reporting requirements under the Commodity Exchange Act via compliance with corresponding capital and financial reporting requirements of Japan. The Commission also is soliciting public comment on a proposed order providing for the conditional availability of substituted compliance in connection with the application.

**DATES:** Comments must be received on or before October 7, 2022.

**ADDRESSES:** You may submit comments, identified by “Japan Swap Dealer Capital Comparability Determination”, by any of the following methods:

*CFTC Comments Portal:* <https://comments.cftc.gov>. Select the “Submit Comments” link for this proposed order and follow the instructions on the Public Comment Form.

*Mail:* Send to Christopher Kirkpatrick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW, Washington, DC 20581.

*Hand Delivery/Courier:* Follow the same instructions as for Mail, above.

Please submit your comments using only one of these methods. To avoid possible delays with mail or in-person deliveries, submissions through the CFTC Comments Portal are encouraged.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to <https://comments.cftc.gov>. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that you believe is exempt from disclosure under the Freedom of Information Act (“FOIA”), a petition for confidential treatment of the exempt information may be submitted according to the procedures established in Regulation 145.9.<sup>1</sup>

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from <https://comments.cftc.gov> that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the proposed determination and order will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the FOIA.

**FOR FURTHER INFORMATION CONTACT:**

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**SUPPLEMENTARY INFORMATION:** The Commodity Futures Trading Commission (“Commission” or “CFTC”) is soliciting public comment on an application submitted by the Financial Services Agency of Japan (“FSA”), dated September 30, 2021

<sup>1</sup> 17 CFR 145.9. Commission regulations referred to in this release are found at 17 CFR chapter I, and are accessible on the Commission’s website at <https://www.cftc.gov/LawRegulation/CommodityExchangeAct/index.htm>.

(“FSA Application”), requesting that the Commission determine that registered nonbank<sup>2</sup> swap dealers (“SDs”) organized and domiciled in Japan (“Japanese nonbank SDs”) may satisfy certain capital and financial reporting requirements under the Commodity Exchange Act (“CEA”) <sup>3</sup> by being subject to and complying with comparable capital and financial reporting requirements under Japanese laws and regulations.<sup>4</sup> The Commission also is soliciting public comment on a proposed Commission Comparability Determination order that would allow Japanese nonbank SDs, subject to certain conditions, to comply with certain CFTC SD capital and financial reporting requirements in the manner as set forth in the proposed order.

### I. Introduction

#### A. Regulatory Background—CFTC Capital, Margin, and Financial Reporting Requirements for Swap Dealers and Major Swap Participants

Section 4s(e) of the CEA <sup>5</sup> directs the Commission and “prudential regulators” <sup>6</sup> to impose capital requirements on SDs and major swap participants (“MSPs”) registered with the Commission. Section 4s(e) of the CEA also directs the Commission and prudential regulators to adopt regulations imposing initial and variation margin requirements on swaps entered into by SDs and MSPs that are not cleared by a registered derivatives clearing organization (“uncleared swaps”).

Section 4s(e) applies a bifurcated approach with respect to the above Congressional directives, requiring each SD and MSP that is subject to the regulation of a prudential regulator (“bank SD” and “bank MSP,” respectively) to meet the minimum capital requirements and uncleared swaps margin requirements adopted by the applicable prudential regulator, and requiring each SD and MSP that is not

<sup>2</sup> As discussed in Section I.A. below, the Commission has capital jurisdiction over registered SDs that are not subject to the regulation of a U.S. banking regulator (*i.e.*, nonbank SDs).

<sup>3</sup> 7 U.S.C. 1 *et seq.* The CEA may be accessed through the Commission’s website, [www.cftc.gov](http://www.cftc.gov).

<sup>4</sup> See Letter from Yuji Yamashita, Deputy Commissioner for International Affairs, Financial Services Agency of Japan, dated September 30, 2021. The FSA Application is available on the Commission’s website at: <https://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm>.

<sup>5</sup> 7 U.S.C. 6s(e).

<sup>6</sup> The term “prudential regulators” is defined in the CEA to mean the Board of Governors of the Federal Reserve System (“Federal Reserve Board”); the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency. See 7 U.S.C. 1a(39).

subject to the regulation of a prudential regulator (“nonbank SD” and “nonbank MSP,” respectively) to meet the minimum capital requirements and uncleared swaps margin requirements adopted by the Commission.<sup>7</sup> Therefore, the Commission’s authority to impose capital requirements and margin requirements for uncleared swap transactions extends to nonbank SDs and nonbank MSPs, including nonbanking subsidiaries of bank holding companies regulated by the Federal Reserve Board.

The prudential regulators implemented Section 4s(e) in 2015 by amending existing capital requirements applicable to bank SDs and bank MSPs to incorporate swap transactions into their respective bank capital frameworks, and by adopting rules imposing initial and variation margin requirements on bank SDs and bank MSPs that engage in uncleared swap transactions.<sup>8</sup> The Commission adopted final rules imposing initial and variation margin obligations on nonbank SDs and nonbank MSPs for uncleared swap transactions on January 6, 2016.<sup>9</sup> The Commission also approved final capital requirements for nonbank SDs and nonbank MSPs on July 24, 2020, which were published in the **Federal Register** on September 15, 2020 with a compliance date of October 6, 2021 (“CFTC Capital Rules”).<sup>10</sup>

Section 4s(f) of the CEA addresses SD and MSP financial reporting requirements.<sup>11</sup> Section 4s(f) of the CEA authorizes the Commission to adopt rules imposing financial condition reporting obligations on all SDs and MSPs (*i.e.*, nonbank SDs, nonbank MSPs, bank SDs, and bank MSPs). Specifically, Section 4s(f)(1)(A) of the CEA provides, in relevant part, that each registered SD and MSP must make financial condition reports as required by regulations adopted by the Commission.<sup>12</sup> The Commission’s financial reporting obligations were adopted with the Commission’s nonbank SD and nonbank MSP capital requirements, and also had a compliance date of October 6, 2021 (“CFTC Financial Reporting Rules”).<sup>13</sup>

### *B. Commission Capital Comparability Determinations for Non-U.S. Nonbank Swap Dealers and Non-U.S. Nonbank Major Swap Participants*

Regulation 23.106 establishes a substituted compliance framework whereby the Commission may determine that compliance by a non-U.S. domiciled nonbank SD or non-U.S. domiciled nonbank MSP with its home country’s capital and financial reporting requirements will satisfy all or parts of the CFTC Capital Rules and all or parts of the CFTC Financial Reporting Rules (such a determination referred to as a “Capital Comparability Determination”).<sup>14</sup> The availability of such substituted compliance is conditioned upon the Commission issuing a determination that the relevant foreign jurisdiction’s capital adequacy and financial reporting requirements, and related financial recordkeeping and reporting requirements, for non-U.S. nonbank SDs and/or non-U.S. nonbank MSPs are comparable to the corresponding CFTC Capital Rules and CFTC Financial Reporting Rules. The Commission will issue a Capital Comparability Determination in the form of a Commission order (“Capital Comparability Determination Order”).<sup>15</sup>

The Commission’s approach for conducting a comparability determination with respect to the CFTC Capital Rules and the CFTC Financial Reporting Rules is a principles-based, holistic approach that focuses on whether the applicable foreign jurisdiction’s capital and financial reporting requirements achieve comparable outcomes to the

corresponding CFTC requirements.<sup>16</sup> In this regard, the approach is not a line-by-line assessment or comparison of a foreign jurisdiction’s regulatory requirements with the Commission’s requirements.<sup>17</sup> In performing the analysis, the Commission recognizes that jurisdictions may adopt differing approaches to achieving comparable outcomes, and the Commission will focus on whether the foreign jurisdiction’s capital and financial reporting requirements are comparable to the Commission’s in purpose and effect, and not whether they are comparable in every aspect or contain identical elements.

A person requesting a Capital Comparability Determination is required to submit an application to the Commission containing: (i) a description of the objectives of the relevant foreign jurisdiction’s capital adequacy and financial reporting requirements applicable to entities that are subject to the CFTC Capital Rules and the CFTC Financial Reporting Rules; (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 CFTC Capital Rules and CFTC Financial Reporting Rules, including, at a minimum, the methodologies for establishing and calculating capital adequacy requirements and whether such methodologies comport with any international standards; and (iii) a description of the ability of the relevant foreign regulatory authority to supervise and enforce compliance with the relevant foreign jurisdiction’s capital adequacy and financial reporting requirements. The applicant must also submit, upon request, such other information and documentation as the Commission deems necessary to evaluate the comparability of the capital adequacy and financial reporting requirements of the foreign jurisdiction.<sup>18</sup>

The Commission may consider all relevant factors in making a Capital Comparability Determination, including: (i) the scope and objectives of the relevant foreign jurisdiction’s capital and financial reporting requirements; (ii) whether the relevant foreign jurisdiction’s capital and financial reporting requirements achieve comparable outcomes to the Commission’s corresponding capital

<sup>14</sup> 17 CFR 23.106. Regulation 23.106(a)(1) provides that a request for a Capital Comparability Determination may be submitted by a non-U.S. nonbank SD or non-U.S. nonbank MSP, a trade association or other similar group on behalf of its SD or MSP members, or a foreign regulatory authority that has direct supervisory authority over one or more non-U.S. nonbank SDs or non-U.S. nonbank MSPs. Commission regulations provide that any non-U.S. nonbank SD or non-U.S. nonbank MSP that is dually-registered with the Commission as a futures commission merchant (“FCM”) is subject to the capital requirements of Regulation 1.17 and may not petition the Commission for a Capital Comparability Determination. See 17 CFR 23.101(a)(5) and (b)(4), respectively. Furthermore, non-U.S. bank SDs and non-U.S. bank MSPs may not petition the Commission for a Capital Comparability Determination with respect to their respective financial reporting requirements under Regulation 23.105(p) (17 CFR 23.105(p)). Commission staff has issued, however, a time-limited no-action letter stating the Market Participants Division will not recommend enforcement action against a non-U.S. bank SD that files with the Commission certain financial information that is provided to its home country regulator in lieu of certain financial reports required by Regulation 23.105(p). See CFTC Staff Letter 21–18, issued on August 31, 2021.

<sup>15</sup> 17 CFR 23.106(a)(3).

<sup>16</sup> 17 CFR 23.106(a)(3)(ii). See also 85 FR 57462 at 57521.

<sup>17</sup> See 85 FR 57521.

<sup>18</sup> 17 CFR 23.106(a)(2).

<sup>7</sup> 7 U.S.C. 6s(e)(2).

<sup>8</sup> See *Margin and Capital Requirements for Covered Swap Entities*, 80 FR 74840 (Nov. 30, 2015).

<sup>9</sup> See *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR 636 (Jan. 6, 2016).

<sup>10</sup> See *Capital Requirements of Swap Dealers and Major Swap Participants*, 85 FR 57462 (Sept. 15, 2020).

<sup>11</sup> 7 U.S.C. 6s(f).

<sup>12</sup> 7 U.S.C. 6s(f)(1)(A).

<sup>13</sup> See 85 FR 57462.

requirements and financial reporting requirements; (iii) 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; and (iv) any other facts or circumstances the Commission deems relevant, including whether the Commission and foreign regulatory authority or authorities have a memorandum of understanding ("MOU") or similar arrangement that would facilitate supervisory cooperation.<sup>19</sup>

In performing the comparability assessment for foreign nonbank SDs, the Commission's review will include the extent to which the foreign jurisdiction's requirements address: (i) the process of establishing minimum capital requirements for nonbank SDs and how such process addresses risk, including market risk and credit risk of the nonbank SD's on-balance sheet and off-balance sheet exposures; (ii) the types of equity and debt instruments that qualify as regulatory capital in meeting minimum requirements; (iii) the financial reports and other financial information submitted by a nonbank SD to its relevant regulatory authority and whether such information provides the regulatory authority with the means necessary to effectively monitor the financial condition of the nonbank SD; and (iv) the regulatory notices and other communications between a nonbank SD and its foreign regulatory authority that address potential adverse financial or operational issues that may impact the firm. With respect to the ability of the relevant foreign regulatory authority to supervise and enforce compliance with the foreign jurisdiction's capital adequacy and financial reporting requirements, the Commission's review will include a review of the foreign jurisdiction's surveillance program for monitoring nonbank SDs' compliance with such capital adequacy and financial reporting requirements, and the disciplinary process imposed on firms that fail to comply with such requirements.

In performing the comparability assessment for foreign nonbank MSPs,<sup>20</sup> the Commission's review will include the extent to which the foreign jurisdiction's requirements address: (1) the process of establishing minimum capital requirements for nonbank MSPs and how such process establishes a

minimum level of capital to ensure the safety and soundness of the nonbank MSP; (ii) the financial reports and other financial information submitted by a nonbank MSP to its relevant regulatory authority and whether such information provides the regulatory authority with the means necessary to effectively monitor the financial condition of the nonbank MSP; and (iii) the regulatory notices and other communications between a nonbank MSP and its foreign regulatory authority that address potential adverse financial or operational issues that may impact the firm. With respect to the ability of the relevant foreign regulatory authority to supervise and enforce compliance with the foreign jurisdiction's capital adequacy and financial reporting requirements, the Commission's review will include a review of the foreign jurisdiction's surveillance program for monitoring nonbank MSPs' compliance with such capital adequacy and financial reporting requirements, and the disciplinary process imposed on firms that fail to comply with such requirements.

Regulation 23.106 further provides that the Commission may impose any terms or conditions that it deems appropriate in issuing a Capital Comparability Determination.<sup>21</sup> Any specific terms or conditions with respect to capital adequacy or financial reporting requirements will be set forth in the Commission's Capital Comparability Determination Order. As a general condition to all Capital Comparability Determination Orders, the Commission expects to require notification from applicants of any material changes to information submitted by the applicants in support of a comparability finding, including, but not limited to, changes in the relevant foreign jurisdiction's supervisory or regulatory regime.

The Commission's capital adequacy and financial reporting requirements are designed to address and manage risks that arise from a firm's operation as a SD and MSP. Given their functions, both sets of requirements and rules must be applied on an entity-level basis (meaning that the rules apply on a firm-wide basis, irrespective of the type of transactions involved) in order to effectively address risk to the firm as a whole. Therefore, in order to rely on a Capital Comparability Determination, a nonbank SD or nonbank MSP domiciled in the foreign jurisdiction and subject to supervision by the relevant regulatory authority (or authorities) in the foreign jurisdiction must file a notice with the

Commission of its intent to comply with the applicable capital adequacy and financial reporting requirements of the foreign jurisdiction set forth in the Capital Comparability Determination in lieu of all or parts of the CFTC Capital Rules and/or CFTC Financial Reporting Rules.<sup>22</sup> Notices must be filed electronically with the Commission's Market Participants Division ("MPD").<sup>23</sup> The filing of a notice by a non-U.S. nonbank SD or non-U.S. nonbank MSP provides MPD staff, acting pursuant to authority delegated by the Commission,<sup>24</sup> with the opportunity to engage with the firm and to obtain representations that it is subject to, and complies with, the laws and regulations cited in the Capital Comparability Determination and that it will comply with any listed conditions. MPD will issue a letter under its delegated authority from the Commission confirming that the non-U.S. nonbank SD or non-U.S. nonbank MSP may comply with the foreign laws and regulations cited in the Capital Comparability Determination in lieu of complying with the CFTC Capital Rules and CFTC Financial Reporting Rules upon MPD's determination that the firm is subject to and complies with such foreign laws and regulations, is subject to the jurisdiction of the applicable foreign regulatory authority (or authorities), and can meet all of the conditions in the Capital Comparability Determination.

Each non-U.S. nonbank SD and/or non-U.S. nonbank MSP that receives, in accordance with the applicable Commission Capital Comparability Determination, confirmation from the Commission that it may comply with a foreign jurisdiction's capital adequacy and/or financial reporting requirements will be deemed by the Commission to be in compliance with the corresponding CFTC Capital Rules and/or CFTC Financial Reporting Rules.<sup>25</sup> Accordingly, if a nonbank SD or nonbank MSP fails to comply with the foreign jurisdiction's capital adequacy and/or financial reporting requirements, the Commission may initiate an action for a violation of the corresponding CFTC Capital Rules and/or CFTC Financial Reporting Rules.<sup>26</sup> In addition, a non-U.S. nonbank SD or

<sup>22</sup> 17 CFR 23.106(a)(4).

<sup>23</sup> Notices must be filed in electronic form to the following email address: [MPDFinancialRequirements@cftc.gov](mailto:MPDFinancialRequirements@cftc.gov).

<sup>24</sup> See 17 CFR 140.91(a)(11).

<sup>25</sup> 17 CFR 23.106(a)(4)(ii). Confirmation will be issued by MPD under authority delegated by the Commission. See Regulation 140.91(a)(11) (17 CFR 140.91(a)(11)).

<sup>26</sup> *Id.*

<sup>19</sup> See 17 CFR 23.106(a)(3) and 85 FR 57520-57522.

<sup>20</sup> Regulation 23.101(b) requires a nonbank MSP to maintain positive tangible net worth. There are no MSPs currently registered with the Commission.

<sup>21</sup> See 17 CFR 23.106(a)(5).

non-U.S. nonbank MSP that receives confirmation of its ability to use substituted compliance remains subject to the Commission's examination and enforcement authority.<sup>27</sup>

The Commission will consider an application for a Capital Comparability Determination to be a representation by the applicant that the laws and regulations of the foreign jurisdiction that are submitted in support of the application are finalized and in force, that the description of such laws and regulations is accurate and complete, and that, unless otherwise noted, the scope of such laws and regulations encompasses the relevant non-U.S. nonbank SDs and/or non-U.S. nonbank MSPs domiciled in the foreign jurisdiction.<sup>28</sup> A non-U.S. nonbank SD or non-U.S. nonbank MSP that is not legally required to comply with a foreign jurisdiction's laws or regulations determined to be comparable in a Capital Comparability Determination may not voluntarily comply with such laws or regulations in lieu of compliance with the CFTC Capital Rules or the CFTC Financial Reporting Rules. Each non-U.S. nonbank SD or non-U.S. nonbank MSP that seeks to rely on a Capital Comparability Determination Order is responsible for determining whether it is subject to the foreign laws and regulations found comparable in the Order.

### *C. Japan Financial Services Agency's Application for a Capital Comparability Determination for Japanese-Domiciled Nonbank Swap Dealers*

The FSA Application requests that the Commission issue a Capital Comparability Determination finding that compliance with certain designated capital requirements of Japan (the "Japanese Capital Rules") and certain designated financial reporting requirements of Japan (the "Japanese Financial Reporting Rules") by a Japanese nonbank SD registered with the FSA as a Type I Financial Instruments Business Operator ("FIBO") satisfies corresponding CFTC Capital Rules and CFTC Financial Reporting Rules applicable to a nonbank SD under Sections 4s(e) and (f) of the CEA and

Regulations 23.101 and 23.105.<sup>29</sup> There are currently three Japanese nonbank SDs registered with Commission, and the FSA has represented that each of the three Japanese nonbank SDs are FSA-registered and regulated FIBOs.<sup>30</sup> The FSA Application requests that the Commission's Capital Comparability Determination cover each of the three Japanese nonbank SDs and any future Japanese registered and domiciled FIBOs that register with the Commission as nonbank SDs.

The FSA has represented that the capital adequacy and financial reporting requirements for swap activities in Japan are governed by the Japanese legal framework for financial regulation, which is mainly composed of Acts, Cabinet Orders, Ministerial Orders, and FSA Notices.<sup>31</sup> With regard to the Japanese Capital Rules and the Japanese Financial Reporting Rules, the Financial Instruments and Exchange Act (Act No. 25 of 1948) ("FIEA") and its related order, Cabinet Office Order on Financial Instruments Business (Cabinet Office Order No. 52 of 2007) ("COO"), stipulate the prudential capital and financial reporting requirements applicable to FIBOs, including Japanese nonbank SDs.<sup>32</sup> FIEA, COO, and related FSA Notices impose mandatory capital and reporting requirements on FIBOs, including Japanese nonbank SDs. Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. ("Supervisory Guidelines for FIBO") also supplement the framework.<sup>33</sup> The technical requirements for FIBOs, including Japanese nonbank SDs, to calculate capital adequacy ratios are specified in

the FSA Notice No. 59 of 2007 ("Notice on Capital") in accordance with Article 177(8) and Article 178(1) of the COO.

## **II. General Overview of CFTC and Japanese Nonbank Swap Dealer Capital Rules**

### *A. General Overview of CFTC Nonbank Swap Dealer Capital Rules*

The CFTC Capital Rules provide nonbank SDs with three alternative capital approaches: (i) the Tangible Net Worth Capital Approach ("TNW Approach"); (ii) the Net Liquid Assets Capital Approach ("NLA Approach"); and (iii) the Bank-Based Capital Approach ("Bank-Based Approach").<sup>34</sup>

Nonbank SDs that are "predominantly engaged in non-financial activities" may elect the TNW Approach.<sup>35</sup> The TNW Approach requires a nonbank SD to maintain a level of "tangible net worth" <sup>36</sup> equal to or greater than the higher of: (i) \$20 million plus the amount of the nonbank SD's "market risk exposure requirement" <sup>37</sup> and "credit risk exposure requirement" <sup>38</sup> associated with the nonbank SD's swap

<sup>34</sup> 17 CFR 23.101.

<sup>35</sup> 17 CFR 23.101(a)(2). The term "predominantly engaged in non-financial activities" is defined in Regulation 23.100 (17 CFR 23.100) and generally provides that: (i) the nonbank SD's, or its parent entity's, annual gross financial revenues for either of the previous two completed fiscal years represents less than 15 percent of the nonbank SD's or the nonbank SD's parent's, annual gross revenues for all operations (*i.e.*, commercial and financial) for such years, and (ii) the nonbank SD's, or its parent entity's, total financial assets at the end of its two most recently completed fiscal years represents less than 15 percent of the nonbank SD's, or its parent's, total consolidated financial and nonfinancial assets as of the end of such years.

