

## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Parts 1, 23, and 140

RIN 3038-AD54

#### Capital Requirements of Swap Dealers and Major Swap Participants

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Commodity Futures Trading Commission (Commission or CFTC) is proposing regulations that would implement the new statutory framework in the Commodity Exchange Act (CEA), added by the Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These new provisions of the CEA require, among other things, the Commission to adopt capital requirements for certain swap dealers (SDs) and major swap participants (MSPs). The proposed rules also provide for related financial condition reporting and recordkeeping by SDs and MSPs. The Commission further proposes to amend existing capital and financial reporting regulations for futures commission merchants (FCMs) that also register as SDs or MSPs. The proposed regulations also include requirements for supplemental FCM financial reporting to reflect section 724 of the Dodd-Frank Act. In order to align the comment periods for this proposed rule and the Commission's earlier proposed rulemaking on margin requirements for uncleared swaps,<sup>1</sup> the comment period for the proposed margin rulemaking is being extended elsewhere in the **Federal Register** today, so that commenters will have the opportunity to review the proposed capital and margin rules together before the expiration of the comment periods for either proposed rule.

**DATES:** Comments must be received on or before July 11, 2011.

**ADDRESSES:** You may submit comments, identified by RIN 3038-AD54, by any of the following methods:

- *Agency Web site, via its Comments Online process:* <http://comments.cftc.gov>. Follow the instructions for submitting comments through the Web site.

• *Mail:* Send to David A. Stawick, Secretary, Commodity Futures Trading Commission, 1155 21st Street, NW., Washington, DC 20581.

• *Hand delivery/Courier:* Same as Mail above.

• *Federal eRulemaking Portal:* <http://www.regulations.gov/search/index.jsp>.

Follow the instructions for submitting comments.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to <http://www.cftc.gov>. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures set forth in § 145.9 of the Commission's regulations.<sup>2</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 <http://www.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 rulemaking 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 Freedom of Information Act.

#### FOR FURTHER INFORMATION CONTACT:

Thomas Smith, Deputy Director, Thelma Diaz, Associate Director, or Jennifer Bauer, Special Counsel, Division of Clearing and Intermediary Oversight, 1155 21st Street, NW., Washington, DC 20581. Telephone number: 202-418-5137 and electronic mail: [tsmith@cftc.gov](mailto:tsmith@cftc.gov); [tdiaz@cftc.gov](mailto:tdiaz@cftc.gov); or [jbauer@cftc.gov](mailto:jbauer@cftc.gov).

#### SUPPLEMENTARY INFORMATION:

##### I. Background

###### A. Legislation Requiring Rulemaking for Capital Requirements of SDs and MSPs

On July 21, 2010, President Obama signed the Dodd-Frank Act.<sup>3</sup> Title VII of the Dodd-Frank Act amended the CEA<sup>4</sup> to establish a comprehensive regulatory framework to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of SDs and MSPs; (2) imposing clearing and trade execution requirements on standardized derivative

products; (3) creating rigorous recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commission's oversight.

The legislative mandate to establish registration and regulatory requirements for SDs and MSPs appears in section 731 of the Dodd-Frank Act, which adds a new section 4s to the CEA. Section 4s(e) explicitly requires the adoption of rules establishing capital and margin requirements for SDs and MSPs, and applies a bifurcated approach that requires each SD and MSP for which there is a prudential regulator to meet the capital and margin requirements established by the applicable prudential regulator, and each SD and MSP for which there is no prudential regulator to comply with Commission's capital and margin regulations.

The term "prudential regulator" is defined in a new paragraph 39 of the definitions set forth in section 1a of the CEA, as amended by section 721 of the Dodd-Frank Act. This definition includes the Board of Governors of the Federal Reserve System (Federal Reserve Board); the Office of the Comptroller of the Currency (OCC); the Federal Deposit Insurance Corporation (FDIC); the Farm Credit Administration; and the Federal Housing Finance Agency (FHFA). The definition also specifies the entities for which these agencies act as prudential regulators, and these consist generally of federally insured deposit institutions; farm credit banks; federal home loan banks; and the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. In the case of the Federal Reserve Board, it is the prudential regulator not only for certain banks, but also for bank holding companies and any foreign banks treated as bank holding companies. The Federal Reserve Board also is the prudential regulator for subsidiaries of these bank holding companies and foreign banks, but excluding their nonbank subsidiaries that are required to be registered with the Commission as SDs or MSPs.

In general, therefore, the Commission is required to establish capital requirements for all registered SDs and MSPs that are not banks, including nonbank subsidiaries of bank holding companies regulated by the Federal Reserve Board. In addition, certain swap activities currently engaged in by banks may be conducted in such nonbank subsidiaries and affiliates as a result of the prohibition on Federal assistance to swap entities under section 716 of the

<sup>2</sup> Commission regulations referred to herein are found at 17 CFR Ch. 1 (2010). Commission regulations are accessible on the Commission's Web site, <http://www.cftc.gov>.

<sup>3</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at <http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm>.

<sup>4</sup> 7 U.S.C. 1 et seq.

<sup>1</sup> See 76 FR 23732 (April 28, 2011).

Dodd-Frank Act. Generally, insured depository institutions (IDIs) that are required to register as SDs may be required to comply with section 716 by “pushing-out” to an affiliate all swap trading activities with the exception of: (1) The IDI’s hedging or other similar risk mitigating activities directly related to the IDI’s activities; and (2) the IDI acting as a SD for swaps involving rates or reference assets that are permissible for investment under banking law.

The Commission is further required to adopt other regulations that implement provisions in section 4s related to financial reporting and recordkeeping by SDs and MSPs. Section 4s(f)(2) of the CEA specifically directs the Commission to adopt rules governing financial condition reporting and recordkeeping for SDs and MSPs, and section 4s(f)(1)(A) expressly requires each registered SD and MSP to make such reports as are required by Commission rule or regulation regarding the SD’s or MSP’s financial condition. The Commission also is authorized to propose record retention and inspection requirements consistent with the provisions of section 4s(f)(1)(B).<sup>5</sup>

*B. Consultation With U.S. Securities and Exchange Commission and Prudential Regulators*

Section 4s(e)(3)(D) of the CEA calls for comparability of the capital requirements that the Commission, United States Securities and Exchange Commission (SEC) and prudential regulators (together, referred to as “Agencies”) adopt for SDs, MSPs, security-based swap dealers (SSDs) and major security-based swap participants (MSSPs) (together, referred to as “swap registrants”). Section 4s further specifies the expected scope and frequency of consultation by the Agencies regarding the capital requirements of swap registrants. Section 4s(e)(3)(D) requires the Agencies to establish and to maintain, to the maximum extent practicable, comparable minimum capital requirements. Section 4s(e)(3)(D) also requires the Agencies to periodically, but not less frequently than annually, consult on minimum capital requirements for swap registrants.

As directed by Dodd-Frank, and consistent with precedent for harmonizing where practicable the minimum capital and financial condition and related reporting requirements of dual registrants, staff

<sup>5</sup> The Commission previously has proposed certain record retention requirements for SDs and MSPs regarding their swap activities. See 75 FR 76666 (Dec. 9, 2010).

from each of the Agencies has had the opportunity to provide oral and/or written comments to the regulations for SDs and MSPs in this proposing release, and the proposed regulations incorporate elements of the comments provided. The Commission will continue its discussions with the Agencies in the development of their respective capital regulations to implement the Dodd-Frank Act.

The Commission is relying to a great extent on existing regulatory requirements in proposing capital requirements for SDs and MSPs. Specifically, under this proposal, any SD or MSP that is required to register as an FCM would be required to comply with the Commission’s existing capital requirements set forth in § 1.17 for FCMs. Furthermore, any SD or MSP that is neither a registered FCM nor a bank, but is part of a U.S. bank holding company, would be required to comply with the applicable bank capital requirements that are established by the Federal Reserve Board for bank holding companies. Lastly, any SD or MSP that was not required to register as an FCM and is not part of a U.S. bank holding company would compute its capital in accordance with proposed regulations summarized in part II of this release.

*C. Considerations for SD and MSP Rulemaking Specified in Section 4(s)*

Section 4s(e)(2)(C) of the CEA requires the Commission, in setting capital requirements for a person designated as a swap registrant for a single type or single class or category of swap or activities, to take into account the risks associated with other types/classes/categories of swap and other activities conducted by that person that are not otherwise subject to regulation by virtue of their status as an SD or MSP. Section 4s(e)(3)(A) also refers to the need to offset the greater risk that swaps that are not cleared pose to SDs, MSPs, and the financial system, and the Commission, SEC, and prudential regulators are directed to adopt capital requirements that: (1) Help ensure the safety and soundness of the registrant; and (2) are appropriate for the risk associated with the uncleared swaps held by the registrants.

*D. Other Considerations Under the CEA for FCM Financial Responsibility Requirements*

Entities that register as SDs and MSPs may include entities that also are registered as FCMs.<sup>6</sup> FCM registrants are

subject to existing Commission regulations establishing capital, segregation, and financial reporting requirements under the CEA.<sup>7</sup> Two primary financial safeguards under the CEA are: (1) The requirement under section 4d(a)(2) that FCMs segregate from their own assets all money and property belonging to their customers trading on U.S. markets;<sup>8</sup> and (2) the requirement under section 4f(b) for compliance with minimum capital requirements for FCMs.<sup>9</sup> The capital requirements for FCMs are set forth in Commission § 1.17, and reporting requirements related to capital and the FCM’s protection of customer funds are set forth in §§ 1.10, 1.12, and 1.16 of the Commission’s regulations.<sup>10</sup>

*1. Background on FCM Capital Requirements in § 1.17*

FCM capital requirements in § 1.17 are designed to require a minimum level

purchase or sale of a commodity for future delivery, (2) a security futures product, (3) a swap, (4) any commodity option authorized under Section 4c of the CEA, or (5) any leverage transaction authorized under section 19 of the CEA, or that is engaged in soliciting or accepting orders to act as a counterparty in any agreement, contract, or transaction described in sections 2(c)(2)(C)(i) or 2(c)(2)(D)(i) of the CEA, and in connection with such activities, accepts any money, securities or property (or extends credit) to margin, guarantee, or secure trades or contracts.

<sup>7</sup> The Commission’s regulatory responsibilities include monitoring the financial integrity of the commodity futures and options markets and intermediaries, such as FCMs, that market participants employ in their trading activities. The Commission’s financial and related recordkeeping and reporting rules are part of a system of financial safeguards that also includes exchange and clearinghouse risk management and financial surveillance systems, exchange and clearinghouse rules and policies on clearing and settlements, and financial and operational controls and risk management employed by market intermediaries themselves.

<sup>8</sup> The requirement that FCMs segregate customer funds is set forth in section 4d(a)(2) of the CEA. Section 4d(a)(2) requires, among other things, that an FCM segregate from its own assets all money, securities, and other property held for customers as margin for their commodity futures and option contracts, as well as any gains accruing to such customers from open futures and option positions. Part 30 of the Commission’s regulations also requires FCMs to hold “secured amount” funds for U.S. customers trading in non-U.S. futures markets separate from the firms’ proprietary funds.

<sup>9</sup> Section 4f(b) of the CEA provides that FCMs must meet the minimum financial requirements that the Commission “may by regulation prescribe as necessary to insure” that FCMs meet their obligations as registrants.

<sup>10</sup> Regulation 1.10 includes a requirement for FCMs to file annual financial statements that have been certified by an independent public accountant in accordance with § 1.16. Regulation 1.10 also requires generally that FCMs file with the Commission non-certified Form 1-FR-FCM financial reports each month. Regulation 1.12 requires FCMs to provide notice of a variety of predefined events as or before they occur. Such notice is intended to provide the Commission with the opportunity to assess the FCM’s ability to meet its financial requirements on an ongoing basis.

<sup>6</sup> An FCM is defined as an individual, association, partnership, corporation, or trust that engages in soliciting or in accepting orders for: (1) The

of liquid assets in excess of the FCM's liabilities to provide resources for the FCM to meet its financial obligations as a market intermediary in the regulated futures and options market. The capital requirements also are intended to ensure that an FCM maintains sufficient liquid assets to wind-down its operations by transferring customer accounts in the event that the FCM decides, or is forced, to cease operations as an FCM.

Paragraph (a) of § 1.17 addresses the first component of the FCM capital rule by specifying the minimum amount of adjusted net capital that a registered FCM is required to maintain. Specifically, § 1.17 sets the minimum adjusted net capital requirement as the greatest of: (1) \$1,000,000; (2) for an FCM that engages in off-exchange foreign currency transactions with persons that are not eligible contract participants as defined in section 1a(12) of the CEA (i.e. retail participants), \$20,000,000, plus 5 percent of the FCM's liabilities to the retail forex participants that exceeds \$10,000,000; (3) 8 percent of the risk margin (as defined in § 1.17(b)(8)) of customer and non-customer exchange-traded futures positions and over-the-counter (OTC) swap positions that are cleared by a clearing organization and carried by the FCM; (4) the amount of adjusted net capital required by a registered futures association of which the FCM is a member; and (5) for an FCM that also is registered as securities broker or dealer, the amount of net capital required by rules of the SEC.

The requirements for the calculation of the FCM's adjusted net capital represent the second component of the FCM capital rule. Regulation 1.17(c)(5) generally defines the term "adjusted net capital" as an FCM's "current assets", i.e., generally liquid assets, less all of its liabilities (except certain qualifying subordinated debt), and further reduced by certain capital charges (or haircuts) to reflect potential market and credit risk of the firm's current assets.

## 2. Capital Required for Uncleared Swaps Under § 1.17

FCMs historically have not engaged in significant OTC derivatives transactions. The capital treatment of such transactions under § 1.17 is one of the factors that has resulted in OTC transactions being conducted in affiliated entities. Specifically, an FCM in computing its adjusted net capital is required to mark its OTC derivatives position to market, and to reflect any unrealized gain or loss in its statement of income. If the FCM experiences an unrealized loss on its OTC derivatives

position, the unrealized loss is recorded as a liability to the counterparty and results in a reduction of the firm's adjusted net capital. If the FCM experiences an unrealized gain on the OTC derivatives position, the FCM would record a receivable from the counterparty. If the receivable was not secured through the receipt of readily marketable financial collateral, the FCM would be required to exclude the receivable from the calculation of its current assets under § 1.17(c)(2)(ii).

An FCM, in computing its adjusted net capital, is further required to compute a capital charge to reflect the potential market risk associated with its OTC derivatives positions. Regulation 1.17(c)(5) establishes specific capital charges for market risk for an FCM's proprietary positions in physical inventory, forward contracts, fixed price commitments, and securities. Historically, the Commission has required an FCM to use the capital charge provisions specified in § 1.17(c)(5)(ii), or capital charges established by the SEC for securities brokers or dealers, for its OTC derivatives positions.

## 3. Capital and Reporting Requirements for FCMs That Also Are SDs or MSPs

Section 4s(e)(3)(B)(i) of the CEA recognizes that the requirements applicable to SDs and MSPs under section 4s do not limit the Commission's authority with respect to FCM regulatory requirements. Furthermore, with respect to cleared swaps, section 724 of the Dodd-Frank Act provides that if a SD or MSP accepts any money, securities, or property (or extends credit in lieu of money, securities, or property) from, or on behalf of, a swaps customer to margin, guarantee, or secure a swap position cleared by or through a derivatives clearing organization, the SD or MSP must register with the Commission as an FCM.<sup>11</sup> Therefore, the requirement to comply with CFTC FCM capital requirements extends to SDs and MSPs that are required to register as FCMs as a result of carrying customer accounts containing cleared swap positions. This would include SDs and MSPs that are

subject to regulation by prudential regulators, and are required to register as FCMs. In part II.B of this release, the Commission proposes specific capital and financial reporting requirements applicable to FCMs that also are registered as SDs or MSPs.

### E. Structure and Approach

Consistent with the objectives set forth above, part II of this release summarizes regulations that the Commission proposes in order to establish minimum capital and financial reporting requirements for SDs and MSPs that are not banks. As noted in previous proposed rulemaking issued by the Commission, the Commission intends, where practicable, to consolidate regulations implementing section 4s of the CEA in a new part 23.<sup>12</sup> By this **Federal Register** release, the Commission is proposing to adopt the capital requirements and related financial condition reporting requirements of SDs and MSPs under subpart E of part 23 of the Commission's regulations.

In addition to the amendments being proposed for subpart E of part 23, the Commission also is proposing certain other amendments to FCM regulations contained in part 1. The proposed regulations for SD and MSP capital and financial reporting, as well as capital and financial reporting requirements for FCMs, are discussed in part II of this release. Additional amendments for part 140 of the Commission's regulations are discussed in part III of this release.

## II. Proposed Capital and Financial Reporting Regulations Under Part 23 for SDs and MSPs and Part 1 for FCMs

Proposed § 23.101 would specify capital requirements applicable to SDs and MSPs. Regulation 23.101 includes language specifying exemptions from the Commission's proposed SD–MSP capital rules, however, for any SD or MSP that is: (1) Subject to regulation by a prudential regulator; (2) designated by the Financial Stability Oversight Council as a systemically important financial institution (SIFI) and subject to supervision by the Federal Reserve Board; or (3) registered as an FCM.

The capital requirements of SDs and MSPs that are subject to regulation by a prudential regulator would be established by the prudential regulator. As identified by the prudential regulators, applicable capital regulations for the entities they regulate include the following: (1) In the case of insured depository institutions, the capital adequacy guidelines adopted under 12

<sup>11</sup> Section 724 of the Dodd-Frank Act amends Section 4d of the CEA by adding a new provision, Section 4d(f)(1), which provides that it is unlawful for any person to accept money, securities, or other property from or on behalf of a swap customer to margin, guarantee or secure a swap cleared by or through a derivatives clearing organization unless the person is registered as an FCM under the CEA. See, also, Section 4s(e)(3)(B)(i)(I) of the CEA, as amended by Section 731 of the Dodd-Frank Act, which provides the Commission with authority to impose capital requirements upon SDs and MSPs that are registered as FCMs.

<sup>12</sup> See 75 FR 71379, 71383 (November 23, 2010).

U.S.C. 1831o; (2) in the case of a bank holding company or savings and loan holding company, the capital adequacy guidelines applicable to bank holding companies under 12 CFR part 225; (3) in the case of a foreign bank or the U.S. branch or agency of a foreign bank, the applicable capital rules pursuant to 12 CFR 225.2(r)(3)(i); (4) in the case of “Edge corporations” or “Agreement corporations”, the applicable capital adequacy guidelines pursuant to 12 CFR 211.12(c)(2); (5) in the case of any regulated entity under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (*i.e.*, Fannie Mae and its affiliates, Freddie Mac and its affiliates, and the Federal Home Loan Banks), the risk-based capital level or such other amount as required by the Director of FHFA pursuant to 12 U.S.C. 4611; (6) in the case of the Federal Agricultural Mortgage Corporation, the capital adequacy regulations set forth in 12 CFR part 652; and (7) in the case of any farm credit institution (other than the Federal Agricultural Mortgage Corporation), the capital regulations set forth in 12 CFR part 615.<sup>13</sup>

Any SD or MSP that was determined to be a SIFI by the Financial Stability Oversight Council would be subject to supervision by the Federal Reserve Board.<sup>14</sup> In this proposal, the Commission is electing not to impose an additional capital requirement on a SD or MSP that is designated a SIFI and subject to regulation of the Federal Reserve Board. As part of the application process (and similar to FCM application requirements under § 1.17), proposed § 23.101 would require an applicant for registration as an SD or MSP to demonstrate its compliance with the applicable Commission-imposed regulatory capital requirements, or to demonstrate instead that it is supervised by a prudential regulator or is designated as a SIFI.

While the Commission is not proposing to impose capital requirements on a registered SD or MSP that is subject to prudential regulation or is designated as a SIFI, the Commission is proposing to require

<sup>13</sup> See joint proposed rulemaking issued by the prudential regulators on April 12, 2011, titled “Margin and Capital Requirements for Covered Swap Entities.”

<sup>14</sup> Section 113 of the Dodd-Frank Act sets forth the process by which U.S. nonbank financial companies (as defined in section 102(a)(4)(B) of the Dodd-Frank Act) may be designated as systemically important. Accordingly, a company that is registered as a SD or MSP with the Commission may be designated as a SIFI by the Financial Stability Oversight Council under a process laid out in Title I of the Dodd-Frank Act. Entities that are designated as SIFIs under Title I of the Dodd-Frank Act are considered to be supervised by the Federal Reserve Board.

such an entity to file capital information with the Commission upon request. Proposed § 23.105(c)(2) provides that, upon the request of the Commission, each SD or MSP subject to prudential supervision or designated as a SIFI must provide the Commission with copies of its capital computations and accompanying schedules and other supporting documentation. The capital computations must be in accordance with the regulations of the applicable prudential regulator with jurisdiction over the SD or MSP.

Furthermore, any SD or MSP that is required to register as an FCM, including an SD or MSP that is subject to supervision by a prudential regulator or is designated a SIFI and subject to regulation by the Federal Reserve Board, would be subject to the capital requirements set forth in § 1.17 for FCMs. Part II.B.2 of this release discusses the applicable requirements for FCMs that also are registered as SDs or MSPs.

#### *A. Proposed Minimum Capital Requirements for SDs and MSPs That Are Not FCMs*

##### 1. Subsidiaries of Bank Holding Companies

The requirements for SDs and MSPs under proposed § 23.101 reflect the fact that these firms may include subsidiaries of U.S. bank holding companies that are required by section 716 of Dodd-Frank to “push out” to an affiliate certain swap trading activities. The prudential regulators for the banks that may be required to comply with section 716 include the Federal Reserve Board, the FDIC, and the OCC. The capital rules of these banking agencies have addressed OTC derivatives since 1989, when the banking agencies implemented their risk based capital adequacy standards under the first Basel Accord.<sup>15</sup> As noted by these banking agencies, they have amended and

<sup>15</sup> The Basel Committee on Banking Supervision is a committee of banking supervisory authorities established in 1974 by the central bank Governors of the Group of Ten countries. In 1988, the Basel Committee published a document titled the “International Convergence of Capital Measurement and Capital Standards” (the “Basel Capital Accord”), which set forth an agreed framework for measuring capital adequacy and the minimum requirements for capital for banking institutions. There have been several amendments to the Basel Capital Accord in the intervening years, including, in January of 1996, the “Amendment to the Capital Accord to Incorporate Market Risks.” The Basel Committee issued a revised framework in June of 2004 (“Basel II”), and has continued to propose additional amendments thereafter. In 2010, the Basel Committee issued further requirements for internationally active banks that are set forth in “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems.”

supplemented their capital rules over time to take into account developments in the derivatives markets, including through the addition of market risk amendments which required banks and bank holding companies meeting certain thresholds to calculate their capital requirements for trading positions through models approved by the appropriate banking regulator. The banks affected by the provisions of Section 716 also may include certain large, complex banks, which together with certain bank holding companies are subject to other requirements for computing credit risk requirements under Basel II capital standards that have been implemented by these banking agencies.<sup>16</sup> The Federal Reserve, OCC, and FDIC also have stated their intention to implement requirements under recent Basel III proposals, which would establish additional capital requirements for the banks and bank holding companies for which these banking agencies are the prudential regulator.

Described in very general terms, the capital rules adopted by these banking agencies establish the required minimum amount of regulatory capital in terms of a “minimum ratio of qualifying total capital to weighted risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of Tier 1 capital.”<sup>17</sup> For purposes of this requirement, the assets and off-balance sheet items of the bank or bank holding company are weighted relative to their risk (primarily credit risk): The greater the risk, the greater the weighting. Large, complex banks must make further adjustments to these risk-weighted assets for the additional capital they must hold to reflect the market risk of their trading assets. The bank or bank holding company’s total capital must equal or exceed at least 8 percent of its risk-weighted assets, and at least half of its total capital must meet the more restrictive requirements of the definition of Tier 1 capital. For example, a bank’s total capital, but not its Tier 1 capital, may include certain mandatory convertible debt.<sup>18</sup>

The terms of proposed § 23.101 have been drafted to maintain consistent capital requirements among bank and nonbank subsidiaries (other than FCM

<sup>16</sup> The advanced approaches rules are codified at 12 CFR part 325, appendix D (FDIC); 12 CFR part 3, appendix C (OCC); and 12 CFR part 208, appendix F and 12 CFR part 225, appendix G (Federal Reserve Board).

<sup>17</sup> See, 12 CFR part 225, appendix A, § II.A.

<sup>18</sup> Mandatory convertible debt securities are subordinated debt instruments that require the issuer to convert such instruments into common or perpetual preferred stock by a date at or before the maturity of the debt instruments.

subsidiaries) of a U.S. bank holding company. By meeting requirements in the specified banking regulations, the SD or MSP will be subject to comparable capital regulations applicable to their parent U.S. bank holding companies, including the same credit risk and market risk capital requirements. Establishing a regime that imposes consistent capital requirements on nonbank subsidiaries, bank holding companies, and banks with respect to their swap activities further enhances the regulatory regime by attempting to remove incentives for registrants to engage in regulatory arbitrage.

The Commission has determined that it is appropriate to defer to the Federal Reserve Board's existing capital requirements for SDs and MSPs that are nonbank subsidiaries of a U.S. bank holding company because the existing capital requirements encompass the scope of the swaps activity and related hedging activity contemplated under the Dodd-Frank Act; the existing requirements sufficiently account for certain risk exposures, including credit and market risks; and the existing requirements meet the statutory requirement of ensuring the safety and soundness of the SD or MSP and are appropriate for the risk associated with the non-cleared swaps held by the SD or MSP.<sup>19</sup>

The proposed regulation provides that a SD or MSP that is a nonbank subsidiary of a U.S. bank holding company would have to comply with a regulatory capital requirement specified by the Federal Reserve Board as if the subsidiary itself were a U.S. bank holding company. The scope of such a regulatory capital requirement would include the swap transactions and related hedge positions that are part of the SD's or MSP's swap activities. Specifically, the SD or MSP would be required to comply with a regulatory capital requirement equal to or in excess of the greater of: (1) \$20 million of Tier 1 capital as defined in 12 CFR part 225, appendix A, § II.A;<sup>20</sup> (2) the SD's or MSP's minimum risk-based ratio requirements, as if the subsidiary itself were a U.S. bank holding company subject to 12 CFR part 225, and any appendices thereto; or (3) the capital required by a registered futures

association of which the SD or MSP is a member.

