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Prudential Regulators and CFTC Adopt Margin Rules for Non-Cleared Swaps

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[1] mandates the margining of bilateral swaps and security-based swaps that are not cleared by a registered derivatives clearing organization or a registered clearing agency (collectively, Non-Cleared Swaps). Dodd-Frank requires U.S. federal financial regulators to adopt implementing rules for collecting and posting mandated initial and variation margin by the following registered entities (Swap Entities): swap dealers and major swap participants registered with the U.S. Commodity Futures Trading Commission (the CFTC) and security-based swap dealers and major security-based swap participants registered with the U.S. Securities and Exchange Commission (the SEC).

To implement these requirements, five U.S. prudential regulators (the Prudential Regulators) adopted a joint final rule (the PR Final Rule)[2] on October 22, 2015; it covers Swap Entities that are supervised by one of the Prudential Regulators (Bank CSEs). On December 16, 2015, the CFTC adopted its own final rule (the CFTC Final Rule),[3] which covers Swap Entities that are not supervised by one of the Prudential Regulators (Non-Bank CSEs; and together with Bank CSEs, CSEs) if they are registered with the CFTC. The SEC is expected to adopt an implementing rule covering Non-Bank CSEs registered with the SEC.

As required by legislation enacted after Dodd-Frank, the Prudential Regulators and the CFTC also adopted companion interim final rules (collectively, the Interim Final Rules and, together with the PR Final Rule and the CFTC Final Rule, the Swap Margin Rules).[4] The Interim Final Rules exempt from the margin requirements Non-Cleared Swaps entered into with counterparties that qualify for certain exceptions to or exemptions from Dodd-Frank's mandatory clearing requirements.

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[1] Pub. L. 111–203, 124 Stat. 1376 (2010). These requirements are in Title VII of Dodd-Frank.

[2] *See* Prudential Regulators, *Margin and Capital Requirements for Covered Swap Entities*, Final Rule, 80 Fed. Reg. 74840 (November 30, 2015), available at: http://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf. The Supplementary Information published by the Prudential Regulators with the PR Final Rule is referred to herein as the PR Preamble. The five Prudential Regulators are the Office of the Comptroller of the Currency; the Board of Governors of the Federal Reserve System (the Federal Reserve); the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency.

[3] *See* CFTC, *Margin Requirements for Covered Uncleared Swaps for Swap Dealers and Major Swap Participants*, Final Rule, 81 Fed. Reg. 636 (January 6, 2016), available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf. The Supplementary Information published by the CFTC with the CFTC Final Rule is referred to herein as the CFTC Preamble.

[4] *See* Prudential Regulators, *Margin Requirements for Covered Swap Entities,* Interim Final Rule, 80 Fed. Reg. 74916 (November 30, 2015) (PR Interim Final Rule), available at: http://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28670.pdf. The CFTC published its companion interim final rule (the CFTC Interim Final Rule) with the CFTC Final Rule. The comment period for the PR Interim Final Rule is open until January 31, 2016. The comment period for the CFTC Interim Final Rule is open until February 5, 2016.

The Swap Margin Rules closely follow the Prudential Regulators' and CFTC's respective 2014 rule proposals (the 2014 PR Rule Proposal and the 2014 CFTC Rule Proposal; collectively, the 2014 Rule Proposals).[5] They are also largely consistent with the policy framework establishing minimum standards for margin requirements for non-centrally cleared derivatives published in March 2015 by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (the BCBS/IOSCO Standards).[6]

In adopting the PR Final Rule, the Prudential Regulators also briefly addressed the capital requirements applicable to Bank CSEs.[7] The CFTC deferred action on capital requirements for Non-Bank CSEs subject to its jurisdiction.[8]

An overview of the Swap Margin Rules follows, together with brief descriptions of key implications for certain categories of market participants. Appendix A provides a side-by-side comparison of key provisions of the PR Final Rule and the CFTC Final Rule.

Common Purpose and Effect

The Swap Margin Rules address both initial margin and variation margin. Initial margin is collateral collected or posted to secure potential future exposure under one or more Non-Cleared Swaps. Variation margin is collateral provided by one party to its counterparty in light of changes in value of the underlying swap obligations since trade execution. In adopting the Swap Margin Rules, the Prudential Regulators and the CFTC emphasized that the margin requirements are intended to reduce risks for individual CSEs and for the financial system as a whole.[9]

The Swap Margin Rules do not directly impose requirements on the counterparties to CSEs. However, CSEs must collect margin from, and post margin to, certain counterparties, and they must generally arrange for initial margin posted by either counterparty to be held with an independent third-party custodian; accordingly, CSEs' counterparties will in effect become subject to the new margin requirements.

Principal Differences

The principal *jurisdictional* difference between the PR Final Rule and the CFTC Final Rule is that Bank CSEs are subject to the PR Final Rule, while Non-Bank CSEs that are registered with CFTC are subject to the CFTC Final Rule. Non-Bank CSEs that are registered with the SEC (once its registration regime is in place) will be subject to the SEC's own margin rules (once they are adopted). Moreover, the PR Final Rule covers all Non-Cleared Swaps

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[5] *See* Prudential Regulators, *Margin and Capital Requirements for Covered Swap Entities*, Proposed Rule, 79 Fed. Reg. 57348 (September 24, 2014), available at: http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf; CFTC, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, Proposed Rule, 79 Fed. Reg. 59898 (October 3, 2014) available at: http://www.gpo.gov/fdsys/pkg/FR-2014-10-03/pdf/2014-22962.pdf. An earlier Sidley Update reviewed the 2014 Rule Proposals. *See* Sidley Update, *Margin Requirements for Uncleared Swaps Continue to Take Form: Prudential Regulators and CFTC Re-Propose Similar Rules* (November 12, 2014), available at: http://www.sidley.com/news/11-12-14-derivatives-update.

[6] *See* Basel Committee on Banking Supervision and International Organization of Securities Commissioners, *Margin Requirements for Non-Centrally Cleared Derivatives* (March 2015), available at: http://www.bis.org/bcbs/publ/d317.pdf.

[7] *See* PR Preamble at 74846 ("[T]he final rule requires a covered swap entity to comply with regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime.").

[8] *See* CFTC Preamble at 636, footnote 4 ("The Commission will address capital requirements in a separate release.").

[9] For example, the Prudential Regulators cited their "safety and soundness authority" over Bank CSEs, in addition to their express statutory authority under Dodd-Frank, as the basis for the PR Final Rule. The Prudential Regulators and CFTC placed little emphasis on protecting counterparties of CSEs as such. Indeed, certain requirements that CSEs post margin are justified not because they protect the CSE's counterparties, but because they may "forestall a build-up of potentially destabilizing exposures in," and may "reduce overall risk to," the financial system. *See* PR Preamble at 74843; CFTC Preamble at 649.

to which a Bank CSE is a party (whether swaps or security-based swaps), while the CFTC Final Rule covers only those Non-Cleared Swaps that are subject to the CFTC's jurisdiction (i.e., it does not cover security-based swaps even when traded by a CFTC-registered Non-Bank CSE).[10] The table below indicates, by regulator, which rules will apply to a given transaction depending on the type of transaction and the type of CSE that is a party to the transaction (assuming eventual adoption by the SEC of its margin rules):

	Transaction Type	
CSE Type	***Swap***	***Security-Based Swap***
Bank CSE (CFTC- or SEC-Registered)	Prudential Regulators	Prudential Regulators
Non-Bank CSE (CFTC-Registered)	CFTC	N/A
Non-Bank CSE (SEC-Registered)	N/A	SEC

Bank CSEs include CSEs that are federally insured deposit institutions, bank holding companies, certain foreign banks and certain subsidiaries of bank holding companies and foreign banks. However, a CSE that is a nonbank subsidiary of a bank holding company—such as a non-bank swap dealer registered with the CFTC—would be a Non-Bank CSE that is subject to the CFTC Final Rule rather than to the PR Final Rule. Thus, as indicated in the table above (middle left column and bottom right column), a Non-Bank CSE that is registered with both the CFTC and the SEC (e.g., as both a swap dealer and a security-based swap dealer) will be directly subject to margining requirements in respect of all Non-Cleared Swaps (i.e., the CFTC's requirements will apply to the Non-Bank CSE's swaps, and the SEC's requirements will apply to its security-based swaps). However, a Non-Bank CSE that is registered with only one of the two agencies will not be directly subject to margining requirements for Non-Cleared Swaps that fall under the second agency's jurisdiction (as indicated above by the "N/A" designations).[11]

Substantive differences between the PR Final Rule and the CFTC Final Rule are less significant. The principal difference relates to transactions between a CSE and its affiliates: subject to certain conditions, the CFTC Final Rule generally exempts affiliate transactions from the CSE's requirements *to post and to collect* initial margin, while the PR Final Rule exempts such transactions only from the CSE's requirement *to post* initial margin

[10] For simplicity of presentation, throughout this Sidley Update we use the term "Non-Cleared Swaps," which encompasses security-based swaps as well as swaps, even when discussing requirements under the CFTC Final Rule (which, as noted, do not apply to security-based swaps).

[11] For example, a Non-Bank CSE that is registered as a security-based swap dealer with the SEC but not as a swap dealer (or major swap participant) with the CFTC will not be directly subject to the CFTC Final Rule. Note, however, that when it trades with a CFTC-registered Non-Bank CSE or with a Bank CSE, it will, in effect, become indirectly subject to the CFTC Final Rule by virtue of being a financial end user counterparty of a CSE subject to either CFTC Final Rule or the PR Final Rule (all as discussed below).

(leaving the collection requirement intact). That difference is discussed below. Under both Final Rules, variation margin must be collected and posted when a CSE transacts with its affiliates.

Substantive differences of less significance relate to: (i) the definition of "financial end user" (concerning certain treasury affiliates when acting as principal); (ii) the approval process for models that are used to establish initial margin amounts (including CFTC delegation of authority to the National Futures Association (NFA)); (iii) segregation of any initial margin that a CSE posts above the amount mandated (the PR Final Rule being more restrictive than the CFTC Final Rule); and (iv) calculating and documenting variation margin requirements (the CFTC Final Rule being more detailed). Those differences are also discussed below.

Although the PR Final Rule includes a provision addressing that rule's cross-border reach, the CFTC deferred final action on its own cross-border rule, which it separately proposed in June 2015 (the CFTC Cross-Border Margin Proposal)[12] to supplement the 2014 CFTC Rule Proposal.[13]

Finally, the PR Final Rule and the CFTC Final Rule use different defined terms and other terminology in a number of places even though the Prudential Regulators and CFTC do not appear to have intended any substantive difference. For example, the PR Final Rule uses "non-cleared," while the CFTC Final Rule uses "uncleared," when designating swaps and security-based swaps subject to their requirements. And the PR Final Rule uses the defined term "affiliate," while the CFTC Final Rule uses the defined term "margin affiliate" for the same concept.