<sup>36</sup> The term "tangible net worth" is defined in Regulation 23.100 and generally means the net worth (*i.e.*, assets less liabilities) of a nonbank SD, computed in accordance with applicable accounting principles, with assets further reduced by a nonbank SD's recorded goodwill and other intangible assets.

<sup>37</sup> The terms "market risk exposure" and "market risk exposure requirement" are defined in Regulation 23.100 (17 CFR 23.100) and generally mean the risk of loss in a financial position or portfolio of financial positions resulting from movements in market prices and other factors. Market risk exposure is the sum of: (i) general market risks including changes in the market value of a particular asset that results from broad market movements, which may include an additive for changes in market value under stressed conditions; (ii) specific risk, which includes risks that affect the market value of a specific instrument but do not materially alter broad market conditions; (iii) 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 (iv) comprehensive risk, which is the measure of all material price risks of one or more portfolios of correlation trading positions.

<sup>38</sup> The term "credit risk exposure requirement" is defined in Regulation 23.100 (17 CFR 23.100) and generally reflects the amount at risk if a counterparty defaults before the final settlement of a swap transaction's cash flows.

<sup>27</sup> *Id.*

<sup>28</sup> The Commission has provided the FSA with an opportunity to review for accuracy and completeness, and comment on, the Commission's description of relevant Japanese laws and regulations on which this proposed Capital Comparability Determination is based. The Commission relies on this review and any corrections received from the FSA in making its proposal. A comparability determination based on an inaccurate description of foreign laws and regulations may not be valid.

<sup>29</sup> The FSA's application did not request a Capital Comparability Determination with respect to nonbank MSPs as currently there are no MSPs registered with the Commission and, accordingly, no nonbank MSPs domiciled in Japan and registered with the FSA. Accordingly, the Commission's Capital Comparability Determination and proposed Order does not address nonbank MSPs.

<sup>30</sup> FSA Application, pp. 4–5 (footnote 11).

<sup>31</sup> *Id.*, p. 4.

<sup>32</sup> Businesses categorized as Type I Financial Instruments Business (Article 28(1) of the FIEA) can only be conducted by Type I FIBOs registered under Article 29 of the FIEA. Type I Financial Instruments Business includes market transactions of derivatives and foreign market derivatives transactions pertaining to certain highly liquid securities and over-the-counter transactions of derivatives.

<sup>33</sup> In order to implement and reinforce the legal framework, the FSA has developed and published supervisory guidelines. The supervisory guidelines are meant for FSA staff, but are public documents, which are expected to be followed by the applicable financial institutions. Financial institutions are consulted in connection with the establishment of, and any amendments to, the supervisory guidelines. Supervision and enforcement are conducted based on the supervisory guidelines.

and related hedge positions that are part of the nonbank SD's swap dealing activities; (ii) eight percent of the nonbank SD's "uncleared swap margin" amount;<sup>39</sup> or (iii) the amount of capital required by a registered futures association of which the nonbank SD is a member.<sup>40</sup> The TNW Approach is intended to ensure the safety and soundness of a qualifying nonbank SD by requiring the firm to maintain a minimum level of tangible net worth that is based on the nonbank SD's swap dealing activities to provide a sufficient level of capital to absorb losses resulting from its swap dealing and other business activities.

The TNW approach requires a nonbank SD to compute its market risk exposure requirement and credit risk exposure requirement using standardized capital charges set forth in Securities and Exchange Commission ("SEC") Rule 18a-1 (17 CFR 240.18a-1) that are applicable to entities registered with the SEC as security-based swap dealers ("SBSDs") or standardized capital charges set forth in CFTC Regulation 1.17 applicable to entities registered as FCMs or entities dually-registered as an FCM and nonbank SD.<sup>41</sup> Nonbank SDs that have received Commission or NFA approval pursuant to Regulation 23.102 may use internal models to compute market risk and/or credit risk capital charges in lieu of the SEC or CFTC standardized capital charges.<sup>42</sup>

A nonbank SD that elects the NLA Approach is required to maintain "net capital" in an amount that equals or exceeds the greater of: (i) \$20 million; (ii) 2 percent of the nonbank SD's uncleared swap margin amount; or (iii) the amount of capital required by NFA.<sup>43</sup> The NLA Approach is intended

to ensure the safety and soundness of a nonbank SD by requiring the firm to maintain at all times at least one dollar of highly liquid assets to cover each dollar of the nonbank SD's liabilities.

A nonbank SD is required to reduce the value of its highly liquid assets by the market risk exposure requirement and/or the credit risk exposure requirement in computing its net capital.<sup>44</sup> A nonbank SD that does not have Commission or NFA approval to use internal models must compute its market risk exposure requirement and/or credit risk exposure requirement using the standardized capital charges contained in SEC Rule 18a-1 (17 CFR 240.18a-1) as modified by the Commission's rule.<sup>45</sup>

A nonbank SD that has obtained Commission or NFA approval, may use internal market risk and/or credit risk models to compute market risk and/or credit risk capital charges in lieu of the standardized capital charges.<sup>46</sup> A nonbank SD that is approved to use internal market risk and/or credit risk models is further required to maintain a minimum of \$100 million of "tentative net capital."<sup>47</sup>

The Commission's NLA Approach is consistent with the SEC's SBSB capital rule, and is based on the Commission's capital rule for FCMs and the SEC's capital rule for securities broker-dealers ("BDs"). The quantitative and qualitative requirements for NLA Approach internal market and credit risk models are also consistent with the quantitative and qualitative requirements of the Commission's Bank-Based Approach as described below.

The Commission's Bank-Based Approach for computing regulatory capital for nonbank SDs is based on certain capital requirements imposed by the Federal Reserve Board for bank holding companies.<sup>48</sup> The Bank-Based Approach also is consistent with the Basel Committee on Banking Supervision's ("BCBS") international framework for bank capital requirements.<sup>49</sup> The Bank-Based

Approach requires a nonbank SD to maintain regulatory capital equal to or in excess of each of the following requirements: (i) \$20 million of common equity tier 1 capital; (ii) an aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital (including qualifying subordinated debt) equal to or greater than 8 percent of the nonbank SD's risk-weighted assets (provided that common equity tier 1 capital comprises at least 6.5 percent of the 8 percent minimum requirement); (iii) an aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital equal to or greater than 8 percent of the nonbank SD's uncleared swap margin amount; and (iv) an amount of capital required by NFA.<sup>50</sup> The Bank-Based Approach is intended to ensure that the safety and soundness of a nonbank SD by requiring the firm to maintain at all times qualifying capital in an amount sufficient to absorb unexpected losses, expenses, decrease in firm assets, or increases in firm liabilities without the firm becoming insolvent.

The terms used in the Commission's Bank-Based Approach are defined by reference to regulations of the Federal Reserve Board.<sup>51</sup> Specifically, the term "common equity tier 1 capital" is defined for purposes of the CFTC Capital Rules to generally mean the sum of a nonbank SD's common stock instruments and any related surpluses, retained earnings, and accumulated other comprehensive income.<sup>52</sup> The term "additional tier 1 capital" is defined to include the nonbank SD's common equity tier 1 capital and further includes such additional equity instruments as preferred stock.<sup>53</sup> The term "tier 2 capital" is defined to include certain types of instruments that include both debt and equity characteristics (e.g., certain perpetual preferred stock instruments and subordinated term debt instruments).<sup>54</sup> Subordinated debt also must meet certain requirements to qualify as tier 2 capital, including that the term of the subordinated debt instrument is for a minimum of one year (with the exception of approved revolving subordinated debt agreements which may have a maturity term that is less than one year), and the debt instrument is an effective subordination of the

<sup>39</sup> The term "uncleared swap margin" is defined in Regulation 23.100 (17 CFR 23.100) to generally mean the amount of initial margin that a nonbank SD would be required to collect from each counterparty for each outstanding swap position of the nonbank SD. A nonbank SD 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 uncleared swap margin regulations. A nonbank SD must compute the uncleared swap margin amount in accordance with the Commission's margin rules for uncleared swaps. See 17 CFR 23.154.

<sup>40</sup> The National Futures Association ("NFA") is currently the only entity that is a registered futures association. The Commission will refer to NFA in this document when referring to the requirements or obligations of a registered futures association.

<sup>41</sup> 17 CFR 23.101(a)(2)(ii)(A).

<sup>42</sup> *Id.*

<sup>43</sup> 17 CFR 23.101(a)(1)(ii)(A). "Net capital" consists of a nonbank SD's highly liquid assets (subject to haircuts) less all of the firm's liabilities, excluding certain qualified subordinated debt. See 17 CFR 240.18a-1 for the calculation of "net capital."

<sup>44</sup> See 17 CFR 240.18a-1(c) and (d).

<sup>45</sup> See 17 CFR 23.101(a)(1)(ii).

<sup>46</sup> See 17 CFR 23.102.

<sup>47</sup> 17 CFR 23.101(a)(1)(ii)(A)(1). The term "tentative net capital" is defined in Regulation 23.101(a)(1)(ii)(A)(1) by reference to SEC Rule 18a-1 and generally means a nonbank SD's net capital prior to deducting market risk and credit risk capital charges.

<sup>48</sup> See 17 CFR 23.101(a)(1)(i).

<sup>49</sup> The 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 England, Bank of France, Bank of Japan, Banco de Mexico, and Bank of Canada.

<sup>50</sup> 17 CFR 23.101(a)(1)(i).

<sup>51</sup> *Id.* Regulation 23.101(a)(1)(i) references Federal Reserve Board Rule 217.20 (12 CFR 217.20) for purposes of defining the terms used in establishing the minimum capital requirements under the Bank-Based Approach.

<sup>52</sup> See 12 CFR 217.20(b).

<sup>53</sup> See 12 CFR 217.20(c).

<sup>54</sup> See 12 CFR 217.20(d).

rights of the lender to receive any payment, including accrued interest, to other creditors.<sup>55</sup>

Common equity tier 1 capital, additional tier 1 capital, and tier 2 capital are unencumbered and generally long-term or permanent forms of capital that help ensure that a nonbank SD will be able to absorb losses resulting from its operations and maintain confidence in the nonbank SD as a going concern. In addition, in setting an equity ratio requirement, this limits the amount of asset growth and leverage a nonbank SD can incur, as a nonbank SD must fund its asset growth with a certain percentage of regulatory capital.

A nonbank SD also must compute its risk-weighted assets using standardized capital charges or, if approved, internal models. Risk-weighting assets involves adjusting the notional or carrying value of each asset based on the inherent risk of the asset. Less risky assets are adjusted to lower values (*i.e.*, have less risk-weight) than more risky assets. As a result, nonbank SDs are required to hold lower levels of regulatory capital for less risky assets and higher levels of regulatory capital for riskier assets.

Nonbank SDs not approved to use internal models to risk-weight their assets must compute market risk capital charges using the standardized charges contained in CFTC Regulation 1.17 and SEC Rule 18a–1, and must compute their credit risk charges using the standardized capital charges set forth in regulations of the Federal Reserve Board for bank holding companies (Subpart D of 17 CFR part 217).<sup>56</sup>

Standardized market risk charges are computed under CFTC Regulation 1.17 and SEC Rule 18a–1 by multiplying, as appropriate to the specific asset schedule, the notional value or market value of the nonbank SD's proprietary financial positions (such as swaps, security-based swaps, futures, equities, and U.S. Treasuries) by fixed percentages set forth in the Regulation or Rule.<sup>57</sup> Standardized credit risk charges require the nonbank SD to multiply on-balance sheet and off-balance sheet exposures (such as receivables from counterparties, debt instruments, and exposures from derivatives) by predefined percentages set forth in the applicable Federal

Reserve Board regulations contained in Subpart D of 17 CFR part 217.

A nonbank SD also may apply to the Commission or NFA for approval to use internal models to compute market risk exposure and/or credit risk exposure for purposes of determining its total risk-weighted assets.<sup>58</sup> Nonbank SDs approved to use internal models for the calculation of credit risk or market risk, or both, must follow the model requirements set forth in Federal Reserve Board regulations for bank holding companies (Subpart E and F, respectively, of 17 CFR part 217). Credit risk and market risk capital charges computed with internal models require the estimation of potential losses, with a certain degree of likelihood, within a specified time period, of a portfolio of assets. Internal models allow for consideration of potential co-movement of prices across assets in the portfolio, leading to offsets of gains and losses. Internal credit risk models can also further include estimation of the likelihood of default of counterparties.

#### *B. General Overview of Capital Rules for Japanese Nonbank SDs*

The Japanese Capital Rules impose bank-like capital requirements on a Japanese nonbank SD that are consistent with the BCBS framework for international bank-based capital standards.<sup>59</sup> The Japanese Capital Rules are intended to require each Japanese nonbank SD to hold a sufficient amount of qualifying equity and subordinated debt to absorb decreases in the value of firm assets and to cover losses from its activities, including possible counterparty defaults and margin collateral shortfalls associated with its swap dealing activities, without the firm becoming insolvent.

The Japanese Capital Rules require each Japanese nonbank SD to hold and maintain a “capital adequacy amount” equal to 120 percent or more of the Japanese nonbank SD's “risk equivalent amount.”<sup>60</sup> A Japanese nonbank SD's “capital adequacy amount” is composed of the firm's equity classified as “Basic Items” and “Supplemental Items.”<sup>61</sup> Basic Items are composed of the firm's balance sheet capital including: (i) issued and outstanding shares; (ii) the payment for an application for new shares; (iii) the capital surplus; (iv) the earned surplus; (v) the negative valuation difference on available-for-

sale securities; and (vi) the firm's own treasury stock.<sup>62</sup> Supplemental Items provide an additional layer of capital beyond Basic Items and are composed of the positive valuation difference on available-for-sale securities and certain subordinated debt instruments.<sup>63</sup>

A Japanese nonbank SD's capital adequacy amount must be composed of at least 50 percent Basic Items, and limits are imposed on the aggregate amount of subordinated debt that may be used to meet the capital adequacy amount.<sup>64</sup> Subordinated debt also must satisfy specified conditions in order to be included in the Japanese nonbank SD's capital. Specifically, the subordinated debt instrument must: (i) contain special provisions subordinating the rights of the lender to the payment of principal and interest; (ii) not be secured by the Japanese nonbank SD; (iii) have a minimum original maturity of more than five years for long term subordinated debt, and at least two years for short term subordinated debt; (iv) provide that any early redemption must be done voluntarily by the Japanese nonbank SD and must be approved by the FSA; and (v) contain special provisions setting forth that no interest payment shall be made to the lender if such payment would result in the Japanese nonbank SD capital adequacy ratio falling below certain thresholds.<sup>65</sup>

A Japanese nonbank SD's “risk equivalent amount” is calculated as the sum of the firm's: (i) market risk equivalent amount, which is the amount equivalent to possible risks which may accrue due to fluctuations in the prices of securities and other proprietary assets and transactions held;<sup>66</sup> (ii) counterparty risk equivalent amount, which is the amount equivalent to possible risks which may accrue due to the default in performance of contracts by the counterparties to transactions or any other reason;<sup>67</sup> and (iii) basic risk equivalent amount, which is the amount equivalent to possible risk which may accrue in the ordinary course of

<sup>62</sup> Article 176(1)(i) through (vi) of the COO.

<sup>63</sup> Article 176(1)(vii) of the COO.

<sup>64</sup> The Japanese Capital Rules provide that the total amount of Supplemental Items must be less than the total amount of the Japanese nonbank SD's Basic Items. See Article 176(1)(vii) of the COO.

<sup>65</sup> Article 176(2) and (3) of the COO.

<sup>66</sup> Article 178(1)(i) of the COO and Article 10 through 14 of the Notice on Capital. The “market risk equivalent amount” corresponds to “market risk” in the BCBS and Bank-Based Approach frameworks.

<sup>67</sup> Article 178(1)(ii) of the COO and Article 15 through 15–7 of the Notice on Capital. The “counterparty risk equivalent amount” corresponds to “credit risk” in the BCBS and Bank-Based Approach frameworks.

<sup>55</sup> The subordinated debt must meet the requirements set forth in SEC Rule 18a–1d (17 CFR 240.18a–1d). See 17 CFR 23.101(a)(1)(i)(B).

<sup>56</sup> See 17 CFR 23.101(a)(1)(i)(B) and the definition of the term *BHC risk-weighted assets* in 17 CFR 23.100.

<sup>57</sup> See 17 CFR 1.17(c)(5) and 17 CFR 240.15c3–1(c)(2).

<sup>58</sup> See 17 CFR 23.102.

<sup>59</sup> FSA Application, p. 9.

<sup>60</sup> Article 46–6(2) of the FIEA, Article 176 of the COO and Section IV–2–1 (Preciseness of Capital Adequacy Ratio) of the Supervisory Guidelines for FIBO.

<sup>61</sup> FSA Application, p. 14.

executing business, such as errors in business handling.<sup>68</sup> The risk equivalent amount is a method of risk-weighting the Japanese nonbank SD's assets by adjusting the notional or carrying value of each asset based on the inherent risk of the asset. Less risky assets have a lower risk equivalent amount than assets with higher risk. As a result, Japanese nonbank SDs are required to hold lower levels of regulatory capital for assets with a lower risk equivalent amount and higher levels of regulatory capital for assets with a higher level of risk equivalent amount.

To calculate its risk equivalent amount, a Japanese nonbank SD risk-weights its assets and exposures using specified standardized weights or approved internal model-based methodologies. The Japanese Capital Rules, including various ordinances, notices<sup>69</sup> and guidelines,<sup>70</sup> set out quantitative and qualitative requirements that internal models must meet in order to obtain and maintain approval. Topics addressed by the quantitative and qualitative requirements include model governance, validation, monitoring, and review.

Modeled credit risk and market risk capital charges require the estimation of potential losses, with a certain degree of likelihood, within a specified time period, of a portfolio of assets.<sup>71</sup> Internal models allow for consideration of potential co-movement of prices across assets in the portfolio, leading to offsets of gains and losses. Internal credit risk models can also further include estimation of the likelihood of default of counterparties.

### III. Commission Analysis of the Comparability of the Japanese Capital Rules and Japanese Financial Reporting Rules With the CFTC Capital Rules and CFTC Financial Reporting Rules

The following section provides a description and comparative analysis of

the regulatory requirements of the Japanese Capital Rules and Japanese Financial Reporting Rules to the CFTC Capital Rules and CFTC Financial Reporting Rules. Immediately following a description of the requirement(s) of the CFTC Capital Rules or the CFTC Financial Reporting Rules for which a comparability determination was requested by the FSA, the Commission provides a description of Japan's corresponding laws, regulations, or rules. The Commission then provides a comparative analysis of the Japanese Capital Rules or the Japanese Financial Reporting Rules with the corresponding CFTC Capital Rules or CFTC Financial Reporting Rules. The Commission identifies any material differences between the respective rules.

The Commission performed this proposed Capital Comparability Determination by assessing the comparability of the Japanese Capital Rules for Japanese nonbank SDs as set forth in the FSA Application and in the English language translation of certain Japanese laws and regulations, with the Commission's Bank-Based Approach. For clarity, the Commission did not assess the comparability of the Japanese Capital Rules to the Commission's TNW Approach or NLA Approach as the Commission understands that all Japanese nonbank SDs, as of the date of the FSA Application, are subject to the current bank-based capital approach of the Japanese Capital Rules. Accordingly, for clarity, when the Commission makes a preliminary determination herein about the comparability of the Japanese Capital Rules with the CFTC Capital Rules, the determination pertains to the comparability of the Japanese Capital Rules with the Bank-Based Approach under the CFTC Capital Rules.

As described below, it is proposed that any material changes to the Japanese Capital Rules will require notification to the Commission. Therefore, if there are subsequent material changes to the Japanese Capital Rules to include, for example, another capital approach,—the Commission will review and assess the impact of such changes on the Capital Comparability Determination Order as it is then in effect, and may amend or supplement the Order.<sup>72</sup>

In addition, although the BCBS bank capital standards establish minimum capital standards that are consistent with the requirements of the Commission's Bank-Based Approach,

the Commission notes that consistency with the BCBS standards is not determinative of a finding of comparability with the CFTC Capital Rules. In the Commission's view, a foreign jurisdiction's consistency with the BCBS international bank standards is an element in the Commission's comparability assessment, but, in and of itself, it may not be sufficient to demonstrate comparability with the CFTC Capital Rules without an assessment of the individual elements of the foreign jurisdiction's capital framework.

Capital and financial reporting regimes are complex structures comprised of a number of interrelated regulatory components. Differences in how jurisdictions approach and implement these regimes are expected, even among jurisdictions that base their requirements on the principles and standards set forth in the BCBS international framework. Therefore, the Commission's comparability determination involves a detailed assessment of the relevant requirements of the foreign jurisdiction and whether those requirements, viewed in the aggregate, lead to an outcome that is comparable to the outcome of the CFTC's corresponding requirements. Consistent with this approach, the Commission has grouped the CFTC Capital Rules and the CFTC Financial Reporting Rules into key categories that focus the analysis on whether the Japanese capital and financial reporting requirements are comparable to the Commission's requirements in purpose and effect, and not whether the Japanese requirements meet every aspect or contain identical elements as the Commission's requirements.

Specifically, as discussed in detail below, the Commission used the following key categories in its review: (i) the quality of the equity and debt instruments that qualify as regulatory capital, and the extent to which the regulatory capital represents committed and permanent capital that would be available to absorb unexpected losses or counterparty defaults; (ii) the process of establishing minimum capital requirements for a Japanese nonbank SD and how such process addresses market risk and credit risk of the firm's on-balance sheet and off-balance sheet exposures; (iii) the financial reports and other financial information submitted by a Japanese nonbank SD to its relevant regulatory authorities to effectively monitor the financial condition of the firm; and (iv) the regulatory notices and other communications between the Japanese nonbank SD and its relevant regulatory authorities that detail

<sup>68</sup> Article 178(1)(iii) of the COO and Article 16 of the Notice on Capital.