The proposed \$20 million minimum Tier 1 capital requirement is consistent with the minimum adjusted net capital requirement that Congress established for Commission registrants engaging in bilateral off-exchange foreign currency transactions with retail participants.<sup>21</sup> The Commission believes that SDs and MSPs that engage in bilateral swap transactions should be subject to a minimum capital requirement that is at least equal to the minimum level of capital Congress established for registrants engaged in retail bilateral off-exchange foreign currency transactions.

The additional proposed minimum capital requirement based on membership requirements of a registered futures association is similar to FCM requirements under § 1.17, and is appropriate in light of proposed Commission rules that would require each SD and MSP to be a member of a registered futures association. Currently, the National Futures Association (NFA) is the only registered futures association. The proposal recognizes that NFA may adopt SD and MSP capital rules at some later date, and would incorporate such requirements into the Commission's regulation.

## 2. Commercial and Other Firms That Are Not Part of Bank Holding Companies

Certain SDs and MSPs subject to proposed regulation § 23.101 may be commercial firms or other entities with no affiliations to U.S. bank holding companies. For such SDs and MSPs, the proposed rule would require that their regulatory capital requirement as measured by "tangible net equity" meet or exceed: (1) \$20 million of "tangible net equity," plus the amount of the SD's or MSP's over-the-counter derivatives credit risk requirement and additional market risk exposure requirement (as defined below), or (2) the capital required by a registered futures association of which the SD or MSP is a member.

For purposes of the proposed capital requirement, the term "tangible net equity" is defined in proposed § 23.102 as a SD's or MSP's equity as computed under generally accepted accounting principles as established in the United States, less goodwill and other intangible assets.<sup>22</sup> The proposal would further require an SD or MSP in computing its tangible net equity to

consolidate the assets and liabilities of any subsidiary or affiliate for which the SD or MSP guarantees the obligations or liabilities. In accordance with similar provisions in existing capital rules for FCMs, the proposal further provides that the SD or MSP may consolidate the assets and liabilities of a subsidiary or affiliate of which the SD or MSP has not guaranteed the obligations or liabilities, provided that the SD or MSP has obtained an opinion of counsel stating that the net asset value of the subsidiary or affiliate, or the portion of the net asset value attributable to the SD or MSP, may be distributed to the SD or MSP within 30 calendar days. Lastly, the proposal would further require that each SD or MSP included within the consolidation shall at all times be in compliance with its respective minimum regulatory capital requirements. The requirement for the SD or MSP to calculate its tangible net equity on a consolidated basis is consistent with the requirements in § 1.17 for FCMs, and ensures that the SD's or MSP's tangible net equity reflects any liabilities and other obligations for which the SD or MSP may be directly or indirectly responsible.

The term "over-the-counter derivatives credit risk requirement" is defined in proposed § 23.100 and refers to the capital that the SD or MSP must maintain to cover potential counterparty credit exposures for receivables arising from OTC swap positions that are not cleared by or through a clearing organization. The term "additional market risk exposure requirement" is defined in proposed § 23.100 and refers to the additional amount of capital the SD or MSP must maintain for the total potential market risk associated with such swaps and any product used to hedge such swaps, including futures, options, other swaps or security-based swaps, debt or equity securities, foreign currency, physical commodities, and other derivatives. The Commission is proposing to include swap transactions and related hedge positions that are part of the SD's swap activities in the over-the-counter derivatives credit risk requirement and market risk exposure requirement, and not swap positions or related hedges that are part of the SD's commercial operations.<sup>23</sup> MSPs would

<sup>19</sup> Section 4s(e)(3)(A)(i) and (ii) of the CEA.

<sup>20</sup> The Federal Reserve Board regulations governing bank holding companies are set forth in 12 CFR part 225. These regulations establish a minimum ratio of qualifying total capital to weighted risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of Tier 1 capital.

<sup>21</sup> See sections 2(c)(2)(B)(i) and (ii) of the CEA.

<sup>22</sup> The Commission is explicitly requesting comment on whether certain intangible assets, such as royalties, should be permitted in the SD's or MSP's calculation of tangible net equity.

<sup>23</sup> For example, if an SD entered into a swap transaction with a counterparty as part of its swap dealing activities, the over-the-counter derivatives credit risk requirement and market risk exposure requirement associated with the swap position and any positions hedging or otherwise related to the swap position would be included in the SD's calculation of its minimum capital requirement. If, however, an SD entered into a swap transaction to

include all swap positions in the market risk and over-the-counter derivatives credit exposure requirement. A discussion of the methodology for computing the over-the-counter derivatives credit risk requirement and the market risk exposure requirement is set forth in part II.C. of this release.

The computation of regulatory capital based upon an SD's or MSP's tangible net equity is a significant, but necessary, departure from the Commission's traditional adjusted net capital rule for FCMs. A primary distinction between the tangible net equity and adjusted net capital methods is that the tangible net equity approach does not require that a registrant maintain the same degree of highly liquid assets as the traditional FCM adjusted net capital computation. The proposed tangible net equity computation would allow SDs and MSPs to include in their minimum capital computation assets that would not qualify as current assets under FCM adjusted net capital requirements, such as property, plant and equipment, and other potentially-illiquid assets.

The Commission is proposing a capital requirement based upon a SD's or MSP's tangible net equity based upon its understanding that potential SD and MSP registrants do not conduct their business operations in a manner comparable to traditional FCMs. For example, certain entities that are extensively or primarily engaged in the energy or agricultural business may be required to register as SDs or MSPs. Although these SDs and MSPs may have significant amounts of balance sheet equity, it may also be the case that significant portions of their equity is comprised of physical and other non-current assets, which would preclude the firms from meeting FCM capital requirements without engaging in significant corporate restructuring and incurring potentially undue costs.

The Commission believes that setting a capital requirement that is different from the traditional FCM adjusted net capital approach is acceptable for SDs and MSPs that are not acting as market intermediaries in the same manner as FCMs. Readily available liquid assets are essential for FCMs to meet their key financial obligations. FCMs have core obligations for the funds they hold for and on behalf of their customers, and FCMs further guarantee their customers' financial obligations with derivatives clearing organizations, including obligations to make appropriate initial

mitigate risk associated with its commercial activities, the swap position and any related positions would not be included in the SD's calculation of its minimum capital requirement.

and variation margin payments to derivatives clearing organizations. SDs and MSPs, however, do not interact with derivatives clearing organizations to clear customer transactions and cannot engage in transactions with customers trading on designated contract markets without registering as FCMs.

*B. Proposed Minimum Capital Requirements for SDs and MSPs That Are FCMs*

The Commission is proposing to essentially impose the current FCM capital regime on SDs and MSPs that also are registered as FCMs. FCMs currently are required, pursuant to § 1.17, to maintain a minimum level of adjusted net capital that is equal to or greater than the greatest of: (1) \$1,000,000; (2) \$20,000,000 for an FCM engaged in off-exchange foreign currency transactions with retail participants, plus an additional 5 percent of the total liabilities to the retail foreign currency customers that exceeds \$10,000,000; (3) the sum of 8 percent of the risk margin on cleared futures and cleared swap positions carried in customer and non-customer accounts; (4) the amount of adjusted net capital required by a registered futures association of which the FCM is a member; and (5) for an FCM that also is registered as a securities broker-dealer, the amount of net capital required by the SEC.<sup>24</sup>

The Commission is proposing amendments to § 1.17 that would impose a minimum \$20 million adjusted net capital requirement if the FCM also is an SD or MSP. The \$20 million minimum requirement is consistent with the Commission's proposal to adopt a \$20 million minimum capital requirement for SDs and MSPs that are not FCMs, and is further consistent with the Commission's recent adoption of a \$20 million minimum capital requirement for FCMs that engage in off-exchange foreign currency transactions with retail participants.

Furthermore, the Commission notes that the current capital regulations would impose a risk-based capital requirement on SDs and MSPs that are required to register as FCMs as a result of their carrying and clearing of customer swap or futures transactions with a clearing organization. As noted above, the current regulation requires an FCM to maintain adjusted net capital

that is equal to or greater than 8 percent of the risk margin associated with cleared futures and swap transactions carried by the FCM in customer and non-customer accounts. The 8 percent of margin, or risk-based capital rule, is intended to require FCMs to maintain a minimum level of capital that is associated with the level of risk associated with the customer positions that the FCM carries.

*C. Required Calculations for Credit Risk and Market Risk Requirements*

The proposed regulations include an application process by which certain SDs and MSPs may apply to the Commission for approval to use proprietary internal models for their capital calculations required by part 23. For those SDs and MSPs whose calculations are not permitted to be based upon such models, the proposed regulations sets forth other specified requirements for the SD's or MSP's required market and credit risk calculations.

**1. Request for Approval of Calculations Using Internal Models**

The Commission recognizes that internal models, including value-at-risk (VaR) models, can provide a more effective means of recognizing the potential economic risks or exposures from complex trading strategies involving OTC derivatives and other investment instruments. In this connection, the Commission has previously adopted § 1.17(c)(6), which allows certain FCMs that are dually-registered with the SEC to elect to use internally developed models to compute market risk deductions for proprietary positions in securities, forward contracts, foreign currency, and futures contracts, and credit risk deductions for unsecured receivables from counterparties in OTC transactions (the "Alternative Capital Computation") in lieu of the standard deductions set forth in § 1.17(c). A precondition of using the Alternative Capital Computation is the SEC's review and written approval of the firm's application to use internal models in computing its capital under SEC regulations, and the requirement that the model and the firm's risk management meet certain qualitative and quantitative requirements set forth in SEC Rule 15c3-1e. The firm also was required to maintain at least \$1 billion of tentative net capital and \$500 million in net capital.<sup>25</sup> The firm further was obligated to report to the SEC and to the

<sup>24</sup> FCMs that register as security-based swap dealers also will be subject to minimum capital requirements established by the SEC for security-based swap dealers.

<sup>25</sup> See 17 CFR 15c3-1(a)(7).

CFTC if its tentative net capital fell below \$5 billion.<sup>26</sup>

Significant resources, however, are necessary for regulators to effectively assess and to periodically review proprietary internal models. Absent concerns regarding future Commission resources to implement an adequate program for the effective direct supervision of internal models used by SDs and MSPs, the Commission would propose regulations to establish a framework by which FCMs that are registered as SDs or MSPs could submit internal models to the Commission for review and approval for use in their required capital calculations. Such a program would include the continuous and direct review by Commission staff of the policies and procedures applicable to, and output of, such proprietary models.

In view, however, of current Commission resources which does not support the development of a program to conduct the initial review and ongoing assessment of internal models, and the uncertainty of future funding levels for the necessary staffing resources, this release provides for an application process for approval of SD and MSP capital calculations using internal models, but limits the initial pool of applicants to those whose internal models are subject to review by the Federal Reserve Board or the SEC. Specifically, proposed § 23.103 would permit a nonbank SD or MSP that also is part of a U.S. bank holding company subject to oversight by the Federal Reserve Board to apply to the Commission for approval by written order to use proprietary internal models to compute market risk and credit risk capital requirements under the applicable U.S. bank holding company regulations. The SD or MSP also may apply for such approval if it also is registered as an SSD or MSSP, and the internal models for which it seeks approval have been reviewed and are subject to the regular assessment by the SEC.

#### a. Application Process and Requirements for Internal Models

As set forth in the proposed regulation, the application must address several factors including: (1) Identifying the categories of positions that the SD or MSP holds in its proprietary accounts; (2) describing the methods that the SD or MSP will use to calculate its market risk and credit risk capital requirements; (3) describing the internal models; and (4) describing how the SD or MSP will calculate current exposure and potential

future exposure. The SD or MSP also must explain the extent to which the internal models have been reviewed and approved by the Federal Reserve Board, or, as applicable, the SEC.

The proposal would further provide that the internal models must meet such requirements as are adopted by U.S. regulators under the Basel Accord, including requirements implemented as part of Basel III. In particular, the internal models must meet the requirements that are set forth in regulations of the Federal Reserve Board at 12 CFR part 225, appendix E and appendix G applicable to market risk and OTC counterparty credit risk; or, as applicable to SSDs or MSSPs, the requirements set forth in SEC regulations. Such requirements include, but are not limited to, the requirements in these regulations to assess the effectiveness of such models by conducting appropriate backtesting and for the application of multipliers to the model outputs that would be based on the results of such backtesting.

The proposed regulation further specifies that the application shall be in writing and filed with the regional office of the Commission having jurisdiction over the SD or MSP as set forth in § 140.2 of the Commission's regulations. The application may be filed electronically in accordance with instructions approved by the Commission and specified on the Commission's Web site. A petition for confidential treatment of information within the application may be submitted according to procedures set forth in § 145.9. The proposed rule further provides that the SD or MSP must promptly, upon the request of the Commission at any time, provide any other explanatory information as the Commission may require at its discretion regarding the SD's or MSP's internal models and related capital computations.

As set forth in proposed § 23.103, upon recommendation by Commission staff, the Commission may approve the application, or approve an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission may require, if the Commission finds the approval to be necessary or appropriate in the public interest or for the protection of investors, after determining, among other things, whether the applicant has met the requirements of this section and is in compliance with other applicable rules promulgated under the Act and by self-regulatory organizations. The proposed rule also specifies the following conditions under which such Commission approval may be

terminated: (1) Internal models that were previously approved are no longer approved or periodically reviewed by the Federal Reserve Board or the SEC; (2) the SD or MSP has changed materially a mathematical model described in the application or changed materially its internal risk management control system without first submitting amendments identifying such changes and obtaining Commission approval for such changes; (3) the Commission in its own discretion determines that as a result of changes in the operations of the SD or MSP the internal models are no longer sufficient for purposes of the capital calculations of the SD or MSP; (4) the SD or MSP fails to come into compliance with its requirements under the terms of the Commission's approval under § 23.103, after having received from the Commission's designee written notification that the firm is not in compliance with its requirements, and must come into compliance by a date specified in the notice; or (5) upon any other condition specified in the Commission approval order.

#### b. Approval Criteria if SD or MSP Also Is an FCM

If the application made under proposed part 23 is from an SD or MSP that also is an FCM, proposed § 23.103 provides that the application shall specify that the firm requests approval to calculate its adjusted net capital (not tangible net equity or other regulatory capital) using proprietary internal models. The Commission also is proposing to provide in § 1.17(c)(7) that any FCM that also is registered as an SD or MSP, or also is registered as an SSD or MSSP, and which has received approval of its application to the Commission under § 23.103 for capital computations using the firm's internal models, shall calculate its adjusted net capital in accordance with the terms and conditions of such Commission approval. The Commission further is proposing to amend § 1.17(c)(6)(i) to recognize the possibility that FCMs that have been authorized to elect to use the Alternative Capital Computation may be SDs or MSPs and required to register as such with the Commission. The amended § 1.17(c)(6)(i) would permit these FCMs to continue to apply the Alternative Capital Computation pending the Commission's determination of the application that such FCMs must file under proposed part 23.

<sup>26</sup> See 17 CFR 15c3-1e(e)(1).

## 2. Calculations by SDs and MSPs That Are Not Using Internal Models and Are Not FCMs

As noted earlier, the internal models that may be approved for use in the capital calculations of SDs and MSPs must meet qualifying standards under the Basel Accord. In addition to specifying qualifying criteria for internal models, the Basel Accord also includes other requirements for capital calculations that do not incorporate measurements from the firm's internal models.

### a. OTC Derivatives Credit Risk

Proposed § 23.104 sets forth capital calculations for OTC derivatives credit risk that are based on Basel requirements that do not incorporate internal models. The proposed required credit risk deduction also includes a concentration charge specified in SEC Rule 15c3-1e. The charge as proposed would equal the sum of (1) a counterparty exposure charge (summarized below) and (2) a counterparty concentration charge, which would equal 50 percent of the amount of the current exposure to any counterparty in excess of 5 percent of the SD's or MSP's applicable minimum capital requirement, plus a portfolio concentration charge of 100 percent of the amount of the SD's or MSP's aggregate current exposure for all counterparties in excess of 50 percent of the SD's or MSP's applicable minimum capital requirement.

The counterparty exposure charge would equal the sum of the net replacement values in the accounts of insolvent or bankrupt counterparties plus the "credit equivalent amount" of the SD's or MSP's exposure to its other counterparties. The SD or MSP would be permitted to offset the net replacement value and the credit equivalent amount by the value of collateral submitted by the counterparty, as specified and subject to certain haircuts in the proposed rule. The resultant calculation would be multiplied by a credit risk factor of 8 percent.

For purposes of this computation, the credit equivalent amount would equal the sum of the SD's or MSP's current exposure and potential future exposure to each of its counterparties that is not insolvent or bankrupt. The current exposure for multiple OTC positions would equal the greater of (i) the net sum of all positive and negative mark-to-market values of the individual OTC positions, subject to permitted netting pursuant to a qualifying master netting

agreement; or (ii) zero.<sup>27</sup> The potential future exposure for multiple OTC positions that are subject to a qualifying master netting agreement is calculated in accordance with the following formula:  $Anet = (0.4 \times Agross) + (0.6 \times NGR \times Agross)$ , where: (i) Agross equals the sum of the potential future exposure for each individual OTC position<sup>28</sup> subject to the swap trading relationship documentation that permits netting;<sup>29</sup> and (ii) NGR equals the ratio of the net current credit exposure to the gross current credit exposure. In calculating the NGR, the gross current credit exposure equals the sum of the positive current credit exposures of all individual OTC derivative contracts subject to any netting provisions of the swap trading relationship documentation, which must be legally enforceable in each relevant jurisdiction, including in insolvency proceedings. The proposed rule also requires that the gross receivables and gross payables subject to the netting agreement can be determined at any time; and that the SD or MSP, for internal risk management purposes, monitors and controls its exposure to the counterparty on a net basis. The credit risk equivalent amount may be reduced to the extent of the market value of collateral pledged to and held by the swap dealer or major swap participant to secure an over-the-counter position. The collateral would be subject to the following requirements:

- The collateral must be in the swap dealer or major swap participant's physical possession or control; *Provided, However,* collateral may include collateral held in independent third party accounts as provided under part 23;
- The collateral must meet the requirements specified in a credit support agreement meeting the requirements of § 23.151;
- If the counterparty is a swap dealer, major swap participant or financial entity as defined in § 23.150, certain

<sup>27</sup> For a single OTC position, the current exposure is the greater of the mark-to-market value of the over-the-counter position or zero.

<sup>28</sup> For a single over-the-counter position, the potential future exposure, including an over-the-counter position with a negative mark-to-market value, is calculated by multiplying the notional principal amount of the position by the appropriate conversion factor in Table E of the proposed rules. Table E is the same as the table proposed as "Table to 1.3(sss)" in proposed rulemaking issued jointly by the CFTC and SEC for purposes of the further definition of the term "major swap participant." See 75 FR 80174, 80214 (December 21, 2010). Both tables remove any references to credit ratings and require the same charge to be applied to all corporate debt regardless of rating.

<sup>29</sup> 76 FR 6715.

additional requirements apply as described in the proposed rule at § 23.104(j); and

- Applicable haircuts must be applied to the market value of the collateral.

Once the credit equivalent amount is computed as described above, the SD or MSP would be required to apply a credit risk factor of 50 percent, regardless of any credit rating of the counterparty by any credit rating agency.<sup>30</sup> However, the SD or MSP also may apply to the Commission for approval to assign internal individual ratings to each of its counterparties, or for an affiliated bank or affiliated broker-dealer to do so. The application will specify which internal ratings will result in application of a 20 percent risk weight, 50 percent risk weight, or 150 percent risk weight. Based on the strength of the applicant's internal credit risk management system, the Commission may approve the application. The SD or MSP must make and keep current a record of the basis for the credit rating for each counterparty, and the records must be maintained in accordance with § 1.31 of the Commission's regulations.

### b. Additional Market Risk Exposure

Proposed § 23.103 specifies required calculations for market risk that are based on Basel "standardized" measurement procedures for assessing market risk arising from positions in traded debt and equity and in commodities and foreign currencies. The Basel standardized approach also includes market risk exposure requirements for options that have debt instruments, equities, foreign currency, or commodities as the underlying positions. Although proposing requirements based on the Basel standardized approach for market risk calculations, Commission staff recognizes that the Basel Accord expressly supports capital requirements based on internal risk measurement models as the better approach for a bank that has a significant business in options or commodities.<sup>31</sup> However, as discussed above, absent a program for the review and approval of internal

<sup>30</sup> The Basel credit risk factors are determined for counterparties based on credit ratings assigned by credit rating agencies to such counterparties. Section 939A of the Dodd-Frank Act requires the Commission to review and modify regulations that place reliance on credit rating agencies. Accordingly, the Commission is proposing a 50 percent credit risk factor in lieu of assigning a credit risk factor based on ratings issued by credit rating agencies.

<sup>31</sup> See "Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework—Comprehensive Version," issued by the Basel Committee on Banking Supervision in June 2006.

models, the Commission believes that this established approach is the most appropriate method for computing market risk charges.

The Basel standardized charges seek to address “general market risk,” meaning the risk of changes in the market value of transactions that arise from broad market movements, such as changing levels of market interest rates, broad equity indices, or currency exchange rates. Where applicable, the Basel standardized charges also seek to address “specific” risk, which is defined as changes in the market value of a position due to factors other than broad market movements. Such specific risk may include default risk,<sup>32</sup> event risk (the risk of loss on a position that could result from sudden and unexpected large changes in market prices or specific events other than the default of the issuer), and idiosyncratic risk (the risk of loss in the value of a position that arises from changes in risk factors unique to that position).

Applying the Basel standardized approach, the proposed rules require the calculation of separate charges for general and specific market risk for positions in equities and debt instruments (including options with underlying instruments in these categories), which are summed to determine the total charge required with respect to such positions. Only general market charges are calculated for positions in commodities and foreign currencies (including options with underlying instruments in these categories). For purposes of computing such specific and general market risk charges, off-balance sheet positions are included. For example, swaps are included in the calculation as two positions, with a receiving side treated as a long position and a paying side treated as a short position, and using market values of the notional position in the underlying debt or equity instrument, or index portfolio. The required calculations for specific risk and general market risk charges are described in more detail below.

#### i. Specific Risk

For positions in equities, the proposed specific risk charge equals 8 percent of the firm’s gross equity positions, i.e., the absolute sum of all long equity positions and of all short

<sup>32</sup> Default risk is the risk of loss on a position that could result from the failure of an obligor to make timely payments of principal or interest on its debt obligation, and the risk of loss that could result from bankruptcy, insolvency, or similar proceeding. For credit derivatives, default risk means the risk of loss on a position that could result from the default of the reference exposure(s).

equity positions, with netting allowed when the SD or MSP has long and short positions in exactly the same instrument.

The specific risk charge required for debt instruments is based on risk-weight factors applied to the debt instrument positions of the SD or MSP. The applicable required risk weight factor is based in part on the identity of the obligor. For example, all positions in debt instruments of national governments of the Organization of Economic Co-operation and Development (“OECD”) countries are assigned zero specific risk. Other debt securities issued by “qualifying” borrowers are assigned risk weights that vary by maturity; specifically, 0.25 percent (6 months or less); 1 percent (6 to 24 months); or 1.6 percent (over 24 months). Qualifying debt instruments include those issued by U.S. government-sponsored agencies; general obligation debt instruments issued by states and other political subdivisions of OECD countries and multilateral development banks; and debt instruments issued by U.S. depository institutions or OECD-banks that do not qualify as capital of the issuing institution.

The Basel standardized approach also permits certain rated corporate debt securities to be included as qualifying debt. However, given the legislative directive to eliminate the use of credit ratings in Commission regulations, the proposed rules do not permit any differentiation among the charges applied to corporate debt securities. As a result, the proposed rule would apply the same haircut to highly-rated debt as to debt that is not highly-rated, i.e., the maximum specific risk weight of 8 percent. The total proposed specific risk charge for debt instruments would equal the sum of the risk-weighted positions, with netting allowed for long and short positions (including derivatives) in identical debt issues or indices.

In drafting the terms of proposed § 23.103, the Commission has taken into consideration Basel provisions relating to specific risk that have been incorporated into banking regulations of the Federal Reserve Board, FDIC, and OCC.<sup>33</sup> These agencies have recently, however, proposed revisions to their general market risk and specific risk rules in light of certain amendments to the Basel Accord developed in 2005 and

<sup>33</sup> The market risk capital rules of the OCC, Federal Reserve Board, and FDIC appear respectively at 12 CFR part 3, appendix B; 12 CFR part 208, appendix E and part 225, appendix E, and 12 CFR part 325, appendix C.

2009.<sup>34</sup> The revisions proposed by these banking agencies include requirements applicable to the treatment of credit derivatives in the calculation of standardized specific risk charges, and the proposed rules also set forth other offsetting permitted under the Basel Accord for positions in a credit derivative and its corresponding underlying instrument. The Commission’s proposed requirements for credit derivatives include text that is based on the banking agencies’ proposed rules. In particular, the text in proposed § 23.104(c)(5) is the same as the text proposed by the proposed banking agencies.

#### ii. General Market Risk Charges

In contrast to the Basel standardized approach to specific risk charges, the federal banking agencies have not adopted the Basel standardized approach for computing general market risk capital charges.<sup>35</sup> In 1995, U.S. banking regulators considered proposed rules to implement two approaches under the Basel Accord for the capital treatment of market risk: the internal models approach and the standardized approach. These agencies subsequently determined, however, that only the internal models approach would apply to general market risk capital charges, noting that “an institution with significant exposure to market risk can most accurately measure that risk using detailed information available to the institution about its particular portfolio processed by its own risk measurement model.”<sup>36</sup> The Commission, however, is proposing the Basel standardized approach since such an approach does not rely upon proprietary internal models. The terms in the proposed § 23.104 for general market risk therefore take into consideration the terms originally contemplated by these banking agencies in the 1995 proposed

<sup>34</sup> See 76 FR 1890 (January 11, 2011)(proposing amendments that include revisions to standardized specific risk charges). This proposed rulemaking refers to Basel Accord revisions set forth in “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects”, issued by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) in July 2005, and to the “Revisions to the Basel II Market Risk Framework, Guidelines for Computing Capital for Incremental Risk in the Trading Book” and “Enhancements to the Basel II Framework” issued by the Basel Committee on Banking Supervision in July of 2009.

<sup>35</sup> With permission by its federal banking regulator, a bank also may use internal models for calculating specific risk charges. See 76 FR 1890, 1893 (January 11, 2011) (discussion of specific risk requirements currently applicable to banks).

<sup>36</sup> See 60 FR 38082 (July 25, 1995) (release proposing market risk capital charges) and 61 FR 47358, 47359 (September 6, 1996) (release adopting internal models approach).

rules. Proposed § 23.104 requires the calculation of separate charges for general market risk for positions in equities, debt instruments, commodities and foreign currency (including options with underlying instruments in these categories), which are summed to determine the total general market risk requirement with respect to such positions.

