

December 19, 2016

## CFTC Re-Proposes Capital Rules for Swap Dealers

On December 2, 2016, the Commodity Futures Trading Commission (CFTC) unanimously approved a re-proposal of rules (the “Proposed Rules” or the “Proposal”) that set minimum financial capital requirements for swap dealers (SDs) and major swap participants (MSPs) that are not subject to prudential regulation (each, a “Covered Swap Entity” or “CSE”).<sup>1</sup> The core financial requirement is capital equal to the greatest of \$20 million or 8% of the initial margin required on the CSE’s cleared and uncleared swaps, security-based swaps, futures and foreign futures, but the Proposed Rules permit or require different types of CSEs to adopt different approaches to meeting these requirements<sup>2</sup>:

1. A Covered Swap Entity can generally elect one of two approaches to computing its regulatory capital:
  - A) an approach (the “bank-based approach”) based on maintaining minimum levels of common equity tier 1 capital, as defined under the rules for bank holding companies, or
  - B) an approach (the “net liquid assets approach”) based on having minimum net capital computed in accordance with the rules adopted by the Securities and Exchange Commission (SEC) for security-based swap dealers, but with some specific adjustments.
2. A Covered Swap Entity that is a futures commission merchant (FCM)<sup>3</sup> must meet existing FCM net capital requirements (as amended by the Proposed Rules to establish market and credit risk charges specifically applicable to swaps and security-based swaps).
3. A CSE that is predominantly engaged in non-financial activities (i.e., at least 85% of its assets and revenues are non-financial) can alternatively elect to meet a tangible net worth test.
4. An SD organized and domiciled outside the United States may follow the capital adequacy requirements of its home jurisdiction if the CFTC has made a capital comparability determination with respect to those non-US rules.

<sup>1</sup> According to the CFTC, there are currently 53 provisionally registered SDs that will be subject to the Proposed Rules. The other 51 US and non-US entities that are now provisionally registered as SDs are prudentially regulated entities that are covered by capital rules adopted by the bank regulators. The CFTC has not, however, published a list categorizing each swap dealer individually by name in these regards (nor has anyone else).

<sup>2</sup> The Proposed Rules specify that a CSE must always meet any greater regulatory capital requirements imposed on it by any registered futures association of which it is a member, but the only such association currently in existence is the National Futures Association (NFA), which does not currently set capital requirements for swap dealers or MSPs.

<sup>3</sup> According to the CFTC, there are currently five SDs that fall into this category.

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5. An SD that is also a broker-dealer that is registered with the SEC and approved to use internal models as an “alternative net capital” (ANC) firm may simply comply with its existing SEC capital requirements.
  6. The only requirement applicable to a major swap participant is that the MSP must maintain a positive tangible net worth.

Exhibit A contains a table summarizing the applicable capital requirements and approaches from the Proposed Rules.

Other noteworthy points concerning the Proposed Rules are as follow:

- A. An SD that elects either the bank-based approach or the net liquid assets approach also will be subject to liquidity requirements set in Regulation 23.104(a). For SDs electing the bank-based approach, the liquidity requirement will be based on the liquidity requirements adopted by the prudential regulators. For SDs electing the net liquid assets approach, the liquidity requirement is based on the one proposed by the SEC for security-based swaps. SDs also will have to perform a monthly liquidity stress test, keep liquidity reserves and have a contingency funding plan.
- B. The margin prong of the capital requirement for an SD is calculated as 8% of the sum of a) the initial margin owed by the SD on uncleared swaps (without giving effect to the SD’s initial margin threshold or minimum transfer amount), b) the initial margin owed by the SD on uncleared security-based swaps (without giving effect to any initial margin threshold or minimum transfer amount set by the SEC), and c) the amount of initial margin required by clearing organizations for all the SD’s cleared proprietary futures, foreign futures, swaps and security-based swaps.
- C. No swap dealer can make distributions to equity holders or redeem shares if its regulatory capital is less than 120% of the required minimum or if such actions have been restricted by CFTC order.
- D. A Covered Swap Entity may apply to the CFTC or the NFA for approval to use internal models to calculate market and credit risk capital charges for the purposes of computing its regulatory capital. Appendix A of the Proposed Rules sets detailed qualitative and quantitative standards for model approval that are similar to existing standards applied by the prudential regulators and the SEC. A CSE that does not have approval to use internal models must use rules-based standardized capital charges set in Regulation 23.103.
- E. Any swap dealer subject to the Proposed Rules will be required to provide the routine reports identified in Exhibit B and the event-driven notices identified in Exhibit C that typically require filings after discovery of an enumerated event within 24 hours, or in some cases, immediately. All financial statements and other filings must be accompanied by an oath or affirmation from the CEO or similar officer that the information provided is true and correct. MSPs subject to the Proposed Rule will have similar but fewer reporting requirements.
- F. Although an SD that is prudentially regulated is exempt from the substance of the Proposed Rule, it will be required to provide the CFTC with the reports and notices specified in Exhibit D.