<sup>69</sup> Article 13 of the Notice on Capital.

<sup>70</sup> *Principles for Model Risk Management*, Financial Services Agency of Japan (November 12, 2021).

<sup>71</sup> The Japanese Capital Rules require Japanese nonbank SDs with model approval for market risk to use a VaR model with a 99 percent, one-tailed confidence interval with (i) price changes equivalent to a ten business-day movement in rates and prices, (ii) effective historical observation periods of at least one year, and (iii) at least monthly data set updates. See Article 13(3)(i), (ii), and (iv) of the Notice on Capital. Japanese nonbank SDs approved to use credit risk models are required to use specified formulas to calculate the expected exposure at default of the counterparty. See Article 15-2 of the Notice on Capital.

<sup>72</sup> The Commission also may amend or supplement the Order to address any material changes to the CFTC Capital Rules and CFTC Financial Reporting Rules that are adopted after a final Order is issued.



potential adverse financial or operational issues that may impact the firm. The Commission also reviewed the manner in which compliance by a Japanese nonbank SD with the Japanese Capital Rules and Japanese Financial Reporting Rules is monitored and enforced. The Commission invites public comment on all aspects of the FSA Application and on the Commission's proposed Capital Comparability Determination discussed below.

*A. Regulatory Objectives of CFTC Capital Rules and CFTC Financial Reporting Rules and Japanese Capital Rules and Japanese Financial Reporting Rules*

**1. Regulatory Objectives of CFTC Capital Rules and CFTC Financial Reporting Rules**

The regulatory objectives of the CFTC Capital Rules and the CFTC Financial Reporting Rules are to further the Congressional mandate to ensure the safety and soundness of nonbank SDs to mitigate the greater risk to nonbank SDs and the financial system arising from the use of swaps that are not cleared.<sup>73</sup> A primary function of the nonbank SD's capital is to protect the solvency of the firm from decreases in the value of firm assets and from losses, including losses resulting from counterparty defaults and margin collateral failures, by requiring the firm to maintain an appropriate level of capital, including qualifying subordinated debt, to absorb such losses without becoming insolvent. With respect to swap positions, capital and margin perform complementary risk mitigation functions by protecting nonbank SDs, containing the amount of risk in the financial system as a whole, and reducing the potential for contagion arising from uncleared swaps.

The objective of the CFTC Financial Reporting Rules is to provide the Commission with the means to monitor and assess a nonbank SD's financial condition, including the nonbank SD's compliance with minimum capital requirements. The CFTC Financial Reporting Rules are designed to provide the Commission and NFA, which along with the Commission oversees nonbank SDs' compliance with Commission regulations, with a comprehensive view of the financial health and activities of the nonbank SD. The Commission's rules require nonbank SDs to file financial information, including periodic unaudited and annual audited financial statements, specific financial position information, and notices of

certain events that may indicate a potential financial or operational issue that may adversely impact the nonbank SD's ability to meet its obligations to counterparties and other creditors in the swaps market, or impact the firm's solvency.

**2. Regulatory Objective of Japanese Capital Rules and Japanese Financial Reporting Rules**

The regulatory objective of the Japanese Capital Rules is to ensure the safety and soundness of FIBOs, including Japanese nonbank SDs. The Japanese Capital Rules are designed to preserve the financial stability and solvency of a Japanese nonbank SD by requiring the firm to maintain a sufficient amount of qualifying equity and subordinated debt to absorb decreases in the value of firm assets and to cover losses from business activities, including counterparty defaults and margin collateral shortfalls associated with the firm's swap dealing activities. The Japanese Capital Rules also place an emphasis on high quality equity, as a Japanese nonbank SD must maintain at least 50 percent of its minimum capital requirement in the form of Basic Items.<sup>74</sup> The Japanese Capital Rules further enhance a Japanese nonbank SD's capital available to meet its minimum capital requirements by requiring the firm to subtract the balance sheet carrying value of its fixed assets from the firm's Basic Items in computing its minimum capital.<sup>75</sup>

The objective of the Japanese Financial Reporting Rules is to enable the FSA to assess the financial condition and safety and soundness of Japanese nonbank SDs. The Japanese Financial Reporting Rules aim to achieve this objective by requiring each Japanese nonbank SD to provide financial reports and other financial position and capital information to the FSA on a regular basis. The financial reporting by a Japanese nonbank SD provides the FSA with information necessary to effectively monitor the Japanese nonbank SD's overall financial condition and its ability to meet its regulatory obligations as a FIBO.

<sup>74</sup> The Japanese Capital Rules provide that the total amount of Supplemental Items must be less than the total amount of the Japanese nonbank SD's Basic Items. See Article 176(1)(vii) of the COO.

<sup>75</sup> Article 177 of the COO. The Japanese Capital Rules require a Japanese nonbank SD to deduct fixed assets from the firm's Basic Items to better ensure that the Japanese nonbank's regulatory capital represents more liquid assets that may be promptly liquidated at values comparable to carrying value to meet obligations to creditors and to cover losses.

**3. Commission Analysis**

The Commission has reviewed the FSA Application and the relevant Japanese laws and regulations, and has preliminarily determined that the overall objectives of Japanese Capital Rules and CFTC Capital Rules are comparable in that both sets of rules are intended to ensure the safety and soundness of nonbank SDs by establishing a regulatory regime that requires nonbank SDs to maintain a sufficient amount of qualifying regulatory capital to absorb losses, including losses from swaps and other trading activities, and to absorb decreases in the value of firm assets without the nonbank SDs becoming insolvent. The Japanese Capital Rules and CFTC Capital Rules are also based on, and consistent with, the BCBS international bank capital framework, which was designed to ensure that banking entities hold sufficient levels of capital to absorb losses and decreases in the value of assets without the banks becoming insolvent.

The Japanese Capital Rules are comparable in purpose and effect to the CFTC Capital Rules in that both regulatory approaches compute the minimum capital requirements based on the level of a nonbank SD's on-balance sheet and off-balance sheet exposures, with the objective and purpose of ensuring that the nonbank SD's capital is adequate to absorb losses resulting from such exposures. The Japanese Capital Rules and CFTC Capital Rules also provide for a comparable approach to the calculation of on-balance sheet and off-balance sheet risk exposures using standardized or internal model-based approaches that result in comparable risk exposure amounts. The Japanese Capital Rules' and CFTC Capital Rules' requirements for identifying and measuring on-balance sheet and off-balance sheet exposures under standardized or internal model-based approaches are also consistent with the requirements set forth under the BCBS international bank capital framework for identifying and measuring on-balance sheet and off-balance sheet exposures.

The Japanese Capital Rules and CFTC Capital Rules further achieve comparable outcomes and are comparable in purpose and effect in that both limit the types of capital instruments that may qualify as regulatory capital to cover the on-balance sheet and off-balance sheet risk exposures to high quality equity capital and qualifying subordinated debt instruments that meet conditions designed to ensure that the holders of

<sup>73</sup> See 7 U.S.C. 6s(e)(3)(A).



the debt have effectively subordinated their claims to other creditors of the nonbank SD. Both the Japanese Capital Rules and the CFTC Capital Rules define high quality capital by the degree to which the capital represents permanent capital that is contributed, or readily available to a nonbank SD, on an unrestricted basis to absorb unexpected losses, including losses from swaps trading and other activities, without the nonbank SD becoming insolvent.

The Japanese Financial Reporting Rules are also comparable in purpose and effect with the CFTC Financial Reporting Rules as both the FSA and CFTC require nonbank SDs to file periodic financial reports, including unaudited financial reports and an annual audited financial report, detailing their financial operations and demonstrating their compliance with minimum capital requirements. In addition to providing the CFTC and FSA with information necessary to comprehensively assess the financial condition of a nonbank SD on an ongoing basis, the financial reports further provide the CFTC and FSA with information regarding potential changes in a nonbank SD's risk profile by disclosing changes in account balances reported over a period of time. Such changes in account balances may indicate that the nonbank SD has entered into new lines of business, has increased its activity in an existing line of business relative to other activities, or has terminated a previous line of business.

The prompt and effective monitoring of the financial condition of nonbank SDs through the receipt and review of periodic financial reports supports the Commission and FSA in meeting their respective objectives of ensuring the safety and soundness of nonbank SDs. In this connection, the early identification of potential financial issues provides the Commission and FSA with an opportunity to address such issues with the nonbank SD before they develop to a state where the financial condition of the firm is impaired such that it may no longer hold a sufficient amount of qualifying regulatory capital to absorb decreases in the value of firm assets or cover losses from its business activities, including the firm's swap dealing activities and obligations to swap counterparties.

The Commission invites public comment on its analysis above, including comment on the FSA Application and relevant Japanese laws and regulations.

## *B. Nonbank Swap Dealer Qualifying Capital*

### *1. CFTC Capital Rules: Qualifying Capital Under Bank-Based Approach*

The CFTC Capital Rules require a nonbank SD electing the Bank-Based Approach to maintain regulatory capital in the form of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital in amounts that meet certain stated minimum requirements set forth in Regulation 23.101.<sup>76</sup> Common equity tier 1 capital, additional tier 1 capital, and tier 2 capital are composed of certain defined forms of equity of the nonbank SD, including common stock, retained earnings, and qualifying subordinated debt.<sup>77</sup> The Commission's requirement for a nonbank SD to maintain a minimum amount of defined qualifying capital and subordinated debt is intended to ensure that the firm maintains a sufficient amount of regulatory capital to absorb decreases in the value of the firm's assets and to cover losses resulting from the firm's swap dealing and other activities, without the firm becoming insolvent.

Common equity tier 1 capital is generally composed of an entity's common stock instruments and any related surpluses, retained earnings, and accumulated other comprehensive income, and is a more conservative or permanent form of capital than additional tier 1 and tier 2 capital.<sup>78</sup> Additional tier 1 capital is generally composed of equity instruments such as preferred stock and certain hybrid securities that may be converted to common stock if triggering events occur.<sup>79</sup> Total tier 1 capital is composed of common equity tier 1 capital and further includes additional tier 1 capital.<sup>80</sup> Tier 2 capital includes certain types of instruments that include both debt and equity characteristics such as qualifying subordinated debt.<sup>81</sup>

Subordinated debt must meet certain conditions to qualify as tier 2 capital under the CFTC Capital Rules. Specifically, subordinated debt instruments must have a term of at least one year (with the exception of approved revolving subordinated debt agreements which may have a maturity term that is less than one year), and contain terms that effectively subordinate the rights of lenders to

receive any payments, including accrued interest, to other creditors of the firm.<sup>82</sup>

Common equity tier 1 capital, additional tier 1 capital, and tier 2 capital are permitted to be included in a nonbank SD's regulatory capital and used to meet the firm's minimum capital requirement due to their characteristics of being permanent forms of capital that are subordinate to the claims of other creditors, which ensures that a nonbank SD will have this regulatory capital to absorb decreases in the value of the firm's assets and losses from business activities, including swap dealing activities, without the firm becoming insolvent.

### *2. Japanese Capital Rules: Qualifying Capital*

The Japanese Capital Rules require each Japanese nonbank SD to maintain a "capital adequacy amount" (*i.e.*, Basic Items and Supplemental Items) that equals or exceeds 120 percent of the firm's "risk equivalent amount," which is the sum of the firm's market risk, credit risk, and basic risk.<sup>83</sup> Basic Items are composed of the Japanese nonbank SD's balance sheet capital including: issued and outstanding shares; (ii) the payment for an application for new shares; (iii) the capital surplus; (iv) the earned surplus; (v) the negative valuation difference on available-for-sale securities; and (vi) the firm's own treasury stock.<sup>84</sup> Supplemental Items include the positive valuation difference on available-for-sale securities and certain subordinated debt instruments.<sup>85</sup> Subordinated debt instruments also must meet certain conditions to qualify as Supplemental Items under the Japanese Capital Rules, including containing appropriate provisions subordinating the rights of the lender to the payment of principal and interest to other creditors of the Japanese nonbank SD.<sup>86</sup> The Japanese Capital Rules also provide that a minimum of 50 percent of a Japanese nonbank SD's capital adequacy amount must be composed of Basic Items.<sup>87</sup>

The Japanese Capital Rules further require a Japanese nonbank SD, in computing its capital adequacy amount, to deduct the balance sheet carrying

<sup>82</sup> The subordinated debt must meet the requirements set forth in SEC Rule 18a-1d (17 CFR 240.18a-1d). See 17 CFR 23.101(a)(1)(i)(B).

<sup>83</sup> See Article 46-6-2 of the FIEA, Article 176 of the COO and Section IV-2-1 (Preciseness of Capital Adequacy Ratio) of the Supervisory Guidelines for FIBO.

<sup>84</sup> See Article 176(1)(i) through (vi) of the COO.

<sup>85</sup> See Article 176(1)(vii) of the COO.

<sup>86</sup> Article 176(2) and (3) of the COO.

<sup>87</sup> FSA Application, pp. 14-15.

<sup>76</sup> See 17 CFR 23.101(a)(1)(i).

<sup>77</sup> The terms "common equity tier 1 capital," "additional tier 1 capital," and "tier 2 capital" are defined in the bank holding company regulations of the Federal Reserve Board. See 12 CFR 217.20.

<sup>78</sup> 12 CFR 217.20.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

value of fixed assets from its Basic Items.<sup>88</sup> The deduction of the carrying value of fixed assets is a conservative approach to the computation of a Japanese nonbank SD's capital adequacy amount as it excludes the value of non-liquid fixed assets from the firm's total Basic Items. The deduction of the carrying value of fixed assets from a Japanese nonbank SD's Basic Items reduces the amount of regulatory capital that the firm may recognize in meeting its capital requirements, and places an emphasis on the Japanese nonbank SD maintaining liquid assets to meet its minimum capital requirement to absorb business losses and decreases in the value of firm assets, and to satisfy financial obligations to counterparties and creditors.<sup>89</sup>

### 3. Commission Analysis

The Commission has reviewed the FSA Application and the relevant Japanese laws and regulations, and has preliminarily determined that the Japanese Capital Rules are comparable in purpose and effect to CFTC Capital Rules with regard to the types and characteristics of a nonbank SD's equity that qualifies as regulatory capital in meeting its minimum requirements. The Japanese Capital Rules and the CFTC Capital Rules for nonbank SDs both require a nonbank SD to maintain a quantity of high-quality and permanent capital that, based on the firm's activities and on-balance sheet and off-balance sheet exposures, is sufficient to absorb losses and decreases in the value of the firm's assets without resulting in the firm becoming insolvent.

The Japanese Capital Rules and the CFTC Capital Rules permit nonbank SDs to recognize comparable forms of equity capital and qualifying subordinated debt instruments toward meeting minimum capital requirements, with both the Japanese Capital Rules and the CFTC Capital Rules placing an emphasis on high quality equity capital instruments. In this regard, the types and characteristics of the equity instruments included in Basic Items under the Japanese Capital Rules are comparable to the types and characteristics of equity instruments comprising common equity tier 1 capital and additional tier 1 capital under the CFTC Capital Rules.

<sup>88</sup> See Article 177 of the COO for a breakdown of the fixed assets to be deducted from the Basic Items.

<sup>89</sup> The Japanese Capital Rules require a Japanese nonbank SD to deduct illiquid fixed assets from its regulatory capital to better ensure that the firm's regulatory capital reflects assets that may be more promptly liquidated at values comparable to carrying values to meet losses. As discussed *infra*, under the CFTC Capital Rules, fixed assets are not deducted from regulatory capital, and are included in the nonbank SD's risk weighted assets.

Specifically, the Japanese Capital Rules' Basic Items and the CFTC Capital Rules' common equity tier 1 capital and additional tier 1 capital are comparable in that these forms of equity capital have similar characteristics (*e.g.*, the equity must be in the form of high-quality, committed, and permanent capital) and these forms of capital represent contributed equity capital that generally has no priority to the distribution of firm assets or income with respect to other shareholders or creditors of the firm, which allows a nonbank SD to use this equity to absorb decreases in the value of firm assets and cover losses from business activities, including the firm's swap dealing activities.

Supplemental Items under the Japanese Capital Rules are also comparable to tier 2 capital under the CFTC Capital Rules. Specifically, the qualifying conditions imposed on subordinated debt instruments are comparable under the Japanese Capital Rules and the CFTC Capital Rules and ensure that the debt has qualities that support its recognition by a nonbank SD as equity for capital purposes, including that the debt lenders have effectively subordinated their claims for repayment on the debt to other creditors of the nonbank SD. Qualifying subordinated debt under the Japanese Capital Rules and CFTC Capital Rules also must contain provisions limiting or restricting repayment of the subordinated loans if such repayments result in the nonbank SD's equity falling below certain defined thresholds. These terms and conditions provide assurances that the subordinated debt is appropriate to be recognized as regulatory capital available to a nonbank SD to meet its obligations and to absorb business losses and decreases in the value of firm assets.

The Japanese Capital Rules differ from the CFTC Capital Rules, however, in that the Japanese Capital Rules require Japanese nonbank SDs to exclude the carrying value of fixed assets from the sum of the Basic Items in computing the capital adequacy amount. The CFTC Capital Rules do not require a nonbank SD to exclude fixed assets from the firm's common equity tier 1 capital or additional tier 1 capital. The deduction of the carrying value of fixed assets is a stricter capital standard as it imposes an obligation on Japanese nonbank SDs to meet minimum regulatory capital requirements with assets that are more liquid than fixed assets.

Having reviewed the FSA Application and the relevant Japanese laws and regulations, the Commission has made a preliminary determination that the

Japanese Capital Rules and CFTC Capital Rules impose comparable requirements on Japanese nonbank SDs with respect to the types and characteristics of equity capital that must be used to meet minimum regulatory capital requirements. The Commission invites public comment on its analysis above, including comment on the FSA Application and relevant Japanese laws and regulations.

### C. Nonbank Swap Dealer Minimum Capital Requirement

#### 1. CFTC Capital Rules: Nonbank SD Minimum Capital Requirement

The CFTC Capital Rules require a nonbank SD electing the Bank-Based Approach to maintain regulatory capital that satisfies each of the following criteria: (i) an amount of common equity tier 1 capital of at least \$20 million; (ii) an aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital in an amount equal to or in excess of 8 percent of the nonbank SD's uncleared swap margin amount; (iii) an aggregate amount of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital equal to or greater than 8 percent of the nonbank SD's total risk-weighted assets, provided that common equity tier 1 capital comprises at least 6.5 percent of the 8 percent; and (iv) the amount of capital required by the NFA.<sup>90</sup>

Prong (i) above requires each nonbank SD electing the Bank-Based Approach to maintain a minimum of \$20 million of common equity tier 1 capital in order to operate as a nonbank SD. The requirement that each nonbank SD electing the CFTC Bank-Based Approach maintain a minimum of \$20 million of common equity tier 1 capital is also consistent with the minimum capital requirement for nonbank SDs electing the NLA Approach and the TNW Approach.<sup>91</sup> The Commission adopted this minimum requirement as it believed that the role a nonbank SD performs in the financial markets by engaging in swap dealing activities warranted a minimum level of capital, stated as a fixed dollar amount that does not fluctuate with the level of the firm's

<sup>90</sup> See 17 CFR 23.101(a)(1)(i). NFA has not adopted a separate capital requirement for a nonbank SD.

<sup>91</sup> Nonbank SDs electing the NLA Approach are subject to a minimum capital requirement that includes a fixed minimum dollar amount of net capital of \$20 million. See 17 CFR 23.101(a)(1)(ii)(A)(1). Nonbank SDs electing the TNW Approach are required to maintain levels of tangible net worth that equals or exceeds \$20 million plus the amount of the nonbank SDs' market risk and credit risk associated with the firms' dealing activities. See 17 CFR 23.101(a)(2)(ii)(A).

dealing activities, to help ensure that the firm meets its financial commitments to swap counterparties and creditors without the firm becoming insolvent.<sup>92</sup>

Prong (ii) above is a minimum capital requirement that is based on the amount of uncleared margin for swap transactions entered into by the nonbank SD and is computed on a counterparty by counterparty basis. The requirement for a nonbank SD to maintain minimum capital equal to 8 percent of the firm's uncleared swap margin provides a capital floor based on a measure of the risk and volume of the swap positions, and the number of counterparties and the complexity of operations, of the nonbank SD. The intent of the minimum capital requirement based on a percentage of the nonbank SD's uncleared swap margin was to establish a minimum capital requirement that would help ensure that the nonbank SD meets all of its obligations as a SD to market participants, and to cover potential operational risk, legal risk and liquidity risk in addition to the risks associated with its trading portfolio.<sup>93</sup>

Prong (iii) above is a minimum capital requirement that is based on the Federal Reserve Board's capital requirements for bank holding companies and is consistent with the BCBS international capital adequacy framework for banking institutions. As noted above, a nonbank SD under prong (iii) must maintain an aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital in an amount equal to or greater than 8 percent of the nonbank SD's total risk-weighted assets, with common equity tier 1 capital comprising at least 6.5 percent of the 8 percent. Risk-weighted assets are a nonbank SD's on-balance sheet and off-balance sheet exposures, including proprietary swap, security-based swap, equity, and futures positions, weighted according to risk. The Bank-Based Approach requires each nonbank SD to maintain regulatory capital in an amount that equals or exceeds 8 percent of the firm's total risk-weighted assets to help ensure that the nonbank SD's level of capital is sufficient to absorb decreases in the value of the firm's assets and unexpected losses resulting from business activities, including uncollateralized defaults from swap counterparties, without the nonbank SD becoming insolvent.