Phase-In Periods

The Swap Margin Rules include the following phase-in periods (which are consistent with those in the BCBS/IOSCO Standards):

- *Initial margin*: Four-year phase-in period, starting on September 1, 2016 and ending on September 1, 2020. Initial margin requirements are phased in as a function of the average daily aggregate notional amount of Non-Cleared Swaps, foreign exchange forwards and foreign exchange swaps of each of the CSE and its counterparty (each on a consolidated basis with affiliates) for March, April and May of the year during which the annual September 1 compliance date occurs.
- *Variation margin*: Six-month phase-in period, beginning on September 1, 2016 and ending on March 1, 2017. Variation margin requirements are also phased in based on the average daily aggregate notional amounts.

In general, the phase-in thresholds mean that Non-Cleared Swaps only between the largest CSEs will be subject to initial margin requirements in 2016. Please see Appendix B for more detail. As discussed below, Non-Cleared

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[12] *See* CFTC, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements*, Proposed Rule, 80 Fed. Reg. 41376 at 41388 (July 14, 2015), available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-16718a.pdf. An earlier Sidley Update reviewed the CFTC Cross-Border Margin Proposal. *See* Sidley Update, *CFTC Proposes Rules for Cross-Border Application of Margin Requirements for Uncleared Swaps* (August 4, 2015), available at: http://www.sidley.com/news/08-04-2015-derivatives-update.

[13] In adopting the CFTC Final Rule, the CFTC stated that "The Prudential Regulators . . . issued a provision addressing cross-border application of their margin rule. The Commission will address this aspect of the rule in a separate rulemaking." CFTC Preamble at 638.

Swaps executed by a CSE and a given counterparty before the applicable phase-in date will be effectively grandfathered.

Application of the Swap Margin Rules

Counterparty Classification

The Swap Margin Rules establish four categories of CSE counterparties for purposes of applying margin requirements to the Non-Cleared Swaps of CSEs:

- other Swap Entities (i.e., Bank CSEs and Non-Bank CSEs)[14]
- "financial end users" with "material swaps exposure"
- "financial end users" without "material swaps exposure"
- other counterparties, including non-financial end users, sovereigns and multilateral development banks

Each CSE must classify each of its counterparties to Non-Cleared Swaps into one (and only one) category at any time. In certain instances, the CSE's classifications will change over time, as additional market participants may become Swap Entities when they were not before, and the volume of business for financial end users may expand or contract so that they do or do not present material swaps exposure. The Prudential Regulators and the CFTC indicated that CSEs may rely in good faith on the reasonable representations of their counterparties in determining whether the counterparty is a financial end user with material swaps exposure.[15] Thus, counterparties to CSEs should expect that their documentation with CSEs (relevant credit support annex or other part of ISDA master agreement) will include (i) a representation as to the classification of the counterparty and (ii) a covenant to promptly notify the CSE of any change in the counterparty's classification.

Result of Counterparty Classification

CSEs are required to post and collect both initial margin and variation margin with respect to Non-Cleared Swaps entered into with other Swap Entities and with financial end users with material swaps exposure. In addition, CSEs must post and collect variation margin (but not initial margin) with respect to financial end users without material swaps exposure. The Swap Margin Rules do not impose specific margin requirements with respect to other counterparties.[16] Below is a tabular representation of the basic applicability of the requirements.

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[14] Although this Sidley Update uses the terms "Swap Entity" and "CSE" in reference to the Swap Margin Rules without distinction, the terms are defined in subtly different ways under the PR Final Rule and the CFTC Final Rule. Under the PR Final Rule, the definition of "swap entity" is consistent with the definition used here, covering security-based swap dealers and MSPs registered with the SEC as well as swap dealers and MSPs registered with the CFTC; however, the CFTC's definition of the same term is limited to CFTC-registered swap dealers and MSPs. This has potential consequences under the CFTC Final Rule's initial margin requirements. *See infra* note 26 and accompanying text.

The effect of this disparity on classification under the definition of "CSE" follows a similar pattern: Whether CFTC-registered or SEC-registered, a CSE will be subject to the PR Final Rule if it is regulated by a Prudential Regulator. However, even though the Prudential Regulators adopted the PR Final Rule as a common rule, each adopted its own definition of "covered swap entity" (e.g., in the case of the Federal Reserve, covering state member banks, bank holding companies foreign banking organizations, foreign banks that do not operate insured branches, state branches and state agencies of foreign banks and Edge or agreement corporations). In contrast, only CFTC-registered CSEs that are not regulated by a Prudential Regulator (what we refer to here as "Non-Bank CSEs") will be subject to the CFTC Final Rule, leaving SEC-registered CSEs that are not regulated by a Prudential Regulator to the jurisdiction of the SEC once it adopts margin rules governing Non-Bank CSEs that are security-based swap dealers or major security-based swap participants.

[15] *See* PR Preamble at 74858; CFTC Preamble at 645.

[16] The term "other counterparty" is not defined in the Swap Margin Rules; however, the PR Final Rule refers to "other counterparties" when imposing a generic, risk-based requirement on Bank CSEs in respect of Non-Cleared Swaps with counterparties that are neither Swap Entities nor financial end users. *See* PR Final Rule, Sections _.3(d) and _.4(c) (requiring the collection of initial and variation margin from other counterparties "at

CSE Counterparty	Initial Margin	Variation Margin
Swap Entity	Yes	Yes
Financial End User *with* Material Swaps Exposure	Yes	Yes
Financial End User *without* Material Swaps Exposure	No	Yes
Non-Financial End User	No	No

As discussed further below, transactions between CSEs and their affiliates are subject to reduced requirements in certain respects.

Material Swaps Exposure

A financial end user entity has "material swaps exposure" if, on the applicable compliance date, the entity *and its affiliates* have an average daily aggregate notional amount of Non-Cleared Swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds $8 billion.[17] Financial end users below that threshold are not subject to initial margin requirements. The $8 billion level, increased from $3 billion in the 2014 Rule Proposals, is generally consistent with the €8 billion threshold under the BCBS-IOSCO Standards.[18] Non-Cleared Swaps that are exempt pursuant to the Interim Final Rules will not count toward the calculation of material swaps exposure under the Swap Margin Rules.[19]

For purposes of determining material swaps exposure (and as a general rule of construction under the Swap Margin Rules), affiliation is determined by reference to certain accounting consolidation principles.[20]

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such times and in such forms and such amounts (if any), that the covered swap entity determines appropriately addresses the credit risk posed by the counterparty"). The CFTC Final Rule defines "Non-Financial End User" ("a counterparty that is not a swap dealer, a major swap participant, or a financial end user"), but does not use that defined term or otherwise include a requirement for Non-Bank CSEs that trade with such counterparties. The defined term is apparently a holdover from the CFTC's 2014 Rule Proposal, which included documentation and hypothetical valuation requirements for such counterparties that were not retained when the rule was finalized. *See* CFTC Preamble at 647.

[17] Daily average aggregate Non-Cleared Swap notional amounts for the months of June, July and August of the previous calendar year are to be used by CSEs in classifying their counterparties. In contrast, such amounts for the months of March, April and May of the current year (in which the September 1 compliance date falls) are to be used by CSEs in ascertaining the inception date of (phased-in) ongoing required margining for specific counterparties as so classified.

[18] In addressing the potential for changing exchange rates to create a meaningful gap between the dollar threshold under the PR Final Rule and Euro threshold under the BCBS/IOSCO Standards, the Prudential Regulators stated that they "expect to consider periodically the numerical amounts expressed in the final rule and their relation to amounts denominated in other currencies in differing jurisdictions. The Agencies will then propose adjustments, as appropriate, to these amounts." PR Preamble at 74852. The CFTC made an identical statement. *See* CFTC Preamble at 677.

[19] *See* PR Final Rule, Section _.2; CFTC Final Rule, Section 23.151.

[20] The PR Final Rule states that "[a] company is an affiliate of another company if (1) Either company consolidates the other on financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles, the International Financial Reporting Standards, or other similar standards; (2) Both companies are consolidated with a third company on a financial statement prepared in accordance with such principles or standards; (3) For a company that is not subject to such principles or standards, if consolidation as described in paragraph (1) or (2) of this definition would have occurred if such principles or standards had applied; or (4) [Prudential Regulator] has determined that a company is an affiliate of another company, based on [Prudential Regulator's] conclusion that either company provides significant support to, or is materially subject to the risks or losses of, the other company." PR Final Rule, Section _.2. The CFTC Final Rule's definition of "margin affiliate" follows this formulation in substance, though it does not include clause (4) (or an analogue thereto). *See* CFTC Final Rule, Section 23.151.

Transactions between affiliates are counted toward the affiliated group's $8 billion threshold, but the definition of "material swaps exposure" under the Swap Margin Rules provides that such transactions are counted only once (to avoid "double-counting").

"*Financial End Users*"

The Swap Margin Rules, like the 2014 Rule Proposals, use the term "financial end user" to identify CSE counterparties (in addition to other Swap Entities) that may trigger margin requirements for Non-Cleared Swaps. That term differs materially from the term "financial entity," which was put forward by the Prudential Regulators in the original 2011 rule proposal and is used by the CFTC to determine which entities may be entitled to rely on the so-called "end-user exemption" from mandatory swap clearing.[21] The precedent term includes a prong that captures entities that are "predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature" as defined in Section 4(k) of the BHCA.[22] "Financial entity" consequently covers a broad range of entities engaged in activities in the financial markets. The CFTC's use of the term for purposes of its end user exemption from swap clearing requirements has led to concern, as it captures entities that have not traditionally considered themselves to be "financials."

In contrast, the term "financial end user" under the Swap Margin Rules is more specific, being limited to financial firms that are subject to specified federal or state regulation, licensing and/or registration (and non-U.S. firms that would be financial end users as so defined if they were organized under U.S. federal or state law). Accordingly, certain financial entities that do not benefit from the end-user exemption from mandatory swap clearing may nonetheless fall outside of the class of entities whose transactions are subject to margining under the Swap Margin Rules.

In general, the kinds of entities that are covered by the definition of "financial end user" include the following (subject to the definition's specific terms[23]):

Although this is consistent with the 2014 CFTC Rule Proposal, it contrasts with how affiliation was proposed to be determined under the 2014 PR Rule Proposal, which defined the term "affiliate" by reference to the concept of "control" applicable under the Bank Holding Company Act of 1956 (BHCA).

[21] *See* Sidley Update, *End-User Exception from the Clearing Mandate and the Trade Execution Requirement under Dodd-Frank Act* (August 13, 2014), available at: http://www.sidley.com/news/08-12-2014-derivatives-update.

[22] 12 USC 1843(k).