Proposed Rules were published in the *Federal Register* on December 16. The comment period ends March 16, 2017.

# EXHIBIT A

## Summary Table of Capital Requirements and Approaches for Covered Swap Entities

(A non-US swap dealer may comply with home jurisdiction capital rules if the CFTC has made a Capital Comparability Determination with respect to the non-US rules.)

Capital Rule Approach	Swap Entities Eligible to Use Approach	Nature of Capital Required	Capital Requirement equals or exceeds the greatest of the following amounts for the relevant category:
Bank-based Capital	<ul style="list-style-type: none"> <li>• Non-Bank Subsidiaries of BHC</li> <li>• Stand-Alone SDs</li> <li>• BDs (including, OTC Derivatives Dealers and ANC Firms)</li> </ul>	Common Tier 1 Equity (as defined under the bank holding company regulations)	<ul style="list-style-type: none"> <li>• \$20 million</li> <li>• 8% of risk-weighted assets (RWA) (Basel Model or Regulation 1.17 table) plus current counterparty credit risk</li> <li>• 8% of the total amount of a swap dealer's margin</li> <li>• Amount of capital required by the NFA</li> </ul>
Net Liquid Assets Capital CFTC Regulation 1.17	<ul style="list-style-type: none"> <li>• Non-Bank Subsidiaries of BHC</li> <li>• FCMs (SDs)</li> <li>• Stand-Alone SDs</li> </ul>	Net Discounted Assets (Assets – Liabilities = Net Capital, which is discounted (according to Regulation 1.17))	<ul style="list-style-type: none"> <li>• \$20 million or \$100 million if approved to use capital models</li> <li>• 8% of the total amount of a swap dealer's margin</li> <li>• Amount of capital required by the NFA</li> </ul>
Net Liquid Assets Capital SEC Rule 15c3-1	<ul style="list-style-type: none"> <li>• BDs (SDs)</li> <li>• BDs (OTC Derivatives Dealers)</li> </ul>	Net Discounted Assets (Assets – Liabilities = Net Capital, which is discounted (according to SEA 15c3-1 or VaR based models))	<ul style="list-style-type: none"> <li>• \$20 million</li> <li>• 8% of the total amount of a swap dealer's margin</li> <li>• Amount of capital required by the NFA</li> </ul>
Alternative Net Capital (ANC)	ANC Firms	Net Discounted Assets (Assets – Liabilities = Net Capital, which is discounted (VaR based model))	<ul style="list-style-type: none"> <li>• \$5 billion tentative net capital (not discounted) 154</li> <li>• \$6 billion early warning net capital (not discounted)</li> <li>• \$1 billion Net Discounted Assets</li> <li>• Amount of capital required by the NFA</li> </ul>
Non-Financial Swap Dealers	Non-financial Entities (no more than 15% financial assets or revenues)	Equity	<ul style="list-style-type: none"> <li>• \$20 million plus market and credit risk charges</li> <li>• 8% of the total amount of a swap dealer's margin</li> <li>• Amount of capital required by the NFA</li> </ul>
MSPs	MSP	Equity	<ul style="list-style-type: none"> <li>• ≥\$1 tangible net worth</li> <li>• Amount of capital required by the NFA</li> </ul>

(This table is a modified version of a table that appears in the Proposed Rules.)