A nonbank SD must compute its risk-weighted assets using standardized market risk and/or credit risk charges,

unless the nonbank SD has been approved by the Commission or NFA to use internal models.<sup>94</sup> For standardized market risk charges, the Commission adopts by reference the standardized market risk charges set forth in Regulation 1.17 for FCMs and SEC Rule 18a-1 for nonbank SBSs.<sup>95</sup> The standardized market risk charges under Regulation 1.17 and SEC Rule 18a-1 are calculated as a percentage of the market value or notional value of the nonbank SD's marketable securities and derivatives positions, with the percentages applied to the market value or notional value increasing as the expected or anticipated risk of the positions increases.<sup>96</sup> As stated above, the nonbank SD must maintain qualifying capital in an amount that equals or exceeds 8 percent of the firm's total market risk-weighted assets.<sup>97</sup>

With respect to standardized credit risk charges for exposures from non-derivatives positions, a nonbank SD computes its on-balance sheet and off-balance sheet exposures in accordance with the standardized credit risk charges adopted by the Federal Reserve Board and set forth in Subpart D of 12 CFR 217.<sup>98</sup> Standardized credit risk charges are computed by multiplying the amount of the exposure by defined counterparty credit risk factors that range from 0 percent to 150 percent.<sup>99</sup> A nonbank SD with off-balance sheet exposures is required to calculate a credit risk charge by multiplying each exposure by a credit conversion factor that ranges from 0 percent to 100

percent, depending on the type of exposure.<sup>100</sup>

A nonbank SD may compute standardized credit risk charges for derivatives positions, including uncleared swaps and non-cleared security-based swaps, using either the current exposure method ("CEM") or the standardized approach for measuring counterparty credit risk ("SA-CCR").<sup>101</sup> Both CEM and SA-CCR are non-model, rules-based, approaches to calculating counterparty credit risk for derivatives positions. Credit risk under CEM is the sum of: (i) the current exposure (*i.e.*, the positive mark-to-market) of the derivatives contract; and (ii) the potential future exposure, which is calculated as the product of the notional principal amount of the derivatives contract multiplied by a standard credit risk conversion factor set forth in the rules of the Federal Reserve Board.<sup>102</sup> Credit risk under SA-CCR is defined as the exposure at default amount of a derivatives contract, which is computed as the sum of: (i) the replacement costs of the contract (*i.e.*, the positive mark-to-market); and (ii) the potential future exposure of the contract multiplied by a factor of 1.4.<sup>103</sup>

A nonbank SD also may obtain approval from the Commission or NFA to use internal models to compute market risk and/or credit risk charges in lieu of the standardized charges. A nonbank SD seeking approval to use an internal model is required to submit an application to the Commission or NFA.<sup>104</sup> The application is required to include, among other things, a list of categories of positions that the nonbank SD holds in its proprietary accounts and a brief description of the methods that the nonbank SD will use to calculate deductions for market risk and/or credit risk charges for such positions, as well as a description of the mathematical models used to compute market risk and credit risk charges.

A nonbank SD approved by the Commission or NFA to use internal models to compute market risk is required to comply with Subpart F of the Federal Reserve Board's Part 217

<sup>94</sup> See 17 CFR 23.101(a)(1)(i)(B) and the definition of the term *BHC equivalent risk-weighted assets* in 17 CFR 23.100.

<sup>95</sup> See paragraph (3) of the definition of the term *BHC equivalent risk-weighted assets* in 17 CFR 23.100.

<sup>96</sup> See 17 CFR 1.17(c)(5) and 17 CFR 240.18a-1(c)(1).

<sup>97</sup> See 17 CFR 23.100 (definition of *BHC equivalent risk-weighted assets*). As noted, a nonbank SD is required to maintain qualifying capital (*i.e.*, an aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital) in an amount that exceeds 8 percent of its market risk-weighted assets and credit-risk-weighted assets. The regulations, however, require the nonbank SD to effectively maintain qualifying capital in excess of 100 percent of its market risk-weighted assets by requiring the nonbank SD to multiply its market-risk weighted assets by a factor of 12.5.

<sup>98</sup> See 23.101(a)(1)(i)(B) and paragraph (1) of the definition of the term *BHC equivalent risk-weighted assets* in 17 CFR 23.100.

<sup>99</sup> See 17 CFR 217.32. Lower credit risk factors are assigned to entities with lower credit risk and higher credit risk factors are assigned to entities with higher credit risk. For example, a credit risk factor of 0% is applied to exposures to the U.S. government, the Federal Reserve Bank, and U.S. government agencies (see 12 CFR 217.32(a)(1)), and a credit risk factor of 100% is assigned to an exposure to foreign sovereigns that are not members of the Organization of Economic Co-operation and Development (see 12 CFR 217.32(a)(2)).

<sup>100</sup> See 17 CFR 217.33.

<sup>101</sup> See 17 CFR 217.34. See also, Regulation 23.100 (17 CFR 23.100) defining the term *BHC risk-weighted assets*, which provides that a nonbank SD that does not have model approval may use either CEM or SA-CCR to compute its exposures for over-the-counter derivative contracts without regard to the status of its affiliate entities to use CEM or SA-CCR under the Federal Reserve Board's capital rules.

<sup>102</sup> See 12 CFR 217.34.

<sup>103</sup> See 12 CFR 217.132(c).

<sup>104</sup> See 17 CFR 23.102(c).

<sup>92</sup> See, e.g., 85 FR 57492.

<sup>93</sup> See, 85 FR 57462.

regulations (“Subpart F”).<sup>105</sup> Subpart F is based on models that are consistent with the BCBS Basel 2.5 capital framework.<sup>106</sup> The Commission’s qualitative and quantitative requirements for internal capital models also are comparable to the SEC’s existing internal capital model requirements for broker-dealers in securities and SBSBs,<sup>107</sup> which are also broadly based on the BCBS Basel 2.5 capital framework.

A nonbank SD approved to use internal models to compute credit risk is required to perform such computation in accordance with Subpart E of the Federal Reserve Board’s Part 217 regulations.<sup>108</sup> These internal credit risk modeling requirements are also based on the Basel 2.5 capital framework and the Basel 3 capital framework.

Under the Basel 2.5 capital framework, nonbank SDs have flexibility in developing their internal models, but must follow certain minimum standards. Internal market risk and credit risk models must follow a Value at Risk (“VaR”) structure to compute, on a daily basis, a 99th percentile, one-tailed confidence interval for the potential losses resulting from an instantaneous price shock equivalent to a 10-day movement in prices (unless a different time-frame is specifically indicated). The simulation of this price shock must be based on a historical observation period of minimum length of one year, but there is flexibility on the method used to render simulations, such as variance-covariance matrices, historical simulations, or Monte Carlo.

The Commission and the Basel standards for internal models also have requirements on the selection of appropriate risk factors as well as on data quality and update frequency.<sup>109</sup>

One specific concern is that internal models must capture the non-linear price characteristics of options positions, including but not limited to, relevant volatilities at different maturities.<sup>110</sup>

In addition, BCBS standards for market risk models include a series of additive components for risks for which the broad VaR is ill-suited or that may need targeted calculation. These include the calculation of a Stressed VaR measure (with the same specifications as the VaR, but calibrated to historical data from a continuous 12-month period of significant financial stress relevant to the firm’s portfolio); a Specific Risk measure (which includes the effect of a specific instrument); an Incremental Risk measure (which addresses changes in the credit rating of a specific obligor which may appear as a reference in an asset); and a Comprehensive Risk measure (which addresses risk of correlation trading positions).

## 2. Japanese Capital Rules: Japanese Nonbank Swap Dealer Minimum Capital Requirements

The Japanese Capital Rules impose bank-like capital requirements on a Japanese nonbank SD that, consistent with the BCBS international bank capital framework, require the Japanese nonbank SD to hold a sufficient amount of qualifying equity capital and subordinated debt to absorb decreases in the value of a firm assets and to cover losses from its business activities, including the firm’s swap dealing activities, without the firm becoming insolvent. Specifically, the Japanese Capital Rules require each Japanese nonbank SD to maintain a “capital adequacy amount” that equals or exceeds 120 percent of the firm’s “risk equivalent amount.”<sup>111</sup> The “capital adequacy amount” is calculated as the Japanese nonbank SD’s qualifying balance sheet equity capital in the form of Basic Items and Supplemental Items. The Japanese Capital Rules further require that at least 50 percent of the Japanese nonbank SD’s capital used to meet the 120 percent minimum requirement must be composed of Basic Items, and any subordinated debt

included in Supplemental Items must meet regulatory requirements designed to ensure that the debt is adequately subordinated to claims of other potential creditors of the firm.<sup>112</sup>

The Japanese nonbank SD’s “risk equivalent amount” is calculated as the sum of the: (i) market risk equivalent amount; (ii) counterparty risk equivalent amount; and (iii) basic risk equivalent amount.<sup>113</sup> Comparable to nonbank SDs under the CFTC Bank-Based Approach, the Japanese Capital Rules require Japanese nonbank SDs to compute market risk and/or credit risk using a standardized approach or, if approved to use internal models, market risk and/or credit risk models. The basic risk equivalent amount is computed as an amount equal to 25 percent of the Japanese nonbank SD’s defined annual operating expenses, and is intended to provide a capital cushion to cover risks that may accrue in the course of executing ordinary business operations, such as error in business transactions.<sup>114</sup>

For standardized market risk charges, the Japanese Capital Rules require a Japanese nonbank SD to calculate a market risk equivalent amount to reflect possible decreases in value of the firm’s financial positions including equity risk, interest rate risk, foreign exchange risk, commodity risk, crypto asset risk, and option risk.<sup>115</sup> The market risk equivalent amount is calculated by the Japanese nonbank SD by multiplying specified market risk charges set forth in the Japanese Capital Rules by the notional or market value of the relevant assets and positions. A Japanese nonbank SD is further required to include the full value of its market risk equivalent amount in its aggregate risk equivalent amount, which effectively requires the Japanese nonbank SD to hold qualifying equity capital and subordinated debt in an amount that equals or exceeds 120 percent of the market risk equivalent amount.

With respect to credit risk for non-derivatives positions, the Japanese Capital Rules require a Japanese nonbank SD to calculate its standardized counterparty risk equivalent amount by multiplying its exposure under a given transaction by the specific risk weight applicable to the counterparty under the provisions of the

<sup>105</sup> See paragraph (4) of the definition of *BHC equivalent risk-weighted assets* in 17 CFR 23.100.

<sup>106</sup> Compare 17 CFR 23.100 (providing for a nonbank SD that is approved to use internal models to calculate market and credit risk to calculate its RWAs using Subparts E and F of 12 CFR part 217), Subpart F of 12 CFR, 17 CFR 23.101(a)(1)(ii) (providing for an SD that elects the Net Liquid Assets Approach to calculate its net capital in accordance with Rule 18a–1), and 17 CFR 23.102(a), with Basel Committee on Banking Supervision, *Revisions to the Basel II Market Risk Framework* (2011), <https://www.bis.org/publ/bcbs193.pdf> (describing the revised internal model approach under Basel 2.5).

<sup>107</sup> The SEC internal model requirements for SBSBs are listed in 17 CFR 240.18a–1(d). See also SEC FOCUS Report Part II, *Computation of Net Capital* (Filer Authorized to Use Models) (providing for inclusion of a market risk exposure section for Basel 2.5 firms).

<sup>108</sup> 12 CFR 217 Subpart E.

<sup>109</sup> See 17 CFR Appendix A to Subpart E of Part 23(i)(2)(iii), and Basel Committee on Banking Supervision, *Revisions to the Basel II Market Risk*

*Framework* (2011), paragraph 718(Lxxvi)(e), available at: <https://www.bis.org/publ/bcbs193.pdf>.

<sup>110</sup> The Commission’s requirement is set forth in paragraph (i)(2)(iv)(A) of Appendix A to Subpart E of 17 CFR part 23. See also, Basel Committee on Banking Supervision, *Revisions to the Basel II Market Risk Framework* (2011), paragraph 718(Lxxvi)(h), available at: <https://www.bis.org/publ/bcbs193.pdf>.

<sup>111</sup> Article 46–6(2) of the FIEA, Article 176 of the COO and Section IV–2–1 (Preciseness of Capital Adequacy Ratio) of the Supervisory Guidelines for FIBO.

<sup>112</sup> Article 176(1)(vii) of the COO.

<sup>113</sup> Article 46–6(2) of the FIEA, Article 176 of the COO and Section IV–2–1 (Preciseness of Capital Adequacy Ratio) of the Supervisory Guidelines for FIBO.

<sup>114</sup> Article 178(1)(iii) of the COO and Article 16 of the Notice on Capital.

<sup>115</sup> FSA Notice No. 59 of 2007, Chapter III, Section 2, Article 4.

Japanese Capital Rules. In this regard, the Japanese Capital Rules impose risk-weights ranging from 0 percent to 25 percent on exposures to governmental financial institutions, non-governmental financial institutions, general corporations, and individuals.<sup>116</sup> For certain exposures, credit ratings are used to determine the percentage of the counterparty credit risk exposure and, if no credit ratings are available, the Japanese nonbank SD generally applies a 25 percent risk-weight.

A Japanese nonbank SD is required to include the full amount of the counterparty risk equivalent in its aggregate risk equivalent amount. Therefore, a Japanese nonbank SD is effectively required to maintain a capital adequacy amount that is equal to or in excess of 120 percent of its credit risk equivalent amount.

With respect to credit risk for derivatives positions, the Japanese Capital Rules require a Japanese nonbank SD that is not approved to use credit risk models to calculate its exposure using the CEM, which is one of the standardized methods that a nonbank SD may use to calculate its credit risk exposure under a derivatives transaction pursuant to the Commission's Bank-Based Approach.<sup>117</sup> Under the CEM, a Japanese nonbank SD calculates its exposures for over-the-counter derivatives using a standardized rules-based approach, and is required to hold an amount of qualifying capital that equals or exceeds 120 percent of the aggregate derivatives exposures.

Japanese nonbank SDs may use internal models approved by the FSA to calculate their market risk equivalent amount and/or counterparty risk equivalent amount in lieu of the standardized charges. Japanese Capital Rules set out qualitative and quantitative requirements<sup>118</sup> that internal models must meet in order to be approved for use. The Japanese Capital Rules also require Japanese nonbank SDs to satisfy qualitative and quantitative requirements in order to continue to use models after obtaining the initial approval. These qualitative and quantitative requirements address: the effective review and assessment of models during development, validation, and periodic examinations; identification of key assumptions and limitations; and management of model risk. In this regard, Japanese nonbank SDs approved to use internal models for capital purposes are subject to principles for model risk

management.<sup>119</sup> The principles lay out practices for nonbank SDs, covering model governance, model risk rating, documentation, testing, monitoring, independent validation, controls of vendor products and external resources, and internal audit. The ongoing monitoring includes frequent tests, such as stress testing, backtesting and benchmarking. The FSA periodically confirms that firms using models are adhering to the conditions set.

The internal market risk model-based methodology contained in the Japanese Capital Rules is based on the Basel 2.5 standard,<sup>120</sup> and requires a Japanese nonbank SD to use a VaR model with a 99 percent, one-tailed confidence level with: (i) price changes equivalent to a 10 business-day movement in rates and prices; (ii) effective historical observation periods of at least one year; and (iii) at least monthly data set updates.<sup>121</sup> The Japanese Capital Rules require a Japanese nonbank SD using approved internal models for market risk to calculate a stressed VaR, specific risk, incremental risk, and comprehensive risk of correlation trading.<sup>122</sup>

The Japanese Capital Rules' internal credit risk model-based methodology is also based on the Basel 2.5 standard. The Japanese Capital Rules allow for the estimation of expected exposure, as a measure of potential future exposure, based on VaR techniques as well, with adjustments to the period of risk, as appropriate to the asset and counterparty.<sup>123</sup> Credit risk models may include internal ratings based on the estimation of default probabilities, consistent with the Basel framework and subject to the same model risk management guidelines.

### 3. Commission Analysis

The Commission has reviewed the FSA Application and the relevant Japanese laws and regulations, and has preliminarily determined that the Japanese Capital Rules are comparable in purpose and effect to CFTC Capital Rules with regard to the establishment of a nonbank SD's minimum capital requirement and the calculation of the nonbank SD's amount of regulatory capital. Although there are differences

in the minimum capital requirements and calculation of regulatory capital between the Japanese Capital Rules and the CFTC Capital Rules, as discussed below, the Commission preliminarily believes that the Japanese Capital Rules and CFTC Capital Rules are designed to ensure the safety and soundness of a nonbank SD and, subject to the proposed condition discussed below, will achieve comparable outcomes by requiring the firm to maintain a minimum level of qualifying regulatory capital and subordinated debt to absorb losses from the firm's business activities, including its swap dealing activities, and decreases in the value of the firm's assets, without the nonbank SD becoming insolvent.

The CFTC Capital Rules require a nonbank SD electing the Bank-Based Approach to maintain regulatory capital in an amount that meets or exceeds each of the following requirements: (i) \$20 million of common equity tier 1 capital; (ii) 8 percent of the nonbank SD's uncleared swap margin amount; (iii) 8 percent of the nonbank SD's risk-weighted assets (with common equity tier 1 capital comprising at least 6.5 percent of the 8 percent); and (iv) the amount of capital required by NFA.<sup>124</sup> The Japanese Capital Rules require a Japanese nonbank SD to maintain regulatory capital in an amount equal to or in excess of 9.6 percent of the market risk, credit risk, and operational risk of the firm.<sup>125</sup>

The Japanese Capital Rules differ from the CFTC Capital Rules in that the Japanese Capital Rules do not impose a capital requirement on Japanese nonbank SDs based on a minimum dollar amount or based on a percentage of the margin for uncleared swap transactions. However, the approach for conducting a Capital Comparability Determination is a principles-based, holistic approach that focuses on whether the applicable foreign jurisdiction's capital requirements achieve comparable outcomes to the corresponding CFTC requirements for nonbank SDs.<sup>126</sup> The focus of the comparability determination is on

<sup>124</sup> 17 CFR 23.101(a)(1)(i). NFA has not adopted additional capital requirements for nonbank SDs and, therefore, an analysis of the comparability of this element of the CFTC Capital Rules with the Japanese Capital Rules is not applicable.

<sup>125</sup> The Japanese Capital Rules require a Japanese nonbank SD to maintain a capital adequacy amount that equals or exceeds 120 percent of its risk-weighted assets. Adjusting the Japanese Capital Rules approach to be consistent with the CFTC Capital Rules approach results in a Japanese nonbank SD having an effective minimum capital requirement of 9.6 percent of its risk weighted assets.

<sup>126</sup> 17 CFR 23.106(a)(3)(ii). See also 85 FR 57520 at 57521.

<sup>116</sup> Article 15(3) of the Notice on Capital.

<sup>117</sup> See 17 CFR 23.101(a)(1)(i) and *supra*, note 78.

<sup>118</sup> Article 13 of the Notice on Capital.

<sup>119</sup> *Principles for Model Risk Management*, Financial Services Agency (November 12, 2021). The principles are available at: <https://www.fsa.go.jp/en/news/2021/2021112en.html>.

<sup>120</sup> Compare Article 1 through 14–11 of the Notice on Capital with Revisions to the Basel II Market Risk Framework.

<sup>121</sup> Article 13(3)(i), (ii) and (iv) of the Notice on Capital.

<sup>122</sup> Article 13–2 and 14–9 of the Notice on Capital.

<sup>123</sup> FSA Notice 15.2–2.

whether the foreign jurisdiction's capital requirements are comparable to the Commission's in purpose and effect, and not on whether the foreign jurisdiction's capital requirements are comparable in every aspect or contain identical elements based on a line-by-line assessment or comparison of the foreign jurisdiction's regulatory requirements with the Commission's regulatory requirements.<sup>127</sup>

Based on a principles-based assessment, the Commission preliminarily believes, subject to the proposed condition below, and further subject to its consideration of public comments to the proposed Capital Comparability Determination and Order, that the purpose and effect of the Japanese Capital Rules and the CFTC Capital Rules are comparable. In this connection, the Japanese Capital Rules and CFTC Capital rules are both designed to require a nonbank SD to maintain a sufficient amount of qualifying regulatory capital and subordinated debt to absorb losses resulting from the firm's business activities, and decreases in the value of firm assets, without the nonbank SD becoming insolvent. As discussed below, the Commission specifically seeks public comment on the question of whether requirements under the Japanese Capital Rules are comparable in purpose and effect to the Commission's requirement for a nonbank SD to hold regulatory capital equal to or greater than 8 percent of its uncleared swap margin amount.

The Commission preliminarily believes that the Japanese Capital Rules and CFTC Capital Rules impose a comparable approach by requiring a nonbank SD to maintain qualifying equity capital and qualifying subordinated debt in an amount that equals or exceeds the nonbank SD's risk-weighted assets, which are composed of the aggregate of the firm's market risk and credit risk charges. The Japanese Capital Rules, however, require a Japanese nonbank SD to maintain a higher percentage of regulatory capital relative to the firm's risk-weighted assets than the CFTC Capital Rules require. Specifically, the Japanese Capital Rules require a Japanese nonbank SD to maintain regulatory capital equal to or greater than 9.6 percent of the firm's risk-weighted assets.<sup>128</sup>

Furthermore, the Japanese Capital Rules add operational risk to the market risk and credit risk charges in setting the minimum capital requirements whereas the CFTC Capital Rules sets operational risk as a separate minimum capital requirement from the market risk and credit risk calculation of the risk weighted assets.<sup>129</sup> Specifically, as noted above, under the Japanese Capital Rules the basic risk equivalent amount is computed as an amount equal to 25 percent of the Japanese nonbank SD's defined annual operating expenses, and is intended to provide a capital cushion to cover risks that may accrue in the course of executing ordinary business operations, such as error in business transactions.<sup>130</sup> In addition, the Japanese Capital Rules require a Japanese nonbank SD to deduct the carrying value of fixed assets from its Basic Items in computing its regulatory capital, which promotes a degree of liquidity into the Japanese nonbank SD's regulatory capital. The Commission preliminarily believes the inclusion of an operational risk charge with the market risk and credit risk charges, and the deduction of the carrying value of fixed assets from regulatory capital, will achieve a comparable outcome to the Commission's requirement for nonbank SDs to hold regulatory capital in excess of 8 percent of its uncleared swap margin amount. The Commission specifically seeks public comment below on the comparability of this Commission requirement with the Japanese requirements designed to address operational risk.