#### Equities

The standardized measure of market risk for equities applies to direct holdings of equity securities, equity derivatives and off-balance-sheet positions whose market values are directly affected by equity prices. The required charge is the sum of the specific risk charge, calculated as described above, and of the general market risk charge, which is equal to 8.0 percent of the difference between the sum of the firm's long and the sum of the firm's short positions. The net long or short position must be calculated separately for each national market. Thus, for example, a long position in U.S. companies traded on the New York Stock Exchange cannot be netted against a short position in Japanese companies traded on the Tokyo Stock Exchange. Long and short equity positions (including derivatives) in identical equity issues or equity indices in the same market may be netted.

#### Debt Instruments

Applying the "maturity" method under the Basel standardized approach, on and off-balance-sheet debt positions are distributed among a range of time-bands and zones that are specified by the Basel Accord, which are designed to take into account differences in price sensitivities and interest rate volatilities across various maturities. The time-band into which a position is distributed is determined by its maturity (fixed rate instruments) or the nearest interest rate reset date of the instrument (floating rates). Long positions are treated as positive amounts and short positions are treated as negative amounts. The net long or short position for each time-band is multiplied by the risk weight specified in a table set forth in the Basel Accord.<sup>37</sup> The resulting risk-weighted position represents the amount by which the market value of that debt position is expected to change for a specified movement in interest

<sup>37</sup> The risk-weights provided in the table approximate the price sensitivity of various instruments. The price sensitivity of zero coupon and low coupon instruments can be materially greater than that of instruments with higher coupons, and the table therefore assigns higher risk weights to low coupon instruments.

rates. The sum of all risk-weighted positions (long or short) across all time-bands is the base capital charge for general market risk.

The standardized approach also requires a "time-band disallowance" to address the basis risk that exists between instruments with the same or similar maturities and also the possibly different price movements that may be experienced by different instruments within the same time-band due to the range of maturities (or repricing periods) that may exist within a time-band. To capture this risk, a disallowance of 10 percent is applied to the smaller of the offsetting (long or short) positions within a time-band.<sup>38</sup> This amount would be added to the SD's or MSP's base capital charge.

Additional disallowances address the risk that interest rates along the yield curve are not perfectly correlated and that the risk-weighted positions may not be offset fully. The required disallowances, which apply to the smaller of the offsetting positions, are specified in a table provided under the Basel Accord, and range from 30 percent to 100 percent. The amount of each disallowance varies in size by zone: Greater netting is allowed for positions in different time bands but within the same zone than is allowed for positions that are in different zones. The firm must first determine "intra-zone" disallowance amounts, and then the required "inter-zone" disallowances across zones. An SD's or MSP's general market risk requirement for debt instruments within a given currency would be the sum of (1) the value of its net risk-weighted position and (2) all of its time-band, intra-zone and inter-zone disallowances.<sup>39</sup> The capital charges would be separately computed for each currency in which an SD or MSP has significant positions.

Certain debt securities would not be included in the charges described above, but would instead be subject to the capital treatment under applicable provisions in the SEC's capital regulation at 17 CFR 240. 15c3-1. For example, municipal securities would be subject to capital requirements in the

<sup>38</sup> For example, if the sum of weighted long positions within a time-band equals \$100 million and the sum of weighted short positions equals \$90 million, the disallowance for the time-band would be 10 percent of \$90 million, or \$9 million. Also, if the offsetting amounts (long and short) are equal, the disallowance can be applied to either figure.

<sup>39</sup> The Basel standardized approach includes another maturity ladder approach for interest rate products, the "duration method," which is not included in the proposed Appendix as it requires computations that are less standardized.

SEC rule.<sup>40</sup> All collateralized debt obligations, asset-backed securities or mortgage-backed securities, except pass-through mortgage-backed securities issued or guaranteed as to principal or interest by the United States or any agency thereof, would also be governed by the SEC rule.<sup>41</sup>

#### Commodities

The market risk capital requirement for commodities risk applies to holdings or positions taken in commodities, including precious metals, but excluding gold (which is treated as a foreign currency because of its market liquidity). The required charge addresses directional risk, which is the risk that a commodity's spot price will increase or decrease, as well as other important risks such as basis risk, interest rate risk, and forward gap risk.

For purposes of determining the charge, the firm is required to calculate its net position in each commodity on the basis of spot rates. Long and short positions in the same commodity may be netted, and different categories of commodities may be netted if deliverable against each other. Under the "simple" approach under the Basel Accord, the firm's capital charge for directional risk would equal 15 percent of its net position, long or short, in each commodity, and a supplemental charge of 3.0 percent of the gross position in each commodity is added to cover basis, interest rate and forward gap risk.<sup>42</sup>

#### Foreign Exchange

The market risk capital requirement for foreign exchange covers the risk of holding or taking positions in foreign currencies (including gold). The charge is determined by the firm's net positions in a given currency, including its net spot and forward positions; any guarantees that are certain to be called and likely to be irrecoverable; its net future income and expenses that are not yet accrued, but that are already fully hedged; and any other items

<sup>40</sup> This proposed separate treatment is consistent with the SEC's analysis when considering, in 1997, capital provisions similar to the Basel standardized approach for debt instruments. Although the proposed rules were not adopted, the proposing release included pertinent analysis that the market price of municipal securities "depends on tax issues to a much greater extent than other debt instruments," and that the price movements of non-investment grade debt securities "tend to be based primarily on issuer-specific factors." See 62 FR 67996 (December 30, 1997).

<sup>41</sup> *Id.* at 68002.

<sup>42</sup> The standardized approach will in certain instances offer more than one measurement technique, of increasing degrees of complexity. The "simplified" method for calculating general market risk charges for positions in commodities has been included in the proposed rules.

representing a profit or loss in foreign currencies. For purposes of the calculation, forward and future positions are converted into the reporting currency at spot market rates.

The standardized approach assumes the same volatility for all currencies and requires an SD or MSP to take capital charge equal to 8.0 percent of the sum of (a) its net position in gold and (b) the greater of the sum of the net short positions or the sum of the net long positions in each foreign currency.

#### Options

The proposed rule is based on the “delta-plus method” under the Basel standardized approach, which includes capital charges related to the option’s *delta* (its price sensitivity relative to price changes in the underlying security, rate, or index); *gamma* (the change in delta for a given change in the underlying); and *vega* (the effect of changes in the volatility of the underlying).<sup>43</sup> The three separate capital charges are computed as follows:

*Delta risk charge*—This charge is determined by incorporating options positions in the calculations (including specific risk if applicable) that are required elsewhere in the proposed rule for positions in commodities, foreign currencies, equities, and debt instruments. Specifically, options are included as positions equal to the market value of the underlying instrument multiplied by the delta. To determine the delta, and also gamma and vega, sensitivities of the options, the firm will use option pricing models that will be subject to Commission review.

*Total gamma risk charge*—This charge requires the following steps: (1) For each option, perform a “gamma impact” calculation that is based on a Taylor series expansion and expressed in the Basel Accord as: Gamma impact =  $.05 \times \text{Gamma} \times \text{VU}^2$ . In this formula, VU refers to the variation of the underlying of the option and is computed by multiplying the market value of the underlying by percentages derived from those specified elsewhere in the proposal for commodities, foreign currencies, equities and debt instruments.<sup>44</sup>

<sup>43</sup> Two other methods under the Basel standardized approach for options are not included in the Appendix, as the “simplified” method applies only to purchased options, and the “scenario” method incorporates measurements that must meet the same qualitative requirements applicable to the internal models approach. See 60 FR at 38091 (discussing restrictions on use of simplified and scenario methods).

<sup>44</sup> Applying the required percentages, VU would be determined for a commodity option by multiplying the market value of the underlying

(2) The gamma impact for each option will be positive or negative, and for options on the same underlying, the individual gamma impacts will be summed, resulting in a net gamma impact for each underlying that is either positive or negative.

(3) Net positive gamma impacts amounts are disregarded, and the capital charge equals the absolute value of the sum of all of the net negative gamma impact amounts.

*Total vega risk charge*—This charge requires the following steps: (1) Sum the vegas for all options on the same underlying, and multiply by a proportional shift in volatility of  $\pm 25$  percent;<sup>45</sup> and (2) The total capital charge for vega risk will be the sum of the absolute value of the individual capital charges computed for options positions in the same underlying.

#### 3. Calculations by SDs and MSPs That Are Not Using Internal Models and Are FCMs

The existing capital treatment under § 1.17 for those FCMs that are not approved to use internal models would remain the same under the proposed rules. Thus, SDs and MSPs that are also FCMs and not approved to use internal models for their capital calculations would be required to deduct 100 percent of the receivables associated with their uncleared swaps, except the extent of the market value, minus specified haircuts, of acceptable collateral that secure such receivables. The margin rules that have been proposed may result in fewer unsecured receivables for the FCM’s uncleared swaps, especially as the Commission also is proposing to amend § 1.17(c)(2)(ii)(G) to provide that

commodity by 15 percent; for a foreign currency by multiplying the market value of the underlying by 8 percent; for an equity or index by multiplying the market value of the underlying by 12 percent or 8 percent respectively, and for options on debt instruments or interest rates, the market value of the underlying multiplied by the risk weights for the appropriate time band as derived from Table A. The text of the rules for the gamma risk charge simplifies the required computation for options with debt instruments or interest rates as the underlying, by providing a table of specific risks weights to be used.

<sup>45</sup> Vega is quoted to show the theoretical price change for every 1 percentage point change in implied volatility. Assuming a European short call option with volatility of 20 percent, for purposes of the required calculation the volatility has to be increased by a relative shift of 25 percent (only an increase in volatility carries a risk of loss for a short call option.) Thus, in this example, the vega capital charge should be calculated on the basis of a change in volatility of 5 percentage points from 20 percent to 25 percent. Assuming vega in this example equals 168, a 1 percent increase in volatility increases the value of the option by 1.68. Accordingly, the capital charge for vega risk is calculated as follows:  $5 \times 1.68 = 8.4$

receivables from third-party custodians that arise from initial and/or variation margin deposits associated with bilateral swap transactions pursuant to proposed § 23.158 will be included in the FCM’s current assets.

The Commission also is proposing to provide greater clarity and transparency to the market risk haircut charges under § 1.17 for OTC derivatives positions, by adding new paragraphs (iii) and (iv) to § 1.17(c)(5) that would address proprietary OTC swap transactions that are not cleared by or through a clearing organization. The proposal is intended to codify existing guidance provided by the Commission and SEC regarding the computation of capital charges for OTC derivative transactions.

As proposed, § 1.17(c)(5)(iii)(A) would require a capital charge equal to the notional amount of an interest rate swap multiplied by the applicable percentages of the underlying securities specified in SEC Rule 15c3-

1(c)(2)(vi)(A)(1), as if such notional amount was the market value of a security issued or guaranteed as to principal or interest by the United States, if the interest rate swap position was not hedged with U.S. Treasury securities of corresponding maturities or matched with offsetting interest rate swap positions with corresponding terms and maturities.<sup>46</sup> Proposed § 1.17(c)(5)(iii)(B) would address uncleared swaps maturing in 10 years or less that are hedged with U.S. Treasury securities of corresponding maturities, or matched with offsetting interest rate swap positions with corresponding terms and maturities, and would require a capital charge of 1 percent of the notional amount of such interest rate swaps. Proposed § 1.17(c)(5)(iii)(C) would require a capital charge of 3 percent of the notional amount of the interest rate swap, if the swap was hedged with U.S. Treasury securities of corresponding maturities or matched with offsetting interest rate swap positions with corresponding terms and maturities, and such interest rate swap positions were maturing in more than 10 years.

Proposed § 1.17(c)(5)(iv) addresses the capital charges on proprietary OTC swap positions in credit default swaps, equity swaps, or commodity swaps that are not cleared by or through a clearing organization. Credit default swaps that are not hedged by the same securities underlying the swap are subject to a capital charge computed by multiplying the notional principal amount of the

<sup>46</sup> SEC Rule 15c3-1(c)(2)(vi)(A)(1) lists haircut percentages between 0 percent and 6 percent based upon the time to maturity of the security.

swap by the applicable percentages as determined by the underlying securities under SEC Rule 15c3-1(c)(2)(vi) and taking into account the remaining maturity of the swap agreement.

Equity swaps would be subject to a capital charge equal to 15 percent of the net notional principal amount of the swap transaction. Commodity swaps would be subject to a capital charge equal to 20 percent of the net market value of the notional amount of the commodities underlying the swap transaction.

#### *D. Failure To Meet Minimum Capital Requirements*

Regulation 1.17(a)(4) currently provides that any FCM that fails to meet, or is unable to demonstrate compliance with, the minimum capital requirement must transfer all customer accounts and immediately cease doing business as an FCM until it is capable of demonstrating compliance with the capital requirements. The FCM may continue to trade for liquidation purposes only unless the Commission or the FCM's designated self-regulatory organization (DSRO) provides otherwise.<sup>47</sup> The Commission and the FCM's DSRO also have the authority to grant the FCM up to a maximum of 10 business days to come back into compliance with the capital regulations without having to transfer customer accounts if the FCM can immediately demonstrate the capability of achieving capital compliance.

The Commission is not proposing to amend § 1.17(a)(4). Accordingly, if an FCM that also is registered as an SD or MSP fails to maintain the minimum level of capital, it would have to cease operating as an FCM and transfer the customer futures and cleared swap accounts that it carries to another FCM. The FCM also could request that the Commission or DSRO grant the firm up to 10 business days to come back into compliance with the minimum capital requirements if the FCM could demonstrate an immediate plan to achieve compliance.

The Commission recognizes that an FCM that is an SD or MSP and has open uncleared bilateral swap transactions cannot transfer the uncleared bilateral swap transactions in a manner similar to customer futures and cleared swap transactions. In such situations, the agreements between the SD or MSP and

its counterparties should dictate the process. As previously proposed by the Commission, each SD or MSP would be required to establish written policies and procedures reasonably designed to ensure that each SD or MSP and its counterparties have agreed in writing to all of the terms governing their swap trading relationship. The Commission further has proposed that the swap trading relationship documentation include a written agreement by the parties on terms relating to events of default or other termination events, and dispute resolution procedures. Therefore, the SD's or MSP's written agreements with its counterparties should address the possible undercapitalization of the SD or MSP and the parties' rights in such a situation.<sup>48</sup>

Proposed § 23.105(a) requires an SD or MSP to provide the Commission with immediate notice if the SD or MSP fails to maintain compliance with the minimum capital requirements. FCMs also are required to provide the Commission with immediate notice under § 1.12(a). Upon receipt of an undercapitalization notice, the Commission would engage the SD or MSP to assess the situation and to determine whether the SD or MSP would be able to take reasonable actions to bring itself back into compliance with the minimum capital requirements. The Commission would further assess what other actions were necessary depending on the facts and circumstance of each situation, including the need for providing immediate notice to the SD's or MSP's swap counterparties.

#### *E. SD and MSP Financial Reporting Requirements*

##### **1. SD and MSP Financial Statement Requirements**

Section 4s(f)(1)(A) of the CEA, as amended by section 731 of the Dodd-Frank Act, expressly requires each registered SD and MSP to make such reports as are required by Commission rule or regulation regarding the SD's or MSP's financial condition. The Commission is proposing new § 23.106, which would require certain SDs and MSPs to file monthly unaudited financial statements and annual audited financial statements with the Commission and with any registered futures association of which they are members.

Proposed § 23.106 would apply to SDs and MSPs, except any SDs or MSPs that are subject to the capital requirements of a prudential regulator, or designated by the Financial Stability Oversight Council as a SIFI. SDs and MSPs that are subject to regulation by a prudential regulator would comply with the applicable financial reporting obligations imposed by such prudential regulator. SDs and MSPs that are designated as SIFIs would comply with any financial reporting obligations imposed by the Federal Reserve Board. Registered SDs or MSPs that are subject to prudential regulation or designated as SIFIs, however, would be required pursuant to proposed § 23.105(d) to provide the Commission with copies of their capital computations and supporting documentation upon the Commission's request. In addition, SDs and MSPs that are required to register with the Commission as FCMs would not be required to file financial reports under § 23.106, and would continue to comply with the FCM financial reporting obligations set forth in § 1.10 of the Commission's regulations.

The proposed financial statements under part 23 would include a statement of financial condition; a statement of income or loss; a statement of cash flows; and a statement of changes in stockholders', members', partners', or sole proprietor's equity. The financial statements also would include a schedule reconciling the firm's equity, as set forth in the statement of financial condition, to the firm's regulatory capital by detailing any goodwill or other intangible assets that are required to be deducted from the SD's or MSP's equity in order to compute its net tangible equity as required under proposed § 23.101. The schedule would further disclose the firm's minimum required capital under § 23.101 as of the end of the month or end of its fiscal year, as applicable, and the amount of regulatory capital it held at such date.

The proposed financial statements would be required to be prepared in accordance with generally accepted accounting principles as established in the United States, using the English language, and in U.S dollars. The unaudited financial statements would be required to be filed within 17 business days of the end of each month and the annual audited financial statements would be required to be filed within 90 days of the end of the SD's or MSP's fiscal year.

Proposed § 23.106 also would authorize the Commission to require a SD or MSP that was not subject to regulation by a prudential regulator to

<sup>47</sup> The term "designated self-regulatory organization" is defined at § 1.3(ff) as the self-regulatory organization of an FCM that has been delegated the responsibility of reviewing such FCM's compliance with minimum financial requirements and financial reports under a plan approved by the Commission pursuant to § 1.52.

<sup>48</sup> See 76 FR 6715 (Feb. 8, 2011). Proposed § 23.504 would require each SD or MSP to execute with its counterparties swap trading relationship documentation that address, among other things, the events of default or other termination events.

file with the Commission additional financial or operational information, and to prepare and to keep current ledgers or other similar records which show or summarize each transaction affecting the SD's or MSP's asset, liability, income, expense and capital accounts. These accounts would be required to be classified in accordance with United States generally accepted accounting principles. Proposed § 23.106 also would provide that the comprehensive data records supporting the information contained in the SD's or MSP's unaudited and annual audited financial reports must be maintained and retained for a period of five years pursuant to § 1.31 of the Commission's regulations.

## 2. SD and MSP Notice Filing Requirements

Proposed § 23.105 would require SDs and MSPs to provide the Commission, and the registered futures association of which the SDs or MSPs are members, with written notice in the event of certain enumerated financial or operational issues. The proposal is intended to provide the Commission and the appropriate registered futures association with timely notice of potentially adverse financial or operational issues that may warrant immediate attention and ongoing surveillance. The proposed notice requirements are comparable to the notice requirements currently existing for FCMs under § 1.12 of the Commission's regulations. Proposed § 23.105 would not be applicable to SDs and MSPs that are registered as FCMs. Such SDs and MSPs would be subject to the FCM notice requirements set forth in § 1.12 and, as noted above, such requirements are comparable to the proposed SD and MSP notice requirements set forth in § 23.105.

Proposed § 23.105 also would not be applicable to SDs or MSPs that are subject to the capital requirements of a prudential regulator, with the exception of two provisions that are discussed below. SDs and MSPs that are subject to capital requirements imposed by a prudential regulator would be subject to the applicable financial surveillance program of its prudential regulator. The first exception is the proposed requirement in § 23.105(c) that a SD or MSP that is subject to the capital rules of a prudential regulator file notice with the Commission and with a registered futures association if the SD or MSP fails to maintain compliance with the minimum capital requirements established by its prudential regulator. The second exception is set forth in proposed § 23.105(e) which requires an

SD or MSP to provide the Commission with notice if it fails to maintain current books and records.

While the prudential regulator will be assessing such an SD's or MSP's financial condition, the Commission believes that notice of a CFTC registrant's failure to maintain compliance with applicable minimum capital requirements is critical information that may impact the Commission's assessment and monitoring of the SD's or MSP's ongoing compliance with applicable non-capital CFTC regulations and the SD's or MSP's potential adverse impact on counterparties, including other Commission registered SDs and MSPs.

The proposed notice provisions would require a SD or MSP to give telephonic notice to the Commission, followed by a written notice, whenever it knows or should know that the firm does not maintain tangible net equity in excess of its minimum requirement under § 23.101. The SD or MSP also would be required to file documentation containing a calculation of its current tangible net equity with its notice of undercapitalization.

Proposed § 23.105 also would require a SD or MSP to file a written notice with the Commission whenever its tangible net equity fails to exceed 110 percent of its minimum tangible net equity requirement as computed under § 23.101. The SD or MSP would be required to file the notice within 24 hours of failing to maintain tangible net equity at a level that is 110 percent or more above its minimum tangible net equity requirement. Proposed § 23.105 also would require a registered SD or MSP to provide written notice of its failure to maintain current books and records, or of a substantial reduction in capital as previously reported to the Commission.

## *E. Proposed Financial Reporting and Other Amendments to FCM Regulations Relating to Customer Cleared Swap Transactions*

The Commission issued in December 2010 an advanced notice of proposed rulemaking seeking comment on possible models to implement section 4d(f)(2) of the CEA, as added by section 724 of the Dodd-Frank Act, which provides that funds deposited by customers to margin a cleared swap transaction shall not be commingled with the funds of the FCM or used to margin, guarantee or secure the positions of any other customer other than the customer that deposited the funds.<sup>49</sup> The Commission is proposing

in this release amendments to certain FCM financial reporting requirements in §§ 1.10, 1.12, and 1.16 of the Commission's regulations to address the segregation of swap customers' funds. The proposed financial reporting requirements are similar to the current financial reporting requirements that FCMs must meet with respect to the segregation of customer funds deposited under section 4d(a)(2) of the CEA as margin for futures contracts and options on futures contracts executed on a designated contract market. The Commission is further proposing to amend § 1.17 to provide that certain capital charges relating to undermarginated customer and noncustomer accounts extends to undermarginated customer and noncustomer accounts that carry cleared swap transactions.

### 1. Financial Reporting Requirements in § 1.10

Regulation 1.10 currently requires each FCM to prepare and to file unaudited financial condition reports, Form 1-FR-FCM, within 17 business days of the close of business each month. The Form 1-FR-FCM is required to be filed with the Commission and with the FCM's DSRO. An FCM also is required to file a Form 1-FR-FCM audited by an independent public accountant as of the end of the FCM's fiscal year. The audited financial Form 1-FR-FCM is required to be filed with the Commission and with the FCM's DSRO organization within 90 calendar days of the date of the FCM's fiscal year end.

Regulation 1.10(d) provides that each unaudited and audited Form 1-FR-FCM must include: a Statement of Financial Condition; a Statement of the Computation of Minimum Capital Requirements; a Statement of Income (Loss); a Statement of Changes in Ownership Equity; a Statement of Changes in Liabilities Subordinated to Claims of General Creditors Pursuant to a Satisfactory Subordination Agreement; a Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Commodity Exchanges; and a Statement of Secured Amounts and Funds Held in Separate Accounts for Foreign Futures and Options Customers Pursuant to § 30.7.

The Commission is proposing to amend §§ 1.10(d)(1) and (2) to include a new Statement of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer Accounts Under 4d(f) of the CEA in both the unaudited monthly Form 1-FR-FCM and the audited annual Form

<sup>49</sup> 75 FR 75162 (Dec. 2, 2010).

1–FR–FCM, respectively. This Statement is comparable to the statement required for the segregation of customer funds for trading on designated contract markets, the Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Commodity Exchanges. The proposed swap segregation statement is intended to provide an FCM that carries accounts for customers that maintain cleared swap positions with a schedule to document and to demonstrate its compliance with its obligation to treat, and deal with all money, securities, and property of any swap customer received to margin, guarantee, or secure a swap cleared by or through a derivatives clearing organization (including money, securities, or property accruing to swap customers as the result of such a swap) as belonging to the FCM's swap customers as required by section 4d of the CEA as amended by section 724 of the Dodd-Frank Act.

Pursuant to the proposal, each FCM would be required to include the Statement of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer Accounts Under 4d(f) of the CEA in both its unaudited monthly financial Form 1–FR–FCM filings and its annual audited Form 1–FR–FCM filings. In addition, each FCM would be required to include a reconciliation of any material reconciling items between the Statement of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer Accounts Under 4d(f) of the CEA contained in the audited annual Form 1–FR–FCM and the corresponding unaudited monthly financial Form 1–FR–FCM filed as of the FCM's year end date, or include a statement that there were no material reconciling items.

The Commission also is proposing to amend § 1.10(g)(2)(ii) to provide that an FCM's Statement of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer Accounts Under 4d(f) of the CEA will not be treated as exempt from mandatory public disclosure under the Freedom of Information Act and the Government in the Sunshine Act and Parts 145 and 147 of Chapter I of the Commission's regulations. This proposed amendment would treat the public disclosure of an FCM's financial information regarding the holding of funds for customers' cleared swap transactions in a manner that is consistent with the public disclosure of information regarding the segregation of customer funds for trading on U.S. commodity exchanges, and regarding

the securing of customer funds for trading on foreign boards of trade pursuant to § 30.7 of the Commission's regulations.

The Commission is further proposing a technical amendment to § 1.10(c)(1), which directs an FCM, and other registrants, to file the reports and other information required by § 1.10 with Commission's Regional Office with jurisdiction over the registrant's principal place of business. Commission § 140.02 establishes the jurisdiction of each Regional Office over filing requirements of registrants based upon the geographic location of the principal business office of the registrants. In order to clarify where a registrant should file required financial information with the Commission, the Commission proposes to amend § 1.10(c) to include a reference to the geographic listing in § 140.02 of the Commission's regulations.

Except for the technical amendment described above, the other proposed amendments implementing reporting requirements for funds of cleared swap customers would not be adopted or effective unless the Commission adopts, after issuing proposed rules for comment, regulations establishing requirements for collateral posted by cleared swap customers under section 4d(f) of the CEA.

## 2. Audited Financial Statement Requirements in § 1.16

The Commission is proposing to amend § 1.16 of the Commission's regulations. Regulation 1.16 sets forth the qualifications that an independent public accountant must meet to be qualified to conduct the annual examinations of an FCM as required by § 1.10(b)(1)(ii), and establishes the minimum audit objectives of the independent accountant's examination of an FCM.

Regulation 1.16(c)(2) provides that the accountant's report on the audit of an FCM must state whether the audit was made in accordance with generally accepted auditing standards and must designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case which have been omitted and the reason for the omission of such procedures. Regulation 1.16(c)(3) further provides that the accountant's report must clearly state the opinion of the accountant with respect to the financial statements and schedules covered by the report and the accounting principles and practices reflected therein.

