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The U.S. Margin Requirements: The Impact on Special Purpose Vehicles (SPVs) used in Securitizations, Repackagings and other Structured Products

Key Takeaways:

> Unlike final or proposed Non-Cleared Swaps margin requirements in Europe, Japan, Hong Kong, Canada and many other jurisdictions, the U.S. Margin Rules generally require the posting and collecting of margin whenever a Swap Dealer executes a Non-Cleared Swap with the type of SPV commonly used in securitizations or repackagings.

> Any SPV raising or accepting money from investors, or using 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 trading activity, will be required to post and collect margin with respect to Non-Cleared Swaps when its counterparty is a Swap Dealer, unless an exemption or exclusion is available.

> Without any regulatory relief or other regulatory changes, U.S. Swap Dealers and many non-U.S. Swap Dealers affiliated with a U.S. parent will be required to post and collect daily margin when executing Non-Cleared Swaps with an SPV as part of a securitization or repackaging. Daily margin obligations will require significant changes to the structure and operation of securitization and repackaging transactions.

> Swap Dealers and industry groups should engage U.S. regulators for needed guidance, clarification and regulatory relief.

> The recent substituted compliance determination from the CFTC continues to require non-U.S. Swap Dealers, that will rely on their local non-U.S. requirements for substituted compliance, to comply with the CFTC's margin requirements in respect of Non-Cleared Swap transactions with SPVs (in addition to the local non-U.S. requirements).

> Non-U.S. Swap Dealers unaffiliated with a U.S. parent will likely be eligible to elect the PR Exclusion or the CFTC Exclusion from the U.S. Margin Rules.

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Introduction

The U.S. bank regulators[1] (the "**Prudential Regulators**") and the U.S. Commodity Futures Trading Commission (the "**CFTC**", and together with the Prudential Regulators, the "**Agencies**") finalized their respective versions of the margin requirement for swaps and security-based swaps not cleared through a clearinghouse ("**Non-Cleared Swaps**") earlier this year.[2] The Prudential Regulators' final rule (the "**PR Rule**") and the CFTC's final rule (the "**CFTC Rule**", together with the PR Rule, the "**U.S. Margin Rules**")[3] were largely consistent. You can find a summary in our Client Note published on June 8, 2016 (the "**MR Client Note**").[4] In this Client Note, a bank, dealer and other regulated financial entity subject to the U.S. Margin Rules is referred to as a "**Covered Swap Entity**" or "**CSE**".

The U.S. Margin Rules generally apply to transactions between a CSE and a "financial end user", unless an exclusion/exemption is available. Other jurisdictions utilize a defined term to identify the scope of counterparties that trigger margin requirements, but what will be critical for any CSE is to determine where the term "financial end user" captures an entity that is **not** captured by the similar term under another jurisdiction's margin requirements. A significant area where the U.S. Margin Rules diverge from margin requirements in Europe, Japan, Hong Kong, Canada and many other jurisdictions is the application of the U.S. Margin Rules to special purpose vehicles. Unlike many other jurisdictions, the U.S. Margin Rules expressly identify many special purpose vehicles as being "financial end users" and therefore subject to the U.S. Margin Rules.

This Client Note will focus on the application of the U.S. Margin Rules in the context of securitization and repackaging special purpose vehicles ("**SPVs**") and summarizes what we consider to be the key impacts of the U.S. Margin Rules on an SPV that is subject to the U.S. Margin Rules (a "**Covered SPV**" or "**CSPV**").

Special Purpose Vehicles

An asset-backed issuer is often structured as a bankruptcy remote SPV established solely for the purpose of financing a specific pool of assets through the issuance of securities. Securitization is the operation by which the SPV acquires or takes on risks associated with underlying assets such as loans, or

[1] Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, the Federal Reserve Board, the Farm Credit Administration or the Federal Housing Finance Agency.

[2] As relates to covered swap entities subject to the CFTC Rule, the term "**Non-Cleared Swap**" is only with respect to a swap and does not include a security-based swap.

[3] 80 FR 229, November 30, 2015, *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28670.pdf; 81 FR 636, January 6, 2016, *available at* http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2015-32320a (note that the CFTC interim final rule is included with the FR release of the CFTC final rule); 81 FR 34818, May 31, 2016, *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-12612a.pdf.

[4] UPDATED: Prudential Regulators and the CFTC Finalize Swap Margin Requirements and Cross-Border Rules (June 8, 2016), http://www.linklaters.com/Insights/us-publications/Pages/UPDATED-Prudential-Regulators-CFTC-Finalize-Swap-Margin-Requirements-Cross-Border-Rules.aspx.

receivables which either produce a predictable cash flow or grant the right to a future cash flow, the cash flows from which are then directly or indirectly passed through to third-party investors through the issuance by the SPV of tradeable securities. "Repacks" is short for "repackaging" or "repackaged security" and gives a name to the process of using an SPV to repackage an existing security into something with added features and enhancements so it can be sold on to new investors via the SPV's issuance of notes.