The calculation of market risk charges and credit risk charges is also comparable under the Japanese Capital Rules and the CFTC Capital Rules. Both regimes require a nonbank SD to use standardized approaches to compute

maintain an effective minimum capital ratio of 9.6 percent of the firm's risk-weighted assets and the CFTC Capital Rules require a nonbank SD to maintain a minimum capital ratio of 8 percent of the firm's risk-weighted assets.

<sup>129</sup> In establishing the requirement that a nonbank SD must maintain a level of regulatory capital in excess of 8 percent of the uncleared swap margin amount associated with the firm's swap transactions, the Commission stated that the intent of the uncleared swap margin amount was to establish a method of developing a minimum amount of capital for a nonbank 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. See, 85 FR 57462 at 57485.

<sup>130</sup> Article 178(1)(iii) of the COO and Article 16 of the Notice on Capital. The basic risk equivalent amount is calculated as 25 percent of certain defined operating expenses incurred by the Japanese nonbank SD over a 12-month period, and includes general expenses, selling expenses, and financial expenses.

market and credit risk, unless the firms are approved to use internal models. The standardized approaches follow the same structure that is now the common global standard: allocating assets to categories according to risk and assigning each a risk weight; allocating counterparties to categories according to risk assessments and assigning each a risk factor; calculating gross exposures based on the valuation of assets; calculating a net exposure allowing offsets following well defined procedures and subject to clear limitations; adjusting the net exposure by the market risk weights; and finally, for credit risk exposures, multiplying the sum of net exposures to each counterparty by the corresponding risk factor. After reviewing the standardized risk weights contained in the Japanese Capital Rules and the CFTC Capital Rules, the Commission preliminarily believes that the resulting risk charges are comparable for corresponding categories of instruments and credit exposures.

Internal market risk and credit risk models under the Japanese Capital Rules and the CFTC Capital Rules are based on the BCBS framework and contain comparable quantitative and qualitative requirements covering the same risks, including comparable model risk management requirements. As both rule sets address the same types of risk, with similar allowed methodologies, calibrated to similar risk levels and under similar controls, the Commission preliminarily believes that these requirements are comparable, as they produce similar market and credit risk charges for comparable exposures. Market risk charges increase capital requirements, or conversely are deducted from available capital, in full amount. Credit risk charges increase capital requirements, or conversely are deducted from available capital, with an adjustment. This adjustment to credit risk charges is applied in the CFTC Capital Rules as a final multiplication of credit risk weights by 8 percent, while the Japanese Capital Rules apply a comparable adjustment directly via the counterparty risk weights. The Japanese Capital Rules and the CFTC Capital Rules contain comparable requirements for the management of model risk, which depend on a series of controls, including the independence of validation, ongoing monitoring and audit. The ongoing monitoring includes frequent tests, such as stress testing, backtesting and benchmarking.

The Japanese Capital Rules differ from the CFTC Capital Rules in that the Japanese Capital Rules do not contain a requirement that each Japanese nonbank

<sup>127</sup> *Id.*

<sup>128</sup> As previously noted, the Japanese Capital Rules require a Japanese nonbank SD to maintain a capital adequacy amount that equals or exceeds 120 percent of its risk-weighted assets. For purposes of comparison of the two rules, the Japanese Capital Rules effectively require a Japanese nonbank SD to

SD maintain a fixed amount of regulatory capital. As noted previously, the requirement in the CFTC Capital Rules for a non-bank SD to maintain a minimum of \$20 million of common equity tier 1 capital is intended to ensure that each nonbank SD maintains a level of capital, without regard to the firm's level of dealing activities, sufficient to meet its obligations to swap market participants given the firm's status as a registered SD.

The Commission preliminarily believes that each CFTC-registered nonbank SD should maintain a minimum level of regulatory capital to help ensure that it satisfies its regulatory obligations and meets its financial commitments to swap counterparties and creditors without the firm becoming insolvent. Therefore, the Commission is proposing to condition the proposed Capital Comparability Determination Order to require each Japanese nonbank SD to maintain a minimum level of regulatory capital in the form of Basic Items, as defined in Article 176 of the COO. Specifically, the proposed condition would require each Japanese nonbank SD to maintain at all times regulatory capital in the form of Basic Items in an amount denominated in yen that is equivalent to or greater than \$20 million in U.S. dollars. The Commission is also proposing that a Japanese nonbank SD may convert the yen-denominated amount of its Basic Items to the U.S. dollar equivalent based on a commercially reasonable and observed exchange rate.

Having compared the minimum capital requirements and the calculation of regulatory capital under the Japanese Capital Rules for Japanese nonbank SDs with the corresponding minimum capital requirements and calculation of regulatory capital under the CFTC's Capital Rules for nonbank SDs, the Commission preliminarily finds that, subject to the proposed condition discussed above, the minimum capital requirements and calculation of regulatory capital are comparable. The Commission invites public comment on its analysis above, including comment on the FSA Application and Japanese laws and regulations, and the Commission's preliminary determination that the Japanese Capital Rules and the CFTC Capital Rules are comparable in purpose and effect and achieve comparable outcomes with respect to the minimum regulatory capital requirements and the calculation of regulatory capital for nonbank SDs.

The Commission also specifically seeks public comment on the question of whether the requirement under the Japanese Capital Rules for a Japanese

nonbank SD to hold qualifying capital in an amount equal to 25 percent of its defined annual operating expenses is sufficiently comparable in purpose and effect to the CFTC's requirement for a nonbank SD to hold qualifying capital in amount equal to at least 8 percent of the nonbank SD's uncleared swap margin amount.

The Commission further requests comment on the proposed condition that each Japanese nonbank SD maintains a minimum level of regulatory capital in the form of yen-denominated Basic Items (as defined in Article 176 of the COO) that equals or exceeds the equivalent of \$20 million U.S. dollars. Lastly, the Commission requests comment on the proposed requirement that a Japanese nonbank SD determine the amount of yen-denominated Basic Items it holds in U.S. dollars by using a commercially reasonable and observed yen/U.S. dollar exchange rate.

#### *D. Nonbank Swap Dealer Financial Reporting Requirements*

##### **1. CFTC Financial Recordkeeping and Reporting Rules for Nonbank Swap Dealers**

The CFTC Financial Reporting Rules impose financial recordkeeping and reporting requirements on nonbank SDs. In this regard, the CFTC Financial Reporting Rules require each nonbank SD to prepare and keep current ledgers or similar records summarizing each transaction affecting the nonbank SD's asset, liability, income, expense, and capital accounts.<sup>131</sup> The nonbank SD's ledgers and similar records must be prepared in accordance with generally accepted accounting principles as adopted in the United States ("U.S. GAAP"), except that if the nonbank SD is not otherwise required to prepare financial statements in accordance with U.S. GAAP, the nonbank SD may prepare and maintain its accounting records in accordance with International Financial Reporting Standards ("IFRS") issued by the International Accounting Standards Board.<sup>132</sup>

The CFTC Financial Reporting Rules also require each nonbank SD to prepare and file with the Commission and NFA periodic unaudited and annual audited financial statements.<sup>133</sup> A nonbank SD that elects the TNW Approach is required to file unaudited financial statements within 17 business days of the close of each fiscal quarter, and its annual audited financial statements

within 90 days of its fiscal year-end.<sup>134</sup> A nonbank SD that elects either the NLA Approach or the Bank-Based Approach is required to file unaudited financial statements within 17 business days of the end of each month, and its annual audited financial statements within 60 days of the end of its fiscal year.<sup>135</sup>

The CFTC Financial Reporting Rules further provide that a nonbank SD's unaudited financial statements must include: (i) a statement of financial condition; (ii) a statement of income/loss; (iii) a statement of changes in liabilities subordinated to claims of general creditors; (iv) a statement of changes in ownership equity; (v) a statement demonstrating compliance with, and calculation of, the applicable regulatory minimum capital requirement; and (vi) such further material information necessary to make the required statements not misleading.<sup>136</sup> The annual audited financial statements must include: (i) a statement of financial condition; (ii) a statement of income/loss; (iii) a statement of cash flows; (iv) a statement of changes in liabilities subordinated to claims of general creditors; (v) a statement of changes in ownership equity; (vi) a statement demonstrating the calculation of, and compliance with, the applicable regulatory minimum capital requirement; (vii) appropriate footnote disclosures; and (viii) a reconciliation of any material differences between the annual audited financial statements and the unaudited financial statements prepared as of the nonbank SD's year-end date.<sup>137</sup>

A nonbank SD that has obtained approval from the Commission or NFA to use internal capital models also must submit certain model metrics, such as aggregate VaR and counterparty credit risk information, each month to the Commission and NFA.<sup>138</sup> A nonbank SD also is required to provide the Commission and NFA with a detailed list of financial positions reported at fair market value as part of its monthly unaudited financial statements.<sup>139</sup> Each nonbank SD is also required to provide information to the Commission and NFA regarding its counterparty credit concentration for the 15 largest exposures in derivatives, a summary of its derivatives exposures by internal credit ratings, and the geographic

<sup>134</sup> 17 CFR 23.105(d)(1) and (e)(1).

<sup>135</sup> *Id.*

<sup>136</sup> 17 CFR 23.105(d)(2).

<sup>137</sup> 17 CFR 23.105(e)(4).

<sup>138</sup> 17 CFR 23.105(k) and (l) and Appendix B to Subpart E of Part 23.

<sup>139</sup> 17 CFR 23.105(l) and Appendix B to Subpart E of Part 23.

<sup>131</sup> 17 CFR 23.105(b).

<sup>132</sup> *Id.*

<sup>133</sup> 17 CFR 23.105(d) and (e).



distribution of derivatives exposures for the 10 largest countries.<sup>140</sup>

The CFTC Financial Reporting Rules also require a nonbank SD to attach to each unaudited and audited financial report an oath or affirmation that to the best knowledge and belief of the individual making the affirmation the information contained in the financial report is true and correct.<sup>141</sup> The individual making the oath or affirmation must be a duly authorized officer if the nonbank SD is a corporation, or one of the persons specified in the regulation for business organizations that are not corporations.<sup>142</sup>

The CFTC Financial Reporting Rules further require a nonbank SD to make certain financial information publicly available by posting the information on its public website.<sup>143</sup> Specifically, a nonbank SD must post on its website a statement of financial condition and a statement detailing the amount of the nonbank SD's regulatory capital and the minimum regulatory capital requirement based on its audited financial statements and based on its unaudited financial statements that are as of a date that is six months after the nonbank SD's audited financial statements.<sup>144</sup> Such public disclosure is required to be made within 10 business days of the filing of the audited financial statements with the Commission, and within 30 calendar days of the filing of the unaudited financial statements required with the Commission.<sup>145</sup> A nonbank SD also must obtain written approval from NFA to change the date of its fiscal year-end for financial reporting.<sup>146</sup>

The CFTC Financial Reporting Rules also require a nonbank SD to provide the Commission and NFA with information regarding the custodianship of margin for uncleared swap transactions ("Margin Report").<sup>147</sup> The Margin Report must contain: (i) the name and address of each custodian holding initial margin or variation margin that is required for uncleared swaps subject to the CFTC margin rules ("uncleared margin rules"), on behalf of the nonbank SD or its swap counterparties; (ii) the amount of initial and variation margin required by the uncleared margin rules held by each custodian on behalf of the nonbank SD

and on behalf its swap counterparties; and (iii) the aggregate amount of initial margin that the nonbank SD is required to collect from, or post with, swap counterparties for uncleared swap transactions subject to the uncleared margin rules.<sup>148</sup> The Commission requires this information in order to monitor the use of custodians by nonbank SDs and their swap counterparties. Such information assists the Commission in monitoring the safety and soundness of a nonbank SD by monitoring whether the firm is current with its swap counterparties with respect to the posting and collecting of margin required by the uncleared margin rules. By requiring the nonbank SD to report the required amount of margin to be posted and collected, and the amount of margin that is actually posted and collected, the Commission could identify potential issues with the margin practices and compliance by nonbank SDs that may hinder the ability of the firm to meet its obligations to market participants. The Margin Report also allows the Commission to identify custodians used by nonbank SDs and their counterparties, which may permit the Commission to assess potential market issues, including a concentration of custodial services by a limited number of banks.

## 2. Japanese Nonbank Swap Dealer Financial Reporting Requirements

The Japanese Financial Reporting Rules impose financial reporting requirements on FIBOs, including Japanese nonbank SDs. Specifically, the Japanese Financial Reporting Rules require each of the Japanese nonbank SDs to submit monthly monitoring survey reports ("Monthly Monitoring Reports") to the FSA.<sup>149</sup> The Monthly Monitoring Reports are required to report on the Japanese nonbank SD's balance sheet, profit and loss statement, capital adequacy ratio, market risk, counterparty risk and liquidity risk.<sup>150</sup> The Monthly Monitoring Reports are typically submitted by the Japanese

nonbank SDs within 2–3 weeks of the end of each month.<sup>151</sup>

Each Japanese nonbank SD is also required to submit a business report to the Commissioner of the FSA within three months of the end of the firm's fiscal year ("Annual Business Report").<sup>152</sup> The Annual Business Report must include a balance sheet, profit and loss statement, statement of changes in shareholders' equity, balance of subordinated debt and statement of capital adequacy ratio.<sup>153</sup>

Furthermore, each Japanese nonbank SD is required to prepare financial statements and business reports every business year pursuant to the Japanese Companies Act (Act No. 86 of 2005). The financial statements include a balance sheet, profit and loss statement, and statement of changes in shareholders' equity, and are required to be audited by an accounting auditor ("Annual Audited Financial Report").<sup>154</sup> The Annual Audited Financial Report must be submitted to and approved by the shareholders' meeting within 3 months of the Japanese nonbank SD's fiscal year-end.<sup>155</sup>

## 3. Commission Analysis

The Commission has reviewed the FSA Application and the relevant Japanese laws and regulations, and has preliminarily determined that the financial reporting requirements of the Japanese Financial Reporting Rules, subject to the conditions specified

<sup>151</sup> There are various types of reports which are required of the Japanese nonbank SDs under "Reporting orders" issued by the FSA in accordance with Article 56–2(1) of the FIEA. Some reports are required to be submitted on monthly basis, whereas other reports are required to be submitted on a quarterly basis, semi-annual basis, or annual basis. In terms of the filing due dates of those reports, the FSA typically does not set a specific deadline and instead requests all reports to be submitted "without delay." In case of monthly reports, the normal practice is for firms to submit such reports within 2 to 3 weeks from the prior month-end.

<sup>152</sup> Article 46–3(1) of the FIEA and Article 172 of the COO.

<sup>153</sup> Appended Forms No.12 of the COO.

<sup>154</sup> Article 328(1) and (2) and Article 435(2) and 436(2)(i) of the Companies Act, and Article 59 of Rules of Corporate Accounting (Ordinance of the Ministry of Justice No. 13 of 2006). The audit requirement applies to a "Large Company," which is defined by Article 2(vi) of the Companies Act as a stock company that satisfies any of the following requirements: (a) that the amount of stated capital in the balance sheet as of the end of the firm's most recent business year is JPY 500 million or more; or (b) that the total sum of the liabilities section of the balance sheet as of the end of the firm's most recent business year is JPY 20 billion or more. The FSA has represented that each of the Japanese nonbank SDs is a Large Company under the Companies Act, and is subject to the audit requirement for its financial statements. See FSA Application p. 18.

<sup>155</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> See II–1–4 (General Supervisory Processes) of the Supervisory Guidelines for FIBO, which directs the FSA (and other supervisors) as part of its offsite monitoring to require FIBOs (including the Japanese nonbank SDs) to submit a monitoring survey report regarding the following matters: capital adequacy ratio, status of business operations and accounting (including a balance sheet and profit and loss statement), status of segregated management of customer assets, market risk, counterparty risk, operational risk, and liquidity risk. The FSA has, pursuant to Article 56–2(1) of the FIEA, ordered the Japanese nonbank SDs to submit monthly monitoring reports to the FSA.

<sup>150</sup> *Id.*

<sup>140</sup> 17 CFR 23.105(l) in Schedules 2, 3, and 4, respectively.

<sup>141</sup> 17 CFR 23.105(f).

<sup>142</sup> *Id.*

<sup>143</sup> 17 CFR 23.105(i).

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> 17 CFR 23.105(g).

<sup>147</sup> 17 CFR 23.105(m).

below, are comparable to CFTC Financial Reporting Rules in purpose and effect as they are intended to provide the FSA and Commission, respectively, with financial information to monitor and assess the financial condition of nonbank SDs and their ongoing ability to absorb decreases in the value of firm assets and to cover losses from business activities, including swap dealing activities, without the firm becoming insolvent.

The Japanese Financial Reporting Rules require Japanese nonbank SDs to file financial reports with the FSA that are comparable with respect to the content of the financial reporting and the frequency of the submission of the financial reports with the requirements for nonbank SDs under the CFTC Financial Reporting Rules. In this regard, the Japanese Financial Reporting Rules require Japanese nonbank SDs to prepare and submit reports that include statements of financial condition, statements of profit and loss, and statements of capital adequacy that are comparable to the statements required of nonbank SDs under Regulation 23.105 of the CFTC Financial Reporting Rules. Accordingly, the Commission has preliminarily determined that a Japanese nonbank SD may comply with the financial reporting requirements contained in Commission Regulation 23.105 by complying with the corresponding Japanese Financial Reporting Rules, subject to the conditions set forth below.<sup>156</sup>

Such substituted compliance is proposed to be conditioned upon a Japanese nonbank SD providing the Commission and NFA with copies of its Monthly Monitoring Report and Annual Business Report filed with the FSA pursuant to Article 56–2(1) and Article 46–3(1), respectively, of the FIEA. It is proposed that a Japanese nonbank SD also must provide the Commission and NFA with a copy of its Annual Audited Financial Report that is required to be prepared pursuant to Article 453(2) of the Companies Act. The Monthly Monitoring Report, Annual Business Report, and Annual Audited Financial Report must be translated into the English language.<sup>157</sup> The Monthly

Monitoring Report and the Annual Business Report must have balances converted from yen to U.S. dollars. The Commission, however, recognizes that the requirement to translate accounts denominated in yen to U.S. dollars on the audited financial statements may impact the opinion provided by the public accountant. The Commission is therefore proposing to accept the Annual Audited Financial Report denominated in yen, provided that the report is translated into the English language.

The Commission also is proposing to condition the Capital Comparability Determination Order below on the Japanese nonbank SD filing (i) its Annual Business Report with the Commission and NFA within 15 business days of the earlier of the date the report is filed with the FSA or the date that the report is required to be filed with the FSA; (ii) its Annual Audited Financial Statement with the Commission and NFA within 15 business days of the approval of the report at the Japanese nonbank SD's shareholder meeting; and (iii) its Monthly Monitoring Report within 15 business days of the earlier of the date the report is filed with the FSA or 35 calendar days after the month-end reporting date.<sup>158</sup> The Commission preliminarily believes that these proposed filing dates provide sufficient time for the respective reports to be translated into the English language and balances converted from yen to U.S. dollars, where applicable.

The filing of English language financial reports by a Japanese nonbank SD with the Commission and NFA is necessary as financial reporting is a critical and central component of the Commission's and NFA's ability to assess the safety and soundness of registered nonbank SDs as required under Section 4s(e) of the CEA.

Although the Commission is proposing to permit Japanese nonbank SDs to comply with the form and content requirements for the financial reports set forth in the Japanese Financial Reporting Rules, the receipt of English language financial reports that have balances converted to U.S. dollars (with the exception of the Annual Audited

Financial Report) is necessary for the Commission to effectively monitor the ongoing financial condition of all nonbank SDs, including Japanese nonbank SDs, to help ensure their safety and soundness and ability to meet their financial obligations to customers, counterparties, and general market participants.

The Commission preliminarily believes that its proposed approach of requiring Japanese nonbank SDs to provide the Commission and NFA with copies of the Monthly Monitoring Reports, Annual Business Reports, and Annual Audited Financial Reports that the firms currently file with the FSA or otherwise prepare strikes an appropriate balance of ensuring that the Commission and NFA receive the financial reporting necessary for the effective monitoring of the financial condition of the nonbank SDs, while also recognizing the appropriateness of providing substituted compliance based on the existing FSA financial reporting requirements and regulatory structure.

The Commission is also proposing to condition the Capital Comparability Determination Order on Japanese nonbank SDs filing the aggregate securities, commodities, and swap positions information set forth in Schedule 1 of Appendix B to Subpart E of Part 23 on a monthly basis with the Commission and NFA.<sup>159</sup> Schedule 1 provides the Commission and NFA with detailed information regarding the financial positions that a nonbank SD holds as of the end of each month, including the firm's swaps positions, which will allow the Commission and NFA to monitor the types of investments and other activities that the firm engages in and will enhance the Commission's and NFA's ability to monitor the safety and soundness of the firm.

The Commission is also proposing to condition the Capital Comparability Determination Order on a Japanese nonbank SD submitting with each Monthly Monitoring Report, Annual Business Report, and Annual Audited Financial Report, as well as the applicable Schedule 1, a statement by an authorized representative or representatives of the Japanese nonbank SD that to the best knowledge and belief of the person(s) the information contained in the respective report is true

<sup>156</sup> A Japanese nonbank SD that qualifies and elects to seek substituted compliance with Japanese Capital Rules must also seek substituted compliance with the Japanese Financial Reporting Rules.