Regulation 1.16(d) sets forth the required audit objective of the accountant's examination of the

financial statements of an FCM and provides, in relevant part, that the audit must be made in accordance with generally accepted auditing standards and must include a review and appropriate tests of the accounting systems, the internal accounting controls, and the procedures for safeguarding customer and firm assets in accordance with the CEA and Commission regulations, since the last examination date. The scope of the audit and review of the FCM's accounting systems, the internal accounting controls, and procedures for safeguarding customer and firm assets must be sufficient to provide reasonable assurance that any material inadequacies existing at the dates of the examination in (1) The accounting systems, (2) the internal accounting controls, and (3) the procedures for safeguarding customer and firm assets (including the segregation requirements of section 4d(a)(2) of the CEA and Commission regulations, and the secured amount requirements of the CEA and part 30 of the Commission's regulations) will be discovered. Regulation 1.16(d) further provides that as specified objectives the audit must include reviews of the practices and procedures followed by the FCM in making daily computations of the segregation requirements of section 4d(a)(2) of the CEA and the secured amount requirements of part 30 of the Commission's regulations.

The proposed amendments would revise § 1.16 to include the proposed new Statement of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer Accounts Under 4d(f) of the CEA within the explicit audit scope of the examination of an FCM. Specifically, the Commission is proposing to amend the term "customer" as defined in § 1.16(a)(4) to include an FCM's swap customers that engage in cleared swap transactions. The proposed amendment would bring cleared swap positions carried in swap customers' accounts explicitly within the scope of the accountant's audit objectives, as set forth in § 1.16(d), which includes the review and appropriate testing of the accounting systems, the internal accounting control, and the procedures for safeguarding customer and firm assets.

The Commission also proposes to amend § 1.16(d)(1) to explicitly provide that the scope of the independent accountant's review of the accounting systems, internal accounting controls, and procedures for safeguarding customer assets must be sufficient to provide reasonable assurance that any

material inadequacy existing as of the date of the examination in (1) the accounting system, (2) the internal accounting controls, and (3) the procedures for safeguarding customer and firm assets will be discovered includes the cleared swap segregation requirements as set forth in section 4d(f) of the CEA. The Commission further proposes to amend § 1.16(d)(2) to include as a material inadequacy in the accounting systems, internal accounting controls, and the procedures for the safeguarding customer and firm assets that are required to be reported to the Commission any conditions which contribute substantially to or, if appropriate corrective action is not taken, could reasonably be expected to result in a violation of the requirement to segregate swap customers' funds.

The proposed amendments to § 1.16 would not be adopted or effective unless the Commission adopts, after issuing proposed rules for comment, regulations establishing segregation requirements for collateral posted by cleared swap customers under section 4d(f) of the CEA. As previously noted, the Commission published an advanced notice of proposed rulemaking on this topic on December 2, 2010.

### 3. Early Warning Requirements in § 1.12

Regulation 1.12 requires an FCM to provide notice to the Commission and to the FCM's DSRO of certain material financial or operational events. The self-reporting of these financial and operational events by an FCM is a key to the Commission's and self-regulatory organizations' financial surveillance oversight programs as such notices may lead to the discovery of accounting, recordkeeping, risk management, or other regulatory failures that require prompt attention to safeguard customer funds and to protect the clearing system.

Regulation 1.12(b) is referred to as the "early warning capital provisions" and currently requires an FCM to file written notice with the Commission and with its DSRO whenever its adjusted net capital is less than: (1) 150 percent of the minimum dollar amount of adjusted net capital required by § 1.17(a)(1)(i)(A); (2) 150 percent of the amount of adjusted net capital required by a registered futures association of which the FCM is a member (except if the registered futures association has adopted a margin-based capital rule, then the FCM is required to file a written notice if its adjusted net capital is less than 110 percent of its minimum adjusted net capital requirement as computed under the registered futures association's margin-based capital requirement); or (3) 110 percent of the

FCM's margin-based capital requirement as computed under § 1.17(a)(1)(i)(B). An FCM that also is registered with the SEC as a broker or dealer is required to provide the Commission with written notice whenever it fails to maintain net capital (as defined in SEC Rule 15c3-1) in an amount that exceeds the "early warning level" set forth in SEC Rule 17a-11(c). The early warning capital provisions are intended to provide the Commission and the FCM's DSRO with prompt notice of potential adverse financial or operational issues that may impact the FCM's ability to meet its obligations to its customers and the clearing system, and provide an opportunity for Commission and DSRO staff to review the financial condition of an FCM that does not maintain a significant amount of excess adjusted net capital prior to the firm falling under the minimum net capital requirement.

The Commission is proposing to amend § 1.12(b) by adding a new paragraph (b)(5) to require any FCM that also is registered with the SEC as a SSD or a MSSP to file a notice with the Commission if the SSD or MSSP fails to maintain net capital above the minimum "early warning level" established by rules or regulations of the SEC. The proposed new paragraph (b)(5) would provide the Commission and the FCM's DSRO with an opportunity to review the financial condition of an FCM and, if necessary, to assess possible courses of regulatory action to protect customer funds and to review potential financial risk presented by the FCM to the clearing system.

The Commission also is proposing to amend § 1.12(f)(4). Regulation 1.12(f)(4) requires an FCM to provide immediate notice by telephone communication, followed by immediate written confirmation, whenever any commodity futures, options, cleared swaps, or other Commission regulated account that the FCM carries is subject to a margin call, or a call for other deposits required by the FCM, that exceeds the FCM's excess adjusted net capital determined under § 1.17, and the call for additional deposits has not been answered by the close of business on the day following the issuance of the call.

The Commission intends for all of the notice provisions of § 1.12 to apply, as applicable, to FCMs that carry swap customer accounts. The Commission, however, believes it is necessary to amend § 1.12(f)(4) due to the reference in the regulation to "commodity interest" accounts. The term "commodity interest" is defined in § 1.3(yy) as any contract for the purchase or sale of a commodity for

future delivery and any contract, agreement, or transaction submitted under section 4c of the CEA. To avoid any confusion and to ensure that an FCM provides the Commission and its self-regulatory organizations with appropriate early warning notice, the Commission is proposing to amend § 1.12(f)(4) to require notice of a failure of the owner of any commodity futures, option, swap, or other Commission regulated account carried by the FCM to meet a margin call that exceeds the FCM's excess adjusted net capital. The proposed amendment is intended to ensure that an FCM is required to file a written notice if a customer account containing cleared swap transactions fails to meet a margin call that exceeds the FCM's excess adjusted net capital.

The Commission also is proposing to amend § 1.12(h) to require an FCM to provide the Commission and its DSRO with immediate notice by telephone, confirmed immediately in writing, if the amount of funds on deposit in accounts segregated for the benefit of the FCM's swap customers is less than the amount that the FCM is required to hold in such accounts. The proposed amendment to § 1.12(h) would impose an obligation upon the FCM that is consistent with an FCM's current obligation to provide immediate telephone notice, confirmed by writing, whenever the FCM fails to maintain the amount of funds in customer segregated or secured accounts as required by § 1.20 and § 30.7, respectively.

### 4. Amendments to 1.17 for FCMs With Cleared Swaps Customers

The Commission proposes to amend Commission regulation 1.17(c)(2)(i) by adding references to cleared swap customers to this regulation, which currently provides that FCMs must exclude from current assets any unsecured commodity futures and options account (as amended, this would include cleared swaps customers and other Commission regulated accounts) containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only: *Provided, however, Deficits or debit ledger balances in unsecured customers', non-customers', and proprietary accounts, which are the subject of calls for margin or other required deposits may be included in current assets until the close of business on the business day following the date on which such deficit or debit ledger balance originated providing that the account had timely satisfied, through the deposit of new funds, the previous day's debit or deficits, if any, in its*

entirety. The Commission is also proposing to add similar references to cleared swap accounts of customers in §§ 1.17(c)(5)(viii) and (ix), which requires certain capital charges when the accounts of customer or noncustomers are undermargined.

The Commission also is proposing to amend provisions in § 1.17(c)(5)(v) that require an FCM to incur a capital charge not only on its proprietary securities included in the FCM's calculation of adjusted net capital, but also for securities held in customer segregated accounts when such securities were not deposited in segregation by a specific customer (i.e., the securities were purchased with cash held in the customer segregated accounts). The purpose of both of these capital requirements is to ensure that the FCM maintains a capital cushion in order to cover potential decreases in the value of the securities. The proposed rule would further require the FCM to incur a capital charge for any securities purchased by the FCM using funds belonging to the FCM's customers and held in the secured accounts for customers trading on foreign markets pursuant to § 30.7 or in segregated accounts for cleared swap customers pursuant to section 4d(f) of the CEA.

#### *C. Request for Comment*

The Commission requests comment on all aspects of the proposed capital and financial reporting regulations. In particular, the Commission request comment on the following:

(1) The Commission's capital proposal for SDs and MSPs includes a minimum dollar level of \$20 million. A non-bank SD or MSP that is part of a U.S. bank holding company would be required to maintain a minimum of \$20 million of Tier 1 capital as measured under the capital rules of the Federal Reserve Board. An SD or MSP that also is registered as an FCM would be required to maintain a minimum of \$20 million of adjusted net capital as defined under § 1.17. In addition, an SD or MSP that is not part of a U.S. bank holding company or registered as an FCM would be required to maintain a minimum of \$20 million of tangible net equity, plus the amount of the SD's or MSP's market risk exposure and OTC counterparty credit risk exposure.

The Commission requests comment on the amount of the proposed minimum dollar amount of regulatory capital. Should the minimum dollar amount of capital be set at a higher or lower level? Is a consistent \$20 million of minimum regulatory capital appropriate for all SDs and MSPs?

(2) The Commission is proposing in § 23.101 to incorporate bank capital requirements into the CFTC capital requirements by requiring non-bank SDs and MSPs that are part of a U.S. bank holding company to meet bank capital requirements. The Commission requests comment on the appropriateness of the proposed incorporation of banking capital regulations in the terms of § 23.101 for such SDs or MSPs.

(3) The Commission is proposing in § 23.101 to establish a regulatory capital requirement that is based upon tangible net equity if the SD or MSP is not: (1) An FCM; (2) part of a U.S. bank holding company; or (3) designated a SIFI. Proposed § 23.102 provides that tangible net equity shall be determined under generally accepted accounting principles and shall exclude goodwill and other intangible assets. The Commission requests comment on the proposed definition of tangible net equity. Should all intangible assets be excluded?

(4) The Commission requests comment on the appropriateness of establishing a minimum regulatory capital requirement based upon tangible net equity for all SDs and MSPs that are not also registered as FCMs, part of U.S. bank holding companies, or designated as SIFIs. Specifically, is the tangible net equity method appropriate for SDs and MSPs that are primarily engaged in non-financial operations? Is the tangible net equity method appropriate for SDs and MSPs that are primarily engaged in financial operations? Should minimum regulatory capital requirements be established under a different method for SDs and MSPs that are primarily financial or trading entities, such as funds or trading firms? Should the Commission impose additional capital or alternative capital requirements on financial firms that qualify to use the tangible net equity approach? What additional or alternative capital requirements would be appropriate for such firms?

(5) The proposed tangible net equity capital computation does not require an SD or MSP to maintain the same level of highly liquid assets as the Commission's current capital requirement for FCMs. Specifically, the tangible net equity capital requirement would allow an SD or MSP to include fixed assets and other illiquid assets in meeting its regulatory capital requirement. Should the capital requirement for the tangible net equity method include a liquidity component that would effectively require an SD or MSP to hold a defined amount of highly liquid assets? What factors should the

Commission consider in adopting a liquidity requirement?

(6) One possible approach to a minimum liquidity requirement is to require an SD or MSP to hold unencumbered liquid assets equal to the sum of the total amount of initial margin that the SD or MSP would have to post with a counterparty for all uncleared swap transactions and the total amount of any unpaid variation margin that the SD or MSP owes to any counterparty. Liquid assets that could qualify for purposes of the liquidity requirement could be limited to cash, obligations guaranteed by the U.S., and obligations of government sponsored entities. Such assets could be part of the general operating assets of the SD or MSP and would not have to be held or "segregated" in any special account by the SD or MSP. Assets posted by the SD or MSP with custodians as margin on uncleared swap transactions could be included in meeting the liquidity requirement. The qualifying liquid assets also could be subject to market value haircuts set forth in the proposed margin rule § 23.157(c). The Commission request comment on this approach to the computation of a liquidity requirement. If the Commission were to adopt such a liquidity requirement, would it be appropriate to incorporate minimum margin thresholds that would have to be exceeded before the SD or MSP was subject to the liquidity requirement? For example, should the Commission consider a rule that would impose a liquidity requirement only if the SD's or MSP's initial and variation margin obligations on uncleared swaps exceeded a minimum threshold? How would such thresholds be determined? What are the appropriate market value haircuts that should be imposed?

(7) The Commission is proposing to amend § 1.17 to specify capital charges for uncleared swap transactions held by an FCM. The Commission request comment on the appropriateness of the proposed calculations. Furthermore, the Commission request comment on viable alternative methods to compute capital charges for uncleared swap positions. Specifically, the Commission requests comment on whether capital charges should be based upon the margin calculations that would be required to be conducted under Part 23 of the proposed regulations.

(8) SDs and MSPs that also are registered as FCMs are required under § 1.17(c)(2)(ii) to exclude unsecured receivables from counterparties to OTC transactions in determining their adjusted net capital under § 1.17. Certain SDs or MSPs that also are

registered as FCMs, however, may elect to use internal models to compute credit risk charges under § 1.17(c)(6) if they comply with the Commission's requirements set forth in § 1.17(c)(6) and have previously obtained an order from the SEC approving the use of such models for purpose of computing regulatory capital. In addition, proposed § 1.17(c)(7) would permit SDs and MSPs that also are registered FCMs to seek Commission approval under § 23.103 to use internal models to compute credit risk charges for OTC derivatives transactions in lieu of the current 100 percent capital charge for unsecured receivables.

The Commission seeks comment on the appropriateness of allowing SDs and MSPs that also are registered as FCMs and have received approval to use internal models to compute their capital requirements to use such models to reduce the 100 percent capital charge for unsecured receivables arising from uncleared OTC swap transactions. The Commission requests comment on this issue as it is concerned that SDs and MSPs may have significant unsecured receivables for uncleared swap transactions that are not subject to variation margin requirements (e.g., bilateral swap positions entered into prior to the effective date of the Dodd-Frank Act). If such SDs and MSPs also were to register as FCMs, the unsecured receivables could have a significant impact on the financial condition of the FCMs and adversely impact the FCMs' customers if the debtor were to default.

(9) The Commission solicits comment on all of the proposed rules related to the use of internal models for computing market risk and counterparty credit risk for capital purposes. Specifically, comment is requested regarding what resources, expertise, and capacity SDs and MSPs ought to have in order to be approved to use internal models.

(10) The Commission solicits comment regarding whether it is appropriate to permit SDs and MSPs to use internal models for computing market risk and counterparty credit risk charges for capital purposes if such models have been approved by a foreign regulatory authority and are subject to periodic assessment by such foreign regulatory authority. What criteria should the Commission consider in assessing whether to approve or to accept a model approved by a foreign regulatory authority?

(11) The Commission previously has proposed regulations that require each SD and MSP to promptly report to the Commission any swap valuation dispute not resolved within one business day if

the counterparty is SD or MSP, or five business days if the counterparty is not an SD or MSP.<sup>50</sup> The Commission requests comment on whether it is appropriate to require an SD or MSP to take a capital charge for the amount of any valuation dispute. Should the SD or MSP take a capital charge immediately upon learning of a valuation dispute, or should the capital charge be taken after one business day or five business days depending on whether the counterparty is an SD/MSP or a non-SD/MSP, respectively? What role should margin deposits have on the calculation of the capital charge? Are there any other issues that the Commission should consider?

(12) What are the costs to counterparties resulting from the capital requirements being proposed by the Commission?

(13) FCMs currently file monthly unaudited financial statements with the Commission, and the Commission is proposing to extend this monthly filing requirement to SDs and MSPs. The Commission seeks comment regarding the frequency of the filing of SD and MSP unaudited financial statements. Specifically, what challenges and costs are associated with monthly financial statement filings? Would the Commission receive adequate financial information from SDs and MSPs if they filed on a quarterly basis? Are there other financial statements or schedules other than, or in addition to, the proposed statements and schedules that the Commission should require from SDs and MSPs?

(14) The Commission is proposing in § 23.106(i) to make available to the public regulatory capital information provided by each SD and MSP in their financial statement filings with the Commission. Specifically, the Commission would make publicly available for each SD or MSP its minimum regulatory capital requirement, the amount of its regulatory capital, and any excess or deficiency in its regulatory capital. The disclosure of the regulatory capital information of SDs and MSPs is consistent with the disclosure of FCM financial information.

### III. Conforming Amendments to Delegated Authority Provisions

Commission §§ 1.10, 1.12, and 1.17 reserve certain functions to the Commission, the greater part of which the Commission has delegated to the Director of the Division of Clearing and Intermediary Oversight through the

provisions of § 140.91 of the Commission's regulations. The Commission proposes to amend § 140.91 to provide similar delegations with respect to functions reserved to the Commission in Part 23.

Proposed § 23.101(c) would require an SD or MSP to be in compliance with the minimum regulatory capital requirements at all times and to be able to demonstrate such compliance to the Commission at any time. Proposed § 23.103(d) would require an SD or MSP, upon the request of the Commission, to provide the Commission with additional information regarding its internal models used to compute its market risk exposure requirement and OTC derivatives credit risk requirement. Proposed § 23.105(a)(2) would require an SD or MSP to provide the Commission with immediate notification if the SD or MSP failed to maintain compliance with the minimum regulatory capital requirements, and further authorizes the Commission to request financial condition reporting and other financial information from the SD or MSP. Proposed § 23.105(d) authorizes the Commission to direct an SD or MSP that is subject to capital rules established by a prudential regulator, or has been designated a systemically important financial institution by the Financial Stability Oversight Council and is subject to capital requirements imposed by the Board of Governors of the Federal Reserve System to file with the Commission copies of its capital computations for any periods of time specified by the Commission.

The Commission is proposing to amend § 140.91 to delegate to the Director of the Division of Clearing and Intermediary Oversight, or the Director's designee, the authority reserved to the Commission under proposed §§ 23.101(c), 23.103(d), and 23.105(a)(2) and (d). The delegation of such functions to staff of the Division of Clearing and Intermediary Oversight is necessary for the effective oversight of SDs and MSPs compliance with minimum financial and related reporting requirements. The delegation of authority also is comparable to the authorities currently delegated to staff of Division of Clearing and Intermediary Oversight under § 140.91 regarding the supervision of FCMs compliance with minimum financial requirements.

The following provisions relating to margin requirements are also proposed to be included in Part 140, in order to provide within Part 140 a complete listing of the functions reserved to the Commission under Subpart E that are

<sup>50</sup> See, proposed § 23.504(e) at 76 FR 6715 (Feb. 8, 2011).

proposed to be delegated to the Director of the Division of Clearing and Intermediary Oversight. As proposed in this release, Part 140 would include delegations for the Commission's ability under proposed § 23.155(b)(4)(ii) and (iii), with respect to initial margin, and under § 23.155(c)(1) and (2) with respect to variation margin, to require at any time that a covered swap entity ("CSE") provide further data or analysis concerning a model or methodology used to calculate margin, or to modify a model or methodology to address potential vulnerabilities. A similar delegation is provided for the Commission's ability under § 23.155(c)(4) to require at any time that the CSE post or collect additional margin because of additional risk posed by a particular product, or because of additional risk posed by a particular party to the swap.

The Commission also is proposing in this release to delegate authority with respect to the Commission's recently proposed § 23.157(d), which would authorize the Commission to take the following actions regarding margin assets: (i) Require a CSE to provide further data or analysis concerning any margin asset posted or received; (ii) require a CSE to replace a margin asset posted to a counterparty with a different margin asset to address potential risks posed by the asset; (iii) require a CSE to require a counterparty that is an SD, MSP, or a financial entity to replace a margin asset posted with the CSE with a different margin asset to address potential risks posed by the asset; (iv) require a CSE to provide further data or analysis concerning margin haircuts; or (v) require a CSE to modify a margin haircut applied to an asset received from an SD, MSP, or a financial entity to address potential risks posed by the asset.

Finally, under proposed § 23.158(c), the Commission may at any time require a CSE to provide further data or analysis concerning any custodian holding collateral collected by the CSE. Further, the Commission may at any time require a CSE participant to move assets held on behalf of a counterparty to another custodian to address risks posed by the original custodian. The Commission is proposing also to include delegations in Part 140 with respect to these functions reserved to the Commission under § 23.158(c). Each of the proposed delegations would be to the Director of the Division of Clearing and Intermediary Oversight, with the concurrence of General Counsel. The Commission requests comment on each of the proposed amendments to § 140.91 described in this release.

#### IV. Related Matters

##### A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA")<sup>51</sup> requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and if so, provide a regulatory flexibility analysis respecting the impact. The Commission has already established certain definitions of "small entities" to be used in evaluating the impact of its rules on such small entities in accordance with the RFA.<sup>52</sup> SDs and MSPs are new categories of registrant. Accordingly, the Commission has not previously addressed the question of whether such persons are, in fact, small entities for purposes of the RFA.

The Commission previously has determined that FCMs should not be considered to be small entities for purposes of the RFA. The Commission's determination was based in part upon their obligation to meet the minimum financial requirements established by the Commission to enhance the protection of customers' segregated funds and protect the financial condition of FCMs generally.<sup>53</sup> Like FCMs, SDs will be subject to minimum capital and margin requirements, and are expected to comprise the largest global financial firms. The Commission is required to exempt from designation entities that engage in a *de minimis* level of swap dealing in connection with transactions with or on behalf of customers. Accordingly, for purposes of the RFA for this and future rulemakings, the Commission is hereby proposing that SDs not be considered "small entities" for essentially the same reasons that FCMs have previously been determined not to be small entities.

The Commission also has previously determined that large traders are not "small entities" for RFA purposes.<sup>54</sup> The Commission considered the size of a trader's position to be the only appropriate test for purposes of large trader reporting.<sup>55</sup> MSPs maintain substantial positions in swaps, creating substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. Accordingly, for purposes of the RFA for this and future rulemakings, the Commission is hereby proposing that MSPs not be considered "small entities" for essentially the same reasons

that large traders have previously been determined not to be small entities.

The Commission is carrying out Congressional mandates by proposing these rules. The Commission is incorporating capital requirements of SDs and MSPs into the existing regulatory capital frameworks. In so doing, the Commission has attempted to formulate requirements in the manner that is consistent with the public interest and existing regulatory requirements. Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant economic impact on a substantial number of small entities.

##### B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA)<sup>56</sup> imposes certain requirements on Federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. This proposed rulemaking, as well as the proposed rulemaking on margin requirements for uncleared swaps, which was first published in the **Federal Register** on April 28, 2011, and is subject to a comment period that is being extended to correspond with the comment period for these proposed capital requirements, contain collections of information for which the Commission has previously sought or received control number from the Office of Management and Budget ("OMB"). This proposed rulemaking, as well as the proposed rulemaking on margin requirements for uncleared swaps, also would result in new mandatory collections of information within the meaning of the PRA. Therefore, pursuant to the PRA, the Commission is submitting a PRA proposal for both the capital and the margin rules, in the form of an amendment to the Commission's existing collection under OMB Control Number 3038-0024, to OMB for its review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.

##### 1. Collections of Information

###### a. Schedule to Form 1-FR-FCM

The Commission has included as an exhibit to this proposed rulemaking the additional schedule that the proposed amendments to § 1.10 would require FCMs to file with respect to the cleared swaps of their customers. The collection of information required by the amended § 1.10 are necessary for the Commission's oversight of the FCM's compliance with its minimum financial requirements under the CEA and

<sup>51</sup> 5 U.S.C. 601 *et seq.*

<sup>52</sup> 47 FR 18618 (Apr. 30, 1982).

<sup>53</sup> *Id.* at 18619.

<sup>54</sup> 47 FR at 18620.

<sup>55</sup> *Id.*

<sup>56</sup> 44 U.S.C. 3501 *et seq.*

implementing regulations of the Commission. The increase in the annual reporting burden associated with OMB Collection of Information Control No. 3038-004 would not be significant, as the Commission estimates that a small percentage of FCMs (approximately 21 FCMs) would be required to file the schedule, and the schedule will be included in the Form 1-FR-FCM that they must already file with the Commission. The requirements in part 23 also require monthly and annual financial reports to be filed with the Commission. The Commission estimates that no more than 250 SDs and 50 MSPs would be required to file such reports. The estimated burden of the proposed part 23 financial reporting requirements was calculated as follows:

- *Estimated number of respondents:* 300.
- *Reports annually by each respondent:* 13.
- *Total annual responses:* 3,900.
- *Estimated average number of hours per response:* 2.75.
- *Annual reporting burden:* 10,725.

#### b. Approval of Margin Models

In the rulemaking proposing margin requirements for uncleared swaps, the Commission would require any SD or MSP to file its margin model with the Commission for approval. Each filing must include an explanation of the manner in which the model meets the requirements of the margin rules; the mechanics of, theoretical basis of, and empirical support for the model; and independent third party validation of the model. The Commission would process filings for models that comply with the minimum requirements established in the margin rules, or that are currently used by a derivatives clearing organization for margining cleared swaps, that are currently used by an entity subject to regular assessment by a prudential regulator for margining uncleared swaps, or that are made available for licensing by a vendor. At a later date, at which point the Commission may have sufficient resources to evaluate such models, the Commission may begin processing filings of proprietary models to be used by SDs and MSPs.

The Commission cannot estimate with precision the frequency with which margin model filings will be made by SDs and MSPs annually, as an SD or MSP may be expected to make one initial filing and then to change or supplement its margin model occasionally. In an attempt to provide conservative estimates, the calculations below have been developed in accordance with the Commission's

estimate that there will be 250 SDs and 50 MSPs that will register with it, and with the assumption that 40% of registrants will make 3 model filings per year with respect to the margining of various swap instruments. The estimated average number of hours per filing includes not only preparation of the filing, but also the time associated with third party evaluation of the model.

*Estimated number of respondents:* 300.

*Frequency of filings:* One initial response, and then occasional filings.

*Filings annually by each respondent:* One initial filing, and 1 to 3 occasional filings annually.

*Total annual filings:* 300 initial filings, and 360 occasional filings annually.

*Estimated average number of hours per filing:* 60 hours.

*Annual filing burden:* 21,600.