[23] Under the PR Final Rule's definition, the following entities (the descriptions of which have been simplified in certain respects) are "financial end users" (subject to certain express exclusions):

> (i) a bank holding company or an affiliate thereof; savings and loan holding company; U.S. intermediate holding company; or nonbank financial institution supervised by the Federal Reserve; (ii) a depository institution; foreign bank; federal or state credit union; institution that functions solely in a trust or fiduciary capacity as described in Section 2(c)(2)(D) of the BHCA; or industrial loan company, industrial bank or certain other similar institutions; (iii) (A) a state licensed/registered credit or lending entity (including a finance company; money lender; installment lender; consumer lender or lending company; mortgage lender, broker or bank; motor vehicle title pledge lender; payday or deferred deposit lender; premium finance company; commercial finance or lending company; or commercial mortgage company); or (B) a state licensed/registered money services business (including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer); (iv) an entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator; (v) an institution chartered in accordance with the Farm Credit Act of 1971 that is regulated by the Farm Credit Administration; (vi) a securities holding company; broker-dealer; investment adviser as defined under the Investment Advisers Act of 1940 (IAA) or investment company registered with the SEC under the Investment Company Act of 1940 (ICA) or a company that has elected to be regulated as a business development company pursuant to the ICA; (vii) a private fund as defined in Section 202(a) of the IAA; an entity that would be an investment company under Section 3 of the ICA but for Section 3(c)(5)(C) thereof; or an entity that is deemed not to be an investment company under Section 3 of the ICA pursuant to Rule 3a–7 thereunder; (viii) a commodity pool, commodity pool operator, commodity trading advisor, floor broker, floor trader, introducing broker or futures commission merchant as defined under the Commodity Exchange Act (CEA); (ix) an employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of the Employee

- depository institutions
- bank holding companies and their affiliates (and savings and loan equivalents)
- credit or lending entities and money services businesses that are licensed or registered under state law
- securities holding companies, broker-dealers and investment advisers
- entities that are registered as investment companies with the SEC, certain entities that rely on specific exemptions from registration (Section 3(c)(5)(C) or Rule 3a-7) and private fund entities
- commodity pools, commodity pool operators, commodity trading advisors, floor brokers, floor traders, introducing brokers and futures commission merchants
- certain employee benefit plans
- insurance companies
- certain entities and arrangements that invest or trade in loans, securities, swaps, funds or other assets

The Swap Margin Rules significantly broadened the last category above from the 2014 Rule Proposals. The related prong of the definition in the 2014 Rule Proposals read:

> An entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets.

The Prudential Regulators and the CFTC broadened the coverage of that prong to cover not only investor vehicles but also certain financial operating entities. Set forth below is the final language (the bracketed text appears in the PR Final Rule but not in the CFTC Final Rule):

> An entity, person or arrangement that is, or holds itself out as being, an entity, person, or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for [the purpose of] investing or trading or facilitating the investing or trading in loans, securities swaps, funds or other assets [for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets].

The Prudential Regulators explained the change as follows:

> In broadening the definition, the Agencies believe that the enumerated list in the proposal of financial end users was not inclusive enough to cover certain financial entities that were not

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Retirement Income and Security Act of 1974; (x) an entity that is organized as an insurance company, primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies, or is subject to supervision as such by a state insurance regulator or foreign insurance regulator; (xi) an entity, person or arrangement that is or holds itself out as being an entity, person or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for the purpose of investing or trading or facilitating the investing or trading in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets; or (xii) an entity that would be a financial end user (as defined above) or a Swap Entity if it were organized under the laws of the U.S. or any state.

See PR Final Rule, Section _.2. Except as discussed immediately below with regard to prong (xi) of the definition, and further below with regard to security-based swap dealers (*see infra* note 26), the CFTC Final Rule's definition of "financial end user" is substantially identical. *See* CFTC Final Rule, Section 23.151.

organized as pooled investment vehicles but that traded or invested their own or client funds (e.g., high frequency trading firms) or that provided other financial services to their clients.[24]

The CFTC did not explain why its formulation of the prong is different from the Prudential Regulators'. Presumably the CFTC intended to preclude arguments that the prong's application could be narrowed by reference to the meaning of the phrases "purpose of" and "for resale or other disposition."

Neither the Prudential Regulators nor the CFTC retained a prong in the 2014 Rule Proposals that would have permitted them to designate other entities as financial end users, though both indicated that they will monitor CSEs and will consider further rulemakings if they determine that further expansion of the definition is warranted.[25]

Initial and Variation Margin Requirements

Two-Way Initial Margin

The Swap Margin Rules require CSEs both to post initial margin to, and to collect initial margin from, other Swap Entities and financial end users with material swaps exposure.[26] The two-way exchange of initial margin is consistent with the BCBS/IOSCO Standards. Initial margin generally may consist of cash, gold or certain securities, including U.S. Treasuries, securities of certain government-sponsored enterprises (GSEs) and certain corporate debt or equity securities.[27]

Initial margin must be collected no later than one business day after the date of the relevant swap transaction, but will be required to be collected only if the amount of initial margin exceeds an "initial margin threshold amount" of $50 million. Initial and variation margin will also be subject to a minimum transfer amount of $500,000. The initial margin threshold amount is applied to all Non-Cleared Swaps between a CSE and its affiliates, on the one hand, and the CSE's counterparty and its affiliates, on the other hand.[28] The initial margin threshold amount and minimum transfer amount have been reduced from the levels proposed in the 2014 Rule Proposals—$65 million and $650,000, respectively—in order to better align with amounts expressed in Euro under the BCBS/IOSCO Standards (given currently prevailing exchange rates).[29]

Two-Way Variation Margin

The Swap Margin Rules require CSEs, on a daily basis, both to post variation margin to, and to collect variation margin from, other Swap Entities and all financial end users, regardless of whether they have material swaps exposure. For the Non-Cleared Swaps of a CSE with another Swap Entity, variation margin must be in the form of cash, either in U.S. dollars or the currency in which payment obligations under the swap in question is

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[24] PR Preamble at 74855. The CFTC expressed a similar rationale. *See* CFTC Preamble at 642.

[25] *See* PR Preamble at 74854; CFTC Preamble at 642.

[26] Because the CFTC's definition of the "swap entity" is limited to CFTC-registered swap dealers and MSPs (*see supra* note 14), when a Non-Bank CSE considers which of its counterparties are subject to initial margin requirements under the CFTC Final Rule, those counterparties that are only security-based swap dealers and MSPs (i.e., are not CFTC-registered swap dealers or MSPs) will be subject to the requirements only if they also have material swaps exposure (since they are not covered by the definition of swap entity under the CFTC Final Rule, but are added expressly to the list of entities covered by the definition of "financial end user").

[27] *See* Appendix F for a full list of eligible collateral.

[28] *See supra* note 20 (discussing the definitions of the term "affiliate" under the PR Final Rule and "margin affiliate" under the CFTC Final Rule).

[29] *See* PR Preamble at 74852; CFTC Preamble at 677.

required to be settled.[30] For the Non-Cleared Swaps of a CSE with a financial end user, variation margin may consist of any type of collateral eligible to be posted as initial margin.[31]

Initial Margin Calculation: CSEs Permitted to Use Valuation Models

The Swap Margin Rules require that initial margin be calculated based on either an approved risk-based model or a table of standardized minimum gross initial margin requirements. The table, together with the formula used in connection with master agreement netting sets, is reproduced below in Appendix C.[32]

Given the relatively high initial margining levels produced by the percentage factors set out in the table, it is expected that most CSEs will use risk models to calculate initial margin. An ISDA working group is developing a standard initial margin model for use by market participants.[33] In order for a CSE to use a model (whether unique to the CSE or part of an industry effort), the model must be approved, in writing, by the CSE's Prudential Regulator (for a Bank CSE) or by the CFTC or a registered futures association[34] (for a Non-Bank CSE) and meet specified modeling criteria.[35] CSEs that use models will be required to calculate initial margin amounts on a daily basis in order to take into account changes over time of swap characteristics (for example, credit quality of the reference obligation for a single-name credit default swap) or of model parameters (for example, changes in the market risk environment that informs the model's stress period).[36] In contrast, CSEs that apply the standardized minimum gross initial margin requirements (based on the tabular factors) will generally not be required to recompute required initial margin levels absent changes in the duration of the applicable transactions.[37]

Variation Margin Calculation: "Mid-Market" and "Mark-to-Market"

The Swap Margin Rules use substantively identical language to define "variation margin amount." In each case, the rule uses the key phrase: "the cumulative mark-to-market change in value to a [CSE]" of a Non-Cleared Swap. In response to comments focusing on the phrase "to a [CSE]" (which also appeared in the 2014 Rule

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[30] PR Final Rule, Section _.6(a)(1); CFTC Final Rule, Section 23.156(b)(1)(i).

[31] PR Final Rule, Section _.6(b); CFTC Final Rule, Section 23.156(b)(1)(ii).

[32] The tables in the Swap Margin Rules are identical. In the case of netting sets under an eligible master netting agreement, the percentage factors found in the tables are used in a related formula, which is also the same under the Swap Margin Rules. *See* PR Final Rule, Appendix A; CFTC Final Rule, Section 23.154(c).

[33] In 2013, ISDA initiated a Working Group on Margin Requirements Implementation Program to facilitate the implementation of the margin rules across jurisdictions. The Program has worked to develop a standard initial margin model (SIMM) that can be used by market participants globally, beginning with a white paper on the SIMM methodology published in December 2013. On October 1, 2015, ISDA published its most recent updates to the SIMM methodology. *See* ISDA, *ISDA SIMM Methodology Version 3.2* (October 1, 2015), available at: https://www2.isda.org/functional-areas/wgmr-implementation/.

[34] Currently, the NFA is the only registered national futures association. Discussion of the NFA's role in this context may be found in the CFTC Preamble at 654.

[35] Potential future exposure of a Non-Cleared Swap subject to mandatory initial margin requirements must be based on an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the Non-Cleared Swap due to an instantaneous price shock over a period equal to the shorter of 10 business days or the maturity of the swap. The model must be based on historical data from a period of at least one year and not more than five years and must incorporate a period of significant financial stress for each asset class that is appropriate to the Non-Cleared Swaps. *See* PR Final Rule, Section _.8(d); CFTC Final Rule, Section 23.154(b)(2).

Initial margin requirements for Non-Cleared Swaps would be based on a 10 business day period, which is considerably longer than the period generally required to be used by clearing houses.

[36] PR Final Rule, Section _.8(b); CFTC Final Rule, Section 23.154(a).

[37] *See,* e.g., CFTC Preamble at 663 (discussing when standardized minimum gross initial margin amounts must be recomputed).

Proposals), the Prudential Regulators and the CFTC both clarified that "[t]he market value used to determine the cumulative mark-to-market change will be mid-market prices, if that is consistent with the agreement of the parties. The final rule is consistent with market practice in this respect."[38]

However, only the CFTC provided a further substantive gloss regarding the methodology for determining "mark-to-market" values, which ties to market prices and other objective criteria. The CFTC Final Rule states:

> [E]ach covered swap entity shall calculate variation margin . . . using methods, procedures, rules, and inputs that to the maximum extent practicable rely on recently-executed transactions, valuations provided by independent third parties, or other objective criteria. . . . Each covered swap entity shall have in place alternative methods for determining the value of an uncleared swap in the event of the unavailability or other failure of any input required to value a swap. [39]

In the CFTC Preamble, the CFTC stated that this calculation requirement "is consistent with that of the Prudential Regulators but is more detailed . . . [and] is consistent with recently-issued international standards."[40]

Initial Margin Must Be Segregated and May Not Be Rehypothecated

The Swap Margin Rules provide that all funds or other property that a CSE posts or collects as *required initial margin* must be segregated and held by one or more custodians that are not affiliates of the CSE or the counterparty. Although that represents the CFTC Final Rule's requirement regarding segregation of margin posted by a Non-Bank CSE, the PR Final Rule goes further, requiring the segregation of any margin posted by a Bank CSE other than variation margin. Thus, initial margin that a Bank CSE posts above the amount required under the PR Final Rule must be segregated (even if the Bank CSE is contractually required to post the additional amount); in contrast, any additional initial margin posted by a Non-Bank CSE is not subject to mandatory segregation under the CFTC Final Rule.