<sup>157</sup> The translation of audited financial statements into the English language is not required to be subject to the audit of the public accountants. The Monthly Monitoring Report and Annual Business Report must convert balances into U.S. dollars. A Japanese nonbank SD must report the exchange rate that it used to convert balances from yen to U.S.

dollars to the Commission and NFA as part of the financial reporting.

<sup>158</sup> As previously noted, the FSA does not set a specific filing date for Monthly Monitoring Reports, electing to instead require firms to file such reports "without delay." The Commission proposes to establish a due date that is no later than 35 calendar days from the reporting date in order to set a definitive filing date that also provides Japanese nonbank SDs with sufficient time to translate the reports into English and convert balances to U.S. dollars.

<sup>159</sup> Schedule 1 of Appendix B to Subpart E of Part 23 includes a nonbank SD's holding of U.S. Treasury securities, U.S. government agency debt securities, foreign debt and equity securities, money market instruments, corporate obligations, spot commodities, and cleared and uncleared swaps, security-based swaps, and mixed swaps in addition to other position information.

and correct, including the translation of the report into the English language and conversion of balances in the reports to U.S. dollars. The statement by the authorized representative or representatives of the Japanese nonbank SD is in lieu of the oath or affirmation required of nonbank SDs under Regulation 23.105(f),<sup>160</sup> and is intended to ensure that reports filed with the Commission and NFA are prepared and submitted by firm personnel with knowledge of the financial reporting of the firm who can attest to the accuracy of the reporting and translation.

The Commission is further proposing to condition the Capital Comparability Determination Order on a Japanese nonbank SD filing the Margin Report specified in Regulation 23.105(m) with the Commission and NFA. The Margin Report contains: (i) the name and address of each custodian holding initial margin or variation margin required by the uncleared margin rules on behalf of the nonbank SD or its swap counterparties; (ii) the amount of initial and variation margin required by the uncleared margin rules held by each custodian on behalf of the nonbank SD and on behalf its swap counterparties; and (iii) the aggregate amount of initial margin required by the uncleared margin rules that the nonbank SD is required to collect from, or post to, swap counterparties for uncleared swap transactions.<sup>161</sup>

The Commission believes that receiving this margin information from Japanese nonbank SDs will assist in the Commission's assessment of the safety and soundness of the Japanese nonbank SDs. Specifically, the Margin Report will provide the Commission with information regarding a Japanese nonbank SD's swap book, the extent to which it has uncollateralized exposures to counterparties or has not met its financial obligations to counterparties. This information, along with the list of custodians holding both the firm's and counterparties' swaps collateral, will assist the Commission in assessing and monitoring potential financial impacts to the nonbank SD resulting from defaults on its swap transactions. The Commission is further proposing to require a Japanese nonbank SD to file its Margin Report at the same time that the Japanese nonbank SD files its Monthly Monitoring Report, and to require the Margin Report to be prepared in the English language with balances reported in U.S. dollars.

The Commission is not proposing to require a Japanese nonbank SD that has

been approved by FSA to use capital models to file the monthly model metric information contained in Regulation 23.105(k) with the Commission or NFA.<sup>162</sup> Regulation 23.105(k) requires a nonbank SD that has obtained approval from the Commission or NFA to use internal capital models to submit to the Commission and NFA each month information regarding its risk exposures, including VaR and credit risk exposure information when applicable. The model metrics are intended to provide the Commission and NFA with information that would assist with the ongoing oversight and assessment of internal market risk and credit risk models that have been approved for use by a nonbank SD. The Commission preliminarily believes, however, that the receipt by the Commission and NFA of model metrics set forth in Regulation 23.105(k) from Japanese nonbank SDs is not necessary as the initial approval and the ongoing assessment of the performance of a Japanese nonbank SD's models will be performed by the FSA as part of its oversight function.

The Commission also is proposing not to require a Japanese nonbank SD to file the monthly counterparty credit exposure information specified in Regulation 23.105(l) and Schedules 2, 3, and 4 of Appendix B to Subpart E of Part 23 with the Commission or NFA. Regulation 23.105(l) requires each nonbank SD to provide information to the Commission and NFA regarding its counterparty credit concentration for the 15 largest exposures in derivatives, a summary of its derivatives exposures by internal credit ratings, and the geographic distribution of derivatives exposures for the 10 largest countries in Schedules 2, 3, and 4, respectively. The Commission preliminarily believes that, under a substituted compliance regime, the FSA is best positioned to monitor a Japanese nonbank SD's credit exposures, which may be comprised of credit exposures to primarily other Japanese counterparties, as part of the FSA's overall monitoring of the financial condition of the firm.

Furthermore, the Commission, in making the preliminary determination to not require a Japanese nonbank SD to file the model metrics and counterparty exposures required by Regulations 23.105(k) and (l), respectively, recognizes that NFA's current risk monitoring program requires each bank SD and each nonbank SD, including each Japanese nonbank SD, to file risk metrics addressing market risk and credit risk with NFA on a monthly basis. This information includes: (i)

monthly VaR for interest rates, credit, foreign exchange, equities, commodities, and total VaR; (ii) total stressed VaR; (iii) interest rate, credit spread, foreign exchange market, and commodity sensitivities; (iv) total swaps current exposure both before and after offsetting against collateral held by the firm; and (v) a list of the 15 largest swaps counterparty current exposures.<sup>163</sup> While there are differences between the information filed with the NFA and the information required under Regulations 23.105(k) and (l), the NFA risk metrics provide a level of information that allows NFA to identify SDs that may pose heightened risk and to allocate appropriate NFA regulatory oversight resources. The Commission preliminarily believes that the proposed financial reporting set forth as conditions in the proposed Capital Comparability Determination Order, and the risk metric and counterparty exposure information required to be reported by nonbank SDs (including Japanese nonbank SDs) under NFA rules, provide the appropriate balance of recognizing the comparability of the Japanese Financial Reporting Rules to the CFTC Financial Reporting Rules while also ensuring that the Commission and NFA receive sufficient data to monitor and assess the overall financial condition of nonbank Japanese SDs.

The Commission invites public comment on its analysis above, including comment on the FSA Application and relevant Japanese Financial Reporting Rules. The Commission also invites comment on the proposed conditions listed above. The Commission recognizes that while the Monthly Monitoring Reports, Annual Business Reports, and Annual Audited Financial Reports contain financial information regarding a Japanese nonbank SD that is comparable to the financial information required of nonbank SDs under Regulation 23.105 (such as statements of financial condition, statements of income, and statements demonstrating compliance with capital requirements), the reports also contain financial information that exceeds the requirements of regulation 23.105 (such as information regarding the holding of customer funds under Japanese laws). The Commission requests comment on the scope of the financial information that Japanese nonbank SDs should be required to file

<sup>160</sup> 17 CFR 23.105(f).

<sup>161</sup> 17 CFR 23.105(m).

<sup>162</sup> 17 CFR 23.105(k).

<sup>163</sup> See NFA Financial Requirements, Section 17—Swap Dealer and Major Swap Participant Reporting Requirements, and Notice to Members—Monthly Risk Data Reporting for Swap Dealers (May 30, 2017).

with the Commission and NFA. Should the Commission limit the financial information required of Japanese nonbank SDs to the types of financial information required of nonbank SDs under regulation 23.105?

The Commission also invites comment on its proposal not to require Japanese nonbank SDs to submit to the Commission and NFA the information set forth in Regulations 23.105(k) and (l). Are there specific elements of the data required under Regulations 23.105(k) and (l) that the Commission should require of Japanese nonbank SDs for purposes of monitoring model performance?

The Commission requests comment on the proposed filing dates for the reports and information specified above. Specifically, do the proposed filing dates provide sufficient time for Japanese nonbank SDs to prepare the reports, translate the reports into English, and, where required, convert balances into U.S. dollars? If not, what period of time should the Commission consider imposing on one or more of the reports?

The Commission also specifically requests comment regarding the setting of compliance dates for the reporting conditions that the proposed Capital Comparability Determination Order would impose on Japanese nonbank SDs. In this connection, if the Commission were to require Japanese nonbank SDs to file the Margin Report as set forth in the proposed Order below, how much time would Japanese nonbank SDs need to develop new systems or processes to capture information that is required? Would Japanese nonbank SDs need a period of time to develop any systems or processes to meet any other reporting conditions in the proposed Capital Comparability Determination Order? If so, what would be an appropriate amount of time for a Japanese nonbank SD to develop and implement such systems or processes?

#### E. Notice Requirements

##### 1. CFTC Nonbank SD Notice Reporting Requirements

The CFTC Financial Reporting Rules require nonbank SDs to provide the Commission and NFA with written notice of certain defined events.<sup>164</sup> The notice provisions are intended to provide the Commission and NFA with an opportunity to assess whether the information contained in the written notices indicates the existence of actual or potential financial and/or operational

issues at a nonbank SD, and, when necessary, allows the Commission and NFA to engage the nonbank SD in an effort to minimize potential adverse impacts on swap counterparties and the larger swaps market. The notice provisions are part of the Commission's overall program for helping to ensure the safety and soundness of nonbank SDs and the swaps markets in general.

The CFTC Financial Reporting Rules require a nonbank SD to provide written notice within specified timeframes if 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.<sup>165</sup> A nonbank SD is also required to provide written notice if the firm experiences a 30 percent or more decrease in excess regulatory capital from its most recent financial report filed with the Commission.<sup>166</sup> A nonbank SD also is required to provide notice if the firm fails to post or collect initial margin for uncleared swap and non-cleared security-based swap transactions or exchange variation margin for uncleared swap or non-cleared security-based swap transactions as required by the Commission's uncleared swaps margin rules or the SEC's non-cleared security-based swaps margin rules, respectively, if the aggregate is equal to or greater than: (i) 25 percent of the nonbank SD's required capital under Regulation 23.101 calculated for a single counterparty or group of counterparties that are under common ownership or control; or (ii) 50 percent of the nonbank SD's required capital under Regulation 23.101 calculated for all of the firm's counterparties.<sup>167</sup>

The CFTC Financial Reporting Rules further require a nonbank SD to provide advance notice of an intention to withdraw capital by an equity holder that would exceed 30 percent of the firm's excess regulatory capital.<sup>168</sup> Finally, a nonbank SD that is dually-registered with the SEC as an SBSB or major security-based swap participant ("MSBSP") must file a copy of any notice with the Commission and NFA that the SBSB or MSBSP is required to file with the SEC under SEC Rule 18a-8 (17 CFR 240.18a-8).<sup>169</sup> SEC Rule 18a-8 requires SBSBs and MSBSPs to provide written notice to the SEC for comparable reporting events as the CFTC Capital Rules in Regulation

23.105(c), including if a SBSB or MSBSP is undercapitalized or fails to maintain current books and records.

##### 2. Japanese Nonbank Swap Dealer Notice Requirements

The FSA maintains a system of notice reporting requirements ("Early Warning System") that is designed to provide the FSA with notice of, and an opportunity to react to, potential financial and/or operational issues with a Japanese nonbank SD prior to the firm falling below the FSA's minimum capital requirements. Specifically, each Japanese nonbank SD is required to submit an immediate notification to the FSA if its capital adequacy ratio falls below 140 percent.<sup>170</sup> The Japanese nonbank SD's notification submitted to the FSA must be accompanied by a Plan Regarding Specific Voluntary Measures to Be Taken in Order to Maintain the Capital Adequacy Ratio, which is expected to include concrete measures that the firm will take to maintain a capital adequacy ratio above 140 percent.<sup>171</sup> The FSA also has the authority to examine the future outlook on the Japanese nonbank SD's capital adequacy ratio through hearings and to urge the firm to make voluntary improvement efforts.<sup>172</sup>

A Japanese nonbank SD also must submit an immediate notification and a Plan Regarding Specific Voluntary Measures to Be Taken in Order to Improve the Capital Adequacy Ratio (the "Plan") to the FSA if the firm's capital adequacy ratio falls below the minimum capital adequacy ratio of 120 percent.<sup>173</sup> The FSA reviews the Plan and, when necessary, identifies the specific method by which a Japanese nonbank SD must bring its capital adequacy ratio back above the prescribed minimum level and the estimated date of the recovery. In situations where the Japanese nonbank SD fails to maintain the minimum level of regulatory capital, the FSA will also examine other aspects of the firm's operations, including the status of segregated management of customer assets and fund-raising. If the FSA finds it to be necessary and appropriate in the public interest or for the protection of investors, the Commissioner of the FSA may order a change of business

<sup>170</sup> The notification is required to be filed pursuant to Article 179 of the COO. As noted in section C.2 above, each Japanese nonbank SD is required to maintain a minimum capital adequacy ratio of 120 percent.

<sup>171</sup> *Id.*

<sup>172</sup> IV-2-2 (Supervisory Response to Cases of Financial Instruments Business Operators' Capital Adequacy Ratio Falling Below Prescribed Level) (1) of the Supervisory Guidelines for FIBO.

<sup>173</sup> Article 179 of the COO.

<sup>164</sup> 17 CFR 23.105(c).

<sup>165</sup> 17 CFR 23.105(c)(1), (2), and (3).

<sup>166</sup> 17 CFR 23.105(c)(4).

<sup>167</sup> 17 CFR 23.105(c)(7).

<sup>168</sup> 17 CFR 23.105(c)(5).

<sup>169</sup> 17 CFR 23.105(c)(6).

methods, order assets to be deposited, or issue orders with respect to matters that are otherwise necessary from a supervisory perspective.<sup>174</sup>

If a Japanese nonbank SD's capital adequacy ratio falls below 100 percent, the Commissioner of the FSA may order the suspension of all or part of the firm's business activities for a period not to exceed three months if the FSA deems such action to be necessary and appropriate for the public interest or for the protection of investors.<sup>175</sup> If the Japanese nonbank SDs capital adequacy ratio does not exceed 100 percent, and the FSA determines that the firm's capital adequacy ratio status is not likely to recover, the Commissioner of the FSA may rescind the registration of the firm.<sup>176</sup>

In addition to the above measures, the FSA may order a Japanese nonbank SD to change its business methods or to otherwise take measures that are necessary for improving its business operations or the state of its assets if the FSA finds such action necessary and appropriate in the public interest or for the protection of investors.<sup>177</sup> Finally, the Prime Minister of Japan may rescind the registration of a Japanese nonbank SD, or order the suspension of all or a part of its business activities for a period of no longer than six months, if the Japanese nonbank SD violates a disposition by a government agency,<sup>178</sup> or is likely to become insolvent due to the state of its business and assets.<sup>179</sup>

### 3. Commission Analysis

The Commission has reviewed the FSA Application and the relevant Japanese laws and regulations, and has preliminarily determined that the Japanese Financial Reporting Rules related to notice provisions, subject to

the conditions specified below, are comparable to the notice provisions of the CFTC Financial Reporting Rules in purpose and effect as each regulator's requirements are intended to provide the FSA and Commission with prompt notice of potential or actual financial or operational issues at a nonbank SD that may impact its ability to continue to meet its financial obligations to swap counterparties and other creditors, or otherwise impair its safety and soundness. The Commission is therefore proposing to issue a Capital Comparability Determination Order providing that a Japanese nonbank SD may comply with the notice provisions required under Japanese laws and regulations in lieu of certain notice provisions required of nonbank SDs under Regulation 23.105(c), subject to the conditions set forth below.

The Japanese Financial Reporting Rules require a Japanese nonbank SD to provide notice to the FSA if the firm experiences a reduction of its regulatory capital that exceeds certain predefined limits ("Japanese Early Warning Notices"). As noted above, pursuant to the Japanese Early Warning Notices, a Japanese nonbank SD is required to provide the FSA with notices if its regulatory capital falls below: (i) 140 percent; or (ii) 120 percent of its minimum capital requirement. The Japanese Early Warning Notices are also required to contain information regarding actions that the Japanese nonbank SD will take to ensure that the firm is properly capitalized.

The Commission has preliminarily determined that these Japanese Early Warning Notices achieve comparable outcomes to CFTC notice provisions contained in Regulation 23.105(c)(1) and (2) that require a nonbank SD to provide notice to the Commission and to NFA if a nonbank SD fails to meet its minimum capital requirement or if the firm's regulatory capital falls below 120 percent of its minimum capital requirement. These notice provisions set forth in the Japanese Financial Reporting Rules and the CFTC Financial Reporting Rules are further comparable in purpose and effect in that the provisions are intended to alert the FSA and Commission/NFA, respectively, of potential financial or operational issues that could have an adverse impact on the safety and soundness of a nonbank SD, including the nonbank SD's ability to meet its financial obligations to customers, counterparties, creditors, and general market participants. The notices are also intended to provide an opportunity for the applicable regulator to monitor a nonbank SD's financial condition and operations to ensure that

the firm takes appropriate actions to maintain, or to regain, compliance with its minimum capital requirements.

The Japanese Financial Reporting Rules differ from the CFTC Financial Reporting Rules in certain respects. Specifically, unlike the CFTC Financial Reporting Rules, the Japanese Financial Reporting Rules do not contain explicit requirements for a Japanese nonbank SD to notify the FSA if the firm fails to maintain current books and records, experiences a decrease in capital over levels previously reported, or fails to collect or post initial margin or variation margin for uncleared swap transactions with swap counterparties that exceed certain threshold levels.<sup>180</sup> The Japanese Financial Reporting Rules also do not require a Japanese nonbank SD to provide the FSA with advance notice of capital withdrawals initiated by equity holders that exceed defined amounts or percentages of the firm's excess regulatory capital.<sup>181</sup>

The Commission is proposing to condition the Capital Comparability Determination Order on a Japanese nonbank SD providing the Commission and NFA with notice if the firm fails to make or to keep current books and records required by the FSA. For avoidance of doubt, in this context the Commission believes that books and records would include current ledgers or other similar records which show or summarize, with appropriate references to supporting documents, each transaction affecting the Japanese nonbank SD's asset, liability, income, expense and capital accounts in accordance with the accounting principles accepted by the FSA.<sup>182</sup> The Commission preliminarily believes that the maintenance of current books and records is a fundamental and essential component of operating as a registered nonbank SD and that the failure to comply with such a requirement may indicate an inability of the firm to promptly and accurately record transactions and to ensure compliance with regulatory requirements, including regulatory capital requirements. Therefore, the proposed Order below is conditioned on a Japanese nonbank SD providing the Commission and NFA with a written notice within 24 hours if

<sup>174</sup> Article 53(1) of the FIEA. IV-2-2 (Supervisory Response to Cases of Financial Instruments Business Operators' Capital Adequacy Ratio Falling Below Prescribed Level) (3) of the Supervisory Guidelines for FIBO indicates four examples of the order: (i) To draft and implement measures (including the drafting of specifics and the implementation schedule) to bring the capital adequacy ratio back above the legally prescribed level and maintain the ratio above that level on a permanent basis; (ii) To implement measures to ensure the protection of investors in preparation for an unexpected event, through appropriate management of securities and cash and careful management of fund-raising; (iii) To avoid activities that could lead to wasteful use of corporate assets; and (iv) To compile the projections of the balance sheet and fund-raising status on a daily basis and the projection of the capital adequacy ratio in ways to reflect the specific measures to be implemented, in order to bring the capital adequacy ratio back above the legally prescribed level.

<sup>175</sup> Article 53(2) of the FIEA.

<sup>176</sup> Article 53(3) of the FIEA.

<sup>177</sup> Article 51 of the FIEA.

<sup>178</sup> Article 52(1)(vii) of the FIEA.

<sup>179</sup> Article 52(1)(viii) of the FIEA.

<sup>180</sup> See 17 CFR 23.105(c)(3), (4), and (7).

<sup>181</sup> See 17 CFR 23.105(c)(5), which requires a nonbank SD to provide written notice to the Commission and NFA two business days prior to the withdrawal of capital by action of the equity holders if the amount of the withdrawal exceeds 30 percent of the nonbank SD's excess regulatory capital.

<sup>182</sup> For comparison, see 17 CFR 23.105(b), which similarly defines the term 'Current books and records' as used in the context of Commission's requirements.

the firm fails to maintain on a current basis the books and records required by the FSA.

The Commission is also proposing to condition the Capital Comparability Determination Order on a Japanese nonbank SD providing the Commission and NFA with a written notice within 24 hours of the firm filing a notice with the FSA pursuant to Article 179(3) of the COO that the firm's regulatory capital has fallen below 140 percent of its minimum requirement. It is proposed that a Japanese nonbank SD also must provide the Commission and NFA with written notice within 24 hours of filing a notice with the FSA that the firm's regulatory capital has fallen below 120 percent of its minimum requirement.

The requirement for a nonbank SD to file notice with the Commission and NFA of a decrease of excess regulatory capital below defined levels is a central component of the Commission's and NFA's oversight program for nonbank SDs.<sup>183</sup> Therefore, the Commission preliminarily believes that it is necessary for the Commission and NFA to receive notice from a Japanese nonbank SD that the firm has filed a regulatory notice with the FSA that its capital level has decreased below 140 percent or 120 percent of its minimum regulatory capital requirement. The notice must be filed by the Japanese nonbank SD within 24 hours of the filing of the notice with the FSA, and the Commission expects that, upon the receipt of a notice, Commission staff and NFA staff will engage with staff of the FSA to obtain an understanding of the facts that led to the filing of the notice and will discuss with the FSA its plan for any ongoing monitoring of the Japanese nonbank SD. Therefore, the Commission's proposal would not require the Japanese nonbank SD to file copies of its recovery plan that is filed with the FSA with the Commission or NFA. To the extent the Commission needs further information from the Japanese nonbank SD, the Commission expects to request such information as part of its assessment of the notice and its discussions with the FSA.