Securitization and repack SPVs are distinct legal entities, legally isolated from the sponsor or originator that establishes them. Securitization and repack SPVs are unlikely to hold significant amounts of assets that would be eligible to be posted under the U.S. Margin Rules and typically operate under organizational and transactional documents that strictly limit the SPV's permitted activities as well as the types of liabilities that it is able to incur. In many instances, if the ability to margin in a manner compliant with the U.S. Margin Rules is not already present, such limitations could make it impossible or impracticable for an SPV to conduct operations associated with daily margining of a Non-Cleared Swap. An inability to execute Non-Cleared Swaps may result in additional risks to investors in notes issued by the SPVs (or, in the case of repacks where the swap provides the main investment exposure, the way that the transaction obtains its investment exposure may need to be reconsidered) since Non-Cleared Swaps are commonly executed to hedge risks and maintain the necessary cash flows for the securitizations and repacks.[5]

Sponsors or arrangers of any SPV will want to consider (1) if the SPV is a Covered SPV, (2) if an exemption/exclusion from the U.S. Margin Rules is available and (3) what can be done when a sponsor has a Covered SPV and no available exclusion from the U.S. Margin Rules. Exhibit A to this Client Note provides a flow chart summarizing the analysis of the U.S. Margin Rules' impact on an SPV, and Exhibit B provides a flow chart summarizing the analysis of potential exemptions/exclusions from the U.S. Margin Rules available to certain SPVs.

Who is subject to the U.S. Margin Rules?

The PR Rule applies to any entity that: (1) is regulated by one of the Prudential Regulators; (2) is registered as a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant; and (3) enters into a Non-Cleared Swap.

[5] A significant portion of securitization transactions involve swaps to transfer cash flows into investments that investors are willing to purchase. In securitization transactions that are not rated by any rating agency, lenders and investors frequently utilize protective "hedge covenants" which require the SPV to hedge imbedded market risk for the benefit of the investors. In rated securitization transactions, rating agencies frequently require hedges to manage interest rate and/or currency risk associated with the underlying assets.

The CFTC Rule applies to any entity that: (1) is a swap dealer or major swap participant for which there is no Prudential Regulator and (2) enters into a Non-Cleared Swap.

The U.S. Margin Rules **do not apply** to a Non-Cleared Swap involving (i) a CSE and a counterparty that is not a CSE or a financial end user or (ii) a CSE and a counterparty that is a financial end user, but for which an exemption or exclusion is available. Due to the Agencies' clear intention to capture securitization and repack SPVs within the scope of the U.S. Margin Rules, most[6] securitization and repack SPVs will be unable to rely on clause (i), since it is unlikely that a securitization/repack SPV would ever be able to claim it is not a financial end user and therefore not subject to the U.S. Margin Rules.

This means securitization and repack SPVs entering into Non-Cleared Swaps with a CSE will need to rely on an exemption or exclusion from the U.S. Margin Rules. In the context of a securitization and repack SPV, those potentially available are the Legacy Swap Exemption, Captive Finance Company Exclusion, PR Exclusion or CFTC Exclusion (as described below). In practice, and as discussed in further detail herein, the only long-term solution for a securitization and repack SPV to avoid the U.S. Margin Rules, after the applicable compliance date, will be in instances where the Non-Cleared Swap is eligible for the Captive Finance Company Exclusion, PR Exclusion or CFTC Exclusion.

Unfortunately, such exclusions are only available for a very limited scope of transactions. The Captive Finance Company Exclusion is limited to SPVs wholly owned by the captive finance company[7] of an end-user. The PR Exclusion and CFTC Exclusion are only available for Non-Cleared Swaps between (i) non-U.S. SPVs and (ii) non-U.S. CSEs[8] which do not consolidate their financial statements with a U.S. parent.

Who is a Financial End User?

The U.S. Margin Rules define "financial end user" by listing the various types of entities the Agencies intend to treat as such.[9] The list is intended to capture entities engaging in financial activities requiring Federal or State registration or giving rise to chartering requirements, such as deposit taking and lending, securities and swaps dealing, or investment advisory activities. Unfortunately for the sponsors or arrangers of securitization and repack SPVs, the list of financial end users expressly includes certain asset management and securitization

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[6] It will only be those securitization SPVs that can utilize the Captive Finance Company Exclusion which can also claim not to be a financial end user. *Infra* note 19.

[7] *Infra* note 20 (related text provides the definition of "**captive finance company**").

[8] *Infra* notes 25 and 31.

[9] PR Rule § __.2 (definition of "**financial end user**"); CFTC Rule § 23.151 (definition of "**financial end user**").

entities, for example, private funds (*i.e.*, 3(c)(1) or 3(c)(7) entities),[10] commodity pools and 3a-7[11] securitization and repack SPVs.

To address the risk that other investment vehicles may not have been expressly identified, the Agencies more generally define "financial end user" to cover any entity that is, or holds itself out as, an entity raising money from investors, accepting money from clients, or using 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. As a result, any SPV or other type of entity that is an investment company or relies on an exemption or exclusion from the Investment Company Act of 1940, which includes SPVs commonly utilized in securitizations and repacks, will be considered a "financial end user".[12]

Despite numerous comments arguing that securitization and repack SPVs should not be captured under this definition, the commentary to the U.S. Margin Rules makes it clear that the Agencies intended to capture these entities as financial end users and subject them to the U.S. Margin Rules.[13]

The result of this situation is that Covered SPVs will need to consider the full implications of the U.S. Margin Rules summarized below:

Counterparty	Margin Collection Requirement[14]
Financial end users with material swaps exposure[15]	Collect and post minimum initial and variation margin.[16] Program SPVs with multi-series issuances will need to aggregate exposures across all series of notes issued by the same SPV.

[10] SPVs which satisfy the requirements of Section 3(c)(1) or 3(c)(7) under the U.S. Investment Company Act of 1940.