In connection with mandated custodial arrangements, rehypothecation of margin is generally prohibited—a prohibition that is at variance with the BCBS/IOSCO Standards, under which "one-time" rehypothecation of initial margin is permitted in certain circumstances.[41]

The prohibition on rehypothecation by the custodian is at odds with the use of cash collateral, which is fungible and typically held as a deposit by the custodian. As the CFTC observed:

> [P]ermitting initial margin collateral to be held in the form of a deposit liability of the custodian bank is inconsistent with the final rule's prohibition against rehypothecation of such collateral. In addition, employing a deposit liability of the custodian bank—or another depository institution—is inconsistent with the final rule's prohibition against use of obligations issued by a financial firm.[42]

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[38] PR Preamble at 74867; CFTC Preamble at 664. Commenters had been concerned that the rule terminology might have been interpreted as requiring CSEs to value Non-Cleared Swaps on their side of the market rather than at mid-market.

[39] CFTC Final Rule, Section 23.155(a) (emphasis added).

[40] CFTC Preamble at 665 (citing IOSCO, *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives* (January 28, 2015)).

[41] *See* BCBS/IOSCO Standards. It is not clear how, if permitted, "one-time" rehypothecation would work in practice.

[42] CFTC Preamble at 671.

In light of this inconsistency, the Swap Margin Rules were modified to permit temporary rehypothecation by custodians that receive initial margin in the form of cash, if the custodian uses the cash to purchase a non-cash asset that qualifies as initial margin. Specifically, the rules permit cash collateral to be held in a general deposit account with the custodian for a "time period reasonably necessary to consummate" the purchase of the non-cash asset.[43]

Enforceable Master Netting Agreements

The Swap Margin Rules permit CSEs to calculate and comply with applicable initial and variation margin amount requirements on a net basis for all Non-Cleared Swaps governed by an eligible master netting agreement (EMNA). The Swap Margin Rules define "eligible master netting agreement" as a written, legally enforceable agreement that:

- creates a single legal obligation for all individual transactions covered by the agreement upon an event of default (following certain permitted stays[44]), including upon an event of receivership, conservatorship, insolvency, liquidation or similar proceeding, of the counterparty; and
- provides the CSE the right to accelerate, terminate and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of receivership, conservatorship, insolvency, liquidation or similar proceeding, of the counterparty, without being stayed or avoided under applicable laws (other than certain permitted stays).[45]

Under the 2014 Rule Proposals, all swaps governed by an EMNA, including those executed before the effective date of the minimum margin requirements, would have been subject to the applicable margin requirements. That would have required a CSE and its counterparty to establish a separate EMNA if they wanted legacy swaps not to be subject to mandated margin requirements. However, as finalized, the Swap Margin Rules permit the parties to an EMNA to identify separate "netting portfolios" or "netting sets" under a single EMNA and to margin as mandated only netting portfolios or sets that include any Non-Cleared Swaps entered into after the applicable compliance date.[46] This approach may be used to distinguish between Non-Cleared Swaps executed before and after applicable phase-in dates established by the Swap Margin Rules. It also may be used to distinguish between Non-Cleared Swaps executed by a CSE with a counterparty before and after the counterparty's status changes in a manner that results in new margin requirements (e.g., when a non-financial end user counterparty becomes a financial end user, or when an existing financial end user counterparty first crosses the threshold for material swaps exposure).

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[43] *See* PR Final Rule, Section _.7(c)(1); CFTC Final Rule Section 23.157(c)(1).

[44] The Swap Margin Rules permit stays imposed in receivership, conservatorship or resolution under the Federal Deposit Insurance Act (12 USC 1811 *et seq.*), Title II of Dodd-Frank, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended (12 USC 4617) or the Farm Credit Act of 1971, as amended (12 USC 2183 and 2279cc), or laws of foreign jurisdictions that are substantially similar to the foregoing U.S. laws. *See* PR Final Rule, Section _.2; CFTC Final Rule, Section 23.151.

[45] In addition, in order to qualify as an EMNA, the agreement must not contain a "walkaway clause," which is defined as a provision permitting a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulting party or its estate, even if the defaulting party is a net creditor under the agreement.

[46] *See* PR Final Rule, Section _.5(a)(3)(ii); CFTC Final Rule Section 23.153(d)(2)(ii).

Applicability of Swap Margin Rules to Inter-Affiliate Swaps

The Swap Margin Rules do not exempt inter-affiliate swaps generally. As noted above the CFTC Final Rule provides significant relief from initial margin requirements for affiliate transactions, while the PR Final Rule provides less relief. Both rules require the collection and posting of variation margin for Non-Cleared Swaps with affiliates (without variation due to affiliate status).

Under the CFTC Final Rule, a Non-Bank CSE is generally *not required to collect initial margin* from an affiliate,[47] provided that the swap transaction is subject to an appropriate centralized risk management program.[48] However, if the affiliate is foreign and has "outward facing" transactions (i.e., swap transactions with third-parties), the exception applies only if the non-U.S. affiliate is itself subject to margin collection requirements on its third-party swaps that the CFTC has deemed eligible for substituted compliance. Otherwise, initial margin must be collected from the non-U.S. affiliate, though the initial margin need not be segregated with a third-party custodian.[49] In addition, under the CFTC Final Rule, a Non-Bank CSE is *not required to post initial margin* to an affiliate except where the affiliate is a Bank CSE and then only if the Bank CSE is required to collect initial margin under the PR Final Rule (i.e., no additional substantive requirement is imposed).

In contrast, under the PR Final Rule, Bank CSEs are *required to collect initial margin* from affiliates, but are *not required to post* initial margin.[50] However, instead of applying a $50 million threshold amount for initial margin collection (which is generally applicable in respect of non-affiliated counterparty groups on a consolidated basis), the PR Final Rule establishes a $20 million notional amount threshold, which applies on an affiliate-by-affiliate basis. In addition, the PR Final Rule permits a Bank CSE to act as custodian for any initial margin collected from an affiliate in the form of non-cash collateral, and the custodian for such initial margin may also be another affiliate of the CSE; however, the Prudential Regulators emphasized that "the restrictions on rehypothecating, repledging, or reusing such collateral . . . will also apply to such non-cash collateral."[51]

The Prudential Regulators responded in the PR Final Rule to comments seeking clarifications regarding the ability of a holding company of both a Bank CSE and its affiliated counterparty to provide initial margin collected by the Bank CSE from the affiliate:

> The rule does not prohibit the margin that a [CSE] must collect on swaps with its affiliated counterparty from being supplied by the parent holding company. . . . To the extent the non-cash collateral [posted by a parent holding company] was not encumbered . . . , the holding company

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[47] As discussed above, the PR Final Rule and the CFTC Final Rule assign substantially the same definition to their respective defined terms, "affiliate" and "margin affiliate." S*ee supra* note 20.

[48] *See* CFTC Final Rule, Section 23.159(a) (conditioning the exemption, in part, on the swaps in question being "subject to a centralized risk management program that is reasonably designed to monitor and to manage the risks associated with the inter-affiliate swaps").

[49] *See* CFTC Final Rule, Section 23.159(c) (imposing the collection requirement on Non-Cleared Swaps with non-U.S. margin affiliates that: (i) are financial end users, (ii) enter into swaps with third parties (either directly or through one or a series of transactions with other margin affiliates), and (iii) are not located in a jurisdiction that has been found by the CFTC to be eligible for substituted compliance and do not collect initial margin on swaps with third parties in a manner that would comply with the CFTC Final Rule).

[50] In lieu of posting initial margin to its affiliates, the Bank CSE must calculate the amount that would have been posted as if posting of initial margin were required (under the Bank CSE's approved internal initial margin model or under the standard initial margin table) and provide documentation of such amount to the affiliate on a daily basis.

Of course, if the affiliate is itself a CSE, the affiliate may be required to collect margin in accordance with the Swap Margin Rules, obviating this exemption from the PR Final Rule's posting requirements.

[51] PR Preamble at 74889 (describing the continued application of PR Final Rule, Section _.7(c)).

> may arrange with its affiliate to use this excess non-cash collateral to satisfy the [CSE's] requirement to collect initial margin under this rule."[52]

The PR Final Rule provides an additional accommodation regarding the amount of initial margin required to be collected from affiliates. The accommodation is linked to exemptions from the CFTC's mandatory clearing requirements for certain inter-affiliate swaps. The CFTC's clearing exemption was finalized in 2013.[53] In effect, the PR Final Rule permits Bank CSEs to collect less initial margin from affiliates than they would from non-affiliates where the swap (or netting portfolio) in question "would be subject to . . . clearing requirements . . . but for an exemption [for affiliate transactions under specified provisions of the CEA or the Exchange Act or CFTC or SEC regulations thereunder]." This is accomplished by permitting the Bank CSE to use a shorter "holding period" for transactions with affiliated counterparties when modeling initial margin requirements.[54]

The BCBS/IOSCO Standards do not require any margining (initial or variation margin) of Non-Cleared Swaps between affiliates, but instead leave the question to be resolved on a jurisdiction-by-jurisdiction basis: "Transactions between a firm and its affiliates should be subject to appropriate regulation in a manner consistent with each jurisdiction's legal and regulatory framework."[55]

Impact on Foreign Exchange Swaps and Forwards

The margin collection and posting requirements of the Swap Margin Rules do not apply to non-cleared foreign exchange swaps or foreign exchange forwards (i.e., physically settled transactions). This is consistent with the U.S. Treasury having exempted such transactions from Dodd-Frank's definition of a "swap" in November 2012.[56] Although not subject to mandatory margining, such foreign exchange swaps and forwards must be counted by CSEs both in determining whether financial end users exceed the threshold for material swaps exposure and in determining the timing of when a counterparty relationship is to be brought into compliance under the phase-in rules. This treatment of foreign exchange swaps and forwards under the Swap Margin Rules is generally consistent with the treatment of such instruments under the BCBS/IOSCO Standards.

Cross-Border Implications

The provisions in the PR Final Rule that address its cross-border reach are similar to those in the 2014 PR Rule Proposal, and while they vary in certain important respects from the CFTC Cross-Border Margin Proposal, there remain more similarities than differences. As noted above, in adopting the CFTC Final Rule the CFTC deferred further action on the CFTC Cross-Border Margin Proposal.