The proposed Capital Comparability Determination Order also requires a Japanese nonbank SD to file notice with the Commission and NFA if: (i) a single counterparty, or group of counterparties under common ownership or control, fails to post required initial margin or pay required variation margin on

uncleared swap and non-cleared security-based swap positions that, in the aggregate, exceeds 25 percent of the Japanese nonbank SD's minimum capital requirement; (ii) counterparties fail to post required initial margin or pay required variation margin to the Japanese nonbank SD for uncleared swap and non-cleared security-based swap positions that, in the aggregate, exceed 50 percent of the Japanese nonbank SD's minimum capital requirement; (iii) a Japanese nonbank SD fails to post required initial margin or pay required variation margin for uncleared swap and non-cleared security-based swap positions to a single counterparty or group of counterparties under common ownership and control that, in the aggregate, exceeds 25 percent of the Japanese nonbank SD's minimum capital requirement; and (iv) a Japanese nonbank SD fails to post required initial margin or pay required variation margin to counterparties for uncleared swap and non-cleared security-based swap positions that, in the aggregate, exceeds 50 percent of the Japanese nonbank SD's minimum capital requirement. The Commission is proposing to require this notice so that, in the event that such a notice is filed, it and NFA may commence communication with the Japanese nonbank SD and the FSA in order to obtain an understanding of the facts that led to the failure to exchange material amounts of initial margin or variation margin in accordance with the applicable margin rules, and to assess whether there is a concern regarding the financial condition of the firm that may impair its ability to meet its financial obligations to customers, counterparties, creditors, and general market participants, or otherwise adversely impact the firm's safety and soundness.

The proposed Capital Comparability Determination Order does not require a Japanese nonbank SD to file notices with the Commission concerning withdrawals of capital or changes in capital levels as such information will be reflected in the financial statement reporting filed with the Commission and NFA as conditions of the order, and because the Japanese nonbank SD's capital levels are monitored by the FSA, which the Commission preliminarily believes renders the separate reporting to the Commission superfluous.

The proposed Capital Comparability Determination Order requires a Japanese nonbank SD to file any notices required under the Order with the Commission and NFA in English and, where applicable, with any balances reported in U.S. dollars. Each notice required by the proposed Capital Comparability

Determination Order must be filed in accordance with instructions issued by the Commission or NFA.

The Commission invites public comment on its analysis above, including comment on the FSA Application and relevant Japanese Financial Reporting Rules. The Commission also invites comment on the proposed conditions to the Capital Comparability Determination Order that are listed above.

The Commission requests comment on the timeframes set forth in the proposed conditions for Japanese nonbank SDs to file notices with the Commission and NFA. In this regard, the proposed conditions would require Japanese nonbank SDs to file certain written notices with the Commission within 24 hours of the occurrence of a reportable event or of being alerted to a reportable event by the FSA. These notices would have to be translated into English prior to being filed with the Commission and NFA. The Commission request comment on the issues Japanese nonbank SDs may face meeting the filing requirements given time-zone difference and translation issues. The Commission also requests specific comment regarding the setting of compliance dates for the notice reporting conditions that the proposed Capital Comparability Determination Order would impose on Japanese nonbank SDs.

#### *F. Supervision and Enforcement*

##### *1. Commission and NFA Supervision and Enforcement of Nonbank SDs*

The Commission and NFA conduct ongoing supervision of nonbank SDs to assess their compliance with the CEA, Commission regulations, and NFA rules by reviewing financial reports, notices, risk exposure reports, and other filings that nonbank SDs are required to file with the Commission and NFA. The Commission and NFA also conduct periodic examinations as part of their supervision of nonbank SDs, including routine onsite examinations of nonbank SDs' books, records, and operations to ensure compliance with CFTC and NFA requirements.<sup>184</sup>

As noted in section D.1 above, financial reports filed by a nonbank SD provide the Commission and NFA with information necessary to ensure the

<sup>183</sup> See Regulation 23.105(c)(4) which requires a nonbank SD to file notice with the Commission and NFA if it experiences a decrease in excess capital of 30 percent or more from the excess capital reported in its last financial filing with the Commission.

<sup>184</sup> Section 17(p)(2) of the CEA (7 U.S.C. 21(p)(2)) requires NFA as a registered futures association to establish minimum capital and financial requirements for nonbank SDs and to implement a program to audit and enforce compliance with such requirements. Section 17(p)(2) further provides that NFA's capital and financial requirements may not be less stringent than the capital and financial requirements imposed by the Commission.

firm's compliance with minimum capital requirements and to assess the firm's overall safety and soundness and its ability to meet its financial obligations to customers, counterparties, creditors, and general market participants. A nonbank SD is also required to provide written notice to the Commission and NFA if certain defined events occur, including that the firm is undercapitalized or maintains a level of capital that is less than 120 percent of the firm's minimum capital requirements.<sup>185</sup> The notice provisions, as stated in section E.1 above, are intended to provide the Commission and NFA with information of potential issues at a nonbank SD that may impact the firm's ability to maintain compliance with the CEA and Commission regulations. The Commission and NFA also have the authority to require a nonbank SD to provide any additional financial and/or operational information on a daily basis or at such other times as the Commission or NFA may specify to monitor the safety and soundness of the firm.<sup>186</sup>

The Commission also has authority to take disciplinary actions against a nonbank SD for failing to comply with the CEA and Commission regulations. Section 4b–1(a) of the CEA provides the Commission with exclusive authority to enforce the capital requirements imposed on nonbank SDs adopted under Section 4s(e) of the CEA.

## 2. FSA Supervision and Enforcement of Japanese Nonbank SDs

The FSA has supervision, audit, and investigation authority with respect to Japanese nonbank SDs, including the authority to require such firms to provide all necessary information for FSA to carry out its supervisory responsibilities.<sup>187</sup> Specifically, the FSA has the authority to require Japanese nonbank SDs to submit documents to the FSA and to conduct onsite inspections at the business offices of the Japanese nonbank SDs.<sup>188</sup>

The FSA also monitors the capital adequacy ratios of Japanese nonbank SDs through supervisory measures on an ongoing basis. The monitoring includes a system of notice requirements, discussed in section E.2 above, that obligate Japanese nonbank SDs to provide notice to the FSA if certain triggering conditions are met. The FSA also has a variety of measures in place to address actual cases of a

Japanese nonbank SD's failure to maintain its required level of minimum capital. Specifically, a Japanese nonbank SD is required to submit a notification and an action plan to the FSA if the Japanese nonbank SD's capital adequacy ratio falls below 120 percent.<sup>189</sup> The FSA will review the plan and, when necessary, identify the specific method by which the Japanese nonbank SD is required to bring its capital adequacy ratio back above the prescribed minimum level. The FSA also may order a Japanese nonbank SD to change its business methods, order assets to be deposited, or issue orders with respect to matters that are otherwise necessary from a supervisory perspective, if the FSA finds it in the public interest or for the protection of customers to take such actions.<sup>190</sup> Furthermore, a Japanese nonbank SD may have all or parts of its business suspended for a period of no more than six months or have its registration revoked if the firm violates certain laws or regulations in connection with the financial instruments business or services,<sup>191</sup> or if the firm is likely to become insolvent.<sup>192</sup> Finally, a Japanese nonbank SD is subject to fines and other possible actions if it fails to submit documents that are required by law to be filed with the FSA.<sup>193</sup>

## 3. Commission Analysis

The Commission has a long history of regulatory cooperation with the FSA. In this connection, the Commission and FSA entered into a Memorandum of Cooperation ("MOC") with regard to the cooperation and the exchange of information in the supervision and oversight of regulated entities that operate on a cross-border basis in both the U.S. and Japan ("Cross-Border Covered Entities"), including nonbank SDs registered with the Commission and FIBOs registered with the FSA.<sup>194</sup> Pursuant to the MOC, the Commission and FSA expressed an intent to consult regularly, as appropriate, regarding: (i) general supervisory issues, including regulatory, oversight, or other related developments; (ii) issues relevant to the operations, activities, and regulation of Cross-Border Covered Entities; and (iii) any other areas of mutual supervisory interest, and to meet periodically to

discuss their respective functions and regulatory oversight programs.<sup>195</sup> The MOC further provides for the Commission and FSA to inform each other of certain events, including any material events that could adversely impact the financial or operational stability of a Cross-Border Covered Entity, and provides a procedure for the Commission or FSA to conduct on-site examinations in, respectively, Japan or the U.S.<sup>196</sup> Pursuant to the terms of the MOC, the Commission intends to communicate and consult with the FSA regarding the supervision of the financial and operational condition of Japanese nonbank SDs.

In addition, as discussed above, as part of FSA's ongoing prudential regulation and supervision of FSA regulated entities, it is able to take all measures necessary to ensure that FSA's capital, financial and reporting rules are implemented.<sup>197</sup> Thus, the Commission preliminarily finds that FSA has the necessary powers and ability to supervise and enforce Japanese nonbank SDs' compliance with Japanese capital adequacy and financial reporting requirements.<sup>198</sup>

The Commission invites public comment on its analysis above, including comment on the FSA Application and relevant Japanese laws and regulations.

## IV. Proposed Capital Comparability Determination Order

### A. Commission's Proposed Comparability Determination

The Commission's preliminary view, based on the FSA's Application and the Commission's review of applicable Japanese laws and regulations, is that the Japanese Capital Rules and the Japanese Financial Reporting Rules, subject to the conditions set forth in the proposed Capital Comparability Determination Order below, achieve comparable outcomes and are comparable in purpose and effect to the

<sup>195</sup> MOC, paragraphs 19 and 26.

<sup>196</sup> MOC, paragraphs 22 and 29. Event-triggered notification in paragraph 22 of the MOC includes any known adverse material change in the ownership, operating environment, operations, financial resources, management, or systems and controls of a Cross-Border Covered Entity, and the failure of a Cross-Border Covered Entity to satisfy any of its requirements for continued authorization or registration where that failure could have a material adverse effect in the jurisdiction of Commission or FSA.

<sup>197</sup> FSA Application, pp 19–20.

<sup>198</sup> In addition, both the Commission and the FSA are signatories to the *IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (revised May 2012), which covers primarily information sharing in the context of enforcement matters.

<sup>185</sup> See 17 CFR 23.105(c).

<sup>186</sup> See 17 CFR 23.105(h).

<sup>187</sup> FSA Application, p. 16.

<sup>188</sup> Article 56–2 of the FIEA.

<sup>189</sup> Article 53(2) of the FIEA.

<sup>190</sup> *Id.*

<sup>191</sup> Article 52(1)(vii) of the FIEA.

<sup>192</sup> Article 52(1)(viii) of the FIEA.

<sup>193</sup> Article 198–6 of the FIEA.

<sup>194</sup> *Memorandum of Cooperation Related to the Supervision of Cross-Border Covered Entities* (Mar. 10, 2014). See the Commission's website at <https://www.cftc.gov/International/MemorandaofUnderstanding/index.htm>.



CFTC Capital Rules and CFTC Financial Reporting Rules. In reaching this preliminary conclusion, the Commission recognizes that there are certain differences between the Japanese Capital Rules and CFTC Capital Rules and certain differences between the Japanese Financial Reporting Rules and the CFTC Financial Reporting Rules. The proposed Capital Comparability Determination Order is subject to proposed conditions that are preliminarily deemed necessary to promote consistency in regulatory outcomes, or to reflect the scope of substituted compliance that would be available notwithstanding certain differences. In the Commission's preliminary view, the differences between the two rule sets would not be inconsistent with providing a substituted compliance framework for Japanese nonbank SDs subject to the conditions specified in the proposed Order below.

Furthermore, the proposed Capital Comparability Determination Order is limited to the comparison of the Japanese Capital Rules to the Bank-Based Approach under the CFTC Capital Rules. As noted previously, the FSA has not requested, and the Commission has not performed, a comparison of the Japanese Capital Rules to the Commission's NAL Approach or TNW Approach.

#### *B. Proposed Capital Comparability Determination Order*

The Commission invites comments on all aspects of the FSA Application, relevant Japanese laws and regulations, the Commission's preliminary views expressed above, the question of whether requirements under the Japanese Capital Rules are comparable in purpose and effect to the Commission's requirement for a nonbank SD to hold regulatory capital equal to or greater than 8 percent of its uncleared swap margin amount, and the Commission's proposed Capital Comparability Determination Order, including the proposed conditions included in the proposed Order, set forth below.

#### **Proposed Order Providing Conditional Capital Comparability Determination for Japanese Nonbank Swap Dealers**

*It is hereby determined and ordered,* pursuant to Commodity Futures Trading Commission ("CFTC" or "Commission") Regulation 23.106 (17 CFR 23.106) under the Commodity Exchange Act ("CEA") (7 U.S.C. 1 *et seq.*) that a swap dealer ("SD") organized and domiciled in Japan and subject to the Commission's capital and

financial reporting requirements under Sections 4s(e) and (f) of the CEA (7 U.S.C. 6s(e) and (f)) may satisfy the capital requirements under Section 4s(e) of the CEA and CFTC Regulation 23.101(a)(1)(i) (17 CFR 23.101(a)(1)(i)) ("CFTC Capital Rules"), and the financial reporting rules under Section 4s(f) of the CEA and Commission Regulation 23.105 (17 CFR 23.105) ("CFTC Financial Reporting Rules"), by complying with certain specified Japanese laws and regulations cited below and otherwise complying with the following conditions, as amended or superseded from time to time:

(1) The SD is not subject to regulation by a prudential regulator defined in section 1a(39) of the CEA (7 U.S.C. 1a(39));

(2) The SD is organized under the laws of Japan and is domiciled in Japan (a "Japanese nonbank SD");

(3) The Japanese nonbank SD is registered as a Type I Financial Instruments Business Operator ("FIBO") with the Japan Financial Services Agency;

(4) The Japanese nonbank SD is subject to and complies with: Articles 28(1), 29, 46–3, 46–6(2), 52(1), 53(1) through (3), 56–2, and 198–6 of the Financial Instruments and Exchange Act (Act No. 25 of 1948); Section II–1–4 (General Supervisory Processes), Section IV–2–1 (Preciseness of Capital Adequacy Ratio), and Section IV–2–2 (Supervisory Response to Cases of Financial Instruments Business Operators' Capital Adequacy Ratio Falling Below Prescribed Level) of the Comprehensive Guidelines for Supervision of Financial Instruments Business Operators; Articles 172, 176, 177(8), 178(1), 179(3), and Appended Forms No. 12 of the Cabinet Office Order on Financial Instruments Business (Cabinet Office Order No. 52 of 2007); Articles 1 through 17 of the Financial Services Agency Notice No. 59 of 2007; Articles 2(vi), 328(1) and (2), 435(2), and 436(2)(i) of the Japanese Companies Act (Act No. 86 of 2005); and Article 59 of the Rules of Corporate Accounting (Ordinance of the Ministry of Justice No. 13 of 2006) (collectively, the "Japanese Capital Rules and Japanese Financial Reporting Rules");

(5) The Japanese nonbank SD maintains at all times an amount of regulatory capital in the form of Basic Items, as defined in Article 176 of the Cabinet Office Order No. 52 of 2007, equal to or in excess of the equivalent of \$20 million in United States dollars ("U.S. dollars"). The Japanese nonbank SD shall use a commercially reasonable and observed yen/U.S. dollar exchange

rate to convert the value of the yen-denominated Basic Items to U.S. dollars;

(6) The Japanese nonbank SD has filed with the Commission a notice stating its intention to comply with the applicable Japanese Capital Rules and Japanese Financial Reporting Rules in lieu of the CFTC Capital Rules and the CFTC Financial Reporting Rules. The notice of intent must include the Japanese nonbank SD's representation that the firm is organized and domiciled in Japan; is a registered FIBO; and is subject to, and complies with, the Japanese Capital Rules and Japanese Financial Reporting Rules. The Japanese nonbank SD may not rely on this Capital Comparability Determination Order until it receives confirmation from Commission staff, acting pursuant to authority delegated by the Commission, that the Japanese nonbank SD may comply with the applicable Japanese Capital Rules and Japanese Financial Reporting Rules in lieu of the CFTC Capital Rules and CFTC Financial Reporting Rules. Each notice filed pursuant to this condition must be prepared in the English language and submitted to the Commission via email to the following address: [MPDFinancialRequirements@cftc.gov](mailto:MPDFinancialRequirements@cftc.gov);

(7) The Japanese nonbank SD prepares and keeps current ledgers and other similar records in accordance with accounting principles required by the Financial Services Agency;

(8) The Japanese nonbank SD files with the Commission and with the National Futures Association ("NFA") a copy of its Monthly Monitoring Report that is required to be filed with the Financial Services Agency pursuant to Article 56–2(1) of the Financial Instruments and Exchange Act. The Monthly Monitoring Report must be translated into the English language and balances must be converted to U.S. dollars. The Monthly Monitoring Report must be filed with the Commission and NFA within 15 business days of the date the Monthly Monitoring Report is filed with the Financial Services Agency or 35 days after the month-end reporting date, whichever is earlier;

(9) The Japanese nonbank SD files with the Commission and with NFA a copy of its Annual Business Report that is required to be filed with the Financial Services Agency in accordance with Article 46–3(1) of the Financial Instruments and Exchange Act and Article 172 of the Cabinet Office Order on Financial Instruments Business. The Annual Business Report must be translated into the English language and balances must be converted to U.S. dollars. The Annual Business Report must be filed with the Commission and

NFA within 15 business days of the earlier of the date the Annual Business Report is filed with the Financial Services Agency or the date that the Annual Business Report is required to be filed with the Financial Services Agency.

(10) The Japanese nonbank SD files with the Commission and with NFA a copy of its Annual Audited Financial Report that is required to be prepared pursuant to Article 435(2) of the Japanese Companies Act (Act No. 86 of 2005). The Annual Audited Financial Report must be translated into the English language and balances may be reported in yen. The Annual Audited Financial Report must be filed with the Commission and NFA within 15 business days of approval of the report at the shareholders' meeting of the Japanese nonbank SD;

(11) The Japanese nonbank SD files Schedule 1 of Appendix B to Subpart E of Part 23 of the CFTC's regulations (17 CFR 23 Subpart E—Appendix B) with the Commission and NFA on a monthly basis. Schedule 1 must be prepared in the English language with balances reported in U.S. dollars and must be filed with the Commission and NFA with the Japanese nonbank SD's Monthly Monitoring Report;

(12) The Japanese nonbank SD submits with each Monthly Monitoring Report, Schedule 1, Margin Report, Annual Business Report, and Annual Audited Financial Report a statement by an authorized representative or representatives of the Japanese nonbank SD that to the best knowledge and belief of the representative or representatives the information contained in the report, including as applicable the translation of the report into the English language and conversion of balances in the report to U.S. dollars, is true and correct. The statement must be prepared in the English language;

(13) The Japanese nonbank SD files a margin report containing the information specified in CFTC Regulation 23.105(m) (17 CFR 23.105(m)) with the Commission and with NFA on a monthly basis. The margin report must be prepared in the English language with balances reported in U.S. dollars and must be filed with the Commission and NFA with the Japanese nonbank SD's Monthly Monitoring Report;

(14) The Japanese nonbank SD files a notice with the Commission and NFA within 24 hours of being informed by the Financial Services Agency that the firm is not in compliance with any component of the Japanese Capital Rules or Japanese Financial Reporting

Rules. The notice must be prepared in the English language;

(15) The Japanese nonbank SD files a notice within 24 hours with the Commission and NFA if it fails to maintain regulatory capital in the form of Basic Items, as defined in Article 176 of the Cabinet Office Order No. 52 of 2007, equal to or in excess of the U.S. dollar equivalent of \$20 million using a commercially reasonable and observed yen/U.S. dollar exchange rate. The notice must be prepared in the English language;

(16) The Japanese nonbank SD provides the Commission and NFA with notice within 24 hours of filing a notice with the Financial Services Agency pursuant to Article 179 of the Cabinet Office Order on Financial Instruments Business that the firm's capital adequacy ratio has fallen below the early warning level of 140 percent. The notice filed with the Commission and NFA must be prepared in the English language;

(17) The Japanese nonbank SD provides the Commission and NFA with notice within 24 hours of filing a notice with the Financial Services Agency pursuant to Article 179 of the Cabinet Office Order on Financial Instruments Business that the firm's capital adequacy ratio has fallen below 120 percent. The notice filed with the Commission and NFA must be prepared in the English language;

(18) The Japanese nonbank SD files a notice with the Commission and NFA within 24 hours if it fails to make or keep current the financial books and records required by the Financial Services Agency. The notice must be prepared in the English language;

(19) The Japanese nonbank SD files a notice with the Commission and NFA within 24 hours of the occurrence of any of the following: (i) a single counterparty, or group of counterparties under common ownership or control, fails to post required initial margin or pay required variation margin on uncleared swap and non-cleared security-based swap positions that, in the aggregate, exceeds 25 percent of the Japanese nonbank SD's minimum capital requirement; (ii) counterparties fail to post required initial margin or pay required variation margin to the Japanese nonbank SD for uncleared swap and non-cleared security-based swap positions that, in the aggregate, exceeds 50 percent of the Japanese nonbank SD's minimum capital requirement; (iii) the Japanese nonbank SD fails to post required initial margin or pay required variation margin for uncleared swap and non-cleared

security-based swap positions to a single counterparty or group of counterparties under common ownership and control that, in the aggregate, exceeds 25 percent of the Japanese nonbank SD's minimum capital requirement; or (iv) the Japanese nonbank SD fails to post required initial margin or pay required variation margin to counterparties for uncleared swap and non-cleared security-based swap positions that, in the aggregate, exceeds 50 percent of the Japanese nonbank SD's minimum capital requirement. The notice must be prepared in the English language;

(20) The Japanese nonbank SD files a notice with the Commission and NFA of a change in its fiscal year-end approved or permitted to go into effect by the Financial Services Agency. The notice required by this paragraph will satisfy the requirement for a nonbank SD to obtain the approval of NFA for a change in fiscal year-end under CFTC Regulation 23.105(g) (17 CFR 23.105(g)). The notice of change in fiscal year-end must be prepared in the English language and filed with the Commission and NFA at least 15 business days prior to the effective date of the Japanese nonbank SD's change in fiscal year-end;

(21) The Financial Services Agency notifies the Commission of any material changes to the information submitted in its application, including, but not limited to, material changes to the Japanese Capital Rules or Japanese Financial Reporting Rules imposed on Japanese nonbank SDs, the Financial Services Agency's supervisory authority or supervisory regime over Japanese nonbank SDs, and proposed or final material changes to the Japanese Capital Rules or Japanese Financial Reporting Rules as they apply to Japanese nonbank SDs; and

(22) Unless otherwise noted in the conditions above, the reports, notices, and other statements required to be filed by the Japanese nonbank SD with the Commission and NFA pursuant to the conditions of this Capital Comparability Determination Order must be submitted electronically to the Commission and NFA in accordance with instructions provided by the Commission or NFA.