[11] SPVs which satisfy the requirements of Rule 3a-7 under the U.S. Investment Company Act of 1940.

[12] The only exception to this would be those SPVs eligible to elect the Captive Finance Company Exclusions, but as discussed in this Client Note, this really only benefits corporate end-users who use SPVs to help finance certain commercial operations.

[13] 80 FR 74857; 81 FR 643.

[14] Under PR Rule § __5(c) and CFTC Rule §§ 23.152(d) and 23.153(e), a CSE will not be deemed to have violated its obligation to collect or post initial or variation margin from or to a counterparty if: (1) the counterparty has refused or otherwise failed to provide or accept the required margin to or from the CSE; and (2) the CSE has (i) made the necessary efforts to collect or post the required margin, or has otherwise demonstrated upon request to the satisfaction of the appropriate Agency that it has made appropriate efforts to collect or post the required margin, or (ii) commenced termination of the Non-Cleared Swap with the counterparty promptly following the applicable cure period and notification requirements.

[15] An entity has "**material swaps exposure**" if that entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds US$8 billion, where such amount is calculated only for business days. PR Rule § __.2 and CFTC Rule § 23.151 (definition of "**material swaps exposure**"). *See also* notes 26 and 27 of the MR Client Note (the Agencies provided that this calculation is a legal entity calculation that must aggregate separate accounts and portfolios of a single legal entity).

[16] PR Rule §§ __.3(a) and (b), __.4(a); CFTC Rule §§ 23.152(a) and (b), 23.153(a).

Counterparty	Margin Collection Requirement[14]
Financial end users without material swaps exposure	Collect and post variation margin. Collect initial margin at such times and in such forms and amounts (if any) that the CSE determines appropriately addresses the credit risk posed by the counterparty and the risks of such swaps.

The most immediate concern for a Covered SPV will be the variation margin requirements, which come into effect on March 1, 2017. Subject to the Legacy Swap Exemption (discussed below), Non-Cleared Swaps between a CSE and a Covered SPV will be subject to minimum variation margin requirements. Most Covered SPVs will not be subject to initial margin requirements until 2020, and even then it is only those Covered SPVs with a material swaps exposure that will be subject to these requirements (i.e., $8 billion notional of Non-Cleared Swaps and foreign exchange forwards and swaps).

As noted above, sponsors or arrangers for securitization SPVs will want to consider how or if it will be possible to continue utilizing a Covered SPV. The threshold inquiry for any Covered SPV will be, "Is the Covered SPV party to a Non-Cleared Swap with a CSE as its counterparty?"

If the counterparty is a CSE, then sponsors or arrangers will want to consider exemptions and exclusions as a potential way to continue executing Non-Cleared Swaps not subject to mandatory margin requirements. If no exemption or exclusion is available, sponsors or arrangers will need to consider whether there are other ways of achieving compliance.

U.S. Margin Rules Exemptions and Exclusions

The Covered SPV's Non-Cleared Swaps entered into before the applicable compliance date (e.g., March 1, 2017, for variation margin) are exempt from the U.S. Margin Rules' margin requirements (swaps entered into prior to the compliance date, "**Legacy Swaps**", and their exclusion from the U.S. Margin Rules, the "**Legacy Swap Exemption**"). For most sponsors or arrangers, this exemption may permit some limited securitization and repack activity to continue as it had prior to the compliance date, but even this exemption has its own issues as discussed below. For a long-term solution, SPVs will need to rely on certain limited exclusions to the U.S. Margin Rules.

Non-financial corporate end-users that utilize an SPV to help finance certain commercial risks related to the purchasing or leasing of their product(s) will be able to exclude their Non-Cleared Swaps entered into with those SPVs that are wholly owned subsidiaries of a Captive Finance Company (as defined below) (the "**Captive Finance Company Exclusion**"). Given the necessary relationship with a corporate end-user for this exclusion to be available, the Captive Finance Company Exclusion is not going to be available for financial entities that sponsor or otherwise utilize SPVs in their business. Covered SPVs of such financial entities should therefore consider whether they can transact with (1) a non-CSE counterparty or (2) a non-U.S. CSE[17] that may elect the exclusion for certain non-U.S. transactions set forth under the PR Rule (the "**PR Exclusion**") or the CFTC Rule (the "**CFTC Exclusion**"), as applicable.

Legacy Swap Exemption

Initially, the Legacy Swap Exemption seems preferable as a short-term fix. However, relying on this exemption may present issues in the future. If, due to partial redemption or other events, an amendment must be made to the terms of the Non-Cleared Swap agreement, the Legacy Swap Exemption will no longer be available. In fact, if the applicable Non-Covered Swap is amended or modified in any way, even if such amendment or modification is immaterial, the Legacy Swap Exemption will no longer be available and the former Legacy Swap will thereafter be subject to the U.S. Margin Rules.[18]

Unlike other jurisdictions which provide that their respective Legacy Swap Exemption permits certain immaterial amendments, the U.S. Margin Rules provide no such qualifications. Covered SPVs will need to track their Legacy Swaps carefully and have processes in place to identify if and when modifications occur or are suggested. Even a change in notional amount or signing up for an ISDA Protocol which affects outstanding Non-Cleared Swaps would make the relevant Non-Cleared Swap ineligible for the Legacy Swap Exemption.