## EXHIBIT B

### Routine Swap Dealer Reporting Requirements

An SD subject to the Proposed Rules will be required to file all of the following routine reports with the CFTC and the NFA pursuant to:

Reporting Requirement	Timing
Unaudited Financial Reports	Monthly, no later than 17 business days after the end of the prior month
Audited Financial Reports	Annual, no later than 60 days after fiscal year end
Report as specified in Regulation 23.105(k) of market and credit risk information (only for any SD approved to use internal models for calculating regulatory capital)	Monthly, no later than 17 business days after the end of the prior month
Report as specified in Regulation 23.105(l) of aggregate securities, commodities and swaps positions	Monthly, no later than 17 business days after the end of the prior month
Report as specified in Regulation 23.105(m) of aggregate margin posted and collected	Monthly, no later than 17 business days after the end of the prior month
Open uncleared swap positions	First business day of each week
Total margin posted and collected and net variation margin collected or posted in the past week	First business day of each week

# EXHIBIT C

## Event-Driven Swap Dealer Notification Requirements

An SD subject to the Proposed Rules will be required to provide the following notices if the relevant notification trigger is met:

Notification Trigger	Notification Timing
Capital below prescribed minimum	Immediate written notification
Capital less than 120% of minimum	Notice within 24 hours
Failure to keep current books and records	Immediate notice followed by written report of remedial actions within 48 hours
Failure to comply with liquidity requirements	Notice within 24 hours
30% or more decrease in capital in excess of minimum from last financial report	No timing specified
Withdrawal of capital in excess of 30% of capital in excess of minimum	Two business days prior written notice
Filing of Notice required under Rule 18a-8 of the '34 Act by an SD that is a security-based swap dealer but not a broker-dealer registered with the SEC	Same day
A single counterparty or group of related counterparties fails to deliver margin and the aggregate amount of fails is equal to or greater than 25% of the SD's minimum capital	Within 24 hours of fail(s)
One or more counterparties fail to deliver margin and the aggregate amount of fails is equal to or greater than 50% of the SD's minimum capital	Within 24 hours of fail(s)
SD fails to deliver margin to a single counterparty or group of related counterparties and the aggregate amount of fails is equal to or greater than 25% of the SD's minimum capital	Within 24 hours of fail(s)
SD fails to deliver margin to one or more counterparties and the aggregate amount of fails is equal to or greater than 50% of the SD's minimum capital	Within 24 hours of fail(s)

# EXHIBIT D

## Reporting Requirements for Prudentially Regulated Swap Dealers

An SD that is subject to prudential regulation will be required to file the following routine and event-driven notices and reports with the CFTC and the NFA pursuant to Regulations 23.105(p) and (q):

Requirement	Timing
Report as specified in Regulation 23.105(p) of financial reports and specific position information	Quarterly, not more than 17 business days after the end of each fiscal quarter
Notice of adjustment of required capital category	Same day notice is filed with relevant prudential regulator
Failure to meet minimum capital requirement	Immediate written notice
A single counterparty or group of related counterparties fails to deliver margin and the aggregate amount of fails is equal to or greater than 25% of the SD's minimum capital	Within 24 hours of fail(s)
One or more counterparties fail to deliver margin and the aggregate amount of fails is equal to or greater than 50% of the SD's minimum capital	Within 24 hours of fail(s)
SD fails to deliver margin to a single counterparty or group of related counterparties and the aggregate amount of fails is equal to or greater than 25% of the SD's minimum capital	Within 24 hours of fail(s)
SD fails to deliver margin to one or more counterparties and the aggregate amount of fails is equal to or greater than 50% of the SD's minimum capital	Within 24 hours of fail(s)
Failure to keep current books and records	Immediate notice followed by written report of remedial actions within 48 hours
Additional financial and operational information	Daily, if requested by CFTC
Statement of financial condition	Quarterly, made publicly available on the SD's website
Statement of regulatory capital and minimum capital requirement	Quarterly, made publicly available on the SD's website
Open uncleared swap positions	First business day of each week
Total margin posted and collected and net variation margin collected or posted in the past week	First business day of each week

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