

The Last Piece of the Puzzle: CFTC Reopens Comment Period for Capital Requirements and Proposes Amendments to Inter-Affiliate Swap Clearing Exemption

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On December 10, 2019, the CFTC reopened the comment period for the proposed capital requirements for swap dealers (**SDs**) and major swap participants (**MSPs**) that are not subject to the capital rules of a prudential regulator (together, **Covered Swap Entities**). These rules are the last set of core requirements yet to be finalized for the CFTC's SD regime. At the same time, the CFTC separately proposed amendments to the exemption from the CFTC's swap clearing requirement for swaps between certain affiliated entities (the **Inter-Affiliate Exemption**) that would codify existing no-action relief.¹

Capital Requirements Comment Period

The CFTC first proposed capital requirements for Covered Swap Entities in 2011, but elected to defer consideration of final rules until after the CFTC adopted final margin rules for uncleared swaps. In 2016, the CFTC re-proposed the capital requirements (the **2016 Proposal**). The CFTC has reopened the comment period for the 2016 Proposal to solicit additional comments in light of changes since 2016, including the SEC's adoption of capital requirements for securities-based swap dealers (**SBSDs**). Our visual memorandum on the SEC's capital requirements is available [here](#).

As a reminder, the 2016 Proposal included three potential options for Covered Swap Entities to calculate their capital requirements:

- the Bank-Based Capital Approach – based on a modified version of the Basel III capital requirements applicable to banking organizations;
- the Net Liquid Assets Capital Approach – based on the SEC's capital requirements for broker-dealers and SBSDs; and
- the Tangible Net Worth Capital Approach – a simplified approach available to Covered Swap Entities that are predominantly engaged in non-financial activities.

Under each of these approaches, a Covered Swap Entity would generally be required to maintain minimum regulatory capital, as calculated using the applicable method, equal to the greatest of: (1) \$20 million; (2) 8% of the risk margin amount;² (3) the amount of capital required by a registered futures association of which the Covered Swap Entity is a member; and (4) 8% of risk-weighted assets (under the

¹ 17 C.F.R. § 50.52.

² The "risk margin amount" is an amount calculated based on the Covered Swap Entity's required amount of initial margin for its uncleared swap and security-based swap positions and certain other cleared derivatives positions.

Bank-Based Capital Approach only).³ In addition, the 2016 Proposal included certain proposed liquidity requirements for Covered Swap Entities.

In reopening the comment period for the 2016 Proposal, the CFTC also included a number of specific questions about certain elements of the 2016 Proposal that suggest the CFTC is considering potential changes to the originally proposed requirements, including whether:

- The proposed 8% risk margin amount used to determine minimum required capital should be set at a lower percentage, such as 4%, or be harmonized with the SEC's approach for SBSBs, which starts at 2% and may be adjusted by the SEC first to 4% and then to 8% over a period of at least five years;
- The calculation of a firm's current capital under the Bank-Based Capital Approach should include capital other than CET1 capital, such as Additional Tier 1 capital, Tier 2 capital, or subordinated debt;
- The proposed standardized market risk charges for certain uncleared swaps and security-based swaps should be harmonized with the SEC's approach to standardized market risk charges applicable to broker-dealers and SBSBs;
- A Covered Swap Entity whose parent company is predominantly engaged in non-financial activities should be permitted use the Tangible Net Worth Capital Approach, even if the Covered Swap Entity itself is not predominantly engaged in non-financial activities;
- The CFTC should accept internal models used to calculate net capital already approved by a prudential regulator, the SEC or a foreign regulator to be used by a firm to comply with the CFTC's requirements for the use of internal models; and
- The CFTC should, similar to the SEC's approach for SBSBs, abandon all or some the proposed liquidity requirements.

Comments on the proposed capital rules must be received on or before March 3, 2020.

Inter-Affiliate Exemption Amendments

One of the important conditions to the Inter-Affiliate Exemption is the requirement that an affiliate counterparty relying on the Inter-Affiliate Exemption must clear any swap subject to the CFTC's clearing requirement that is entered into with an unaffiliated counterparty, unless the swap separately qualifies for an exception from the clearing requirement (the **Outward-Facing Swaps Condition**). When the CFTC originally adopted the Inter-Affiliate Exemption, it provided temporary alternative compliance frameworks that non-U.S. affiliate counterparties could rely on when transacting with non-U.S. unaffiliated counterparties, instead of complying with the Outward-Facing Swaps Condition, until 2014.

When these temporary alternative compliance frameworks expired in 2014, the CFTC extended their availability through no-action relief. In this latest proposed rule, the CFTC proposes to permanently codify versions of the alternative compliance frameworks for purposes of complying with the Outward-Facing Swaps Condition, subject to minor modifications. Comments on the proposed amendments must be received on or before February 21, 2020.

³ The 2016 Proposal also includes amended and additional capital requirements for SDs that are dually-registered as futures commission merchants (**FCMs**) and broker-dealers or are approved to use internal models to compute net capital.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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