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[52] PR Preamble at 74889. The Prudential Regulators caution, however: "Under the final rule, the covered swap entity must have full authority to apply this non-cash collateral to the affiliate's obligations in the event of default, free of any claim by the parent holding company that would interfere with the covered swap entity's rights in the non-cash collateral. Moreover, no aspect of the arrangement may compromise or condition the restrictions on treatment of initial margin collateral in the final rule, including the segregation and rehypothecation requirements . . . , or the [CSE's] interests in the collateral." *Id.*

[53] *See* CFTC, *Clearing Exemption for Swaps Between Certain Affiliated Entities*; Final Rule, 78 Fed. Reg. 21750 (April 11, 2013), available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-07970a.pdf.

[54] The PR Final Rule states that "[a]ny netting portfolio that contains any [swap subject to a shorter holding period] must be identified and separate from any other netting portfolio for purposes of calculating and complying with the initial margin requirements of this [Final Rule]." PR Final Rule, Section _.11(e)(2).

[55] BCBS/IOSCO Standards at 22.

[56] Cash-settled currency swaps, cross-currency swaps and non-deliverable foreign exchange forwards were explicitly not exempted from the "swap" definition and are regulated by the CFTC as swaps.

Like the 2014 PR Rule Proposal (and the CFTC Cross-Border Margin Proposal), the PR Final Rule does not apply at all to a Non-Cleared Swap if certain cross-border conditions are met; and substituted compliance is potentially available in certain other cross-border circumstances. We outline the overall cross-border applicability of the PR Final Rule in Appendix D; here, we highlight certain significant cross-border aspects of the PR Final Rule.

Exclusion

In order for a Non-Cleared Swap transaction to be entirely excluded from the requirements of the PR Final Rule, the following conditions must be met with regard to the Bank CSE and its counterparty:

- The Bank CSE must be a "foreign covered swap entity" (Foreign CSE), which means a Bank CSE that is not:
  - a U.S. person,
  - a U.S. branch or agency of the CSE, or
  - a consolidated subsidiary of a U.S. person.
- The Foreign CSE's counterparty must not be:
  - a U.S. person,
  - a U.S. branch or agency of a non-U.S. bank, or
  - a Swap Entity that is consolidated subsidiary of a U.S. person.
- Neither the Foreign CSE nor its counterparty may be guaranteed by:
  - a U.S. person,
  - a U.S. branch or agency of a non-U.S. bank, or
  - a Swap Entity that is a subsidiary of a U.S. person.

We use the term "U.S. person" to mean any entity organized under the laws of the United States or any State (including any non-U.S. branch or office thereof, and any such entity that is a subsidiary of a foreign bank) or a natural person who is a resident of the United States. Our use of the term in this manner is based on terminology used several times in the PR Final Rule, which, unlike the CFTC Cross-Border Margin Proposal, does not use the defined term "U.S. person." The Prudential Regulators expressly declined a commenter's request to define "U.S. person"; however, they stated that in concept they were seeking a "bright-line" test; this test, for example, obviates inquiry into a person's "principal place of business."[57]

The Prudential Regulators drew a distinction between a "U.S. branch or agency" of a non-U.S. Bank CSE, on the one hand, and the "location of personnel or agents" of the non-U.S. Bank CSE, on the other. The Prudential Regulators expressly declined to follow a commenter request that a U.S. branch or agency of a non-U.S. Bank CSE be considered a "Foreign CSE" and thus eligible for the cross-border exclusion.[58] However, in addressing

[57] *See* PR Preamble at 74883 ("One commenter . . . suggested that the final rule adopt a "U.S. person" definition . . . . Similarly, another commenter urged the Agencies to incorporate a "principal place of business" test into the definition . . . . The Agencies have not adopted the changes recommended by these commenters but have retained the bright-line proposed test that looks to the jurisdiction of organization. As a consequence, the Agencies would consider the place of incorporation of a particular entity to be the location of the entity for purposes of this rule.").

[58] *See* PR Final Rule, Section _.9(c); *see also* PR Preamble at 74883.

comments regarding "a swap transaction with a foreign counterparty [that] is booked by a foreign swap entity but arranged, negotiated, or executed by persons operating from a U.S. branch of such swap entity," the Prudential Regulators stated that they "would generally consider the entity to which the swap is booked as the counterparty for purposes of this section."[59] Although the PR Final Rule includes no further elaboration of that point, the Prudential Regulators' statement in that regard, combined with the express terms of the PR Final Rule, indicates that a Non-Cleared Swap transaction undertaken by personnel or agents of a non-U.S. Bank CSE who are located in the United States would be eligible for exclusion from mandatory margining under the PR Final Rule if the transaction is not booked in a U.S. branch or agency of the non-U.S. Bank CSE (if other conditions for exclusion are met).

That treatment contrasts with the position taken in a 2013 CFTC staff advisory, which interpreted the CFTC's earlier cross-border swap guidance and policy statement (the CFTC 2013 Cross-Border Guidance).[60] That staff advisory interpreted oft-discussed footnote 513 in the CFTC 2013 Cross-Border Guidance, which is to the effect that CFTC transaction-level swap rules would apply to non-U.S. swap dealers "regularly using personnel or agents located in the U.S. to arrange, negotiate, or execute a swap with a non-U.S. person" (even in the absence of a U.S. branch or agency). The staff advisory has been held in abeyance by subsequent CFTC staff no-action relief, and it appears to have been the subject of a request for comment in the CFTC Cross-Border Margin Proposal.[61]

As noted above, the Prudential Regulators did not incorporate into the PR Final Rule the traditional banking concept of "control," which was used in their proposed definitions of "affiliate" and "subsidiary" in the 2014 PR Rule Proposal. The PR Final Rule adopts the approach found in the CFTC Final Rule, which ties affiliation to consolidation under U.S. GAAP. Nonetheless, both approaches—based on bank regulatory "control" or based on GAAP consolidation—are consistent with a traditional bank supervisory perspective: bank regulators supervise affiliated groups, whether or not members of the group are intertwined via express guarantees or other formal financial maintenance undertakings. Although this supervisory approach contrasts with the approach of the CFTC 2013 Cross-Border Guidance—where the scope of application of rules to separate entities generally depends on there being some level of guarantee, keepwell or other express financial support—it is consistent with the approach to affiliation subsequently taken in the CFTC Cross-Border Margin Proposal. In a sense, cross-pollination is at work here: The CFTC is now proposing to operate in the mode of a prudential regulator (as it focuses on the supervision of affiliated entities irrespective of intercompany guarantees), and Prudential Regulators are forgoing traditional bank regulatory concepts of control and affiliation (as they adopt a rule based in part on U.S. GAAP).

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[59] *See* PR Preamble at 74883, footnote 183; *see also* PR Final Rule, Section _.9(b).

[60] CFTC, *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations;* Rule, 78 Fed. Reg. 45292 (July 26, 2013), available at: https://www.gpo.gov/fdsys/pkg/FR-2013-07-26/pdf/2013-17958.pdf.

[61] Although the CFTC Cross-Border Margin Proposal does not mention either footnote 513 or the staff's advisory, it effectively revisits both as they would bear on margin requirements for Non-Cleared Swaps. The CFTC Cross-Border Margin Proposal provides that Non-Cleared Swaps between non-U.S. CSEs and non-U.S. persons are excluded from application of the CFTC's margin requirements, subject to a number of qualifications and conditions. One of those conditions is that the "non-U.S. CSE is not a U.S. branch of a non-U.S. CSE." However, the CFTC Cross-Border Margin Proposal does not propose particular standards for determining when a non-U.S. CSE has executed a swap in a manner that would meet this condition. Instead, it asks specific questions in that regard (including whether a Volcker Rule standard should apply): "How should the Commission determine whether a swap is executed through or by a U.S. branch of a non-U.S. CSE for purposes of applying the Commission's margin rules on a cross-border basis? Should the Commission base the determination of whether the swap activity is conducted at a U.S. branch of a non-U.S. CSE for purposes of applying the Commission's margin rules on a cross-border basis on the same analysis as is used in the Volcker rule?" CFTC Cross-Border Margin Proposal at 41388.

This does not mean that the presence of a cross-border guarantee is irrelevant. As described above, the absence of a U.S. guarantor is a condition to a swap transaction being excluded under the cross-border provisions of the PR Final Rule. However, because exclusion under the PR Final Rule is independently conditioned on the absence of consolidation with a U.S. parent (both for the Foreign CSE and for any non-U.S. counterparty that is itself a Swap Entity), the circumstances where a U.S. guarantee would be likely to make a difference are fewer (because cross-border guarantees are most prevalent between affiliates). Where the Foreign CSE's non-U.S. counterparty is not itself a Swap Entity, exclusion from the PR Final Rule remains possible even if the non-U.S. counterparty is consolidated with a U.S. parent, provided it is not guaranteed by its U.S. parent (or any other U.S. person). Thus, the Prudential Regulators noted that a Foreign CSE could enter into "swaps with a foreign bank or with a foreign subsidiary of a U.S. bank or bank holding company, so long as neither the subsidiary nor the U.S. parent is a covered swap entity[, but could not enter into] a swap with a foreign branch of a U.S. bank or a U.S. branch or subsidiary of a foreign bank."[62]

The definition of guarantee introduced in the 2014 PR Rule Proposal has been largely retained in the PR Final Rule. As a consequence, the definition is triggered only where the beneficiary of the guarantee has "rights of recourse" against the guarantor. This too is consistent with the CFTC Proposed Rule; however, the definitions of guarantee under both the PR Final Rule and the CFTC Cross-Border Margin Proposal are inconsistent, in significant part, with the treatment of guarantee arrangements under the CFTC 2013 Cross-Border Guidance.[63]

Substituted Compliance

Under the PR Final Rule, full substituted compliance (i.e., for requirements both to collect and to post margin) is contemplated where one set of conditions is met, and a more limited version of substituted compliance (i.e., only for posting requirements) is contemplated where a second, less restrictive, set of conditions is met. In contrast, the CFTC Cross-Border Margin Proposal included, in addition to a version of full substituted compliance, two different limited versions of substituted compliance (one related solely to posting margin and the other solely to collecting margin).

For full substituted compliance to be available under the PR Final Rule, a comparability finding must be made in respect of the relevant non-U.S. jurisdiction's requirements for Non-Cleared Swaps,[64] and certain transaction-specific conditions must be met. Full substituted compliance is available not only to Foreign CSEs (as described above), but also to certain other non-U.S. Bank CSEs that don't qualify as "Foreign CSEs": (i) U.S. branches and agencies of non-U.S. Bank CSEs, and (ii) non-U.S. Bank CSEs that are consolidated with a U.S. parent that is a depository institution, Edge corporation or agreement corporation, provided in any case that the non-U.S. Bank

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[62] *See* PR Preamble at 74883.

[63] The CFTC 2013 Cross-Border Guidance discussed guarantees in two principal contexts: (i) determining which swap dealing transactions a non-U.S. person is required to count against its swap dealer de minimis threshold (i.e., it must count swaps with non-U.S. persons if the obligations of the non-U.S. person are guaranteed by a U.S. person), and (ii) determining which Transaction-Level Requirements apply to a given cross-border transaction. In the first context, the CFTC 2013 Cross-Border Guidance used the defined term "guaranteed affiliate," which incorporated a very broad definition of guarantee, including keepwells and other less direct means of credit support; in the second context, the CFTC focused on guarantees with recourse. *Compare* CFTC 2013 Cross-Border Guidance at 45320, footnote 267 (describing a broad category of credit support arrangements related to swap dealer registration requirements) and at 45355-56 (describing guarantees with recourse related to the applicability of Transaction-Level Requirements).