The Captive Finance Company Exclusion

In 2015, the CFTC issued an interpretation letter (the "**Interpretive Letter**") providing that an SPV that is wholly owned by, and consolidated with, a captive finance company (a "**Captive Finance Company**" or "**CFC**") will itself qualify as a Captive Finance Company.[19] Entities which qualify as a CFC are not only able to elect a clearing exception, but are also a unique type of financial entity that is excluded from the definition of "financial end user" and therefore a CSE-counterparty is not required to post and collect margin from a CFC (the "**Captive Finance Company Exclusion**").

A captive finance company is "an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products,

[17] *Infra* notes 25 and 31.

[18] The Agencies provided that Legacy Swaps which are amended, novated or part of a compression exercise resulting in a new swap will no longer be able to benefit from the Legacy Swap Exemption. Commenters to the various proposals requested certain transactions or immaterial changes be permitted for Legacy Swaps, but the Agencies denied such request. However, the CFTC did note that it recognized that certain compression exercises may have implications in a variety of contexts and is open to further discussion about how to address such exercises before implementation of the CFTC Rule. 80 FR 74850-51; 81 FR 675.

[19] CFTC Letter No. 15-27, Interpretation of Section 2(h)(7)(C)(iii) of the Commodity Exchange Act – Captive Finance Companies (May 4, 2015), *available at* http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-27.pdf.

90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company."[20] Although SPV-subsidiaries of CFCs are only indirectly involved in financing, the Interpretive Letter clarifies that it is appropriate to consider the business of such an SPV to be part of the business of the related CFC, so long as: (i) the SPV is wholly-owned by the CFC; (ii) the SPV's financial statements are consolidated with those of the CFC; and (iii) the SPV's sole activity is facilitating financing undertaken by the CFC.

For SPVs participating in Non-Cleared Swaps with a U.S. nexus, the Captive Finance Company Exclusion is the only exclusion available after the applicable compliance dates have arrived and the Legacy Swap Exemption is no longer available. For non-U.S. transactions, the PR Exclusion and the CFTC Exclusion will provide useful exclusions to the U.S. Margin Rules.

The PR Exclusion

The PR Exclusion applies to certain foreign swaps between a CSE and its counterparty (and any guarantor[21] on either side of the trade) when all such parties, including any guarantor (if applicable), are considered a "foreign covered swap entity" under the PR Rule, which includes **any** entity **except** those identified in the table below (which generally includes any entity incorporated in the United States).[22] If such requirements are met, then the Non-Cleared Swap at issue is eligible for the PR Exclusion and therefore excluded from the margin requirements of the PR Rule.

The PR Exclusion is unavailable for any foreign branch of a U.S. bank or a U.S. branch or subsidiary of a foreign bank. The PR Exclusion is also unavailable for any swap involving a counterparty or guarantor that is a "subsidiary" of an entity that is organized under U.S. Federal or State law.[23]

A subsidiary includes a company and its parent (or other company) which share a consolidated financial statement under appropriate accounting rules (or would, if such principles/standards applied).[24] This limitation, that the non-U.S. CSE[25]

[20] 7 U.S.C. 2(h)(7)(C)(iii).

[21] The PR Rule defines "**guarantee**" to mean an arrangement pursuant to which one party to a Non-Cleared Swap has rights of recourse against a third-party guarantor, with respect to its counterparty's obligations under the Non-Cleared Swap. In order to address potential concerns about evasion, the Agencies will deem a guarantee to exist if the third-party guarantor has a guarantee from one or more additional third-party guarantors with respect to the obligations under the Non-Cleared Swap. PR Rule § __.9(g).

[22] Note, this means that for purposes of a fund or other collective investment vehicle, the "principal place of business" for an entity incorporated outside of the U.S. could be New York City, and such fund would still be eligible for the PR Exclusion. 80 FR 74883; *see also* note 74 of the MR Client Note.

[23] PR Rule § __.9(b)(1).

[24] PR Rule § __.2 (definition of "**subsidiary**") The Prudential Regulators also reserved the right to include any other entity as a subsidiary based on a conclusion that either company provides significant support to, or is materially subject to the risks or losses of, the other company. This provision is meant to leave discretion to the Prudential Regulators in order to avoid evasion. The CFTC did not include this provision in the definition of "Foreign Consolidated Subsidiary" under the CFTC Rule.

[25] This term, in the context of the PR Exclusions, is a CSE that is a "foreign covered swap entity" under the PR Rule.

cannot share a consolidated financial statement under appropriate accounting rules with an entity that is organized under U.S. Federal or State law, may prove to be problematic for many non-U.S. CSEs who may operate independently of a U.S. holding company or other parent as it will result in many non-U.S. CSE affiliates with a U.S. parent being unable to elect the PR Exclusion.

One benefit for a Covered SPV's sponsor/arranger analyzing the PR Exclusion is the simplicity in determining whether or not the Covered SPV is considered a "foreign covered swap entity" under the PR Rule. Unlike the CFTC Exclusion, the Prudential Regulators chose to adopt a bright-line test that looks to the jurisdiction of organization and does not consider an entity's ''principal place of business'' (as does the CFTC Exclusion).[26]

	NOT a "foreign covered swap entity"
1.	An entity organized under U.S. Federal or State law, including a U.S. branch, agency or subsidiary of a foreign bank.
2.	A branch or office of an entity organized under U.S. Federal or State law.
3.	A subsidiary of an entity organized under U.S. Federal or State law.