#### c. Approval of Capital Models

In this rulemaking proposing capital requirements for SDs and MSPs, the Commission would permit SDs and MSPs to use internal models to calculate minimum capital requirements, subject to the submission of an application to the Commission for approval of the internal model. The application must address several factors, including: (1) Identifying the categories of positions that the SD or MSP holds in its proprietary accounts; (2) describing the methods that the SD or MSP will use to calculate its market risk and credit risk capital requirements; (3) describing the internal models; and (4) describing how the SD or MSP will calculate current exposure and potential future exposure. The SD or MSP also must explain the extent to which the models have been reviewed and approved by the Federal Reserve Board or, as applicable, the SEC.

The Commission cannot estimate with precision the frequency with which SDs and MSPs will file applications with the Commission for the use of internal capital models. At present, only those SDs or MSPs that are subject to prudential regulation or regulation by the SEC will be permitted to use internal models. The Commission cannot presently determine which SDs and MSPs will be subject either to prudential regulation or regulation by the SEC, how many of those SDs or MSPs will file applications with the Commission, or how frequently those SDs and MSPs may submit applications with respect to revised or new models. The Commission additionally cannot presently determine at what time it may be able to consider applications by SDs

and MSPs that will be subject solely to Commission regulation, or how many of those SDs and MSPs may eventually file applications with the Commission.

In an attempt to provide conservative estimates, the calculations below have been developed in accordance with the Commission's estimate that there will be 250 SDs and 50 MSPs that will register with it, and that 70% of those SDs and MSPs will file initial applications with the Commission for the use of an internal model. The Commission additionally estimates that in subsequent years, it will be asked to review 30 capital models annually.

- *Estimated number of respondents:* 300.

- *Frequency of responses:* One initial response and then occasional filings.

- *Reports by each respondent:* 1 filing occasionally.

- *Total responses:* 210 initial applications and 30 applications annually.

- *Estimated average number of hours per response:* 30 for applicants presently using internal capital models, 60 for each application not subject to approval by a prudential regulator or the SEC.

- *Reporting burden:* 630 hours initial applications, and up to 1,800 hours annually.

#### d. Approval of Counterparty Credit Ratings

This proposed capital rulemaking permits an SD or MSP, which is required to apply a credit risk factor to its counterparties, to apply to the Commission for approval to assign internal individual ratings to each of its counterparties, or for an affiliated bank or affiliated broker-dealer to do so. The Commission does not have experience with such an application process, and therefore cannot estimate with precision the burden hours associated with this regulatory provision. In an attempt to provide conservative estimate, the Commission estimates that it may receive up to 4 applications per year from 70% of the 300 anticipated SDs and MSPs that may use internal application models, and that the preparation and submission of these applications would consume up to 8 hours per application. At such time as the Commission is able to approve internal models of SDs and MSPs that are not subject to prudential regulation, the Commission estimates that it will receive up to 4 applications per year from an additional 20% of SDs and MSPs.

- *Estimated Number of Respondents:* 270.

- *Frequency of Responses:* Up to 4 applications annually.

- *Total Annual Responses:* 840 applications initially, and an additional 240 applications eventually.

- *Estimated average number of hours per response:* 8.

- *Annual Reporting burden:* 6,720 initially, plus an additional 1,920 eventually.

**e. Recordkeeping and Occasional Reporting Obligations**

In this proposed capital rulemaking, the Commission would require SDs and MSPs to present certain information to the Commission on request. Proposed § 23.104 would authorize the Commission to require an SD or MSP that is not subject to prudential regulation to file with the Commission additional financial or operational information, and to prepare and to keep current ledgers or other similar records which show or summarize each transaction affecting the SD's or MSP's asset, liability, income, expense and capital accounts. Under proposed § 23.105, the Commission would require each registered SD or MSP subject to prudential supervision, or each SD or MSP designated as a SIFI, to provide to the Commission, on request, copies of its capital computations and accompanying schedules and other supporting documentation demonstrating compliance with the applicable prudential regulator with jurisdiction over the SD or MSP.

SDs and MSPs additionally will be required to keep comprehensive data records supporting the information contained in the SD's or MSP's unaudited and annual audited financial reports for a period of five years. SDs and MSPs using internal capital models also would be obligated to make and keep current a record of the basis for the credit rating it applies to each of its counterparties for a period of five years.

The Commission is unable to estimate with precision how many requests it will make of SDs and MSPs under proposed §§ 23.104 and 23.105 annually. Additionally, it is unable to estimate with precision the number of records an SD or MSP will be obligated to keep related to the credit rating it applies to its counterparties. In an attempt to provide conservative estimates, the Commission anticipates that it will make 200 requests under §§ 23.104 and 23.105 in the aggregate annually, and that responding to those requests would consume 5 burden hours. It is estimated that recordkeeping of monthly and annual reports, estimated at 3,900 records, would consume .4 burden hours. And, it is estimated that .7 burden hours would be consumed by 210 SDs and MSPs

initially and 270 SDs and MSPs eventually to keep credit rating bases for up to an average of 75 counterparties annually.

**i. Occasional Reporting Obligations**

- *Estimated Number of Respondents:* 200.

- *Frequency of Responses:* Occasional.

- *Total Annual Responses:* 200.

- *Estimated average number of hours per response:* 5 hours.

- *Annual Reporting burden:* 1,000.

**ii. Recordkeeping Obligations**

- *Estimated Number of Recordkeepers:* 300.

- *Estimated Number of Records per Recordkeeper:* Average 94 initially and 89 eventually.

- *Total Annual Recordkeeping:* 19,650 initially and 24,150 eventually.

- *Estimated average number of hours for recordkeeping:* .4 burden hours for 3,900 records, .7 burden hours for 15,750 records initially, and .7 burden hours for 16,905 records eventually.

- *Annual recordkeeping burden:* 12,585 initially and 13,393 eventually.

**f. Occasional Notice Filings**

Finally, the proposed capital rulemaking contains provisions that would require registered SDs and MSPs to provide notice to the Commission in the event that certain material financial or operational events occur. These include the notice filing obligations contained in § 1.12 and in proposed §§ 23.104 and 23.105. In an attempt to provide conservative estimates, the Commission anticipates receiving up to 90 occasional notices annually and that the burden of providing those notices will consume up to .7 burden hours.

- *Estimated Number of Respondents:* 90.

- *Frequency of Responses:* Occasional.

- *Total Annual Responses:* 90.

- *Estimated average number of hours per response:* .7.

- *Annual Reporting burden:* 63.

**2. Information Collection Comments**

The Commission invites the public and other Federal agencies to comment on any aspect of the proposed information collection requirements discussed above. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission will consider public comments on such proposed requirements in:

- Evaluating whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have a practical use;

- Evaluating the accuracy of the estimated burden of the proposed information collection requirements, including the degree to which the methodology and the assumptions that the Commission employed were valid;

- Enhancing the quality, utility, and clarity of the information proposed to be collected; and

- Minimizing the burden of the proposed information collection requirements on FCMs, SDs, and MSPs, including through the use of appropriate automated, electronic, mechanical, or other technological information collection techniques, e.g., permitting electronic submission of responses.

Copies of the submission from the Commission to OMB are available from the CFTC Clearance Officer, 1155 21st Street, NW., Washington, DC 20581, (202) 418-5160 or from <http://RegInfo.gov>. Organizations and individuals desiring to submit comments on the proposed information collection requirements should send those comments to the OMB Office of Information and Regulatory Affairs at:

- The Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503, Attn: Desk Officer of the Commodity Futures Trading Commission;
- (202) 395-6566 (fax); or
- [OIRAsubmissions@omb.eop.gov](mailto:OIRAsubmissions@omb.eop.gov) (e-mail).

Please provide the Commission with a copy of submitted comments so that all comments can be summarized and addressed in the final rule preamble. Please refer to the **ADDRESSES** section of this rulemaking and the margin rulemaking for instructions on submitting comments to the Commission. OMB is required to make a decision concerning the proposed information collection requirements between thirty (30) and sixty (60) days after publication of the NPRM in the **Federal Register**. Therefore, a comment to OMB is best assured of receiving full consideration if OMB (as well as the Commission) receives it within thirty (30) days of publication of this NPRM.

**C. Cost-Benefit Analysis**

Section 15(a) of the CEA<sup>57</sup> requires the Commission to consider the costs and benefits of its action before issuing a rulemaking under the CEA. By its terms, Section 15(a) does not require the Commission to quantify the costs and benefits of a rule or to determine whether the benefits of the rulemaking outweigh its costs; rather, it simply

<sup>57</sup> 7 U.S.C. 19(a).

requires that the Commission “consider” the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the CEA.

*Summary of proposed requirements.* The proposed regulations would implement provisions in Sections 4s(e), (d), and (f) of the Act, which were added by Section 731 of the Dodd-Frank Act. Sections 4s(e), (d), and (f) authorize the Commission to adopt regulations imposing capital requirements and financial condition reporting requirements on SDs and MSPs. The proposed capital requirements would only apply to SDs and MSPs that are not subject to regulation by a prudential regulator. The financial condition reporting requirements primarily apply to SDs and MSPs that are not subject to regulation by a prudential regulator.

The proposed regulations also amend existing requirements for FCMs. Section 724 of the Dodd-Frank Act adds a new Section 4d(f) of the Act, which requires an FCM to segregate from its own assets any money, securities, and property deposited by swap customers to margin, guarantee, or secure swap transactions cleared by or through a derivatives clearing organization. The proposed regulations would require each FCM holding customer funds for cleared swap customers to prepare a monthly Statement of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer Accounts under 4d(f) of the CEA (Cleared Swap Segregation Statement). The Cleared Swap Segregation Statement would be filed as part of the FCMs Form 1-FR-FCM. The proposal also would amend the notice filing requirements and capital requirements for FCMs.

#### Structure of the Analysis

The Commission has decided to propose capital rules for SDs and MSPs falling under four separate categories: (C1) Those that are affiliates of U.S. bank holding companies (BHCs) and are

not registered as FCMs; (C2) those that are not affiliated with a BHC and are not registered as FCMs; (C3) those that are affiliates of a BHC and are registered as FCMs; (C4) those that are not affiliated with a BHC and are registered as FCMs. Costs and benefits for each of these four categories is discussed relative to one of two approaches: (D1) What constitutes capital follows the current practice for the given category, and the method for determining the amount of required capital follows an internal models based approach approved by a prudential regulator; (D2) what constitutes capital is tangible net equity, and the method for determining the amount of required capital follows an internal models based approach approved by a prudential regulator. The first approach, D1, which defines capital as bank capital per the Basel Accords, applies to C1 (affiliates of BHCs that are not FCMs). D1 also applies to C3 (affiliates of BHCs that are FCMs) and C4 (non-affiliates of BHCs that are FCMs); in which cases, the definition of capital is adjusted net capital per Regulation 1.17.<sup>58</sup> The second approach, D2, which defines capital as tangible net equity, applies to C2 (non-affiliates of BHCs that are not FCMs).

#### 1. Costs and Benefits of the Proposed Rule to C1 (Affiliates of BHCs That Are Not FCMs) and C3 (Affiliates of BHCs That Are FCMs)

The rules proposed by the Commission for non-bank subsidiaries of BHCs would be the capital rules of the prudential regulator unless the SD or MSP was an FCM, in which case the capital rules would be the Commission's current FCM capital rules.

The Commission notes that the five prudential regulators have recently issued proposed rules that would not impose new capital requirements on the swap entities subject to their prudential supervision. Instead, the swap entities are required to comply with the regulatory capital rules already made applicable to them by their prudential regulators. As noted by the prudential regulators:

The Agencies have preliminarily determined that compliance with these regulatory capital requirements is sufficient to offset the greater risk to the swap entity and the financial system arising from the use

<sup>58</sup> Strictly speaking, for D1 to apply to C1, the method for determining capital needs to be Basel III, whereas for D1 to apply to C3 and C4, the method for determining capital needs to be Regulation 1.17 coupled with an allowance for calculating market risk and credit risk capital using internal models. The common feature here is the allowed use of approved internal models. The subsequent analysis abstracts away from any potential differences.

of non-cleared swaps, helps ensure the safety and soundness of the covered swap entity, and is appropriate for the greater risk associated with the non-cleared swaps and non-cleared security-based swaps held as a [swap entity]. In particular, the Agencies note that the capital rules incorporated by reference into the proposed rule already address, in a risk-sensitive and comprehensive manner, the safety and soundness risks posed by a [swap entity's] derivatives positions. In addition, the Agencies preliminarily believe that these capital rules sufficiently take into account and address the risks associated with the derivatives positions that a covered swap entity holds and the other activities conducted by a covered swap entity. (internal footnotes omitted).<sup>59</sup>

The Commission is anticipating that some number of nonbank subsidiaries of BHCs will register with the Commission in order to hold positions that Section 716 of the Dodd-Frank Act may require federally insured bank subsidiaries to “push out” into affiliates within the same bank holding company structure. The number of such potential registrants is not known, but the Commission has proposed rules that would result in the same capital requirements regardless of which non-FCM subsidiary within the bank holding company organization holds the positions. This approach produces neither any material costs nor benefits relative to D1, defined as bank capital per the Basel Accords.<sup>60</sup> The only difference between the proposed rule affecting C1 (affiliate of a BHC that is not an FCM) and the current banking regulatory requirements is the proposed minimum regulatory capital requirement of \$20 million. The Commission has requested comment on whether this minimum would result in undue burdens on potential “push out” registrants.

To further promote consistent treatment where an FCM is also a subsidiary of a BHC, the Commission has proposed amendments to § 1.17 to allow it to compute its capital using internal models that have been approved by the Federal Reserve Board, or as applicable, the SEC. Following parallel logic as stated above, the effect of the proposed rule on C3 (affiliate of a BHC that is an FCM), therefore, is to produce neither any material costs nor benefits with respect to the alternative.

<sup>59</sup> See joint proposed rulemaking issued by the prudential regulators on April 12, 2011, titled “Margin and Capital Requirements for Covered Swap Entities.”

<sup>60</sup> This is not to say that the proposed rules for bank capital requirements are without costs and benefits measured with respect to some to-be-specified alternative. It is only to say that a discussion of such costs and benefits is beyond the scope of this analysis.

## 2. Costs and Benefits of the Proposed Rule to C2 (Non-Affiliates of BHCs That Are Not FCMs) and C4 (Non-Affiliates of BHCs That Are FCMs)

For SDs/MSPs that are not affiliated with BHCs and are not FCMs (C2), the tangible net equity approach would not place undue restrictions on an affected firm's working capital. This approach takes into consideration comments received at a public roundtable held jointly by the CFTC and SEC on December 10, 2010, which included representatives from each of the five prudential regulators. Industry commenters noted that some portion of SD and MSP registrants may include commercial or other entities for whom the costs of compliance with either FCM or bank regulatory capital requirements could be substantial, and that such rules may not fully recognize the ability of such firms to act as financially responsible SDs and MSPs by excluding some of their valuable assets from being counted towards regulatory capital.

SDs and MSPs that are not affiliated with BHCs and are not FCMs (C2) and SDs and MSPs that are affiliates of a BHC and are FCMs (C4) might not be permitted to use models. Rather they might have to use the standardized Basel approach. C2 (non-affiliate of BHCs that are not FCMs) would be required to follow the tangible net equity method with a standardized Basel approach with respect to credit and market risks. C4 (non-affiliates that are FCMs) would be required to follow § 1.17, which generally does not include models. Consequently, while C2 and C4 do not share a common capital definition, the costs and benefits of each relate to the potential for SDS and MSPs potentially being subject to a less risk-sensitive (*i.e.*, standardized) capital charge than if they had been permitted to use an internal models based approach to capital determination.

In this case, the cost of requiring an SD/MSP to take a standardized capital charge for some period of time (perhaps, indefinitely) is the opportunity cost on the potentially higher capital requirement under the standardized approach measured relative to an internal models based approach. When determining its proposed rules, the Commission took into consideration commitments by international regulators to develop risk-sensitive capital requirements for SDs and MSPs. As noted in an October 2010 of the Financial Stability Board:

Supervisors should apply prudential requirements that appropriately reflect the risks, including systemic risks, of non-centrally cleared OTC derivatives products,

such as the reforms proposed by [Basel Committee on Banking Supervision] relating to higher capital requirements \* \* \*.<sup>61</sup>

Under the proposed rules, the amount of capital that these SDs and MSPs must hold would be determined by proposed market risk and OTC credit risk requirements that are based on internationally recognized Basel Accord "standardized" methodologies for assessing market risk and OTC derivatives credit risk. The requirements would apply only to uncleared swaps of the SD that are associated with its swap activities, and also would apply to any related hedge positions. These proposed requirements would establish risk sensitive capital requirements that would require SDs and MSPs to hold increasing or decreasing levels of capital as the risk of proprietary positions that they carry increases or decreases, although the level of risk sensitivity achieved under these requirements may prove less than the corresponding level attributable to a well calibrated internal model.

To the extent that the proposed rules would limit the potential use of models, they would potentially increase capital requirements. This potential cost, in turn, needs to be balanced against the operational cost to the Commission of validating internal capital models, as well as the potential model risk arising from an internal models based capital calculation that turns out to be less conservative than the corresponding standardized calculation. Since both potential increased capital requirements resulting under the proposed rules as well as forgone investment opportunities attributable to that increased capital are difficult to assess, the Commission invites comment.

Finally, if increased capital requirements result under the proposed rules, such requirements may promote financial integrity by reducing the aggregate amount of capital at risk, with the cost of this reduction being paid in terms of reduced return expectations. Depending on the level of the increased capital required and the effect it has on the willingness of market participants to engage in swaps transactions, market efficiency may be negatively impacted through the introduction of higher costs. Any significant reduction in market participation would be anticipated to exercise correspondingly negative consequences on price discovery through reductions in liquidity.

<sup>61</sup> See "Implementing OTC Derivatives Market Reforms", report of the Financial Stability Board (FSB) dated October 25, 2010, at p. 34. The FSB was formed in 2009 by representatives of the G-20 countries as a successor to the Financial Stability Forum, formed by the G-7 countries in 1999.

**Public Comment.** The Commission invites public comment on its cost-benefit considerations. Commenters also are invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the Proposal with their comment letters.

## List of Subjects

### 17 CFR Part 1

Brokers, Commodity futures, Reporting and recordkeeping requirements.

### 17 CFR Part 23

Swaps, Swap dealers, Major swap participants, Capital and margin requirements.

### 17 CFR Part 140

Authority delegations (Government agencies).

For the reasons stated in this release, the Commission proposes to amend chapter I of title 17 of the Code of Federal Regulations, by amending in that chapter part 1; part 23, as proposed to be added at 75 FR 71379, published November 23, 2010; and part 140, as follows:

## PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 is revised to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 6, 6a, 6b, 6b-1, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 9a, 12, 12a, 16, 18, 19, 21, and 23.

2. Amend § 1.10 by revising paragraphs (c), (d)(1)(v), (d)(2)(iv), (d)(2)(vi), and (g)(2)(ii) to read as follows:

### § 1.10 Financial reports of futures commission merchants and introducing brokers.

\* \* \* \* \*

(c) *Where to file reports.* (1) Form 1-FR filed by an introducing broker pursuant to paragraph (b)(2) of this section need be filed only with, and will be considered filed when received by, the National Futures Association. Other reports or information provided for in this section will be considered filed when received by the regional office of the Commission with jurisdiction over the state in which the registrant's principal place of business is located (as set forth in § 140.02 of this chapter) and by the designated self-regulatory organization, if any; and reports or other information required to be filed by this section by an applicant for registration will be considered filed when received

by the National Futures Association. Any report or information filed with the National Futures Association pursuant to this paragraph shall be deemed for all purposes to be filed with, and to be the official record of, the Commission.

\* \* \* \* \*

(d) \* \* \*

(1) \* \* \*

(v) For a futures commission merchant only, the statements of segregation requirements and funds in segregation for customers trading on U.S. commodity exchanges and for customers' dealer options accounts, the statement of secured amounts and funds held in separate accounts for foreign futures and foreign options customers in accordance with § 30.7 of this chapter, and the statement of cleared swap customer segregation requirements and funds in cleared swap customer accounts under section 4d(f) of the Act as of the date for which the report is made; and

\* \* \* \* \*

(2) \* \* \*

(iv) For a futures commission merchant only, the statements of segregation requirements and funds in segregation for customers trading on U.S. commodity exchanges and for customers' dealer options accounts, the statement of secured amounts and funds held in separate accounts for foreign futures and foreign options customers in accordance with § 30.7 of this chapter, and the statement of cleared swap customer segregation requirements and funds in cleared swap customer accounts under section 4d(f) of the Act as of the date for which the report is made;

\* \* \* \* \*

(vi) A reconciliation, including appropriate explanations, of the statement of the computation of the minimum capital requirements pursuant to § 1.17 of this part and, for a futures commission merchant only, the statements of segregation requirements and funds in segregation for customers trading on U.S. commodity exchanges and for customers' dealer option accounts, the statement of secured amounts and funds held in separate accounts for foreign futures and foreign options customers in accordance with § 30.7 of this chapter, and the statement of cleared swap customer segregation requirements and funds in cleared swap customer accounts under section 4d(f) of the Act, in the certified Form 1-FR with the applicant's or registrant's corresponding uncertified most recent Form 1-FR filing when material differences exist or, if no material

differences exist, a statement so indicating; and

\* \* \* \* \*

(g) \* \* \*

(2) \* \* \*

(ii) The following statements and footnote disclosures thereof: the Statement of Financial Condition in the certified annual financial reports of futures commission merchants and introducing brokers; the Statements (to be filed by a futures commission merchant only) of Segregation Requirements and Funds in Segregation for customers trading on U.S. commodity exchanges and for customers' dealer options accounts, and the Statement (to be filed by a futures commission merchant only) of Secured Amounts and Funds held in Separate Accounts for foreign futures and foreign options customers in accordance with § 30.7 of this chapter, and the Statement (to be filed by futures commission merchants only) of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer Accounts under section 4d(f) of the Act.

3. Amend § 1.12 by:

a. Revising paragraphs (b)(3), (b)(4), (f)(4), and (h); and

b. Adding paragraph (b)(5).

The revisions and addition read as follows:

**§ 1.12 Maintenance of minimum financial requirements by futures commission merchants and introducing brokers.**

\* \* \* \* \*

(b) \* \* \*

(3) 150 percent of the amount of adjusted net capital required by a registered futures association of which it is a member, unless such amount has been determined by a margin-based capital computation set forth in the rules of the registered futures association, and such amount meets or exceeds the amount of adjusted net capital required under the margin-based capital computation set forth in § 1.17(a)(1)(i)(B) of this part, in which case the required percentage is 110 percent,

(4) For securities brokers or dealers, the amount of net capital specified in Rule 17a-11(c) of the Securities and Exchange Commission (17 CFR 240.17a-11(c)), or

(5) For security-based swap dealers or material security-based swap participants, the amount of net capital specified in the rules of the Securities and Exchange Commission that impose comparable reporting requirements as set forth in this paragraph (b), must file written notice to that effect as set forth

in paragraph (i) of this section within twenty-four (24) hours of such event.

\* \* \* \* \*

(f) \* \* \*

(4) A futures commission merchant shall report immediately by telephone, confirmed immediately in writing by facsimile notice, whenever any commodity futures, option, swap or other Commission regulated account it carries is subject to a margin call, or call for other deposits required by the futures commission merchant, that exceeds the futures commission merchant's excess adjusted net capital, determined in accordance with § 1.17 of this part, and such call has not been answered by the close of business on the day following the issuance of the call. This applies to all accounts carried by the futures commission merchant, whether customer, noncustomer, or omnibus, that are subject to margining, including commodity futures, options on futures, and swap positions. In addition to actual margin deposits by an account owner, a futures commission merchant may also take account of favorable market moves in determining whether the margin call is required to be reported under this paragraph.

\* \* \* \* \*

(h) Whenever a person registered as a futures commission merchant knows or should know that the total amount of its funds on deposit in segregated accounts on behalf of customers, that the total amount set aside on behalf of customers trading on non-United States markets, or that the total amount of its funds in segregated accounts on behalf of customers for cleared swap transactions is less than the total amount of such funds required by the Act and the Commission's rules to be on deposit in segregated futures accounts, secured amount accounts, or segregated cleared swap accounts, the registrant must report such deficiency immediately by telephone notice, confirmed immediately in writing by facsimile notice, to the registrant's designated self-regulatory organization and the principal office of the Commission in Washington, DC, to the attention of the Director and the Chief Accountant of the Division of Clearing and Intermediary Oversight.

\* \* \* \* \*

4. Amend § 1.16 by revising paragraphs (a)(4), (d)(1), and (d)(2)(iv) to read as follows:

**§ 1.16 Qualifications and reports of accountants.**

(a) \* \* \*

(4) *Customer.* The term "customer" includes a customer as defined in

§ 1.3(k) of this part; a cleared swaps customer as defined in § 22.2 of this chapter; and a foreign futures or foreign options customer as defined in § 30.1(c) of this chapter.

\* \* \* \* \*

(d) *Audit objectives.* (1) The audit must be made in accordance with generally accepted auditing standards and must include a review and appropriate tests of the accounting system, the internal accounting controls, and the procedures for safeguarding customer and firm assets in accordance with the provisions of the Act and the regulations thereunder, since the prior examination date. The audit must include all procedures necessary under the circumstances to enable the independent licensed or certified public accountant to express an opinion on the financial statements and schedules. The scope of the audit and review of the accounting system, the internal controls, and procedures for safeguarding customer and firm assets must be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in the accounting system, the internal accounting controls, and the procedures for safeguarding customer and firm assets (including, in the case of a futures commission merchant, the segregation requirements of section 4d(a)(2) of the Act and these regulations, the secured amount requirements of the Act and these regulations, and the segregation requirements for cleared swap positions under section 4d(f) of the Act and these regulations) will be discovered. Additionally, as specified objectives the audit must include reviews of the practices and procedures followed by the registrant in making periodic computations of the minimum financial requirements pursuant to § 1.17 of this chapter and in the case of a futures commission merchant, daily computations of the segregation requirements of section 4d(a)(2) of the Act and these regulations, the secured amount requirements of the Act and these regulations, and the segregation requirements for cleared swap positions under section 4d(f) of the Act and these regulations.

