

Codifying and Demystifying: The CFTC Adopts Amendments to Capital and Financial Reporting Requirements for Swap Dealers Largely Based on Prior Relief

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After adopting final rules in 2020, the Commodity Futures Trading Commission (CFTC) adopted amendments to the capital and financial reporting requirements for Swap Dealers (SDs), which were largely based on prior no-action letters and interpretive guidance issued by CFTC staff.[1]

Section 4s(e) of the Commodity Exchange Act (CEA) requires the CFTC to adopt minimum capital and margin requirements for SDs, and the CFTC issued final rules doing so on September 15, 2020. These rules, adopted in Part 23 of the CFTC's regulations, impose capital requirements on SDs that are not subject to a prudential regulator (nonbank SDs) and detailed financial reporting, recordkeeping and notification requirements, including limited reporting requirements for SDs subject to the capital requirements of a prudential regulator (bank SDs).

However, due to confusion surrounding these new requirements, the CFTC issued eight no-action and interpretative letters in 2021 to help SDs better understand their reporting obligations. The CFTC's policy rationale for adopting amendments almost three years later, on April 30, 2024, was largely to codify CFTC Staff Letters 21-15 and 21-18, on which certain SDs relied while adding clarity and specificity so that SDs can clearly demonstrate their compliance with capital and financial reporting requirements.

These amendments will primarily affect SDs electing to show compliance with net capital requirements through the tangible net worth capital approach and non-US bank SDs.[2] Other SDs may be impacted by the further clarifications.

2024 Amendments

- **Tangible Net Worth Capital Approach** — The CFTC codified guidance from CFTC Staff Letter 21-15, which clarified that a nonbank SD could show it was “predominately engaged in non-financial activities” (using two tests described below) at either the nonbank SD level or at the nonbank SD's consolidated parent level.

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- **Nonbank SD Reporting Requirements and Recordkeeping Standards** —The CFTC clarified that SDs may use International Financial Reporting Standards (IFRS) in lieu of US generally accepted accounting principles (US GAAP) when calculating tangible net worth. The CFTC also harmonized the timing to file both general financial reports and additional information for nonbank SDs that use the tangible net worth capital approach.
 - **Bank SD Reporting** — The CFTC codified relief from CFTC Staff Letter 21-18, which allows bank SDs to provide the CFTC with copies of financial reports required by and filed with a bank SD relevant prudential regulator in lieu of the CFTC's requirements. Foreign-domiciled bank SDs can also file balance sheets and a statement of regulatory capital that match their home company requirements or, if dually registered with the SEC, their SEC filings.
 - **Other Matters** — The CFTC adopted various other amendments that clarify reporting and financial requirements for SDs. These include, but are not limited to, clarifications on certain reporting requirements, updates to forms and how certain instruments can be used to calculate net capital.

Each of these amendments is described in more detail below.

Tangible Net Worth Capital Approach

Nonbank SDs can show compliance with the CFTC's capital requirements through the "Tangible Net Worth Capital Approach" under CFTC Regulation 23.101, but only if the SD is "predominately engaged in non-financial activities." To be "predominantly engaged in non-financial activities" as defined in CFTC Regulation 23.100, a SD had to show that, in either of its two most recently completed fiscal years, (1) its consolidated annual gross financial revenues represented less than 15 percent of the SD's consolidated gross revenue in that fiscal year (the "15 percent revenue test") and (2) the consolidated total financial assets of the SD represented less than 15 percent of the SDs consolidated total assets (the "15 percent asset test"). However, it was unclear if the SD, or the SD's parent entity, would be required to show compliance with these tests.

CFTC Staff Letter 21-15 clarified that to meet the 15 percent revenue and asset tests, a nonbank SD could show compliance with these tests at *either* the nonbank SD level or at the nonbank SD's ultimate consolidated parent level. The CFTC explained in this Staff Letter that many entities may establish nonbank SDs to "ring-fence" certain financial activities, like swap dealing, from the rest of the entity's commercial operations. The definition of "predominately engaged in non-financial activities" in CFTC Regulation 23.100, however, did not make clear at what levels the 15 percent revenue and asset tests could be applied.

The CFTC's 2024 amendments codified this guidance by explicitly permitting the satisfaction of both the revenue and asset tests at the consolidated parent level of the nonbank SD.