The CFTC Exclusion

The CFTC Exclusion provides that a Non-Cleared Swap entered into by a non-U.S. CSE[27] with a counterparty that is not a U.S. person (including a non-U.S. CSE) is excluded from the CFTC Rules, provided that neither counterparty's obligations under the relevant swap are guaranteed[28] by a U.S. person, and that neither counterparty is a Foreign Consolidated Subsidiary ("**FCS**"). Although the scope of the CFTC Exclusion is similar to the PR Exclusion, the CFTC Exclusion, and whether it is available, depends largely on a party's status as a "U.S. person" (or the applicable Non-Cleared Swap being guaranteed by a U.S. Person) and/or whether a counterparty is an FCS. The CFTC Rule's definitions of "**U.S. person**" and "**Foreign Consolidated Subsidiary**" are provided in the tables below.

Some notable similarities between the two exclusions are that both the PR Exclusion and the CFTC Exclusion do not apply if the counterparty is a U.S. branch of a non-U.S. CSE, or if the counterparty which is a non-U.S. CSE shares a consolidated financial statement with a U.S. parent. In a similar vein to the limitations associated with a "subsidiary", as noted above in our discussion of the PR Exclusion, the fact that the CFTC Exclusion is not available to an FCS will create issues for many non-U.S. CSEs.

[26] 80 FR 74883.
[27] *Infra* note 31 (the meaning of this term in the context of the CFTC Exclusion).
[28] The CFTC Rule defines "guarantee" in a manner similar to the PR Rule. *See* CFTC Rule § 23.160(a)(2) and *supra* note 21.

What is a U.S. Person?
1. Any natural person who is a resident of the United States ("**Prong 1**").
2. Any estate of a decedent who was a resident of the Untied States at the time of death ("**Prong 2**").
3. Any corporation, partnership or other business entity (other than a pension plan or trust as described in Prongs 4 or 5 below, respectively) that is organized under U.S. law or which has its principal place of business in the United States, including any branch of such legal entity[29] ("**Prong 3**").
4. Any pension plan for the employees, officers or principals of a business entity described in Prong 3 above, unless the plan is primarily for the foreign employees of such an entity ("**Prong 4**").
5. Any trust governed by U.S. law if a court within the United States is able to exercise primary supervision over the trust's administration ("**Prong 5**").
6. Any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more U.S. persons described in Prongs 1 – 5 above, and in which such U.S. persons bear unlimited responsibility for the obligations and liabilities of the legal entity owners which are responsible for the entity's liabilities[30] ("**Prong 6**").
7. Any individual or joint account, whether discretionary or not, where at least one beneficial owner is a U.S. person as described in Prongs 1 – 6 above ("**Prong 7**").

What is a Foreign Consolidated Subsidiary?
A "**non-U.S. CSE**"[31] in which an ultimate parent entity that is a U.S. person has a controlling financial interest, in accordance with U.S. GAAP, such that the U.S. ultimate parent entity[32] includes the non-U.S. CSE's operating results, financial position and statement of cash flows in the U.S. ultimate parent entity's consolidated financial statements, in accordance with U.S. GAAP. As is further discussed below, substituted compliance would be broadly available to an FCS to the same extent as any other non-U.S. CSE, but such an FCS would not be eligible for the CFTC Exclusion.

[29] The status of a legal entity as a U.S. Person would not generally affect whether a separately incorporated or organized legal entity in the affiliated corporate group is a U.S. Person. Thus, an affiliate or a subsidiary of a U.S. Person that is organized or incorporated in a non-U.S. jurisdiction would not be deemed a U.S. Person solely by virtue of being affiliated with a U.S. Person.

[30] This is likely intended to capture entities having similar characteristics to general partnerships. The CFTC emphasized that this prong of the definition is not meant to capture as a "U.S. person" an entity organized outside of the United States; the swap activity of which is guaranteed by a U.S. person. However, as noted elsewhere in this Client Note, having a guarantee from a U.S. person can impact the overall analysis with respect to substituted compliance and the CFTC Exclusion.

[31] A CSE that is not a U.S. person.

[32] The term "**ultimate parent entity**" means the parent entity in a consolidated group in which none of the other entities in the consolidated group has a controlling interest, in accordance with U.S. GAAP.

The analysis of whether or not a Covered SPV is a “U.S. Person” will require confirmation that it is incorporated outside of the United States and that its “principal place of business” is also outside of the United States. The latter part of this analysis can require significant attention based on the activities of the sponsors or arrangers of, and trustee to, the Covered SPV.

For purposes of this analysis, the CFTC interprets “principal place of business” to mean the location from which the officers, partners or managers of the legal person primarily direct, control and coordinate the activities of the Covered SPV. Consistent with *Hertz Corp. v. Friend*, the principal place of business “should normally be where the corporation maintains its headquarters – provided that the headquarters is the actual center of direction, control and coordination, i.e., the ‘nerve center,’ and not simply an office where the corporation holds its board meetings.”

If Exemptions and Exclusions Are Not Available, What Then?

For Covered SPVs subject to the U.S. Margin Rules, from March 1, 2017, future issuances will be subject to daily variation margin posting and collecting requirements. Covered SPVs which have sufficient assets and operational ability to comply with the applicable U.S. Margin Rules will be well positioned to continue their business from March 1, 2017. Sponsors and arrangers will want to maximize efficiencies in existing Covered SPVs to minimize any new costs to any future issuances, such as those associated with ensuring sufficient eligible collateral will be available to post daily and updating/modifying arrangements with trustees and existing managements so that such parties can perform as required under the U.S. Margin Rules.