Issued in Washington, DC, on July 29, 2022, 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 Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination From the Financial Services Agency of Japan—Commission Voting Summary, Chairman's Statement, and Commissioners' Statements

### Appendix 1—Commission Voting Summary

On this matter, Chairman Behnam and Commissioners Johnson, Goldsmith Romero, and Mersinger voted in the affirmative. Commissioner Pham voted to concur. No Commissioner voted in the negative.

### Appendix 2—Statement of Support of Chairman Rostin Behnam

As CFTC provisionally-registered swap dealers (SDs) operate and manage risk globally, the Commission's supervisory framework must acknowledge the realities of multi-jurisdictional operations. I support the Commission's proposed order and request for comment on its preliminary determination that nonbank<sup>1</sup> swap dealers (SDs) organized and domiciled in Japan are subject to, and comply with, capital and financial reporting requirements in Japan that are comparable to certain capital and financial reporting requirements under the Commodity Exchange Act and the Commission's regulations (Capital Comparability Determination), subject to certain conditions.

Today's preliminary Capital Comparability Determination is the first such order proposed by the Commission since adopting its regulatory substituted compliance framework for non-U.S. domiciled nonbank SDs in July 2020.<sup>2</sup> The Commission is proposing this order in response to an application submitted by the Financial Services Agency of Japan (FSA), which has direct supervisory authority over the three Japanese nonbank SDs that are provisionally-registered with the Commission.

The Commission's principles-based approach to the proposed determination focuses on whether the FSA's capital and financial reporting requirements achieve comparable outcomes to the corresponding CFTC requirements.<sup>3</sup> Specifically, the Commission has also considered the scope and objectives of FSA's capital adequacy and financial reporting requirements; the ability of FSA to supervise and enforce compliance with its capital and financial reporting requirements; and other facts or circumstances the Commission has deemed relevant for this application.

Throughout its analysis, the Commission recognized that jurisdictions may adopt unique approaches to achieving comparable

outcomes, and the Commission has focused on how the FSA's capital and financial reporting requirements are comparable to its own in purpose and effect, rather than whether each are comparable in every particular aspect or contain identical elements. In this regard, the approach was not a line-by-line assessment or comparison of FSA's regulatory requirements with the Commission's requirements.<sup>4</sup>

Consistent with the Commission's authority to issue a Capital Comparability Determination with terms and conditions it deems appropriate, today's proposed order contains 22 conditions. These conditions aim to ensure that the proposed order, if finalized, would only apply to Japanese nonbank SDs that are eligible for substituted compliance and that these Japanese nonbank SDs comply with FSA's capital and financial reporting requirements as well as certain additional capital, margin, position, financial reporting, required recordkeeping, and regulatory notice requirements.

If the Commission, upon consideration of the comments received, determines to issue a favorable comparability determination, an eligible Japanese nonbank SD would be required to file a notice of its intent to comply with FSA's capital adequacy and financial reporting rules in lieu of the Commission's requirements.<sup>5</sup> The Commission (or the Market Participants Division through delegated authority) would then be obligated to confirm to the Japanese nonbank SD that it may comply with the foreign jurisdiction's rules as well as any conditions that would be adopted as part of the final determination, and that, by doing so, it would be deemed to be in compliance with the Commission's corresponding capital adequacy and financial reporting requirements.

I believe it is important to note that today's proposed Capital Comparability Determination, if finalized, would not compromise the Commission's capital and financial reporting requirements. Instead, it recognizes the global nature of the swap markets with dually-registered SDs that operate in multiple jurisdictions that mandate prudent capital and financial reporting requirements. A capital and financial reporting comparability determination order of this kind is not a compromise or deference to a foreign regulatory authority. The Commission would retain its enforcement authority and examinations authority as well as obtain all financial and event specific reporting to maintain direct oversight of nonbank SDs located in Japan.

While the CFTC and the FSA have a pre-existing memorandum of understanding (MOU) in place, it is important to note that an MOU or a similar agreement is not necessary for the Commission and the National Futures Association to monitor these firms' compliance with the conditions of a capital comparability determination.

I look forward to the public's submission of comments and feedback on this proposed determination and order.

I wish to again thank the hardworking staff in the Market Participants Division for all of their efforts towards bringing us here today.

### Appendix 3—Statement of Support of Commissioner Kristin N. Johnson

I support the Commission's issuance of the proposed capital comparability order for comment (Proposed Order). I commend staff's hard work on this matter and their meticulous review of the capital and financial reporting requirements in Japan, as well as their outstanding cooperation with the Financial Services Agency of Japan (JFSA). I also appreciate the JFSA's sustained and meaningful engagement of Commission staff during the entirety of the review process.

The Commission's capital and financial reporting requirements are critical to ensuring the safety and soundness of our regulated swap dealers.<sup>1</sup> Ensuring necessary levels of capital, as well as accurate and timely reporting about financial conditions, helps to protect swap dealers and the broader financial markets ecosystem from shocks, thereby ensuring resiliency.

Prior to the adoption of the CFTC's final rules regarding swap dealer capital which published in the **Federal Register** on September 15, 2020,<sup>2</sup> with a compliance date of October 6, 2021,<sup>3</sup> the Commission had issued interpretive guidance allowing for substituted compliance determinations to be made with respect to other components of the Commission's swap dealer requirements. Under that guidance, the Commission has issued comparability determinations relating to market participants operating in several jurisdictions including the EU, Australia, Canada, Hong Kong, Switzerland, and, notably, Japan.<sup>4</sup> The Proposed Order before the Commission is, however, the first capital comparability determination.

When the Commission initially issued interpretive guidance, many jurisdictions had not yet implemented swaps reforms addressing risk management failures that precipitated the 2008 financial crisis. Today, many jurisdictions have made great strides to adopt effective regulatory regimes, mitigating the systemic risks that previously pervaded global markets. The current procedure for regulatory capital and financial reporting requirements set forth in regulation 23.106 permits foreign nonbank swap dealers, a trade association on behalf of one or more foreign nonbank swap dealers, or a foreign regulatory authority with jurisdiction over a foreign nonbank swap dealer (as the JFSA has done) to file an application for substituted compliance. The Proposed Order, if

<sup>1</sup> See 7 U.S.C. 6s(e); 17 CFR subpart E.

<sup>2</sup> See Capital Requirements of Swap Dealers and Major Swap Participants, 85 FR 57462 (Sept. 15, 2020) (CFTC Capital Rules).

<sup>3</sup> *Id.* at 57462.

<sup>4</sup> The Commission has issued comparability determinations for certain entity-level requirements (Australia, Canada, EU, Hong Kong, Japan, Switzerland), certain transaction-level requirements (EU, Japan), and margin requirements for uncleared swaps (EU, Japan). See CFTC, Comparability Determinations for Substituted Compliance Purposes, <https://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm>.

<sup>1</sup> The Commission has capital jurisdiction over registered SDs that are not subject to the regulation of a U.S. banking regulator (*i.e.*, nonbank SDs). 7 U.S.C. 6s(e)(1).

<sup>2</sup> See 85 FR 57462, 57520 (Sept. 15, 2020). Regulation 23.106 also sets forth the Commission's substituted compliance requirements for major swap participants; however, there are not any registered with the Commission.

<sup>3</sup> 17 CFR 23.106(a)(3)(ii). See also 85 FR 57462 at 57521.

<sup>4</sup> See 85 FR 57462, 57521.

<sup>5</sup> See 17 CFR 23.106(a)(4).

approved, will allow registered nonbank swap dealers organized and domiciled in Japan to satisfy certain capital and financial reporting requirements under the Commodity Exchange Act<sup>5</sup> by being subject to and complying with comparable capital and financial reporting requirements under Japanese laws and regulations.

I support acknowledging market participants' compliance with the regulations of foreign jurisdictions when the requirements lead to an outcome that is comparable to the outcome of complying with the CFTC's corresponding requirements. Substituted compliance must not, however, be confused with deference. To the contrary, the swap dealers that qualify for substituted compliance under regulation 23.106 must be Commission registrants. The Proposed Order, if approved, would continue to ensure that relevant Japan-based swap dealers are subject to the Commission's examination and enforcement authority over the firms.

Capital requirements play a critical role in fostering the safety and soundness of financial markets. As indicated in the Commodity Exchange Act, capital requirements protect market participants against risks such as counterparty default.<sup>6</sup> Robust capital requirements enable individual market participants to absorb losses, meet their obligations, and successfully navigate challenges that may threaten their integrity or trigger systemic risk concerns. As a result, the Commission must be measured in applying its framework for capital comparability determinations. I look forward to reviewing the public comments on this proposed determination.

#### Appendix 4—Statement of Support of Commissioner Christy Goldsmith Romero

I support the Commission's efforts for strong capital requirements and financial reporting to help ensure the safety and soundness of swap dealers whose activities could affect U.S. markets, including through this proposed Capital Comparability Determination for Japan. The proposal promotes financial stability, and the benefits of global harmonization with a like-minded regulator for the global swaps markets. Thank you to the staff for their hard work, and for their thoughtful engagement with me and my office on changes to improve the proposal.

#### *The 2008 Financial Crisis and TARP Capital Injections*

A key cause of the financial crisis was the failure of bank regulators to require financial institutions to have high quality capital in a sufficient amount to serve as a buffer against risk. This included the lack of capital requirements that would ensure that financial institutions that were swap dealers, and other major participants in swaps markets, had adequate capital to absorb losses. The devastating result of this undercapitalization swept rapidly through the highly interconnected financial system. The default or margin failure of one counterparty triggered another, and then

another—which led to a short-term liquidity crisis. Risk and losses also cascaded from subsidiaries and affiliates to bank parent companies and/or bank holding companies, including across borders.

The financial contagion was not limited to major players in the markets. The entire economy suffered, with Main Street bearing the consequences of Wall Street. The federal government made unprecedented capital injections of hundreds of billions of taxpayer dollars into more than 700 financial institutions through the Troubled Asset Relief Program (“TARP”). For the last decade, I served as the Special Inspector General for TARP (“SIGTARP”), providing oversight over TARP programs. I have testified before Congress and reported publicly on lessons learned from inadequate capital requirements pre-crisis, and the need for strong levels of high-quality capital to lower systemic risk in the financial system.

#### *The Dodd Frank Act's Capital Requirements for Swap Dealers*

Swap dealer capital requirements are one of the most critical reforms in the Dodd-Frank Act for derivatives markets. These reforms led the CFTC to allow nonbank swap dealers to use a capital framework similar to what prudential banking regulators apply to banks.<sup>1</sup>

Capital protects the solvency of the swap dealer from unexpected losses such as counterparty defaults and margin collateral failures. Capital requirements are aimed at ensuring a swap dealer has the ability to absorb losses and they prevent market disruption by helping to ensure that swap dealers continue to perform their critical function to provide liquidity and market making. Capital along with margin requirements for uncleared swaps reduces the potential for contagion, thereby lowering systemic risk in the financial system, and promoting financial stability.

#### *The CFTC's First Substituted Compliance Determination for Capital Requirements*

The global nature of the financial crisis also highlighted the need for the CFTC to coordinate with foreign regulators as swap activities in a foreign jurisdiction may have an impact here in the United States. For example, risk of a foreign subsidiary can flow to their U.S. parent company.

The CFTC's “substituted compliance” framework leverages a second regulator, a like-minded foreign regulator that has rules, supervision and enforcement that are comparable in purpose and effect to the CFTC's. Under this global harmonization, the CFTC would allow a non-U.S. entity to be deemed in compliance with CFTC requirements if the non-U.S. entity complied with the foreign regulator's comparable rules.

I am mindful that this proposal is the first of its kind—the first substituted compliance determination for the CFTC's capital rules. Therefore, we should proceed carefully, as we are establishing precedent.

<sup>1</sup> This bank-based approach is consistent with the Basel Committee on Banking Supervision's international framework for bank capital requirements.

The proposal today is for nonbank swap dealers that are domiciled in Japan, where we have a Memorandum of Cooperation and a long history of cooperation with the Japanese Financial Services Agency.<sup>2</sup> Currently, this proposal would apply to Japanese affiliates of Bank of America, Morgan Stanley and Goldman Sachs—three systemically important institutions and three of the largest TARP recipients having collectively received \$60 billion in TARP capital injections. Therefore, it is vital that the CFTC ensures that these swap dealers have adequate amounts of high-quality capital. Public comment will be helpful on whether the CFTC is correct in its preliminary determinations of comparability.

I highlight, and express my appreciation for, the involvement of the Japanese Financial Services Agency in this process. CFTC staff's engagement with our regulatory counterparts in Japan has helped to ensure the accuracy of the staff's assessment of Japanese capital and financial reporting requirements, along with supervisory and enforcement programs.<sup>3</sup>

Substituted compliance does not require an all or nothing determination. The CFTC may continue to require compliance with certain of its rules, and impose any terms or conditions that it deems appropriate.<sup>4</sup>

The CFTC proposes to continue to require that Japanese nonbank swap dealers comply with the CFTC's \$20 million capital requirement, as Japan has no minimum requirement.<sup>5</sup> I strongly support retaining the \$20 million capital requirement. However, the CFTC is not requiring compliance with our requirement that the \$20 million be in the form of common equity tier 1 capital—one of the strongest forms of capital. Instead, the proposal would allow the \$20 million requirement to be satisfied with types of capital defined in a category called “Basic Items” under Japanese regulation. I look forward to commenters' response on whether allowing the \$20 million capital requirement to be satisfied with this category of “Basic Items” is comparable in purpose and effect to the CFTC's requirement that only common equity tier 1 capital be included in the \$20 million.

Japan also does not have a minimum requirement for capital that is tied to the

<sup>2</sup> As noted in the proposal, in making a Capital Comparability Determination the Commission may consider any facts or circumstances it deems relevant, including whether the relevant foreign regulatory authority has a memorandum of understanding or similar arrangement with the Commission that would facilitate supervisory cooperation. See 17 CFR 23.106(a)(3)(iv).

<sup>3</sup> The Commission may consider all relevant factors in making a Capital Comparability Determination, including the ability of the relevant foreign regulatory authority to supervise and enforce compliance with the foreign jurisdiction's capital adequacy and financial reporting requirements. See 17 CFR 23.106(a)(3)(iii). The proposal also makes a preliminary determination that the Japanese financial reporting rules are conditionally comparable in purpose and effect with the CFTC's financial reporting rules.

<sup>4</sup> See 17 CFR 23.106(a)(5).

<sup>5</sup> Japanese capital requirements are consistent with Basel bank capital standards, similar to the CFTC.

<sup>5</sup> 5 U.S.C. 1 *et seq.*

<sup>6</sup> 7 U.S.C. 6s(e).

margin for uncleared swaps entered into by the nonbank swap dealer. The CFTC requires an aggregate of common equity tier 1 capital, additional tier 1 capital and tier 2 capital equal to or greater than 8 percent of the nonbank swap dealer's uncleared swap margin amount. I look forward to commenters' response on the question as to whether Japan's capital requirement in an amount equal to 25% of operating expenses is comparable in purpose and effect to the CFTC's capital requirement equal to 8% of the uncleared swap margin amount.

It is a priority for me to ensure that the CFTC guards against complacency with post-crisis reforms, particularly after market stresses from the pandemic and geopolitical events. We should remember that our capital rules serve as critical pillars of Dodd-Frank reforms to help ensure the safety and soundness of financial institutions, and to protect the market from serious risks and contagion. The CFTC has a duty to ensure that our comparability assessment is sound, and that the foreign regulator is like-minded in not only rules but in their approach, supervision and enforcement. Substituted compliance must leave U.S. markets and our economy at no greater risk than full compliance with our rules.

#### Appendix 5—Concurring Statement of Commissioner Caroline D. Pham

I respectfully concur with the notice of proposed order and request for comment on an application for a capital comparability determination submitted by the Financial Services Agency (FSA) of Japan.

First, I want to recognize the staff's work as each of my fellow Commissioners has done because this is not easy—not only for this rulemaking, but also, generally speaking, swap dealer oversight is an incredibly complex regulatory regime. I also appreciate your commitment to providing substituted compliance.

In addition, in my past work in Japan and with their financial sector, I have enjoyed working with the FSA for many years, and I appreciate their thoughtful and robust oversight of their regulated firms. I also want to say that my thoughts and heart are with the people of Japan regarding the tragic loss of Prime Minister Shinzo Abe.

As I mentioned in my opening statement, the CFTC should take an outcomes-based approach to substituted compliance that appropriately balances and recognizes the nature of cross-border regulation of global markets and firms, and that preserves access for U.S. persons to other markets.<sup>1</sup> I appreciate the Chairman's remarks and I welcome comments, particularly on operational issues with additional reporting requirements given the time difference, language translation, conversion to USD, local governance and regulatory requirements, and differences in financial reporting.

I urge a pragmatic approach with sufficient time to implement conditions before any

compliance date, and I appreciate the thought that the staff have been putting into that. I speak from my past experience as a global head of swap dealer compliance who had to implement global regulatory reforms. I'll also note that in a crisis, such as during the early days of the COVID-19 pandemic, there was timely and effective engagement between and amongst CFTC registrants and U.S. regulators. I have been on many calls and spoken to many regulators all over the world, not only during COVID-19, but also during times of market disruption or potentially material events.

There is a difference between a phone call and a formal written notice, and that's just one example of the conditions in this proposal. So, I appreciate receiving comments on this and any other operational issues and the careful consideration by the staff and the Commission of how to take a practical approach to achieving appropriate oversight and mitigation of risk to the United States and to our markets.

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## DEPARTMENT OF ENERGY

### Federal Energy Regulatory Commission

#### 18 CFR Part 35

[Docket No. RM22–13–000]

#### Credit-Related Information Sharing in Organized Wholesale Electric Markets

**AGENCY:** Federal Energy Regulatory Commission, Department of Energy.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Federal Energy Regulatory Commission (Commission) is proposing, pursuant to section 206 of the Federal Power Act, to amend its regulations to permit credit-related information sharing in organized wholesale electric markets to ensure that credit practices in those markets result in jurisdictional rates that are just and reasonable. The Commission seeks public comment on the proposed regulations.

**DATES:** Comments are due October 7, 2022. Reply comments are due November 7, 2022.

**ADDRESSES:** Comments, identified by docket number, may be filed in the following ways. Electronic filing through <http://www.ferc.gov>, is preferred.

- **Electronic Filing:** Documents must be filed in acceptable native applications and print-to-PDF, but not in scanned or picture format.

- For those unable to file electronically, comments may be filed by USPS mail or by hand (including courier) delivery.

- **Mail via U.S. Postal Service Only:**

Addressed to: Federal Energy Regulatory Commission, Secretary of the Commission, 888 First Street NE, Washington, DC 20426.

- **Hand (including courier) Delivery:**

Deliver to: Federal Energy Regulatory Commission, 12225 Wilkins Avenue, Rockville, MD 20852.

The Comment Procedures Section of this document contains more detailed filing procedures.

#### FOR FURTHER INFORMATION CONTACT:

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#### SUPPLEMENTARY INFORMATION:

##### I. Introduction

1. Pursuant to section 206 of the Federal Power Act (FPA),<sup>1</sup> the Commission is proposing to revise § 35.47 of title 18 of the Code of Federal Regulations to permit regional transmission organizations (RTO) and independent system operators (ISOs) to share among themselves credit-related information regarding market participants in organized wholesale electric markets.<sup>2</sup> The ability of RTOs/ISOs to share credit-related information among themselves could improve their ability to accurately assess market participants' credit exposure and risks related to their activities across organized wholesale electric markets. The ability to share such information could also enable RTOs/ISOs to respond to credit events more quickly and effectively, minimizing the overall credit-related risks of unexpected defaults by market participants in organized wholesale electric markets.

2. To ensure that RTOs'/ISOs' credit policies remain just and reasonable, the Commission proposes to revise its regulations to require each RTO/ISO to adopt tariff provisions that permit the sharing of its market participants' credit-related information with other RTOs/ISOs to enhance credit risk

<sup>1</sup> 16 U.S.C. 824e.

<sup>2</sup> See *Credit Reforms in Organized Wholesale Elec. Mkts.*, Order No. 741, 75 FR 65942 (Oct. 21, 2010), 133 FERC ¶ 61,060, at P 1 n.1 (2010) (“[O]rganized wholesale electric markets include energy, transmission and ancillary service markets operated by independent system operators . . . and regional transmission organizations” which are “responsible for administering electric energy and financial transmission rights markets.”), *order on reh'g*, Order No. 741–A, 134 FERC ¶ 61,126, *reh'g denied*, Order No. 741–B, 135 FERC ¶ 61,242 (2011).

<sup>1</sup> See Statement of Dissent by Commissioner Scott D. O'Malia on Comparability Determinations for Australia, Canada, the European Union, Hong Kong, Japan, and Switzerland: Certain Entity and Transaction-Level Requirements (Dec. 20, 2013).