(2) \* \* \*

(iv) Result in violations of the Commission's segregation, secured amount or cleared swaps segregation amount (in the case of a futures commission merchant), recordkeeping or financial reporting requirements to the extent that could reasonably be expected to result in the conditions

described in paragraph (d)(2)(i), (ii), or (iii) of this section

\* \* \* \* \*

5. Amend § 1.17 by:

- a. Revising paragraph (a)(1)(i)(A);
- b. Revising paragraph (b)(2);
- c. Revising paragraph (b)(9);
- d. Revising paragraph (c)(2)(i);
- e. Revising paragraphs (c)(2)(ii)(D) and (G);
- f. Adding paragraphs (c)(5)(iii) and (iv);
- g. Revising paragraphs (c)(5)(v), (viii), and (ix);
- h. Revising paragraph (c)(6); and
- i. Redesignating paragraphs (c)(7) and (c)(8) as paragraphs (c)(8) and (c)(9) and add new paragraph (c)(7).

The revisions and additions read as follows:

**§ 1.17 Minimum financial requirements for futures commission merchants and introducing brokers.**

(a)(1)(i) \* \* \*

(A) \$1,000,000, *Provided, however,* that if the futures commission merchant also is a registered swap dealer, the minimum amount shall be \$20,000,000;

\* \* \* \* \*

(b) \* \* \*

(2) *Customer.* This term means customer as defined in § 1.3(k) of this chapter; cleared over the counter customer as defined in § 1.17(b)(10) of this chapter, and includes a foreign futures or foreign options customer as defined in § 30.1(c) of this chapter.

\* \* \* \* \*

(9) *Cleared over the counter derivative positions* means over the counter derivative instruments, including swaps as defined in section 1a(47) of the Act, of any person in accounts that are carried on the books of the futures commission merchant and cleared by any organization permitted to clear such instruments under the laws of the relevant jurisdiction, including cleared swaps as defined in section 1a(7) of the Act.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(i) Exclude any unsecured commodity futures, option, cleared swap, or other Commission regulated account containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only: *Provided, however,* Deficits or debit ledger balances in unsecured customers', non-customers', and proprietary accounts, which are the subject of calls for margin or other required deposits may be included in current assets until the close of business on the business day

following the date on which such deficit or debit ledger balance originated providing that the account had timely satisfied, through the deposit of new funds, the previous day's debit or deficits, if any, in its entirety.

(ii) \* \* \*

(D) Receivables from registered futures commission merchants or brokers, resulting from commodity futures, options, cleared swaps, or other Commission regulated transactions, except those specifically excluded under paragraph (c)(2)(i) of this section;

\* \* \* \* \*

(G) Receivables from third-party custodians that arise from initial margin deposits associated with bilateral swap transactions pursuant to § 23.158 of this chapter.

(5) \* \* \*

(iii) For positions in over-the-counter interest rate swaps that are not cleared by a clearing organization, the following amounts:

(A) If not hedged with U.S. Treasury securities of corresponding maturities or matched with offsetting interest rate swap positions with corresponding terms and maturities, the applicable haircut shall be the notional amount of the interest rate swaps multiplied by the applicable percentages for the underlying securities specified in Rule 240.15c3-1(c)(2)(vi)(A)(i) of the Securities and Exchange Commission (17 CFR 240.15c3-1(c)(2)(vi)(A)(i)), as if such notional amount was the market value of a security issued or guaranteed as to principal or interest by the United States;

(B) If hedged with U.S. Treasury securities of corresponding maturities or matched with offsetting interest rate swap positions with corresponding terms and maturities, and such interest rate swaps are maturing in ten years or less, the applicable haircut shall be one percent of the notional amount of the interest rate swaps; and

(C) If hedged with U.S. Treasury securities of corresponding maturities or matched with offsetting interest rate swap positions with corresponding terms and maturities, and such interest rate swaps are maturing in excess of ten years, the applicable haircut shall be three percent of the notional amount of the interest rate swaps;

(iv) For the net position in the following:

(A) Over-the-counter credit default swaps that are not cleared by a clearing organization, the notional principal amount multiplied by the applicable percentages, as determined by the underlying securities and the remaining maturity of the swap agreement, that are

specified in Rule 240.15c3–1(c)(2)(vi) of the Securities and Exchange Commission (17 CFR 240.15c3–1(c)(2)(vi)) (“securities haircuts”) and 100 percent of the value of “nonmarketable securities” as specified in Rule 240.15c3–1(c)(2)(vii) of the Securities and Exchange Commission (17 CFR 240.15c3–1(c)(2)(vii));

(B) Over-the-counter equity swaps that are not cleared by a clearing organization, 15 percent of the notional principal amount;

(C) Over-the-counter foreign currency swap transactions involving euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs, 6 percent of the notional principal amount of the swap transaction;

(D) Over-the-counter foreign currency swap transactions involving currencies other than euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs, 20 percent of the notional principal amount of the swap transaction;

(E) Over-the-counter commodity swaps, 20 percent of the market value of the notional amount of the underlying commodities; or

(F) Over-the-counter swap transactions involving an underlying instrument that is not listed in paragraph (c)(5)(iv)(A), (B), (C), (D), or (E) of this section, 20 percent of the effective notional principal amount of the swap transaction.

(v) In the case of securities and obligations used by the applicant or registrant in computing net capital, and in the case of a futures commission merchant with securities in segregation pursuant to sections 4d(a)(2) and 4d(f) of the Act and the regulations in this chapter, and § 30.7 secured accounts as set forth in part 30 of this chapter, which were not deposited by customers, the percentages specified in Rule 240.15c3–1(c)(2)(vi) of the Securities and Exchange Commission (17 CFR 240.15c3–1(c)(2)(vi)) (“securities haircuts”) and 100 percent of the value of “nonmarketable securities” as specified in Rule 240.15c3–1(c)(2)(vii) of the Securities and Exchange Commission (17 CFR 240.15c3–1(c)(2)(vii));

\* \* \* \* \*

(viii) In the case of a futures commission merchant, for undermargined customer commodity futures, options, cleared swaps or other Commission regulated accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or if there are no such maintenance margin requirements,

clearing organization margin requirements applicable to such positions, after application of calls for margin or other required deposits which are outstanding three business days or less. If there are no such maintenance margin requirements or clearing organization margin requirements, then the amount of funds required to provide margin equal to the amount necessary after application of calls for margin or other required deposits outstanding three business days or less to restore original margin when the original margin has been depleted by 50 percent or more: *Provided*, To the extent a deficit is excluded from current assets in accordance with paragraph (c)(2)(i) of this section such amount shall not also be deducted under this paragraph (c)(5)(viii). In the event that an owner of a customer account has deposited an asset other than cash to margin, guarantee or secure his account, the value attributable to such asset for purposes of this subparagraph shall be the lesser of the value attributable to the asset pursuant to the margin rules of the applicable board of trade, or the market value of the asset after application of the percentage deductions specified in this paragraph (c)(5);

\* \* \* \* \*

(6) \* \* \*

(i) Any futures commission merchant that is also registered with the Securities and Exchange Commission as a securities broker or dealer, and who also satisfies the other requirements of this paragraph (c)(6), may elect to compute its adjusted net capital using the alternative capital deductions that the Securities and Exchange Commission has approved by written order, provided, however, that such order was dated before May 12, 2011;

(B) If an election under this paragraph (c)(6) was authorized before the date specified in paragraph (c)(6)(i)(A) of this section, and the futures commission merchant otherwise remains in compliance with this paragraph (c)(6), a futures commission merchant that is permitted by the Securities and Exchange Commission to use alternative capital deductions for its unsecured receivables from over-the-counter transactions in derivatives, or for its proprietary positions in securities, commodities, forward contracts, swap transactions, options, or futures contracts, may continue to use these same alternative capital deductions when computing its adjusted net capital in lieu of the standard deductions otherwise specified in this section.

(C) If a futures commission merchant computing alternative deductions under paragraph (c)(6)(B) of this section is also registered with the Commission as swap dealer or major swap participant, or registered with the Securities and Exchange Commission as a security-based swap dealer or major security-based swap participant, the alternative deductions approved under this paragraph (c)(6) shall remain effective only if the futures commission merchant has filed an application under § 23.103 of this chapter and the application is pending approval. A denial or approval of an application made under § 23.103 shall also terminate approval of alternative deductions under this paragraph (c)(6). The futures commission merchant's capital deductions must thereafter be calculated as required under the terms of the Commission's order issued under § 23.103.

\* \* \* \* \*

(7) Any futures commission merchant that is also registered as a swap dealer

or major swap participant, or is also registered as a security-based swap dealer or major security-based swap participant, and which has received approval of its application to the Commission under § 23.103 of this chapter for capital computations using the firm's internal models, shall calculate its adjusted net capital in accordance with the terms and conditions of such Commission approval.

\* \* \* \* \*

## PART 23—SWAP DEALERS AND MAJOR SWAP PARTICIPANTS

6. The authority citation for part 23 continues to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 6, 6a, 6b–1, 6c, 6p, 6r, 6s, 6t, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21.

7. Part 23, as proposed to be added at 75 FR 71379, November 213, 2010, is amended by adding Subpart E to read as follows:

### Subpart E—Capital and Margin Requirements for Swap Dealers and Major Swap Participants

Sec.

- 23.100 Definitions applicable to capital requirements.
- 23.101 Minimum financial requirements for swap dealers and major swap participants.
- 23.102 Tangible net equity.
- 23.103 Calculation of market risk exposure requirement and over-the-counter derivatives credit risk requirement using internal models.
- 23.104 Calculation of market risk exposure requirement and over-the-counter derivatives credit risk requirement when models are not approved.
- 23.105 Maintenance of minimum financial requirements by swap dealers and major swap participants.
- 23.106 Financial recordkeeping and reporting requirements for swap dealers and major swap participants.
- 23.107–23.149 [Reserved]

#### § 23.100 Definitions applicable to capital requirements.

For purposes of §§ 23.101 through 23.149 of subpart E, the following terms are defined as follows:

**Market risk exposure.** This term means the risk of loss resulting from movements in market prices. Market risk exposure includes “specific risk” (referring to those risks that affect the market value of a specific instrument, such as the credit risk of the issuer of the particular instrument, but do not materially alter broad market conditions), and it also includes market risk in general (referring to the change in the market value of a particular asset that results from broad market

movements, such as a change in market interest rates, foreign exchange rates, equity prices, and commodity prices).

**Market risk exposure requirement.** This term refers to the amount that the registered swap dealer or major swap participant is required to compute under § 23.104, or to compute using internal models as approved under § 23.103.

**Over-the-counter derivatives credit risk.** This term refers to the risk that the counterparty to an over-the-counter transaction could default before the final settlement of the transaction's cash flows.

**Over-the-counter derivatives credit risk requirement.** This term refers to the amount that the registered swap dealer or major swap participant is required to compute under § 23.104, or to compute using internal models approved under § 23.103.

**Prudential regulator.** This term has the same meaning as set forth in section 1a(39) of the Act, and includes the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency, as applicable to a swap dealer or major swap participant.

**Regulatory capital requirement.** This term refers to each of the capital requirements that § 23.101 of this part applies to a swap dealer or major swap participant.

#### § 23.101 Minimum financial requirements for swap dealers and major swap participants.

(a)(1) Except as provided in paragraph (a)(2), (3), or (4) of this section, each registered swap dealer must meet or exceed the greatest of the following regulatory capital requirements:

(i) Tangible net equity (as defined in § 23.102 of this part) in an amount equal to \$20,000,000 plus the amounts calculated under this part for the swap dealer's market risk exposure requirement and its over-the-counter derivatives credit risk requirement associated with swap positions and related hedge positions that are part of the swap dealer's swap activities; or,

(ii) The amount of capital required by a registered futures association of which the swap dealer is a member.

(2) Except as provided in paragraph (a)(3) or (4) of this section, each registered swap dealer that is a subsidiary of a U.S. bank holding company must meet or exceed the greatest of the following regulatory capital requirements:

(i) \$20 million of Tier 1 capital as defined in 12 CFR part 225, appendix A, § II.A;

(ii) The swap dealer's minimum risk-based ratio requirements set forth in 12 CFR part 225, and any appendices thereto, as if the swap dealer itself were a U.S. bank-holding company; or,

(iii) The amount of capital required by a registered futures association of which the swap dealer is a member.

(3) A registered swap dealer that is subject to minimum capital requirements established by rule or regulation of a prudential regulator, or a registered swap dealer that also is a registered futures commission merchant subject to the capital requirements of § 1.17 of this chapter, is not subject to the regulatory capital requirements set forth in paragraph (a)(1) or (2) of this section.

(4) A registered swap dealer that is a U.S. nonbank financial company that has been designated a systemically important financial institution by the Financial Stability Oversight Council and subject to supervision by the Board of Governors of the Federal Reserve System is not subject to the regulatory capital requirements set forth in paragraph (a)(1) or (2) of this section.

(b)(1) Except as provided in paragraph (b)(2), (3), or (4) of this section, each major swap participant must meet or exceed the greatest of the following regulatory capital requirements:

(i) Tangible net equity (as defined in § 23.102 of this part) in an amount equal to \$20,000,000 plus the amounts calculated under this part for the swap dealer's market risk exposure requirement and its over-the-counter derivatives credit risk requirement associated with swap positions and related hedge positions; or

(ii) The amount of capital required by a registered futures association of which the major swap participant is a member.

(2) Except as provided in paragraph (b)(3) or (4) of this section, each registered major swap participant that is a subsidiary of a U.S. bank-holding company must meet or exceed the greatest of the following regulatory capital requirements:

(i) \$20 million of Tier 1 capital as defined in 12 CFR part 225, appendix A, section II.A;

(ii) The major swap participant's minimum risk-based ratio requirements set forth in 12 CFR part 225, and any appendices thereto, as if the major swap participant itself were a U.S. bank-holding company; or,

(iii) The amount of capital required by a registered futures association of which the major swap participant is a member.

(3) A registered major swap participant that is subject to minimum capital requirements established by rule or regulation of a prudential regulator, or a registered major swap participant that also is a registered futures commission merchant subject to the capital requirements of § 1.17 of this chapter, is not subject to the regulatory capital requirements set forth in paragraph (b)(1) or (2) of this section.

(4) A registered major swap participant that is a U.S. nonbank financial company that has been designated a systemically important financial institution by the Financial Stability Oversight Council and subject to supervision by the Board of Governors of the Federal Reserve System is not subject to the regulatory capital requirements set forth in paragraph (b)(1) or (2) of this section.

(c)(1) Before any applicant may be registered as a swap dealer or major swap participant, the applicant must demonstrate to the satisfaction of the National Futures Association one of the following:

(i) Its compliance with the applicable regulatory capital requirements in paragraphs (a)(1), (2), (b)(1) or (2) of this section;

(ii) that it is a futures commission merchant that complies with § 1.17 of this chapter;

(iii) that its minimum regulatory capital requirements are supervised by a prudential regulator in paragraph (a)(3) or (b)(3) of this section; or

(iv) that it is designated by the Financial Stability Oversight Council as a systemically important financial institution and subject to supervision by the Federal Reserve Board under paragraph (a)(4) or (b)(4) of this section.

(2) Each swap dealer and major swap participant subject to the minimum capital requirements set forth in paragraphs (a) and (b) of this section must be in compliance with the Commission's minimum capital requirements at all times and must be able to demonstrate such compliance to the satisfaction of the Commission.

#### **§ 23.102 Tangible net equity.**

(a) Tangible net equity is a swap dealer's or major swap participant's equity as determined under U.S. generally accepted accounting principles, and excludes goodwill and other intangible assets.

(b)(1) Subject to the provisions of paragraph (b)(2) of this section:

(i) Tangible net equity is computed by consolidating in a single computation assets and liabilities of any subsidiary or affiliate for which the swap dealer or major swap participant guarantees,

endorses, or assumes directly or indirectly the obligations or liabilities; or

(ii) If an opinion of outside counsel is obtained as provided for in paragraph (b)(3) of this section, a swap dealer or major swap participant may elect to consolidate assets and liabilities of a subsidiary or affiliate whose liabilities and obligations have not been guaranteed, endorsed, or assumed directly or indirectly by the swap dealer or major swap participant, but which is majority owned and controlled by the swap dealer or major swap participant.

(2) If the consolidation required or permitted under paragraph (b)(1) of this section results in the increase of the swap dealer's or major swap participant's tangible net equity or decreases the minimum regulatory capital requirement, such benefits shall not be recognized unless an opinion of counsel meeting the requirements of paragraph (b)(3) of this section has been obtained by the swap dealer or major swap participant.

(3) For purposes of paragraph (b)(1) or (2) of this section, the swap dealer or major swap participant shall demonstrate by written opinion of outside counsel that the net asset values or the portion thereof related to the parent's ownership interest in the subsidiary or affiliate, may be caused by the swap dealer or major swap participant or an appointed trustee, to be distributed to the swap dealer or major swap participant within 30 calendar days. Such opinion also must set forth the actions necessary to cause such a distribution to be made, identify the parties having the authority to take such actions, identify and describe the rights of other parties or classes of parties, including but not limited to customers, general creditors, subordinated lenders, minority shareholders, employees, litigants, and governmental or regulatory authorities, who may delay or prevent such a distribution and such other assurances as the Commission by rule or interpretation may require. Such opinion must be current and periodically renewed in connection with the swap dealer's or major swap participant's annual audit pursuant to part 23 of this title or upon any material change in circumstances.

(4) In preparing a consolidated computation of tangible net equity:

(i) Consolidated tangible net equity shall be reduced by the estimated amount of any tax reasonably anticipated to be incurred upon distribution of the assets of the subsidiary or affiliate; and

(ii) Each swap dealer or major swap participant included within the consolidation shall at all times be in compliance with the regulatory capital requirements to which it is subject.

(5) No swap dealer or major swap participant shall guarantee, endorse, or assume directly or indirectly any obligation or liability of a subsidiary or affiliate unless the obligation or liability is reflected in the computation of tangible net equity of the swap dealer or major swap participant, except as provided in paragraph (b)(4)(ii) of this section.

#### **§ 23.103 Calculation of market risk exposure requirement and over-the-counter derivatives credit risk requirement using internal models**

(a) A registered swap dealer or major swap participant may apply to the Commission for approval to use internal models under terms and conditions required by the Commission and by these regulations when calculating:

(1) the amounts that the swap dealer or major swap participant must add to its tangible net equity for its market risk exposure requirement and over-the-counter derivatives credit risk requirement to compute its minimum regulatory capital requirement under §§ 23.101(a)(1)(i) or 23.101(b)(1)(i), respectively, of this part;

(2) Its market risk and over-the-counter derivatives credit risk requirements under 12 CFR part 225, Appendix E and Appendix G, if the swap dealer or major swap participant is a subsidiary of a U.S. bank holding company that must meet regulatory capital requirements set forth in § 23.101(a)(2)(ii) or § 23.101(b)(2)(ii) of this part; or

(3) The deductions from its net capital for market risk exposure and over-the-counter derivatives credit risk, in lieu of deductions otherwise required under § 1.17(c) of this chapter, if the swap dealer or major swap participant also is registered as a futures commission merchant.

(b) The application shall be in writing and filed with the regional office of the Commission having local jurisdiction over the swap dealer or major swap participant as set forth in § 140.2 of this chapter. The application may be filed electronically in accordance with instructions approved by the Commission and specified on the Commission's Web site. A petition for confidential treatment of information within the application may be submitted according to procedures set forth in § 145.9 of this chapter.

(c) The application must identify the categories of positions for which the

swap dealer or major swap participant will use internal models for its computations for market risk and over-the-counter derivatives credit risk, and, for each such category, provide a description of the methods that the swap dealer or major swap participant will use to calculate its deductions, and also, if calculated separately, deductions for specific risk; a description of the internal models, and an overview of the integration of the models into the internal risk management control system of the swap dealer or major swap participant; a description of how the swap dealer or major swap participant will calculate current exposure and potential future exposure for its over-the-counter derivatives credit risk; a description of how the swap dealer or major swap participant will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable; and a description of the estimated market risk exposure and over-the-counter derivatives credit risk exposure amounts to be reported by the swap dealer or major swap participant.

(d) The swap dealer or major swap participant must promptly, upon the request of the Commission at any time, provide any other explanatory information as the Commission may require at its discretion regarding the swap dealer's or major swap participant's internal models and the swap dealer's or major swap participant's computation of its market risk exposure or over-the-counter derivatives credit risk requirements.

(e) Except as permitted under paragraph (f) of this section, the swap dealer or major swap participant requesting approval under this section must be either:

(1) A subsidiary of a U.S. bank holding company whose calculations of minimum risk-based capital requirements under § 23.101 complies with the requirements that are set forth in regulations of the Board of Governors of the Federal Reserve System (Federal Reserve Board) at 12 CFR part 225, appendix E and appendix G for calculating capital requirements for its market risk exposure and over-the-counter derivatives credit risk requirements, and whose internal models have been reviewed and are subject to regular assessment by the Federal Reserve Board; or

(2) A security-based swap dealer or major security-based swap participant registered with the Securities and Exchange Commission, and whose internal models used for calculating capital requirements for its market risk exposure and its over-the-counter

derivatives credit risk have been reviewed and are subject to regular assessment by the Securities and Exchange Commission.

(f) At any time after the effective date of this rule, the Commission may in its sole discretion determine by written order that swap dealers or major swap participants not described in paragraph (e) of this section also may apply for approval under this section to calculate the amount of their market risk exposure requirements or over-the-counter derivatives credit risk requirements using proprietary internal models.

(g) The Commission may approve or deny the application, or approve an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission may require, if the Commission finds the approval to be necessary or appropriate in the public interest or for the protection of customers, after determining, among other things, whether the applicant has met the requirements of this section and is in compliance with other applicable rules promulgated under the Act and by self-regulatory organizations.

(h) A swap dealer or major swap participant may no longer use internal models to compute its market risk exposure requirement and over-the-counter counterparty credit risk requirement, upon the occurrence of any of the following:

(1) Internal models that received Commission approval under paragraph (e) of this section are no longer periodically reviewed or assessed by the Federal Reserve Board or the Securities and Exchange Commission;

(2) The swap dealer or major swap participant has changed materially a mathematical model described in the application or changed materially its internal risk management control system without first submitting amendments identifying such changes and obtaining Commission approval for such changes;

(3) The Commission determines that the internal models are no longer sufficient for purposes of the capital calculations of the swap dealer or major swap participant as a result of changes in the operations of the swap dealer or major swap participant;

(4) The swap dealer or major swap participant fails to come into compliance with its requirements under this section, after having received from the Director of the Division of Clearing and Intermediary Oversight written notification that the firm is not in compliance with its requirements, and

must come into compliance by a date specified in the notice; or

(5) The Commission by written order finds that permitting the swap dealer or major swap participant to continue to use the internal models is no longer necessary or appropriate for the protection of customers of the futures commission merchant (if the swap dealer or major swap participant is also a futures commission merchant) or of the integrity of Commission-regulated markets.

**§ 23.104 Calculation of market risk exposure requirement and over-the-counter derivatives credit risk requirement when models are not approved.**

(a) *General requirements for calculations.* If internal models have not been submitted and received approval under § 23.103 of this part, the market risk exposure requirement shall be calculated as set forth in paragraphs (b) through (d) of this section, and the over-the-counter derivatives credit risk requirement shall be calculated as set forth in paragraphs (e) through (j) of this section.

(b) *Market risk exposure requirement.*

(1) A swap dealer or major swap participant that must meet the minimum regulatory capital requirements in § 23.101(a)(1)(i) or 23.101(b)(1)(i), respectively, shall calculate its market risk exposure requirement as the sum of the amounts for specific risk in paragraphs (c) of this section and the amounts for market risk in general in paragraph (d) of this section, as applied to the swap dealer's or major swap participant's:

(i) Swaps that are not cleared; and

(ii) Debt instruments, equities, commodities or foreign currency, including derivatives of the same, that hedge such uncleared swaps;

(2) A swap dealer or major swap participant that must meet the requirements in § 23.101(a)(2)(ii) or § 23.101(b)(2)(ii) of this part shall calculate the market risk deductions required by 12 CFR part 225, Appendix E as the sum of the amounts for specific risk in paragraphs (c) of this section and the amounts for market risk in general in paragraph (d) of this section, as applied to the swap dealer's or major swap participant's "covered positions", as that term is defined in 12 CFR part 225, Appendix E, Section 2(a); and

(3) A swap dealer or major swap participant that is also a futures commission merchant shall calculate its deductions from net capital for market risk and over-the-counter derivatives credit risk in accordance with § 1.17(c) of this chapter.

(4) The following definitions apply for purposes of the calculation of the market risk exposure requirement:

“*Credit derivative*” means a financial contract that allows one party (the protection purchaser) to transfer the credit risk of one or more exposures (reference exposure(s)) to another party (the protection provider).

“*Debt positions*” means fixed-rate or floating rate instruments, and other instruments with values that react primarily to changes in interest rates, including certain non-convertible preferred stock; convertible bonds; instruments subject to repurchase and lending agreements; and any derivatives (including written and purchased options) for which the underlying instrument is a debt position. Excluded from this definition are asset-backed securities, mortgage-backed securities and collateralized debt obligations (except for pass-through mortgage-backed securities issued or guaranteed as to principal or interest by the United States or any agency thereof); municipal securities; and non-investment grade debt securities. Debt instruments excluded from this definition shall remain subject to applicable haircuts under § 240.15c3-1 of this title.

“*Equity Positions*” means equity instruments and other instruments with values that react primarily to changes in

equity prices, including voting or non-voting common stock, certain convertible bonds, and commitments to buy or sell equity instruments. Also included are derivatives (including written and purchased options) for which the underlying is an equity position.

(c) *Specific risk.* (1) The required deduction from capital for specific risk shall equal the sum of the weighted values for debt positions held by the swap dealer or major swap participant, as determined in paragraph (c)(2) of this section, plus the sum of the weighted values of the equity positions held by the swap dealer or major swap participant, as determined under paragraph (c)(3) of this section.

(2) *Sum of weighted values for debt positions.* The sum of the required weighted values of debt positions is determined by multiplying the weighting factor indicated in Table A in paragraph (c)(2)(v) of this section by the absolute value of the current market value of each net long or short debt position held by the swap dealer or major swap participant, and summing all of the calculated weighted values for each position. For purposes of the calculation:

(i) Interest rate derivatives shall be included as set forth in paragraph (d)(2) of this section;

(ii) Credit derivatives shall be included as set forth in paragraph (c)(4) of this section;

(iii) Long and short debt positions (including derivatives) in identical debt issues or debt indices may be netted; and

(iv) Debt instruments are classified in Table A of this section as one of the following categories:

(A) “*Government category*” includes all debt instruments of central governments that are members of the Organization for Economic Co-operation and Development (“OECD”) including bonds, Treasury bills, and other short-term instruments, as well as local currency instruments of non-OECD central governments to the extent of liabilities booked in that currency;

(B) “*Qualifying category*” includes debt instruments of U.S. government-sponsored agencies, general obligation debt instruments issued by states and other political subdivisions of OECD countries, multilateral development banks, and debt instruments issued by U.S. depository institutions or OECD-banks that do not qualify as capital of the issuing institution; or

(C) “*Other category*” includes debt instruments that are not included in the government or qualifying categories.