Costs

The necessity that a Covered SPV have sufficient liquidity to be able to post margin will introduce new costs. Although the requirements associated with variation margin and initial margin have certain threshold requirements (e.g., Material Swaps Exposure, Initial Margin Threshold and Minimum Transfer Amount) associated with posting and collecting obligations, for a Covered SPV that issues multiple series of notes, such thresholds may be eroded where the Covered SPV has multiple Non-Cleared Swaps with a particular CSE. This is due to the fact that the Agencies focus on the legal entity itself,[33] as opposed to each series and/or different accounts, and will aggregate the Non-Cleared Swaps with a particular CSE. Specifically, the Agencies noted that the calculation of the Initial Margin Threshold amounts and other threshold calculations should be calculated on a “legal entity basis”, even in instances where the single legal entity is a securitization/repack vehicle creating separate issuances of asset-backed

[33] Also see our discussion of Minimum Transfer Amounts in the MR Client Note. This calculation takes the gross exposure for a party between its variation margin and initial margin obligations, which is an issue even for a Covered SPV that is not a multi-series issuer.

securities through the use of a series trust.[34] Despite the fact that a multi-series program SPV will segregate and ring fence the assets and liabilities with respect to each series of issued notes, and limit recourse to the specific series' assets, the Agencies determined that even in such instances the risk is at the entity level despite the bankruptcy remoteness, overcollateralization and other imbedded protections which exist within each series.

Operational and Structural Considerations

Certain operational and structural changes may need to be made to many securitization and repack SPVs to accommodate the U.S. Margin Rules.

Typically, SPVs make required regular payments pursuant to an established priority of payments which are funded by scheduled amounts received on the underlying assets during the preceding collection period. Many securitization and repack SPVs are not currently structured to have the intra-period liquidity (whether in cash, eligible securities or a facility providing ready access to such eligible collateral) necessary for the payment of daily variation margin or potential fluctuations in initial margin. Obtaining funding for margin calls (whether through a dedicated credit facility, from cash reserves or via a third party) may not be practically or economically feasible nor is it clear what structural change could be applied that "fixes" compliance issues.

Many existing securitization and repack SPVs are burdened by restrictions that prohibit the SPV from incurring other debt. While this prohibition protects investors and the SPV's swap counterparties, the restrictions would make it difficult for the SPV should it need to obtain additional funds to post margin on a continuing basis. In anticipation of forthcoming margin obligations, sponsors/arrangers will need to revisit such prohibitions to determine what modifications are necessary to achieve compliance with applicable U.S. Margin Rules.

A committed loan facility will likely require the SPV to incur additional funding costs that may need to be repaid ahead of other creditors, including holders of securities. To provide for the funding of margin by a bank, additional structuring, costs and significant changes to existing securitization and repack programs documentation would need to occur.

Third-party funding to assist a financial end user in meeting its posting obligations is only briefly discussed by the Agencies, leaving uncertainty in the market as to whether third-party funding is only permitted in the limited instances identified by the Agencies or if such structures may be utilized in other contexts, particularly those with a Covered SPV. For example, commentary to the PR Rule states that, in the context of inter-affiliate swaps, the PR Rule permits the margin a CSE must collect on swaps with its affiliated counterparty to be supplied by the parent holding company (e.g., a covered swap entity may act as custodian for non-cash collateral of its parent holding company and, to the extent the non-cash collateral

[34] 80 FR 74864 (Footnotes 139 and 140); 81 FR 653 (Footnotes 156 and 157).

is not encumbered to secure some other obligation of the parent holding company (either to the covered swap entity, another affiliate, or unrelated party), the holding company may arrange with its affiliate to use this excess non-cash collateral to satisfy the covered swap entity's requirement to collect initial margin).[35] However, it is unclear whether the concept of a third-party margin posting entity is generally permissible, or whether it is only allowed in these context-specific circumstances.

Furthermore, many securitization and repack SPVs do not presently have the operational capacity to calculate or collect margin, requiring such SPVs to either entirely rely on the calculations of the CSE-counterparty, or create the operational capacity to confirm or dispute margin calculations. If the SPV ever wants the ability to challenge a margin demand from a CSE-counterparty, the SPV will need operational models to calculate its daily margin position to confirm demands by the CSE are accurate and correct.

Additional costs will be incurred in the implementation of many processes which enable or assist in compliance with the U.S. Margin Rules. Those related to collecting, posting and ensuring that adequate funds remain in the SPV to make such payments going forward are some of the more immediate areas of concern. Current securitization and repack market practices do not involve the securitization/repack SPV, its trustee, or any other designated transaction participant performing such functions. Compliance with the U.S. Margin Rules will involve an increase in the scope of the trustee's, or other designated person's, role (or alternatively, the need to procure a separate calculation/program agent dedicated to a new compliance function) and a related increase in transaction costs.

What to do moving forward?