Nonbank SD Reporting Requirements and Recordkeeping Standards

There was also uncertainty surrounding what accounting standards nonbank SDs would be allowed to use when calculating their tangible net worth. Regulation 23.100 only referenced US GAAP when calculating tangible net worth, but many nonbank SDs use IFRS in lieu of US GAAP. In Staff Letter 21-15, the CFTC acknowledged that the new regulations did not contemplate the inconsistency that would be derived from maintaining current books and records and submitting financial reporting in accordance with IFRS while requiring US GAAP for the computation of tangible net worth. As a result, the CFTC clarified that nonbank SDs, which use IFRS, to compute tangible net worth, so long as they also maintain books and records and file financial reports in accordance with IFRS.

The CFTC initially required nonbank SDs that used the tangible net worth capital approach to file certain financial information monthly while only requiring general financial reports quarterly. In the April 2024 amendments, the CFTC codified guidance contained in CFTC Staff Letter 21-15, which explained that “nonbank SDs that use the tangible net worth capital approach may file the financial information required under Appendix B to Subpart E of Part 23 on a quarterly, as opposed to monthly,” basis. This amendment harmonized the timing to file both general financial reports and additional information as required by the CFTC.

Bank SD Reporting

Numerous bank SDs requested relief from CFTC Regulation 23.105(p), which required bank SDs to report financial information within 30 calendar days of a quarter's end and conflicted with the requirements of relevant prudential regulators. As a result, the CFTC, in Staff Letter 21-18 (later extended under CFTC Staff Letter 23-11), explained that it would not engage in an enforcement action against bank SDs that provide the CFTC with copies of financial reports required by and filed with a bank SDs relevant prudential regulator, instead of complying with CFTC Regulation 23.105(p). The CFTC also provided no-action relief for:

- foreign domiciled bank SDs that file balance sheets and a statement of regulatory capital information in accordance with applicable home country requirements; and
- foreign domiciled bank SDs that are dually registered with the SEC and file comparable SEC-required financial reports and schedules with the CFTC.

The CFTC largely codified all the above no-action relief from Staff Letter 21-18 but provided for an amendment *requiring* any bank SDs dually registered with the SEC as a security-based swap dealer (SBSD) to file Form X-17A-5 FOCUS Report Part IIC with the SEC in lieu of the CFTC's required Call Report. However, Commissioner Caroline Pham pointed out that the CFTC “extended the deadline to 35 days to allow dual registrants to submit the reports on the same day as they do with the SEC, [but] the Commission should have made the deadline on the date Form X-17A-5 FOCUS Report Part IIC is due to be filed with the [SEC]” to avoid a potential conflict in the future if the SEC changes its FOCUS report filing deadlines.

Other Matters

The CFTC also adopted the following amendments as part of its effort to update capital and financial reporting requirements for SDs:

- Clarified that supplemental schedules 1-4 contained in Appendix B are to be provided by all nonbank SDs and must be submitted monthly or quarterly, as applicable.
- Explained that subordinated debt for net capital is subject to a qualification determination by either the Commission or the National Futures Association.
- Edited references within the 2020 Final Rule to provide clarity on applicable market and credit risk charges both for SDs using internal models electing the Bank-Based Capital Approach in Commission regulation 23.102 and for SDs not electing the Bank-Based Capital Approach and not electing to use internal models in Commission regulation 23.103.
- Explained that SDs that are also registered with the SEC as either broker-dealers or SBSBs must file financial reports required to be filed with the SEC, and SDs also registered as futures commission merchants must file Form 1-FR-FCM.
 - SDs that are also registered as FCMs must include a supplemental accountant's report on material inadequacies.

- Revised applicable public disclosure of SD unaudited statement of financial condition information in Commission regulation 23.105(i)(1)(i) to include footnote disclosures and clarified that the amounts of regulatory capital and required minimum regulatory capital to be publicly disclosed in both Commission regulations 23.205(i)(1) and (2) need not be included as a schedule or in any particular format.
- Revised Form 1-FR-FCM to conform with the changes adopted in the 2020 Final Rule to FCM net capital requirements, including adding reporting lines for the market and credit risk charges for swaps and for 2 percent of the risk margin amount in required net capital for FCMs which are also SDs.

Effective Date and Compliance Date

While the effective date of the rule is 30 days after publication in the Federal Register, the rule has a compliance date of September 30, 2024. This additional time is intended to give SDs time to effectuate the amendments, and will apply to all financial reports with an “as of” reporting date of September 30, 2024, or later.

[1] While the amendments also apply to Major Swap Participants (MSPs), there are currently no MSPs. As a result, this article focuses on SDs.

[2] For a full list of provisionally registered swap dealers, see <https://www.cftc.gov/IndustryOversight/Intermediaries/SDs/index.htm>.

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