(v) Table A is as set forth as follows:

TABLE A—“SPECIFIC RISK” WEIGHTING FACTORS FOR DEBT POSITIONS

Category	Remaining maturity (contractual)	Weighting factor (in percent)
Government .....	N/A .....	0.00
Qualifying .....	6 months or less .....	0.25
	Over 6 months to 24 months .....	1.00
	Over 24 months .....	1.60
Other .....	N/A .....	8.00

(3) *Sum of the weighted values for equity positions.* The sum of the required weighted values of equity positions is determined by multiplying a weighting factor of 8 percent by the absolute value of the current market value of each net long or short equity position, and summing all of the risk-weighted values. For purposes of the calculation:

(i) Equity derivatives shall be included as set forth in paragraph (d)(4) of this section; and

(ii) Long and short equity positions (including derivatives) in identical equity issues or equity indices in the same market may be netted.

(4) *Credit derivatives.* The following requirements apply when computing specific risk charges for credit derivatives:

(i) For each credit derivative in which the swap dealer or major swap participant is the protection seller, the credit derivative is treated as a long notional position in the reference exposure, and where the swap dealer or major swap participant is the protection buyer, the credit derivative is treated as a short notional position in the reference exposure.

(ii) The specific risk charge for an individual debt position that represents purchased credit protection is capped at the market value of the protection.

(iii) A set of transactions consisting of a debt position and its credit derivative hedge has a specific risk charge of zero if the debt position is fully hedged by a total return swap (or similar instrument where there is a matching of payments and changes in market value

of the position) and there is an exact match between the reference obligation of the swap and the debt position, the maturity of the swap and the debt position, and the currency of the swap and the debt position.

(iv) The specific risk charge for a set of transactions consisting of a debt position and its credit derivative hedge that does not meet the criteria of paragraph (c)(4)(iii) of this section is equal to 20.0 percent of the capital requirement for the side of the transaction with the higher capital requirement when the credit risk of the position is fully hedged by a credit default swap or similar instrument and there is an exact match between the reference obligation of the credit derivative hedge and the debt position, the maturity of the credit derivative

hedge and the debt position, and the currency of the credit derivative hedge and the debt position.

(v) The specific risk charge for a set of transactions consisting of a debt position and its credit derivative hedge that does not meet the criteria of either paragraphs (c)(4)(iii) or (iv) of this section, but in which all or substantially all of the price risk has been hedged, is equal to the specific risk charge for the side of the transaction with the higher specific risk charge.

(vi) The total specific risk charge for a portfolio of nth-to-default credit derivatives is the sum of the specific risk charges for individual nth-to-default credit derivatives, as computed under this paragraph. The specific risk charge for each nth-to-default credit derivative position applies irrespective of whether a swap dealer or major swap participant is a net protection buyer or net protection seller.

(vii) The specific risk charge for a first-to-default credit derivative is the lesser of:

(A) The sum of the specific risk charges for the individual reference credit exposures in the group of reference exposures; or

(B) The maximum possible credit event payment under the credit derivative contract.

(viii) Where a swap dealer or major swap participant has a risk position in one of the reference credit exposures underlying a first-to-default credit derivative and this credit derivative hedges the swap dealer's or major swap participant's risk position, the swap dealer or major swap participant is

allowed to reduce both the specific risk charge for the reference credit exposure and that part of the specific risk charge for the credit derivative that relates to this particular reference credit exposure such that its specific risk charge for the pair reflects the net position in the reference credit exposure. Where a swap dealer or major swap participant has multiple risk positions in reference credit exposures underlying a first-to-default credit derivative, this offset is allowed only for the underlying reference credit exposure having the lowest specific risk charge.

(ix) The specific risk charge for a second or subsequent-to-default credit derivative is the lesser of:

(A) The sum of the specific risk charges for the individual reference credit exposures in the group of reference exposures, but disregarding the (n-1) obligations with the lowest specific risk add-ons; or

(B) The maximum possible credit event payment under the credit derivative contract.

(x) For second-or-subsequent-to-default credit derivatives, no offset of the specific risk charge with an underlying reference credit exposure is allowed.

(d) *Market Risk in General.* The required deduction from capital for the market risk in general of the swap dealer or major swap participant's proprietary positions shall be computed as set forth in this paragraph:

(1) *Interest rate risk: Time-bands and zones.* A swap dealer or major swap participant shall calculate a general market risk capital charge for interest

rate risk on proprietary positions that equals the sum of the total time-band disallowances in paragraph (d)(1)(vii) of this section; the total intra-zone disallowances and the total inter-zone disallowances in paragraphs (d)(1)(viii)(C) and (F) of this section, and the amount of the final net risk-weighted long or short position in paragraph (d)(1)(viii)(G) of this section, in accordance with the following methodology:

(i) Each long or short interest rate position shall be reported at its current market value and distributed into the time bands of the maturity ladder specified in Table B of this section. Interest rate derivatives shall be included as set forth in paragraph (d)(2) of this section. For purposes of this distribution into time-bands, fixed-rate instruments are allocated according to the remaining term to maturity and floating-rate instruments according to the next repricing date.

(ii) The long interest rate positions in each time-band are summed and the short interest rate positions in each time-band are summed.

(iii) The summed long interest rate positions in each time-band are multiplied by the appropriate risk-weight factor set forth in Table B of this section to determine the risk-weighted long interest rate position for each time-band. The summed short interest rate positions in each time-band also are multiplied by the appropriate risk-weight factor in Table B of this section to determine the risk-weighted short interest rate position for each time-band.

(iv) Table B is as set forth as follows:

TABLE B—TIME-BANDS AND RISK WEIGHTS FOR INTEREST RATE POSITIONS

Zone	Coupon 3% or more	Coupon less than 3%	Risk weight (%)
1 .....	1 month or less .....	1 month or less .....	0.00
1 .....	1 to 3 months .....	1 to 3 months .....	0.20
1 .....	3 to 6 months .....	3 to 6 months .....	0.40
1 .....	6 to 12 months .....	6 to 12 months .....	0.70
2 .....	1 to 2 years .....	1.0 to 1.9 years .....	1.25
2 .....	2 to 3 years .....	1.9 to 2.8 years .....	1.75
2 .....	3 to 4 years .....	2.8 to 3.6 years .....	2.25
3 .....	4 to 5 years .....	3.6 to 4.3 years .....	2.75
3 .....	5 to 7 years .....	4.3 to 5.7 years .....	3.25
3 .....	7 to 10 years .....	5.7 to 7.3 years .....	3.75
3 .....	10 to 15 years .....	7.3 to 9.3 years .....	4.50
3 .....	15 to 20 years .....	9.3 to 10.6 years .....	5.25
3 .....	Over 20 years .....	10.6 to 12 years .....	6.00
3 .....		12 to 20 years .....	8.00
		Over 20 years .....	12.50

(v) If a time-band includes both risk-weighted long interest rate positions and short interest rate positions, such risk-weighted long positions and short interest rate positions are netted,

resulting in a single net risk-weighted long or short interest rate position for each time-band.

(vi) If risk-weighted long interest rate positions and risk-weighted short

interest rate positions in a time-band have been netted, a “time-band disallowance” charge is computed equal to 10 percent of the smaller of the total risk-weighted long interest rate position

or the total risk-weighted short interest rate position, or if the total long risk-weighted interest rate position and the total short risk-weighted interest rate position are equal, 10 percent of either long or short position.

(vii) The total time-band disallowance equals the sum of the absolute values of

the individual disallowances for each time-band in Table B.

(viii) Table C of this section also groups the time-bands into three “zones”: Zone 1 consists of the first three time-bands (0 up to 1 month; 1 month up to 3 months, and 3 months up to 6 months); zone 2 consists of the next four

time-bands (6 months up to 12 months; 1 year up to 2 years; 2 years up to 3 years; and 3 years up to 4 years), and the remaining time-bands in Table C are in zone 3. Table C is as set forth below:

TABLE C—HORIZONTAL DISALLOWANCE

Zone	Time band	Within the zone (%)	Between adjacent zones (%)	Between zones 1 and 3 (%)
1 .....	1 mth or less .....	40	40	100
1 .....	1 to 3 mths .....	.....	.....	.....
1 .....	3 to 6 mths .....	.....	.....	.....
1 .....	6 to 12 mths .....	30	.....	.....
2 .....	1 to 2 yrs .....	.....	.....	.....
2 .....	2 to 3 yrs .....	.....	.....	.....
2 .....	3 to 4 yrs .....	.....	.....	.....
3 .....	4 to 5 yrs .....	30	40	.....
3 .....	5 to 7 yrs .....	.....	.....	.....
3 .....	7 to 10 yrs .....	.....	.....	.....
3 .....	10 to 15 yrs .....	.....	.....	.....
3 .....	15 to 20 yrs .....	.....	.....	.....
3 .....	Over 20 yrs .....	.....	.....	.....

(A) If a zone includes both risk-weighted long positions and risk-weighted short interest rate positions in different time-bands, the risk-weighted long positions and risk-weighted short positions in all of the time-bands within the zone are netted, resulting in a single net risk-weighted long or short position for each zone.

(B) An “intra-zone disallowance” is computed by multiplying the percent disallowance factors for each zone set out in Table C of this section by the smaller of the net risk-weighted long or net risk-weighted short positions within the zone, or if the positions are equal, a percentage of either position.

(C) The total intra-zone disallowance equals the sum of the absolute values of the individual intra-zone disallowances.

(D) Risk-weighted long and short positions are then netted between zone 1 and zone 2, between zone 2 and zone 3, and then zone 3 and zone 1.

(E) An “inter-zone disallowance” is calculated by multiplying the percent disallowance in Table C of this section by the smaller of the net long or short position eliminated by the inter-zone netting, or if the positions are equal, a percentage of either position.

(F) The total inter-zone disallowance equals the sum of the absolute values of the individual inter-zone disallowances.

(G) Lastly, the net risk-weighted long interest rate position or net risk-weighted short interest rate position remaining in the zones are summed to reach a single net risk-weighted long or net risk-weighted short.

*(2) Interest rate derivative contracts.*

(i) Derivative contracts are converted into positions in the relevant underlying instrument and are included in the calculation of specific and general market risk capital charges as described in paragraphs (c) and (d) of this section. The amount to be included is the market value of the principal amount of the underlying or of the notional underlying. In the case of a futures contract on a corporate bond index, positions are included at the market value of the notional underlying portfolio of securities.

(ii) Futures and forward contracts (including forward rate contracts) are converted into a combination of a long position and short position in the notional security. The maturity of a futures contract or a forward rate contract is the period until delivery or exercise of the contract, plus the life of the underlying instrument.

(iii) Swaps are treated as two notional positions in the relevant instruments with appropriate maturities. The receiving side is treated as the long position and the paying side is treated as the short position. For example, an interest rate swap in which the registrant is receiving floating-rate interest and paying fixed is treated as a long position in a floating rate instrument with a maturity equivalent to the period until the next interest rate reset date and a short position in a fixed-rate instrument with a maturity equivalent to the remaining life of the swap.

(iv) For swaps that pay or receive a fixed or floating interest rate against some other reference price, for example, an equity index, the interest rate component is slotted into the appropriate repricing maturity category, with the long or short position attributable to the equity component being included in the equity framework set out in this section.

(v) Offsets of long and short positions (both actual and notional) are permitted in identical derivative instruments with exactly the same issuer, coupon, currency, and maturity before slotting these positions into time-bands. A matched position in a futures and its corresponding underlying may also be fully offset and, thus, excluded from the calculation, except when the futures comprises a range of deliverable instruments. No offsetting is allowed between positions in different currencies.

(vi) Offsetting positions in the same category of instruments can in certain circumstances be regarded as matched and treated by the swap dealer or major swap participant as a single net position which should be entered into the appropriate time-band. To qualify for this treatment the positions must be based on the same underlying instrument, be of the same nominal value, and be denominated in the same currency. The separate sides of different swaps also may be “matched” subject to the same conditions. In addition:

(A) For futures, offsetting positions in the notional or underlying instruments

to which the futures contract relates must be for identical instruments and the instruments must mature within seven days of each other;

(B) For swaps and forward rate contracts, the reference rate (for floating rate positions) must be identical and the coupon closely matched; and

(C) For swaps, forward rate contracts and forwards, the next interest reset date, or for fixed coupon positions or forwards the remaining maturity, must correspond within the following limits:

(1) If the reset (remaining maturity) dates occur within one month, then the reset (remaining maturity) dates must be on the same day;

(2) If the reset (remaining maturity) dates occur between one month and one year later, then the reset (remaining maturity) dates must occur within seven days of each other, or if the reset (remaining maturity) dates occur over one year later, then the reset (remaining maturity) dates must occur within thirty days of each other.

(3) *Equity Risk.* A swap dealer or major swap participant shall calculate a general market risk charge for equity risk on its proprietary positions equal to 8 percent of its net position in each national equity market. For each national equity market, the net position of the swap dealer or major swap participant equals the difference between the sum of the long positions and the sum of the short positions at current market value. Equity derivatives shall be included in this calculation as set forth in paragraph (d)(4) of this section.

(4) *Equity derivatives.* (i) Equity derivatives must be converted into the notional equity positions in the relevant underlying. For example, an equity swap in which a swap dealer or major swap participant is receiving an amount based on the change in value of one particular equity or equity index and paying a different index will be treated as a long position in the former and a short position in the latter.

(ii) Futures and forward contracts relating to individual equities should be reported as current market prices of the underlying. Futures relating to equity indices should be reported as the marked-to-market value of the notional underlying equity portfolio. Equity swaps are treated as two notional positions, with the receiving side as the long position and the paying side as the short position. If one of the legs involves receiving/paying a fixed or floating interest rate, the exposure should be slotted into the appropriate repricing maturity band for debt securities.

Matched positions in each identical equity in each national market may be

treated as offsetting and excluded from the capital calculation, with any remaining position included in the calculations for specific and general market risk. For example, a future in a given equity may be offset against an opposite cash position in the same equity.

(5) *Foreign Exchange Risk.* The swap dealer or major swap participant shall calculate a market risk charge for foreign exchange risk on its proprietary positions equal to:

(i) 8.0 percent of the sum of:

(A) The greater of the sum of the net open short positions or the sum of the net open long positions in each currency; and

(B) The net open position in gold, regardless of sign.

(ii) For purposes of the calculation in paragraph (d)(5)(i) of this section, the net open position in each currency and gold is the sum of:

(A) The net spot position determined by deducting all liabilities denominated in a currency (or gold) from all assets denominated in the same currency (or gold), including accrued interest earned but not yet received and accrued expenses, and

(B) All foreign exchange derivatives and any other item representing a profit or loss in foreign currencies. Forward currency positions should be valued at current spot market exchange rates.

(iii) In order to report the required charge in U.S. currency, the calculation of the net open position requires the nominal amount (or net present value) of the net open position in each foreign currency (and gold) to be converted at spot rates into the reporting currency.

(6) *Commodities risk.* The swap dealer or major swap participant shall calculate a market risk charge for the commodities risk of its proprietary positions. For purposes of this calculation, each long and short commodity position (spot and forward) is expressed in terms of the standard unit of measurement (such as barrels, kilos, or grams). Commodity derivative positions also are converted into notional positions. The open positions in each category of commodities are then converted at current spot rates into U.S. currency, with long and short positions offset to arrive at the net open position in each commodity. Positions in different categories of commodities may not be offset unless deliverable against each other. The total capital requirement for commodities risk is the sum of the following:

(i) 15.0 percent of the net open position, long or short, in each commodity, and

(ii) 3.0 percent of the swap dealer or major swap participant's gross positions, long plus short, in the particular commodity. In valuing gross positions in commodity derivatives for this purpose, a swap dealer or major swap participant should use the current spot price.

(7) *Option positions.* (i) A swap dealer or major swap participant is not required to deduct a capital charge for market risk if the swap dealer or major swap participant writes options that are hedged by perfectly matched long positions in exactly the same options.

(ii) Except for options for which no capital charge is required under paragraph of (d)(7)(i) of this section, a swap dealer or major swap participant shall calculate its market risk charges (both specific and general market) for option activities using the "delta-plus method". Under the delta plus method, a swap dealer or major swap participant shall include delta-weighted options positions within the appropriate measurement framework set forth in paragraphs (c) through (d)(6) of this section.

(iii) The delta-weighted option position is equal to the market value of the underlying instrument multiplied by the option delta. The delta represents the expected change in the option's price as a proportion of a change in the price of the underlying instrument. For example, an option whose price changes \$1 for every \$2 change in the price of the underlying instrument has a delta of 0.50.

(iv) In addition to the capital charges associated with the option's delta, each option position is subject to additional capital charges to reflect risks for the gamma (the change of the delta for a given change in the price of the underlying) and the vega (the sensitivity of the option price with respect to a change in volatility) for each such option position (including hedge positions). The option delta, and gamma and vega sensitivities shall be calculated according to the swap dealer or major swap participant's option pricing model and will be subject to Commission review. The capital requirement for delta risk, plus the additional capital charges for gamma and vega risks, are calculated as follows:

(A) *Options with debt instruments or interest rates as the underlying instrument.* The delta-weighted options positions are included in the specific risk calculations under paragraph (c) of this section, and also are slotted into the debt instrument time-bands in Table B of this section, using a two-legged approach requiring one entry at the time the underlying contract takes effect and

one at the time the underlying contract matures; and

(1) Floating rate instruments with caps or floors should be treated as a combination of floating rate securities and a series of European style options;

(2) For options such as caps and floors whose underlying instrument is an interest rate, the delta and gamma should be expressed in terms of a hypothetical underlying security;

(3) For gamma risk, for each time-band, net gammas that are negative are

multiplied by the risk weights set out in Table D and by the square of the market value of the underlying instrument (net positive gammas may be disregarded);

(4) Table D is as set forth as follows:

TABLE D

Time-band	Modified duration	Assumed interest rate change (%)	Risk-weight for gamma (average assumed for time band)
Under 1 month .....	0.00	1.00	0.00000
1 up to 3 months .....	0.20	1.00	0.00020
3 up to 6 months .....	0.40	1.00	0.00080
6 up to 12 months .....	0.70	1.00	0.00245
1 up to 2 years .....	1.40	0.90	0.00794
2 up to 3 years .....	2.20	0.80	0.01549
3 up to 4 years .....	3.00	0.75	0.02531
4 up to 5 years .....	3.65	0.75	0.03747
5 up to 7 years .....	4.65	0.70	0.05298
7 up to 10 years .....	5.80	0.65	0.07106
10 up to 15 years .....	7.50	0.60	0.10125
15 up to 20 years .....	8.75	0.60	0.13781
Over 20 years .....	10.00	0.60	0.18000

(5) For volatility risk, the capital requirements for vega are calculated in each time-band assuming a proportional shift in volatility of  $\pm 25.0$  percent; and

(6) The additional capital requirement for gamma and vega risk is the absolute value of the sum of the individual capital requirements for net negative gammas plus the absolute value of the sum of the individual capital requirements for vega risk for each time-band.

(B) *Options with equities as the underlying.* The delta-weighted option positions are included in the calculation of the specific risk charge under paragraph (c) of this section, and also are incorporated in the general market risk charge calculated under paragraph (d)(3) of this section, with individual equity issues and indices treated as separate underlyings; and

(1) For gamma risk, the net gammas that are negative for each underlying are multiplied by 0.72 percent (in the case of an individual equity) or 0.32 percent (in the case of an index as the underlying) and by the square of the market value of the underlying;

(2) For volatility risk, the capital requirement for vega is calculated for each underlying, assuming a proportional shift in volatility of  $\pm 25.0$  percent; and

(3) The additional capital requirement for gamma and vega risk is the absolute value of the sum of the individual capital requirements for net negative gammas plus the absolute value of the

individual capital requirements for vega risk.

(C) *Options on foreign exchange and gold positions.* The net delta (or delta-based) equivalent of the total book of foreign currency and gold options is incorporated into the measurement of the exposure in a single currency position as set forth in paragraph (d)(5) of this section; and

(1) For gamma risk, for each underlying exchange rate, net gammas that are negative are multiplied by 0.32 percent and by the square of the market value of the positions;

(2) For volatility risk, the capital requirements for vega are calculated for each currency pair and gold assuming a proportional shift in volatility of  $\pm 25.0$  percent; and

(3) The additional capital requirement for gamma and vega risk is the absolute value of the sum of the individual capital requirements for net negative gammas plus the absolute value of the sum of the individual capital requirements for vega risk.

(D) *Options on commodities.* The delta-weighted positions are incorporated into the measure described in paragraph (d)(6) of this section; and

(1) For gamma risk, net gammas that are negative for each underlying are multiplied by 1.125 percent and by the square of the market value of the commodity;

(2) For volatility risk, a bank calculates the capital requirements for vega for each commodity assuming a

proportional shift in volatility of  $\pm 25.0$  percent; and

(3) The additional capital requirement for gamma and vega risk is the absolute value of the sum of the individual capital requirements for net negative gammas plus the absolute value of the sum of the individual capital requirements for vega risk.

(e) *Credit Risk.* The swap dealer or major swap participant shall compute an additional capital requirement for the credit risk of over-the-counter derivatives transactions that are not cleared in an amount equal to the sum of the following:

(1) A counterparty exposure charge in an amount equal to the sum of the following:

(i) The net replacement value in the account of each counterparty that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default; and

(ii) For a counterparty not otherwise described in paragraph (e)(1)(i) of this section, the credit equivalent amount of the swap dealer or major swap participant's exposure to the counterparty, minus collateral values as set forth in this section, multiplied by a credit risk factor of 50 percent or a credit risk factor computed under paragraph (e)(1)(iii) of this section, multiplied by 8 percent;

(iii) Counterparties may be rated by the swap dealer or major swap participant, or by an affiliated bank or affiliated broker-dealer of the swap dealer or major swap participant, upon

approval by the Commission on application by the swap dealer or major swap participant. The application will specify which internal ratings will result in application of a 20 percent risk weight, 50 percent risk weight, or 150 percent risk weight. Based on the strength of the applicant's internal credit risk management system, the Commission may approve the application. The swap dealer or major swap participant must make and keep current a record of the basis for the credit rating for each counterparty. The records must be maintained in accordance with § 1.31 of this chapter.

(2) A concentration charge by counterparty in an amount equal to 50 percent of the amount of the current exposure to the counterparty in excess of 5 percent of the tangible net equity of the swap dealer or major swap participant and a portfolio concentration charge of 100 percent of the amount of the swap dealer or major swap participant's aggregate current exposure for all counterparties in excess of 50 percent of the tangible net equity of the swap dealer or major swap participant.

(f) *Calculation of the credit equivalent amount.* The credit equivalent amount of a swap dealer or major swap

participant's exposure to a counterparty is the sum of the swap dealer or major swap participant's current exposure to the counterparty, and the swap dealer or major swap participant's potential future exposure to the counterparty.

(g) The current exposure of the swap dealer or major swap participant to a counterparty is calculated as follows:

(1) For a single over-the-counter position, the current exposure is the greater of the mark-to-market value of the over-the-counter position or zero.

(2) For multiple over-the-counter positions, the current credit exposure is the greater of:

(i) The net sum of all positive and negative mark-to-market values of the individual over-the-counter positions, subject to permitted netting pursuant to a qualifying master netting agreement; or

(ii) Zero.

(h) The potential future exposure of the swap dealer or major swap participant is calculated as follows:

(1) For a single over-the-counter position, the potential future exposure, including an over-the-counter position with a negative mark-to-market value, is calculated by multiplying the notional principal amount of the position by the appropriate conversion factor in Table E

of this section. For purposes of this calculation, the swap dealer or major swap participant must use the apparent or stated notional principal amount multiplied by any multiplier in the over-the-counter position. For exchange rate contracts and other similar contracts in which the notional principal amount is equivalent to the cash flows, notional principal amount is the net receipts to each party falling due on each value date in each currency. The potential future exposure of the protection provider of a credit derivative is capped at the net present value of the amount of unpaid premiums. For an over-the-counter derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract. For an over-the-counter derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

TABLE E

Remaining maturity	Interest rate	Foreign exchange rate and gold	Credit	Equity	Precious metals (except gold)	Other
One year or less .....	0.00	0.01	0.10	0.06	0.07	0.10
Over one to five years .....	0.005	0.05	0.10	0.08	0.07	0.12
Over five years .....	0.015	0.075	0.10	0.10	0.08	0.15

(2) For multiple over-the-counter positions that are subject to a qualifying master netting agreement, the swap dealer or major swap participant shall compute its potential future exposure in accordance with the following formula:  $A_{net} = (0.4 \times A_{gross}) + (0.6 \times NGR \times A_{gross})$ , where:

(i)  $A_{gross}$  equals the sum of the potential future exposure for each individual over-the-counter position subject to the qualifying master netting agreement; and

(ii)  $NGR$  equals the ratio of the net current credit exposure to the gross current credit exposure. In calculating the  $NGR$ , the gross current credit exposure equals the sum of the positive current credit exposures of all individual over-the-counter derivative contracts subject to the qualifying master netting agreement.

(i) *Netting agreements.* In computing its credit equivalent amount pursuant to paragraph (f) of this section, a swap

dealer or major swap participant may net gross receivables and gross payables to and from a single counterparty if the swap dealer or major swap participant has entered into a netting agreement with the counterparty that meets the following criteria:

(1) The netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings;

(2) The gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and

(3) For internal risk management purposes, the swap dealer or major swap participant monitors and controls its exposure to the counterparty on a net basis.

(j) *Collateral.* (1) Subject to the haircuts specified in paragraph (j)(2) of this section, a swap dealer or major swap participant may reduce its credit risk equivalent computed under

paragraph (f) of this section to the extent of the market value of collateral pledged to and held by the swap dealer or major swap participant to secure an over-the-counter position. The collateral is subject to the following requirements:

(i) The collateral must be in the swap dealer or major swap participant's physical possession or control; *Provided, However,* collateral may include collateral held in independent third party accounts as provided under part 23 of this chapter;

(ii) The collateral must meet the requirements specified in a credit support agreement meeting the requirements of § 23.151 of this part; and

(iii) If the counterparty is a swap dealer, major swap participant or financial entity as defined in § 23.150 of this part:

(A) The collateral must be financial collateral that is liquid and transferable; marked-to-market each day, and subject

to a daily maintenance margin requirement;

(B) The collateral must be capable of being liquidated promptly by the swap dealer or major swap participant without intervention by any other party;

(C) The collateral must be subject to an agreement that is legally enforceable by the swap dealer or major swap participant against the counterparty and any other parties to the agreement;

(D) The collateral cannot consist of securities issued by the counterparty or a party related to the swap dealer or major swap participant or to the counterparty; and

(E) The collateral cannot be used in determining the credit rating of the counterparty.