U.S. Covered Swap Entities

U.S. CSEs under the PR Rule[36] or CFTC Rule[37] (as applicable) are likely to be left having to impose the applicable U.S. Margin Rules on any Covered SPV counterparty to a Non-Cleared Swap, unless the Agencies provide some relief. Although the Captive Finance Company Exclusion is available, this exclusion is of limited value since CFCs represent such a small part of the market. Another possibility would be for the Agencies to provide some guidance on permissible collateral arrangements based on discussions with market participants who may wish to use third-party collateral providers and/or collateral transformation arrangements for Covered SPVs whose readily accessible collateral would not be "eligible collateral".[38] A collateral transformation arrangement could enable a

[35] 80 FR 74889.
[36] Any CSE that does not have a guarantee from a U.S. entity and is not a "foreign covered swap entity".
[37] Any CSE that is a "U.S. person".
[38] *See* MR Client Note's subsection regarding what types of collateral are "eligible collateral" for the U.S. Margin Rules.

Covered SPV to possess "eligible collateral" only when needed to post margin, but otherwise hold the assets which the Covered SPV is more generally holding to support its other obligations under its issued securities/notes and other transaction agreements. This is important because holding excess eligible collateral would likely negatively impact a Covered SPV's return on assets as eligible collateral tends to be less risky and therefore have lower returns. U.S. CSEs may want to seek guidance from the Agencies in respect of how a fully funded Non-Cleared Swap may be structured to avoid the Covered SPV, which provided such funds from having additional posting obligations in the future. Alternatively, sponsors and arrangers may look to utilize a non-CSE as the counterparty to the Non-Cleared Swap, thereby avoiding the U.S. Margin Rules entirely.

PR Rule "subsidiaries" and CFTC Rule "Foreign Consolidated Subsidiaries"

Although non-U.S. CSEs will generally have some benefits forthcoming from any substituted compliance or other regulatory equivalence determination, the issues associated with a Covered SPV are likely to continue even if there is substituted compliance available to the non-U.S. CSEs. Specifically, based on the recent comparability determination from the CFTC,[39] those CSEs unable to utilize the PR Exclusion or the CFTC Exclusion due to their status as a "subsidiary" or a "Foreign Consolidated Subsidiary" (such CSEs, collectively, "**CSE-Subsidiaries**"), respectively, will face the same difficulties as the U.S. CSEs. The MR Client Note covers the concept of substituted compliance in more detail, but generally, the concept permits certain non-U.S. CSEs, such as a CSE-Subsidiary, to comply with a foreign regulatory framework for Non-Cleared Swaps; provided that the applicable Agency determines that such foreign regulatory framework is comparable to the requirements of the PR Rule or CFTC Rule (as applicable, depending on the Agency). These determinations will be made on a jurisdiction-by-jurisdiction basis. Furthermore, an Agency's determination may be conditional or unconditional and may not cover the entirety of the obligations under the applicable U.S. Margin Rules.

On its face, substituted compliance seems simple: the applicable Agency deems the margin requirements of another jurisdiction "comparable", and, thereafter, any CSE subject to both the U.S. Margin Rules and the margin rules in the non-U.S. jurisdiction may use policies and procedures that comply with its local non-U.S. requirements only, rather than focus on ensuring compliance with the local requirements **and** the U.S. Margin Rules.

Unfortunately, the first substituted compliance determination in respect of the global margin rules did not operate in this manner. Specifically, the CFTC noted that the scope of OTC derivatives and CSE's counterparties subject to the margin

[39] *See* Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 63376 (Sept 15, 2016) *available at* http://www.cftc.gov/LawRegulation/FederalRegister/OrdersandOtherAnnouncements/2016-22045.

requirements are different as between Japan's requirements and the CFTC Rule requirements. In light of such differences, the CFTC stated:

> "It may also be possible that the [CFTC Rule's] definition of ''financial end-user'' could capture an entity that is a non-financial end-user under the [Japanese] margin regime . . . With these differences in scope in mind, the [CFTC] reiterates that no CSE may rely on substituted compliance unless it and its transaction are subject to both the [CFTC Rule] and the [Japanese] margin rules; a CSE may not voluntarily comply with the [Japanese] margin rules where such law does not otherwise apply. Likewise, a CSE that is not seeking to rely on substituted compliance should understand that the [Japanese] margin rules may apply to its counterparty irrespective of the CSE's decision to comply with the Final Margin Rule."[40]

Therefore, the CFTC's substituted compliance still requires non-U.S. CSEs to achieve dual compliance. This means that while compliance with local margin requirements may be the primary focus of a non-U.S. CSE's internal policies and procedures, such policies and procedures will still require a "second-step analysis" to determine whether a counterparty would be subject to the U.S. Margin Rules. If the counterparty is not subject to local margin requirements, but would be subject to the U.S. Margin Rules, then the non-U.S. CSE will need fully developed policies and procedures which are compliant with the U.S. Margin Rules.

It should be noted that the above is only with respect to a CSE subject to the CFTC Rule. CSEs subject to the PR Rule may find a different view with respect to the application of substituted compliance, whenever such determinations are forthcoming. CSE-Subsidiaries and other market participants may wish to engage the regulators directly. This mismatch in scope of covered entities between the U.S. Margin Rules and the other global margin requirements creates significant regulatory complications for a number of market participants reviewing their securitizations, repacks structured products and other capital markets activities which utilize an SPV-issuer. Not only will regulatory processes related to a Non-Cleared Swaps counterparty to a Covered SPV need to fully comply with the CFTC Rule, despite the existence of substituted compliance for most other instances, a review is still required to determine how any such Covered SPVs can continue to engage in its activities in light of operational impracticalities/impossibilities not faced by pure non-U.S. CSEs which can utilize the PR Exclusion or CFTC Exclusion.

What about Europe and Asia?