[64] The PR Final Rule provides: "In determining whether to make a [comparability] determination . . ., the prudential regulators will consider whether the requirements of [the] foreign regulatory framework . . . are comparable to the otherwise applicable requirements of [the PR Final Rule] and appropriate for the safe and sound operation of the covered swap entity, taking into account the risks associated with Non-Cleared Swaps and Non-Cleared security-based swaps." PR Final Rule, Section _.9(d)(2).

CSE's swap obligations are not guaranteed by a U.S. person. Once these qualifications are met by the non-U.S. Bank CSE, it may satisfy its obligations under the PR Final Rule by complying with non-U.S. requirements in respect of which a comparability determination has been made. This holds true "regardless of the location of the counterparty" (as emphasized by the Prudential Regulators in the PR Preamble).[65] Thus, many non-U.S. Bank CSEs may eventually be able to take advantage of substituted compliance, even when dealing with U.S. person counterparties. Although this runs counter to the position taken under the CFTC 2013 Cross-Border Guidance, it is largely consistent with the subsequent position taken in the CFTC Cross-Border Margin Proposal and the position set forth in the BCBS/IOSCO Standards.[66]

The Prudential Regulators addressed commenter concerns regarding the potential for disparate treatment of U.S. Bank CSEs, for which substituted compliance would not be available (even when dealing from non-U.S. branches), and non-U.S. Bank CSEs that are permitted to comply with non-U.S. requirements. The Prudential Regulators stated that "this concern would be addressed through the comparability determination process. A foreign jurisdiction with a substantially different margin requirement that resulted in a demonstrable competitive advantage over U.S. covered swap entities is unlikely to have processes that are comparable to the U.S. compliance requirements."[67]

The more limited substituted compliance provisions of the PR Final Rule apply to Bank CSE requirements to post margin but not to collect it. But while narrower in substance, this form of limited substituted compliance is more broadly available to any Bank CSE (U.S. or non-U.S.), provided that its counterparty is a non-U.S. person[68] (and is not guaranteed by a U.S. person[69]) and is required to collect margin under non-U.S. requirements found to be comparable. The Prudential Regulators gave the following example of their intent: "For example, if a U.S. bank that is a covered swap entity enters into a swap with a foreign hedge fund that does not have a U.S. guarantee and that is subject to a foreign regulatory framework for which the Agencies have made a comparability determination, the U.S. bank must collect the amount of margin that is required under the U.S. rule but need post only the amount of margin that the foreign hedge fund is required to collect under the foreign regulatory framework."[70]

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[65] PR Preamble at 74884.

[66] Under the CFTC 2013 Cross-Border Guidance, a U.S. person would have been ensured CFTC protection (i.e., no substituted compliance was possible) except where the U.S. person is itself a CSE (and operating through a foreign branch). Under the CFTC Cross-Border Margin Proposal, a U.S. person is ensured CFTC protection only where the U.S. person is itself a CSE. For further discussion of the evolution of the CFTC's approach, see the Sidley Update cited above (*supra* note 12).

[67] PR Preamble at 74884.

[68] In fact, the text of the PR Final Rule does not restrict its application to counterparties that are non-U.S. persons. *See* PR Final Rule, Section __.9(d)(4) (requiring only that the counterparty be subject to the non-U.S. requirements that have been found comparable and that it not have a guarantee from a U.S. person). However, the PR Preamble states that the counterparty must be a "foreign counterparty." *See* PR Preamble at 74885. Moreover, conditioning the availability of substituted compliance on the absence of a guarantee from a U.S. person would make no sense if the counterparty itself could be a U.S. person.

[69] The Prudential Regulators noted that they conditioned this relief on the absence of a U.S. guarantee (a condition not found in the 2014 Rule Proposal) in order to align the PR Final Rule with the CFTC Cross-Border Margin Proposal. *See* PR Preamble at 74885.

[70] PR Preamble at 74885.

Questions Resolved by Prudential Regulators and CFTC Regarding Swaps Cleared Outside the United States

Applicability of the margin requirements to Non-Cleared Swaps[71] turns in the first instance on:

- Section 731 of Dodd-Frank, which amended the Commodity Exchange Act (the CEA) to require CSEs to margin swaps that are not cleared by a CFTC-registered derivatives clearing organization (DCO); and
- Section 764 of Dodd-Frank, which amended the Securities Exchange Act of 1934 (Exchange Act) to require CSEs to margin security-based swaps that are not cleared by an SEC-registered clearing agency.[72]

Thus, the 2014 Rule Proposals included definitions that were tied to the clearance of swaps and security-based swaps by registered DCOs and registered clearing agencies. However, these definitions raised questions regarding whether the margin requirements should apply to swaps that are cleared through non-U.S. clearing organizations that are not registered as DCOs with the CFTC or clearing agencies with the SEC. In response to these questions, the Prudential Regulators and the CFTC modified the definitions used in the Swap Margin Rules. The Prudential Regulators and the CFTC interpreted the Dodd-Frank statutory references to registered DCOs and clearing agencies to cover clearing organizations that the CFTC or SEC exempts from its respective registration requirements (in addition to those actually registered). Thus the Swap Margin Rules do not require the margining of swaps and security-based swaps that are cleared outside the United States if the respective non-U.S. clearing organization has been granted an exemption from registration as a DCO or clearing agency (as the case may be).

Documentation

CSEs are required to execute credit support documents with other Swap Entities and financial end users that: (i) provide the CSE and the counterparty with the contractual rights and obligations to collect and post initial and variation margin, (ii) specify the procedures for determining the value of each Non-Cleared Swap for margin calculation purposes, (iii) specify a valuation dispute resolution procedure, and (iv) describe the methodology used to calculate initial margin.[73] It is anticipated that CSEs will request their counterparties to amend their existing agreements to address these requirements.

The Interim Final Rules

Consistent with Sections 731 and 764 of Dodd-Frank, as amended by TRIPRA,[74] the Interim Final Rules exempt from the margin requirements all Non-Cleared Swaps entered into with counterparties that qualify for certain exceptions or exemptions from mandatory clearing under Dodd-Frank. Specifically, the Interim Final Rules provide that the initial and variation margin requirements set forth in the Swap Margin Rules do not apply to Non-Cleared Swaps entered into by a CSE with the following types of counterparties:

- Non-financial entities (including captive finance companies and small financial institutions) that qualify for the clearing exception under Section 2(h)(7)(A) of the CEA or Section 3C(g)(1) of the Exchange Act;

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[71] As noted above, we use the term "Non-Cleared Swaps" to refer to both "non-cleared swaps" as defined under the PR Final Rule and "uncleared swaps" as defined under the CFTC Final Rule.

[72] *See* CEA, Section 6s(e)(2); Exchange Act, Section 15F(e)(2).

[73] *See* PR Final Rule, Section _.10; CFTC Final Rule Section 23.158.

[74] Pub. L. 114-1, 129 Stat. 3 (2015).

- Cooperative entities that qualify for an exemption from clearing under Section 4(c)(1) of the CEA; or
- Treasury affiliates acting as agent that satisfy the criteria for an exception from clearing under Section 2(h)(7)(D) of the CEA or Section 3C(g)(4) of the Exchange Act.

Because the portion of TRIPRA that concerns treasury affiliates is limited to affiliates that *act as agents*, and does not extend to those that act as principals, the Interim Final Rules are similarly limited. However, as recognized in both Preambles, the CFTC's staff has previously granted no-action relief (from mandatory swap clearing requirements) to certain eligible treasury affiliates that *act as principals*.[75] In light of that no-action relief, the CFTC Final Rule's definition of "financial end user" includes an express exclusion for any "eligible treasury affiliate that the Commission exempts from the [uncleared swap margin rules] by rule," and the CFTC Preamble states that the CFTC "will act to implement this approach by rule or staff no-action letter in a separate procedure."[76] Moreover, the Prudential Regulators stated that "to the extent the CFTC acts to exempt [treasury affiliates that act as principals] from clearing by rule, these entities would also be excluded from the definition of financial end user for purposes of [the PR Final Rule]."[77]

The Interim Final Rules will become effective on April 1, 2016, and comments must be received by January 31, 2016 (in the case of the Prudential Regulators) or by February 5, 2016 (in the case of the CFTC).

Key Consequences for Certain Market Participants

Insurance Companies

The Swap Margin Rules define financial end users to include entities organized as insurance companies that are primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies (including foreign insurers). As a result, insurance companies will be required to post and collect (as applicable) variation margin on a daily basis for each transaction with a CSE commencing one day after the execution of each such transaction. In addition, insurance companies that are deemed to have (on a consolidated basis with their affiliates) a material swaps exposure will also be required to post and collect initial margin if the initial margin required for the insurance company (and its affiliates) exceeds the $50 million threshold, and accordingly such companies will need to work with the CSEs with which they transact Non-Cleared Swaps in light of the phase-in requirements.

Insurance companies will also need to monitor regulatory developments where their security-based swap entity counterparties are not subject to regulation by a Prudential Regulator and will thus be subject to rules implemented by the SEC.

Non-CSE Banks

The Swap Margin Rules include banks and bank holding companies in the definition of financial end user. Accordingly, banks that are not CSEs will post and collect (as applicable) variation margin for each Non-Cleared Swap with a CSE as a result of the application of the Swap Margin Rules' collection and posting requirements

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[75] *See* PR Preamble at 74856; CFTC Preamble at 647. Year-end legislation codified, to a significant degree, the CFTC's previous no-action relief. *See* The Consolidated Appropriations Act, 2016, Division O, Title VII, Section 705 (available at: https://www.congress.gov/114/bills/hr2029/BILLS-114hr2029enr.pdf).

[76] CFTC Preamble at 647.

[77] PR Preamble at 74856.

applicable to the CSE. In addition, a bank with material swaps exposure (calculated on a consolidated basis with its affiliates) that is not a CSE will post and collect initial margin with its CSE counterparties if the aggregate initial margin required for the bank and its affiliates exceeds the $50 million threshold.

Hedge Funds and Other Alternative Investment Vehicles

The Swap Margin Rules define financial end user in a manner that includes virtually all hedge funds and other alternative investment vehicles. Funds will therefore be subject to variation margin requirements in connection with Non-Cleared Swaps with CSEs; they will also be subject to initial margin requirements if they have material swaps exposure. For fund managers that have been accustomed to negotiating their own favorable collateral terms with their swaps counterparties (e.g., negotiated unsecured thresholds), the Swap Margin Rules will impose new constraints. However, required initial margin, where the fund has material swaps exposure, will be posted in both directions (subject to the $50 million initial margin threshold and $500,000 minimum transfer amount). Although initial margin amounts will not be netted against one another for posting purposes (and will be subject to mandatory third-party custodial arrangements and a prohibition on rehypothecation), the presence of two-way initial margin posting will limit credit exposure, provided the arrangements are subject to enforceable netting agreements. Funds that do not have material swaps exposure will retain their ability to negotiate initial margin terms with CSEs that may be more favorable than those required by the Swap Margin Rules.