(2) A swap dealer or major swap participant must reduce the market value of the counterparty's collateral used to reduce the swap dealer's or major swap participant's credit risk equivalent amount computed under paragraph (f) of this section by:

(i) Applying the market haircuts specified in § 1.17(c)(5) of this chapter, and a further deduction of 8 percent of the market value of the collateral when the settlement currency of the interest rate position and collateral currency are not the same; or

(ii) where the collateral has been received from a counterparty that is not a swap dealer, major swap participant, or a financial entity as defined in § 23.150 of this part, applying the haircuts required pursuant to a credit support agreement meeting the requirements of § 23.151.

(k) *Sample Calculation of General Market Risk for Debt Instruments Using the Maturity Method.* (1) The following positions are slotted into a maturity ladder as shown below, which uses the risk weights specified in Table B of this section:

(i) Qualifying bond, \$13.33mn market value, remaining maturity 8 years, coupon 8 percent;

(ii) Government bond, \$75mn market value, remaining maturity 2 months, coupon 7 percent;

(iii) Interest rate swap, \$150 mn, bank receives floating rate interest and pays fixed, next interest reset after 12 months, remaining life of swap is 8 years (The position should be reported as the market value of the notional underlying. Depending on the current interest rate, the market value of each leg of the swap (i.e. the 8 year bond and the 9 months floater) can be either higher or lower than the notional amount. For sake of simplicity the example assumes that the current interest rate is identical with the one the swap is based on.)

(iv) Long position in interest rate future, \$50mn, delivery date after 6 months, life of underlying government security is 3.5 years (assumes the current interest rate is identical to the one the futures is based on).

Zone	Time-band and position	Risk weight %	Risk-weighted position	Net time-band positions	Net zone positions
1 .....	0-1 mth .....	0.00			
	1-3 mth Long 75 Gov. bond	0.20	Long 0.15 .....	Long 0.15 .....	Long 1.00.
	3-6 mth Short 50 Future .....	0.40	Short 0.20 .....	Short 0.20.	
	6-12 mths Long 150 Swap ..	0.70	Long 1.05 .....	Long 1.05.	
2 .....	1-2 yrs .....	1.25			
	2-3 yrs .....	1.75			
	3-4 yrs Long 50 Future .....	2.25	Long 1.125 .....	Long 1.125 .....	Long 1.125.
3 .....	4-5 yrs .....	2.75			
	5-7 yrs .....	3.25			
	7-10 yrs Short 150 Swap, Long 13.33 Qual Bond.	3.75	Short 5.625, Long 0.050 .....	Short 5.125 .....	Short 5.125.
	10-15 yrs .....	4.50			
	15-20 yrs .....	5.25			
	Over 20 yrs .....	6.00			

(2) A vertical disallowance is calculated for time-band 7–10 years, and equals 10 percent of the matched positions in the time-band— $10.0 \times 0.5 = 0.05$  (\$50,000).

(3) A horizontal disallowance is calculated for zone 1, and equals 40 percent of the matched positions in the zone— $40.0 \times 0.20 = 0.80$  (\$80,000). The remaining net position in Zone 1 equals +1.00.

(4) A horizontal disallowance is calculated for adjacent zones 2 and 3. It equals 40 percent of the matched positions between the zones— $40.0 \times 1.125 = 0.45$  (450,000). The remaining position in zone 3 equals –4.00.

(5) A horizontal disallowance is calculated between zones 1 and 3. It equals 100 percent of the matched positions between the zones— $100 \times 1.00 = 1.00$  (1,000,000).

(6) The remaining net open position equals 3.00 (\$3,000,000). The total

capital requirement for general market risk for this portfolio equals:

The vertical disallowance .....	\$50,000
Horizontal disallowance in zone 1 .....	80,000
Horizontal disallowance— zones 2 and 3 .....	450,000
Horizontal disallowance— zones 1 and 3 .....	1,000,000
Overall net open position .....	3,000,000
<hr/>	
Total requirement for general market risk .....	4,580,000

(l) *Sample Calculation for Delta-Plus Method for Options.* (1) Assume the swap dealer or major swap participant has a European short call option on a commodity with an exercise price of 490 and a market value of the underlying 12 months from the expiration of the option at 500; a risk-free interest rate at 8 percent per annum, and the volatility at 20 percent. The

current delta for this position is according to the Black-Scholes formula –0.721 (that is, the price of the option changes by –0.721 if the price of the underlying moves by 1). The gamma is –0.0034 (that is, the delta changes by –0.0034 from –0.721 to –0.7244 if the price of the underlying moves by 1). The current value of the option is 65.48.

(2) The first step under the delta-plus method is to multiply the market value of the commodity by the absolute value of the delta:  $500 \times 0.721 = 360.5$ . The delta-weighted position is then incorporated into the measure described for general market risk for commodities. If no other positions in the commodity exist, the delta-weighted position is multiplied by 0.15 to calculate the capital requirement for delta:  $360.5 \times 0.15 = 54.075$ .

(3) The capital requirement for gamma is calculated according to the Taylor expansion by multiplying the absolute

value of the assumed gamma of  $-0.0034$  by 1.125 percent and by the square of the market value of the underlying:  $0.0034 \times 0.01125 \times 500^2 = 9.5625$ .

(4) The capital requirement for vega is calculated next. The assumed current (implied) volatility is 20 percent. Since only an increase in volatility carries a risk of loss for a short call option, the volatility has to be increased by a

relative shift of 25 percent. This means that the vega capital requirement has to be calculated on the basis of a change in volatility of 5 percentage points from 20 percent to 25 percent in this example. According to the Black-Scholes formula used here, the vega equals 168. Thus, a 1 percent or 0.01 increase in volatility increases the value of the option by 1.68. Accordingly, a change in volatility of 5 percentage

points increases the value:  $5 \times 1.68 = 8.4$ . This is the capital requirement for vega risk.

(m) *Summary of Treatment for Interest Rate Derivatives.* (1) The following chart summarizes the application of specific risk and general market risk charges for specific types of interest rate derivatives.

Instrument	Specific risk charge	General market risk charge
Exchange-Traded Future:		
Government security .....	No .....	Yes, as two positions.
Corporate debt security .....	Yes .....	Yes, as two positions.
Index on short-term interest rates (e.g. LIBOR) .....	No .....	Yes, as two positions.
OTC Forward:		
Government security .....	No .....	Yes, as two positions.
Corporate debt security .....	Yes .....	Yes, as two positions.
Index on short-term interest rates. ....	No .....	Yes, as two positions.
FRAs, Swaps .....	No .....	Yes, as two positions.
Forward foreign exchange .....	No .....	Yes, as one position in each currency.
Options:		
Government security .....	No.	General market risk charge for each type of transaction, using the Delta-plus method (gamma and vega receive separate capital charges).
Corporate debt security .....	Yes .....	
Index on short-term interest rates .....	No.	

(2) The chart provided in paragraph (m)(1) of this section is provided as a summary only. The requirements for specific risk and general market risk charges applicable to interest rate derivatives are set forth in paragraphs (a) through (d) of this section.

#### **§ 23.105 Maintenance of minimum financial requirements by swap dealers and major swap participants.**

(a) Each swap dealer or major swap participant who is subject to the minimum capital requirements under § 23.101 of this part and who knows or should have known that its capital at any time is less than the minimum required by § 23.101 of this part, must:

(1) Give telephonic notice, to be confirmed in writing by facsimile notice, that the swap dealer's or major swap participant's capital is less than that required by § 23.101 of this part. The notice must be given immediately after the swap dealer or major swap participant knows or should know that its capital is less than that required by § 23.101 of this part; and

(2) Provide together with such notice documentation in such form as necessary to adequately reflect the swap dealer's or major swap participant's capital condition as of any date such person's capital is less than the minimum required. The swap dealer or major swap participant must provide similar documentation for other days as the Commission may request.

(b) Each swap dealer or major swap participant who is subject to the minimum capital requirements under § 23.101 of this part and who knows or should have known that its capital at any time is less than 110 percent of its minimum capital requirement as determined under § 23.101 of this part, must file written notice to that effect within 24 hours of such event.

(c) Each swap dealer or major swap participant who is subject to capital rules established by a prudential regulator, or has been designated a systemically important financial institution by the Financial Stability Oversight Council and is subject to capital requirements imposed by the Board of Governors of the Federal Reserve System, must provide immediate written notice transmitted by facsimile if it fails to maintain compliance with the minimum capital requirements established by the prudential regulator or the Board of Governors of the Federal Reserve System.

(d) Upon the request of the Commission, each swap dealer or major swap participant who is subject to capital rules established by a prudential regulator, or has been designated a systemically important financial institution by the Financial Stability Oversight Council and is subject to capital requirements imposed by the Board of Governors of the Federal

Reserve System must provide the Commission with copies of its capital computations for any periods of time specified by the Commission. The capital computations must be computed in accordance with the requirements of the swap dealer's or major swap participant's prudential regulator, and must include all supporting schedules and other documentation.

(e) If a swap dealer or major swap participant at any time fails to make or to keep current the books and records required by these regulations, such swap dealer or major swap participant must, on the same day such event occurs, provide facsimile notice of such fact, specifying the books and records which have not been made or which are not current, and within 48 hours after giving such notice file a written report stating what steps have been and are being taken to correct the situation.

(f) A swap dealer or major swap participant that is subject to the minimum capital requirements set forth in § 23.101 of this part, must provide written facsimile notice of a substantial reduction in capital as compared to that last reported in a financial report filed with the Commission pursuant to § 23.105 of this part. This notice shall be provided as follows:

(1) If any event or series of events, including any withdrawal, advance, loan or loss cause, on a net basis, a reduction in tangible net equity of

20 percent or more, notice must be provided within two business days of the event or series of events causing the reduction; and

(2) If the equity capital of the swap dealer or major swap participant would be withdrawn by action of a stockholder or a partner or a limited liability company member or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, or an unsecured advance or loan would be made to a stockholder, partner, sole proprietor, limited liability company member, employee or affiliate, such that the withdrawal, advance or loan would cause, on a net basis, a reduction in excess net tangible equity of 30 percent or more, notice must be provided at least two business days prior to the withdrawal, advance or loan that would cause the reduction:

*Provided, however,* That the provisions of paragraphs (f)(1) and (2) of this section do not apply to any futures or swaps transaction in the ordinary course of business between a swap dealer or major swap participant and any affiliate where the swap dealer or major swap participant makes payment to or on behalf of such affiliate for such transaction and then receives payment from such affiliate for such transaction within two business days from the date of the transaction.

(3) Upon receipt of such notice from a swap dealer or major swap participant, the Director of the Division of Clearing and Intermediary Oversight or the Director's designee may require that the swap dealer or major swap participant provide, within three business days from the date of the request or such shorter period as the Director or designee may specify, such other information as the Director or designee determines to be necessary based upon market conditions, reports provided by swap dealer or major swap participant, or other available information.

(g) Every notice and written report required by this section to be filed by a swap dealer or major swap participant shall be filed with the regional office of the Commission with jurisdiction over the state in which the swap dealer's or major swap participant's principal place of business is located, as set forth in § 140.02 of this chapter, and with the registered futures association of which the swap dealer or major swap participant is a member. In addition, every notice and written report required to be given by this section must also be filed with the Chief Accountant of the Division of Clearing and Intermediary Oversight at the Commission's principal office in Washington, DC.

**§ 23.106 Financial recordkeeping and reporting requirements for swap dealers and major swap participants.**

(a)(1) Except as provided in paragraph (a)(2) of this section, each registered swap dealer or major swap participant must comply with the requirements set forth in paragraphs (b) through (j) of this section.

(2) The requirements in paragraphs (b) through (j) of this section do not apply to any swap dealer or major swap participant that:

(i) Is subject to the capital requirements of a prudential regulator;

(ii) Has been designated a systemically important financial institution by the Financial Stability Oversight Council and is subject to supervision by the Board of Governors of the Federal Reserve System; or

(iii) Is registered as a futures commission merchant.

(b) Each swap dealer or major swap participant shall prepare and keep current ledgers or other similar records which show or summarize, with appropriate references to supporting documents, each transaction affecting its asset, liability, income, expense and capital accounts, and in which (except as otherwise permitted in writing by the Commission) all its asset, liability and capital accounts are classified in accord with generally accepted accounting principles as established in the United States, and as otherwise may be necessary for the capital calculations required under § 23.101. Such records must be maintained in accordance with § 1.31 of this chapter.

(c)(1) Each swap dealer and major swap participant shall file financial reports meeting the requirements in paragraph (c)(2) of this section as of the close of business each month. Such financial reports must be filed no later than 17 business days after the date for which the report is made.

(2) The monthly financial reports must be prepared in the English language and be denominated in United States dollars. The monthly financial reports shall include a statement of financial condition, a statement of income/loss, a statement reconciling the net equity in the statement of financial condition to the firm's tangible net equity, a schedule detailing, as applicable under § 23.101, the calculation of the firm's minimum tangible net equity requirement or its minimum risk-based capital ratios requirements, and showing the excess or deficiency in its regulatory capital after subtracting the minimum tangible net equity requirement from its tangible net equity, or after comparing its risk-based capital ratios to its minimum risk-based

capital ratios. The monthly report and schedules must be prepared in accordance with generally accepted accounting principles as established in the United States.

(d)(1) Each swap dealer and major swap participant shall file annual audited financial reports certified in accordance with paragraph (d)(2) of this section, and including the information specified in paragraph (d)(3) of this section, as of the close of its fiscal year no later than 90 days after the close of the swap dealer's and major swap participant's fiscal year.

(2) The annual audited financial report shall be certified in accordance with the provisions of paragraphs (a) through (e) of § 1.16 of this chapter: *Provided, however,* that for purposes of application of the provisions of § 1.16 to swap dealers and major swap participants, the term “§ 23.101” shall be substituted for the term “§ 1.17,” and the terms “swap dealer” or “major swap participant” shall be substituted for the term “futures commission merchant,” as appropriate.

(3) The annual audited financial reports shall be prepared in accordance with generally accepted accounting principles as established in the United States, be prepared in the English language, and denominated in United States dollars. The annual audited financial reports must include the following:

(i) A statement of financial condition as of the date for which the report is made;

(ii) Statements of income (loss), cash flows, and changes in ownership equity for the period between the date of the most recent certified statement of financial condition filed with the Commission and the date for which the report is made;

(iii) Appropriate footnote disclosures;

(iv)(A) If the swap dealer or major swap participant must comply with capital requirements set forth in § 23.101(a)(1) of this part, a schedule including the swap dealer's or major swap participant's net equity; its intangible assets; its minimum tangible net equity; its minimum tangible net equity requirement; and the excess or deficiency in its regulatory capital after subtracting the minimum tangible net equity requirement from its tangible net equity; or

(B) If the swap dealer or major swap participant must comply with capital requirements set forth in § 23.101(a)(2) of this part, a schedule including the swap dealer's or major swap participant's minimum risk-based capital ratio requirements as calculated using requirements set forth in 12 CFR.

part 225, and appendices thereto, as if the subsidiary itself were a U.S. bank-holding company; its risk-based capital ratios; and the excess or deficiency in its regulatory capital after comparing its risk-based capital ratios to its minimum risk-based capital ratio requirements.

(v) Such further material information as may be necessary to make the required statements not misleading.

(e) A registered swap dealer or major swap participant may not change its fiscal year from that used in its most recent report filed under paragraph (c) or (d) of this section unless it has requested and received written approval for the change from a registered futures association of which it is a member.

(f) Attached to each financial report filed pursuant to this section must be an oath or affirmation that to the best knowledge and belief of the individual making such oath or affirmation the information contained in the financial report is true and correct. The individual making such oath or affirmation must be: If the swap dealer or major swap participant is a sole proprietorship, the proprietor; if a partnership, any general partner; if a corporation, the chief executive officer or chief financial officer; and, if a limited liability company or limited liability partnership, the chief executive officer, the chief financial officer, the manager, the managing member, or those members vested with the management authority for the limited liability company or limited liability partnership.

(g) From time to time the Commission may, by written notice, require any swap dealer or major swap participant to file financial or operational information on a daily basis or at such other times as may be specified by the Commission. Such information must be furnished in accordance with the requirements included in the written Commission notice.

(h) *Procedures for filing with Commission.* (1) Unless filed electronically as permitted under paragraph (h)(2) of this section, all filings made under this section must be addressed to, and received at, the location of the regional office of the Commission with jurisdiction over the state in which the registrant's principal place of business is located as set forth in § 140.02 of this chapter.

(2) All filings of financial reports made pursuant to this section may be submitted to the Commission in electronic form using a form of user authentication assigned in accordance with procedures established by or approved by the Commission, and otherwise in accordance with

instructions issued by or approved by the Commission, if the swap dealer or major swap participant has provided the Commission with the means necessary to read and to process the information contained in such report. Any such electronic submission must clearly indicate the swap dealer or major swap participant on whose behalf such filing is made and the use of such user authentication in submitting such filing will constitute and become a substitute for the manual signature of the authorized signer. In the case of a financial report required under paragraphs (c), (d), or (g) of this section and filed via electronic transmission in accordance with procedures established by or approved by the Commission, such transmission must be accompanied by the user authentication assigned to the authorized signer under such procedures, and the use of such user authentication will constitute and become a substitute for the manual signature of the authorized signer for the purpose of making the oath or affirmation referred to in paragraph (f) of this section.

(i) *Public availability of reports.* (1) Financial information required to be filed pursuant to this section, and not otherwise publicly available, will be treated as exempt from mandatory public disclosure for purposes of the Freedom of Information Act and the Government in the Sunshine Act and parts 145 and 147 of this chapter, except for the information described in paragraph (i)(2) of this section.

(2) The following information will be publicly available:

(i) As applicable, the amounts calculated by the swap dealer or major swap participant as its tangible net equity; its minimum tangible net equity requirement; its tangible net equity in excess of its minimum tangible net equity requirement; its risk-based capital ratios; and the excess or deficiency in its regulatory capital after comparing its risk-based capital ratios to its minimum risk-based capital ratio requirements.

(ii) The opinion of the independent public accountant in the certified annual financial reports.

(3) All information that is exempt from mandatory public disclosure under paragraph (i)(1) of this section will, however, be available for official use by any official or employee of the United States or any State, by the National Futures Association and by any other person to whom the Commission believes disclosure of such information is in the public interest.

## §§ 23.107–23.149 [Reserved]

## PART 140—ORGANIZATION, FUNCTIONS, AND PROCEDURES OF THE COMMISSION

7. The authority citation for part 140 continues to read as follows:

**Authority:** 7 U.S.C. 2 and 12a.

8. Amend § 140.91 by revising the section heading and adding paragraphs (a)(9) through (15) to read as follows:

### § 140.91 Delegation of authority to the Director of the Division of Clearing and Intermediary Oversight.

(a) \* \* \*

(9) All functions reserved to the Commission in § 23.101(c)(2) of this chapter, with the concurrence of the General Counsel or his or her designee;

(10) All functions reserved to the Commission in § 23.103(d) of this chapter, with the concurrence of the General Counsel or his or her designee;

(11) All functions reserved to the Commission in § 23.105(a)(2) and (d) of this chapter, with the concurrence of the General Counsel or his or her designee;

(12) All functions reserved to the Commission in § 23.155(b)(4)(ii), (iii) and (c)(4) of this chapter, with the concurrence of the General Counsel or his or her designee;

(13) All functions reserved to the Commission in § 23.156(c)(1) and (2) of this chapter, with the concurrence of the General Counsel or his or her designee;

(14) All functions reserved to the Commission in § 23.157(d) of this chapter, with the concurrence of the General Counsel or his or her designee; and

(15) All functions reserved to the Commission in § 23.158(c) of this chapter, with the concurrence of the General Counsel or his or her designee.

\* \* \* \* \*

Issued in Washington, DC, on April 27, 2011, by the Commission.

**David A. Stawick,**  
*Secretary of the Commission.*

**Note:** The following appendices will not appear in the Code of Federal Regulations.

### Appendices to Capital Requirements of Swap Dealers and Major Swap Participants—Commission Voting Summary and Statements of Commissioners

#### Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn, Sommers and Chilton voted in the affirmative; Commissioner O'Malia voted in the negative.

**Appendix 2—Statement of Chairman Gary Gensler**

I support the proposed rulemaking to establish capital requirements for nonbank swap dealers and major swap participants. The Dodd-Frank Act requires capital requirements to help ensure the safety and soundness of swap dealers and major swap participants. Capital rules help protect commercial end-users and other market participants by requiring that dealers have sufficient capital to stand behind their obligations with such end-users and market participants. The proposal fulfills the Dodd-Frank Act's mandate in Section 731 to establish capital rules for all registered swap dealers and major swap participants that are not banks, including nonbank subsidiaries of bank holding companies.

The proposed rule addresses capital requirements for swap dealers and major swap participants in three different categories: (1) If they are futures commission merchants (FCMs); 2) if they are subsidiaries of bank holding companies or systemically important financial institutions; or 3) if they are neither.

With regard to dealers that also are FCMs, generally speaking, the Commission's existing capital rules for FCMs would apply.

This is to ensure that FCMs have sufficient capital to continue to carry and clear customer swaps and futures transactions cleared by a DCO.

The proposed rule would require dealers that are subsidiaries of bank holding companies or that have been designated as systemically important financial institutions by the Financial Stability Oversight Council (FSOC) to follow the rules set by the prudential regulators. For instance, a subsidiary of a U.S. bank holding company would have to comply with the capital requirements set by the Federal Reserve Board as if the subsidiary itself were a U.S. bank holding company. This is intended to prevent regulatory arbitrage and ensure consistency among capital regimes for those entities that are regulated by prudential regulators.

For those swap dealers and major swap participants that are not regulated for capital by a prudential capital and not FCMs, part of a bank holding company or a systemically important financial institution, the proposed rule departs from bank capital rules. It takes into consideration that these dealers are likely to have different balance sheets from those financial institutions that traditionally have been subject to prudential supervision. Such entities would be required to maintain

a minimum level of tangible net equity greater than \$20 million plus a measurement for market risk and a measurement for credit risk. This market risk and credit risk would be scaled to the dealers' activities and be measured based upon swaps activity and related hedges. The proposal would allow such firms to recognize as part of their capital fixed assets and other assets that traditionally have not been recognized by prudential regulators.

I also support the proposed rulemaking's financial condition reporting requirements that relate generally to capital and other matters. These reporting requirements are comparable to existing requirements for FCMs and will facilitate ongoing financial oversight of these entities.

CFTC staff worked very closely with prudential regulators to establish these capital requirements that are comparable to the maximum extent practicable. Staff also consulted with the SEC and with international authorities. The rule benefited from the CFTC and SEC staff roundtable on capital and margin requirements where we received significant input from the public.

**Note:** The following exhibit also will not appear in the Code of Federal Regulations.

**BILLING CODE P**

## Exhibit A

Name of Company:

Employer ID No.:

NFA ID No.:

## CFTC FORM 1-FR-FCM

STATEMENT OF CLEARED SWAPS CUSTOMER SEGREGATION REQUIREMENTS AND  
FUNDS IN CLEARED SWAPS CUSTOMER ACCOUNTS UNDER 4D(F) OF THE CEACleared Swaps Customer Requirements

1. Net ledger balance	\$ 0	<input type="checkbox"/> X500
A. Cash	\$ 0	<input type="checkbox"/> X510
B. Securities (at market)	\$ 0	<input type="checkbox"/> X520
2. Net unrealized profit (loss) in open cleared swaps	\$ 0	<input type="checkbox"/> X530
A. Market value of open cleared OTC derivatives option contracts purchased	\$ 0	<input type="checkbox"/> X540
B. Market value of open cleared OTC derivatives option contracts granted (sold)	\$ 0	<input type="checkbox"/> X550
3. Cleared OTC derivatives options	\$ 0	<input type="checkbox"/> X560
4. Net equity (deficit) (add lines 1, 2, and 3)	\$ 0	<input type="checkbox"/> X570
5. Accounts liquidating to a deficit and accounts with debit balances - gross amount	\$ 0	<input type="checkbox"/> X580
Less: amount offset by customer owned securities	\$ 0	<input type="checkbox"/> X590
6. Amount required to be segregated for cleared swaps customers (add lines 4 and 5)	\$ 0	<input type="checkbox"/> X600

Funds in Cleared Swaps Customer Segregated Accounts

7. Deposited in cleared swaps customer segregated accounts at banks	\$ 0	<input type="checkbox"/> X610
A. Cash	\$ 0	<input type="checkbox"/> X620
B. Securities representing investments of cleared swaps customers' funds (at market)	\$ 0	<input type="checkbox"/> X630
C. Securities held for particular cleared swaps customers in lieu of cash (at market)	\$ 0	<input type="checkbox"/> X640
8. Margins on deposit with derivatives clearing organizations in cleared swaps customer segregated accounts	\$ 0	<input type="checkbox"/> X650
A. Cash	\$ 0	<input type="checkbox"/> X660
B. Securities representing investments of cleared swaps customers' funds (at market)	\$ 0	<input type="checkbox"/> X670
C. Securities held for particular cleared swaps customers in lieu of cash (at market)	\$ 0	<input type="checkbox"/> X680
9. Net settlement from (to) derivatives clearing organizations	\$ 0	<input type="checkbox"/> X690
10. Cleared OTC derivatives options	\$ 0	<input type="checkbox"/> X700
A. Value of open cleared OTC derivatives long option contracts	\$ 0	<input type="checkbox"/> X710
B. Value of open cleared OTC derivatives short option contracts	\$ 0	<input type="checkbox"/> X715
11. Net equities with other FCMs	\$ 0	<input type="checkbox"/> X720
A. Net liquidating equity	\$ 0	<input type="checkbox"/> X730
B. Securities representing investments of cleared swaps customers' funds (at market)	\$ 0	
C. Securities held for particular cleared swaps customers in lieu of cash (at market)	\$ 0	
12. Cleared swaps customer funds on hand (describe: )	\$ 0	
13. Total amount in cleared swaps customer segregation (add lines 7 through 12)	\$ 0	
14. Excess (deficiency) funds in cleared swaps customer segregation (subtract line 6 from line 13)	\$ 0	

[FR Doc. 2011-10881 Filed 5-11-11; 8:45 am]

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