As with all CSE counterparties, material swaps exposure will be evaluated for fund entities on a GAAP consolidation basis. For fund managers, this will add a consideration in circumstances where consolidation may result in a fund manager having a "controlling financial interest" in one or more funds. The CFTC more generally noted:

> The Commission acknowledges that some accounting standards, such as the GAAP and IFRS variable interest standards, sometimes require consolidation between a sponsor or manager and a special purpose entity created for asset management, securitization, or similar purposes, under circumstances in which the manager does not hold interests comparable to a majority equity or voting control share. On balance, the Commission believes it is appropriate to treat these consolidated entities as affiliates of their sponsors or managers.[78]

Like insurance companies, funds will also need to monitor regulatory developments where their security-based swap entity counterparties are not subject to regulation by a Prudential Regulator and will thus be subject to rules implemented by the SEC.

Securitization Vehicles

Although not categorically identified as financial end users, many securitization vehicles will constitute financial end users under the Swap Margin Rules (Covered SPVs).[79] As a result, Non-Cleared Swaps between a CSE and a

[78] CFTC Preamble at 647.

[79] The Swap Margin Rules' definition of "financial end user" includes, among others, the following types of entities, which may be securitization vehicles: (i) a private fund as defined in Section 202(a) of the IAA; (ii) an entity that would be an investment company under Section 3 of the ICA but for Section 3(c)(5)(C) thereof; (iii) an entity that is deemed not to be an investment company under Section 3 of the ICA pursuant to Rule 3a–7 thereunder; (iv) a commodity pool or commodity pool operator as defined in the CEA; (v) an entity, person or arrangement that is or holds itself out as being an entity, person or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for [the purpose of] investing or trading or facilitating the investing or trading in loans, securities, swaps funds or other assets [for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets]. *See* PR Final Rule, Section _.2; CFTC Final Rule, Section 23.151 (bracketed text

Covered SPV will be subject to the requirements to post and to collect (as applicable) variation margin on a daily basis for each transaction. Additionally, Covered SPVs with a material swaps exposure—$8 billion notional of Non-Cleared Swaps and foreign exchange forward and swaps—will also be subject to the initial margin requirements. In determining whether an individual Covered SPV has material swaps exposure, exposures of each of the Covered SPV's affiliates must be calculated and included. Accordingly, the classification of a Covered SPV that is consolidated for accounting purposes with another entity will need to take into consideration the swaps exposure of that other entity as well as the exposures of all of its affiliates. Where a Covered SPV is consolidated with a bank or other credit-originating institution that has significant swap activities, it will be more likely that the Covered SPV will be classified as having material swaps exposure because of the activities of its affiliates, and thus be subject to the initial margin requirements. This determination will be dynamic, in that Non-Cleared Swaps for subsequent securitization transactions involving newly created SPVs that are affiliates of Covered SPVs under the Swap Margin Rules will need to be considered. Note, however, that swaps executed by a financial end user at a time when it does not have material swaps exposure (on a consolidated basis) do not automatically become subject to initial margining requirements if the threshold is subsequently crossed as a result of new transactions (including transactions entered into by its affiliates).[80]

Covered SPVs that have material swaps exposure will be required to post and collect initial margin for each Non-Cleared Swap with a CSE if the aggregate initial margin required for the Covered SPV and its affiliates exceeds the $50 million threshold.

Operating Companies, Trading Entities and Energy Companies

Operating Companies (Energy and Non-Energy)

Operating companies, including energy operating companies, will in most cases not constitute financial end users and thus will not be required to post or collect initial margin or variation margin under the Swap Margin Rules. In addition, operating companies that enter into transactions for hedging purposes (and make the necessary elections and filings) are exempt from the clearing mandate. As a result, operating companies may generally engage in swap transactions for hedging purposes without having to clear or otherwise post margin.

It is important to note, however, that even though the Swap Margin Rules do not impose an absolute requirement on CSEs to post margin to or collect margin from non-financial end users, Bank CSEs are required to engage in prudent risk management and thus may require operating companies to post collateral or provide other suitable credit enhancement. In these circumstances, the amount and form of such collateral or credit enhancement is not mandated by the PR Final Rule, but rather will be subject to negotiation between the parties.

Trading Entities (Energy and Non-Energy)

Trading entities, including energy trading entities, that are commodity pools, commodity pool operators or commodity trading advisors or otherwise organized as private funds under the IAA or exempt from investment company registration pursuant to Rule 3a-7 will expressly fall within the definition of financial end users and thus will be required to post and collect (as applicable) variation margin on a daily basis for each transaction

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found only in the PR Final Rule definition). That securitization vehicles are intended by the Prudential Regulators and the CFTC to be treated as financial end users is apparent in both Preambles. *See* PR Preamble at 74857; CFTC Preamble at 640 and 643.

[80] *See supra* note 46 and accompanying text.

with a CSE. In addition, trading entities that are deemed to have (on a consolidated basis with their affiliates) a material swaps exposure will also be required to post and collect initial margin if the initial margin required for the trading entity (and its affiliates) exceeds the $50 million threshold.

The Swap Margin Rules also include a broad provision in the definition of financial end user, which specifies "an entity, person or arrangement that is, or holds itself out as being, an entity, person, or arrangement that raises money from investors, accepts money from clients, *or uses its own money primarily for [the purpose of] investing or trading or facilitating the investing or trading in loans, securities, swaps, funds or other assets [for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets]*" (bracketed text in PR Final Rule only). As a result, a trading entity that is not otherwise a commodity pool or private fund may be captured by this broad language and thus constitute a financial end user under the Swap Margin Rules.

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Appendix A: Summary of Key Provisions of the Swap Margin Rules

	Prudential Regulators	**CFTC**
Applicability	Bank CSEs Non-cleared swaps and non-cleared security-based swaps (Non-Cleared Swaps)	Non-Bank CSEs registered with CFTC Non-Cleared Swaps (other than security-based swaps)
Initial Margin Requirements		
Initial Margin (IM) Requirement	A CSE must post IM to and collect IM from: (i) Swap Entities[81] and (ii) financial end users with material swaps exposure.	
	A Bank CSE is not required to collect IM from non-financial end users, except at such times and in such forms and amounts (if any) as the CSE determines appropriately address the credit risk posed by the counterparty and the risks of the Non-Cleared Swaps.	A Non-Bank CSE is not required to collect IM from non-financial end users.
	A Bank CSE must collect IM from, but is not required to post IM to, an affiliate. Instead of posting IM to an affiliate, the Bank CSE must calculate the amount of eligible collateral that would have otherwise been required to be posted under the Swap Margin Rules (under the Bank CSE's approved internal initial margin model or under the standard initial margin table) and provide documentation of such amount to the affiliate on a daily basis. The applicable IM threshold for a Bank CSE and its affiliates is a $20 million	A Non-Bank CSE is not required to collect IM from, or post IM to,[82] an affiliate, provided that the swap transaction is subject to an appropriate centralized risk management program. However, if the affiliate is foreign and has "outward facing" transactions (i.e., swap transactions with third-parties), the exception applies only if the non-U.S. affiliate is itself subject to margin collection requirements on its third-party swaps that the CFTC has deemed eligible for substituted compliance; otherwise, initial margin

[81] *See supra* notes 14 and 26 (discussing the subtle distinctions between the definitions of swap entity in the PR Final Rule and the CFTC Final Rule).

[82] Technically, the CFTC Final Rule requires a Non-Bank CSE to post initial margin to an affiliate that is a Bank CSE, but only if the Bank CSE is required to collect initial margin under the PR Final Rule (i.e., no additional substantive requirement is imposed).

	notional amount threshold, which applies on an affiliate-by-affiliate basis. In order to avoid double-counting, inter-affiliate swaps need only be counted once in the calculation of required initial margin amounts.	must be collected from the non-U.S. affiliate.
IM Timing	IM posting and collection requirements must be met on a daily basis starting on the business day following entry into the transaction and ending on the date of the transaction's termination or expiration.	
IM Calculations	The amount of IM that must be posted or collected is determined pursuant to either: (i) a standardized schedule (reproduced below) that specifies gross initial margin as a percentage of notional exposure on the basis of asset class and duration or (ii) internal models satisfying certain conditions.	
IM Thresholds	Generally, the IM threshold amount is an aggregate credit exposure of $50,000,000 resulting from all Non-Cleared Swaps between a CSE and its affiliates, on the one hand, and a counterparty and its affiliates, on the other hand. The IM threshold amount for a Bank CSE and its affiliates is $20 million, applied on an affiliate-by-affiliate basis.	
Use of IM Models	A CSE may only use an internal model to calculate required IM if the model has been approved by its Prudential Regulator or CFTC and meets certain requirements, including: (i) quantitative requirements that must be met by the model in calculating potential future exposure, (ii) periodic review requirements, (iii) ongoing validation requirements, subject to control and audit, and (iv) various requirements as to written documentation. A CSE using an internal model must provide 60-day prior written notice to its Prudential Regulator or CFTC of certain changes to the model. The Prudential Regulator of CFTC retains ongoing authority to rescind or condition the CSE's permission to use the model. ISDA's WGMR Initiative is developing a Standard Initial Margin Model (SIMM) that is intended to provide a common IM methodology that can be used by market participants. Once the SIMM is approved by the relevant Prudential Regulator or by the CFTC or NFA, as applicable, a CSE may use the	

<table>
<tr><td></td><td colspan="2">SIMM to calculate IM in lieu of developing its own internal model or using the standardized minimum IM table included in the Swap Margin Rules.</td></tr>
<tr><td>Standardized IM Schedule</td><td colspan="2">See Appendix C</td></tr>
<tr><td>Margin Haircuts</td><td colspan="2">See Appendix E</td></tr>
<tr><td>Eligible Collateral for IM</td><td colspan="2">See Appendix F</td></tr>
<tr><td>IM Custody</td><td colspan="2">All IM that is required to be posted or collected by a CSE must be held by a custodian that is not affiliated with either counterparty (a Third-Party Custodian) pursuant to an agreement that is legal, valid, binding and enforceable under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency or similar proceeding and must impose certain restrictions on the use of such initial margin (Qualifying Custodial Agreement). However, IM that is required to be collected from an affiliate of the CSE (see “Initial Margin (IM) Requirement” above) may be held by the CSE or an affiliate rather than a Third-Party Custodian (though it remains subject to the restrictions on rehypothecation described below).

Any IM collected by a CSE in addition to the regulatory minimum is not required to be held by a Third-Party Custodian.</td></tr>
<tr><td></td><td>Any margin posted by a Bank CSE other than VM (e.g., IM in excess of the regulatory minimum) must be held by a Third-Party Custodian.</td><td>Any IM posted by a Non-Bank CSE in excess of the regulatory minimum is not required to be held by a Third-Party Custodian.</td></tr>
<tr><td>IM Rehypothecation</td><td colspan="2">A Qualifying Custodial Agreement must prohibit the custodian from rehypothecating, repledging, reusing or otherwise transferring (through securities lending, repurchase agreements, reverse repurchase agreements or other means) the funds or other property held by the custodian. A Qualifying Custodial Agreement may permit the posting party to substitute or direct the reinvestment of posted collateral provided that the minimum amount of IM remains posted in the form of eligible collateral.</td></tr>
<tr><td>IM and VM Compliance Dates</td><td colspan="2">See Appendix B</td></tr>
<tr><td>IM Minimum Transfer Amount</td><td colspan="2">$500,000[83]</td></tr>
</table>

[83] The minimum transfer amount provisions of the Swap Margin Rules apply to IM and VM in the aggregate.

Variation Margin	
Variation Margin (VM) Requirement	A CSE must post VM to and collect VM from: (i) Swap Entities, (ii) financial end users with material swaps exposure, and (iii) financial end users without material swaps exposure, including any of the CSE's affiliates.
VM Timing	Posting and collection requirements for VM must be met on a daily basis.
Eligible Collateral for VM	**Transaction between CSE and other Swap Entity:** cash in USD or in currency in which payment obligations under the swap is required to be settled. **Transaction between CSE and financial end user:** all forms of collateral eligible to be posted as IM.
VM Minimum Transfer Amount	**$**500,000[84]

[84] The minimum transfer amount provisions of the Swap Margin Rules apply to IM and VM in the aggregate.

Appendix B: Compliance Dates

Compliance Date	Initial Margin Requirements
September 1, 2016	Initial margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds **$3 trillion**.
September 1, 2017	Initial margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2017 that exceeds **$2.25 trillion**.
September 1, 2018	Initial margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2018 that exceeds **$1.5 trillion**.
September 1, 2019	Initial margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2019 that that exceeds **$0.75 trillion**.
September 1, 2020	Initial margin for any other CSE with respect to covered swaps **with any other counterparty**.

Compliance Date	Variation Margin Requirements
September 1, 2016	Variation margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps for March, April and May of 2016 that exceeds **$3 trillion**.
March 1, 2017	Variation margin for any other CSE with respect to covered swaps **with any other counterparty**.

Appendix C: Standardized Initial Margin Schedule

Asset Class	Duration	Initial Margin Requirements (% of Notional Exposure)
Credit	0-2 years	2%
	2-5 years	5%
	5 years +	10%
Commodity	Any	15%
Equity	Any	15%
FX/Currency	Any	6%
Cross Currency Swaps	0-2 years	1%
	2-5 years	2%
	5 years +	4%
Interest Rate	0-2 years	1%
	2-5 years	2%
	5 years +	4%
Other	Any	15%

The initial margin amount applicable to multiple Non-Cleared Swaps subject to an eligible master netting agreement is generally computed as follows:

Initial Margin = 0.4 x Gross Initial Margin + 0.6 x NGR x Gross Initial Margin

where:

Gross Initial Margin = the sum of the product of each Non-Cleared Swap's effective notional amount and the gross initial margin requirement for all Non-Cleared Swaps subject to the eligible master netting agreement; and

NGR = the net-to-gross ratio (that is, the ratio of the net current replacement cost to the gross current replacement cost).

Appendix D: PR Final Rule Cross-Border Treatment

Applicable CSE	Counterparty	Treatment
U.S. Bank CSE[85] *or* Non-U.S. Bank CSE (unless conditions described below for more favorable treatment are met)	U.S. person[86] *or* Non-U.S. person whose swap obligations **are guaranteed** by a U.S. person, a U.S. branch of a non-U.S. bank, or a non-U.S. Swap Entity that is a consolidated subsidiary of a U.S. person	Final Rule: *Applicable* Substituted Compliance: *Not available*
	Non-U.S. person[87] whose swap obligations **are not guaranteed** by a U.S. person, a U.S. branch of a non-U.S. bank, or a non-U.S. Swap Entity that is a consolidated subsidiary of a U.S. person, and who **is required to collect margin under non-U.S. regulations that are eligible for substituted compliance**	Final Rule: *Applicable* Substituted Compliance: *Available, but only with respect to initial margin posted by Applicable CSE to Counterparty*

[85] For purposes of this table, a U.S. Bank CSE means a Bank CSE that is an entity organized under the laws of the United States or any State (including any non-U.S. branch or agency thereof).

[86] For purposes of this table, U.S. person means any entity organized under the laws of the United States or any State (including any non-U.S. branch or agency thereof) or a natural person who is resident of the United States. Unlike the CFTC Cross-Border Margin Proposal, the PR Final Rule does not itself define (or use the term) "U.S. person"; instead its operative provisions use language similar to the language we use for our defined term. *See supra* note 57 and accompanying text.

[87] The PR Preamble makes clear it must be a non-U.S. counterparty, but the rule is not so limited (though the condition that there not be a U.S. guarantor makes it clear that this was the intention). *See* PR Preamble at 74884; PR Final Rule, Section _.9(b); *see also supra* note 68 and accompanying text.

Foreign CSE (i.e., non-U.S. Bank CSE other than a U.S. branch of a non-U.S. Bank CSE or a consolidated subsidiary of a U.S. parent) *or* U.S. branch of a non-U.S. Bank CSE *or* Non-U.S. Bank CSE that is a consolidated subsidiary of a depository institution, Edge corporation or agreement corporation *and, in each case:* whose swap obligations **are not guaranteed** by a U.S. person	U.S. person *or* non-U.S. person (no distinction)	Final Rule: *Applicable* Substituted Compliance: *Available*
Foreign CSE (i.e., non-U.S. Bank CSE other than a U.S. branch of a non-U.S. Bank CSE or a consolidated subsidiary of a U.S. person) whose swap obligations **are not guaranteed** by a U.S. person, a U.S. branch of a non-U.S. bank, or a non-U.S. swap entity that is a consolidated subsidiary of a U.S. person	Non-U.S. person (other than a Swap Entity that is a consolidated subsidiary of a U.S. person or a U.S. branch of a non-U.S. bank, which are addressed above) whose swap obligations **are not guaranteed** by a U.S. person, a U.S. branch of a non-U.S. bank, or a non-U.S. Swap Entity that is a consolidated subsidiary of a U.S. person	Final Rule: *Not applicable* Substituted Compliance: *N/A*

Appendix E: Margin Haircuts for Eligible Margin Collateral

Asset Class	Discount (%)
Cash in U.S. dollars or another major currency[88]	0.0%
Eligible government and related debt,[89] residual maturity:	
less than one year	0.5%
between one and five years	2.0%
greater than five years	4.0%
Eligible GSE debt, securities residual maturity:	
less than one year	1.0%
between one and five years	4.0%
greater than five years	8.0%
Other eligible publicly traded debt, residual maturity:	
less than one year	1.0%
between one and five years	4.0%
greater than five years	8.0%
Equities, included in:	
S&P 500 or related index	15.0%
S&P 1500 Composite or related index (but not S&P 500 or related index)	25.0%
Gold	15.0%

[88] "Major currency" means (1) United States Dollar (USD); (2) Canadian Dollar (CAD); (3) Euro (EUR); United Kingdom Pound (GBP); (5) Japanese Yen (JPY); (6) Swiss Franc (CHF); (7) New Zealand Dollar (NZD); (8) Australian Dollar (AUD); (9) Swedish Kronor (SEK); (10) Danish Kroner (DKK); (11) Norwegian Kroner (NOK) or (12) Any other currency as determined by the relevant Prudential Regulator or CFTC. *See* PR Final Rule, Section _.2; CFTC Final Rule, Section 23.151.

If cash is not in the same currency as swap obligation, an additional haircut applies.

[89] E.g., central bank, multilateral development bank, GSE securities as defined in the Swap Margin Rules.

Appendix F: Eligible Margin Collateral

Non-Cleared Swaps Between CSEs and Swap Entities

Variation margin for Non-Cleared Swaps between CSEs and Swap Entities must be in the form of available cash funds that are denominated in U.S. dollars or another major currency[90] or the currency of the settlement for the Non-Cleared Swaps (Cash and Cash Equivalents).

Eligible collateral for initial margin is limited to the following, in addition to Cash and Cash Equivalents:[91]

i. A security that is issued by, or unconditionally guaranteed as to the timely payment of principal and interest by (A) the U.S. Department of the Treasury; (B) a U.S. government agency (other than the U.S. Department of the Treasury) whose obligations are fully guaranteed by the full faith and credit of the U.S. government; (C) the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to the CSE or (D) the Bank for International Settlements, the International Monetary Fund or a multilateral development bank;

ii. A publicly traded debt security issued by, or an asset-backed security fully guaranteed as to the payment of principal and interest by, a U.S. Government-sponsored enterprise that is operating with capital support or another form of direct financial assistance received from the U.S. government that enables the repayments of the U.S. Government- sponsored enterprise's eligible securities;

iii. Certain publicly traded debt securities approved by the relevant Prudential Regulator [that are not asset-backed securities and are issued by a U.S. Government-sponsored enterprise not operating with capital support or another form of direct financial assistance from the U.S. government];

iv. [A security solely in the form of:]

   A. [Certain publicly traded debt securities approved by the relevant Prudential Regulator that are not asset-backed securities and are not otherwise described herein;]

   B. Publicly traded common equity that is included in:

      1) The Standard & Poor's Composite 1500 Index or any other similar index of liquid and readily marketable equity securities as determined by the applicable Prudential Regulator or the CFTC; or

      2) An index that a CSE's supervisor in a foreign jurisdiction recognizes for purposes of including publicly traded common equity as initial margin under applicable regulatory policy, if held in that foreign jurisdiction;

v. Securities in the form of redeemable securities in a pooled investment fund representing the security-holder's proportional interest in the fund's net assets and that are issued and redeemed only on the basis of the market value of the fund's net assets prepared each business day after the security-holder makes its investment commitment or redemption request to the fund, if

   A. the fund's investments are limited to the following:

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[90] PR Final Rule, Section _.6.

[91] Bracketed text in PR Final Rule only.

1) Securities that are issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the Treasury, and immediately-available cash funds denominated in U.S. dollars; or

2) Securities denominated in a common currency and issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to the CSE and immediately available cash funds denominated in the same currency; and

B. Assets of the fund may not be transferred through securities lending, securities borrowing, repurchase agreements, reverse repurchase agreements, or other means that involve the fund having rights to acquire the same or similar assets from the transferee; or

vi. Gold.

Non-Cleared Swaps Between CSEs and Financial End Users

Eligible variation margin collateral and initial margin collateral for Non-Cleared Swaps between CSEs and financial end users includes any form of collateral eligible for Initial Margin for Non-Cleared Swaps between CSEs and Swap Entities listed above.

Prohibited Margin Collateral

Mandatory initial margin and variation margin for Non-Cleared Swaps between CSEs and either Swap Entities or financial end users is not permitted to consist of securities issued by any of the following:

i. the posting party or any affiliate thereof;

ii. a bank holding company, savings and loan holding company, U.S. intermediate holding company, foreign bank, depository institution, market intermediary, or company that would be any of the foregoing if it were organized under the laws of the United States or any state, or any affiliate thereof; or

iii. a nonbank financial institution supervised by the Federal Reserve.