With the decision by the Agencies to capture SPVs under the U.S. Margin Rules, they diverged from the margin requirements finalized or proposed elsewhere in

[40] Id. at 63381.

the world, despite knowing that such a divergence would be created. For example, on April 14, 2014, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority jointly published the first draft regulatory technical standards ("**RTS**") on risk-mitigation techniques for OTC derivatives contracts that are not cleared by a central clearing counterparty under Article 11(15) of the European Market Infrastructure Regulation ("**EMIR**"). Under the RTS (and the recently finalized RTS),[41] certain counterparties will not have to comply with all of the margin requirements under the RTS. Significantly, most securitization and repack SPVs will likely be defined as "NFC-" entities; that is, a non-financial counterparty that falls below the threshold of €3 billion in gross notional value for interest rate and foreign exchange derivative contracts or €1 billion in gross notional value for credit derivative contracts.[42] As a result of their characterization as such, securitization and repack SPVs will not be required to exchange initial or variation margin. Rather, any decision to exchange margin can be negotiated by the parties to the swap.[43]

The inclusion of securitization and repack SPVs under the U.S. Margin Rules also diverges from the position in Japan and the proposed position in Hong Kong (as well as other Asian jurisdictions). Under the Japanese margin rules, securitization and repack SPVs may be out of scope of the requirements to exchange initial or variation margin on the basis that they are not conducting OTC derivatives transactions "as a business" or, even if they are within scope, no margin requirements will be applicable if the SPV falls under the threshold of JPY 300 billion in gross notional amount of OTC derivative contracts (determined separately in respect of each limited recourse series of obligations).[44] Under the proposed Hong Kong margin rules, securitization vehicles set up for true sale securitizations and which enter into derivative transactions for the sole purpose of hedging are not covered entities for the purpose of the Hong Kong margin rules. Securitization vehicles set up for synthetic securitizations and other SPVs which cross the applicable threshold of HKD 60 billion in gross notional amount of non-centrally cleared derivatives are covered entities under the proposed Hong Kong margin rules.[45]

As early as 2014, the Agencies were aware that the proposed requirements under the U.S. Margin Rules in respect of U.S. securitization and repack SPVs were on course to diverge relative to the requirements under EMIR. The intention

[41] Issued by the European Commission on October 4, 2016, and requiring non-objection from the European Counsel and European Parliament before it comes into force.
[42] In determining whether the threshold has been exceeded, derivatives entered into for hedging purposes can be excluded.
[43] *See* Note 11, Chapter 1, Article 2, Section 4(b).
[44] *See* the response (No. 29) of the Japan Financial Services Agency to public comments in respect of the Japanese rules on margin requirements for non-centrally cleared OTC derivatives dated March 31, 2016.
[45] *See* Consultation Paper CP 15.02 (Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards) dated December 2015 and published by the Hong Kong Monetary Authority, and the response of the Hong Kong Monetary Authority to key comments on CP 15.02 published by the Hong Kong Monetary Authority in August 2016

of the Agencies to capture SPVs is clear, and if future substituted compliance determinations in respect of Europe and the rest of Asia are similar to the recent substituted compliance determination from the CFTC, even some non-U.S. CSE-Subsidiaries will likely still have to require margin from SPVs categorized as an NFC- under EMIR, or as out-of-scope counterparties (or counterparties falling under the applicable thresholds) under the margin rules of Japan, Hong Kong and other relevant jurisdictions.

What is not clear is whether the Agencies fully appreciate the impact of their decision to capture SPVs as "financial end users". Although some comments were submitted during the proposal phase of the U.S. Margin Rules, it did not receive significant attention from many market participants at such time. Hopefully between now and March 1, 2017, industry groups and market participants can engage regulators for guidance, and determine a path forward.

Conclusion

Under the U.S. Margin Rules, unless an exemption or exclusion is available, swap hedging for securitization and repack SPVs will likely be more expensive given the structural and operational changes that will have to be made. It is possible that a big impact of the implementation of the U.S. Margin Rules on securitization and repack SPVs that is hedging with swap contracts will be much less attractive once compliance is required. The securitization/repack issuer may have to weigh hedging versus ratings. Partial or no hedging would cost less, but it would likely result in lower ratings as the debt will be more exposed to asset depreciation. In addition, the structure of repack transactions which rely on the swap providing the primary investment exposure may need to be further considered.

Further input from swap providers and rating agencies will be helpful to securitization and repack issuers in determining the costs of financing margin and installing (or employing a service provider to provide) margin operations. Such information will also inform securitization and repack issuers as they weigh the benefits and costs of entering into a swap contract against other means to offset the potential depreciation of its securitized/repackaged assets, such as buying an option or increasing overcollateralization.

The U.S. Margin Rules will likely prompt securitization and repack issuers to re-examine features of current industry-standard swap contracts as well. When a swap provider holds variation margin under a swap contract that is in-the-money, will the swap provider require its payments to be made from a senior position in a securitization's/repack's priority of payments? Should such contracts continue the practice of "flipping" these payments to a subordinate position when a swap provider is insolvent or bankrupt? For those securitization and repack SPVs which are not restricted to transacting on a limited recourse basis, will the costs and margin demands of Non-Cleared Swaps push securitization and repack

SPVs to consider cleared swaps which may have lower costs and margin requirements?

Furthermore, as the U.S. Margin Rules exclude Non-Cleared Swap transactions with Captive Finance Companies, it will be up to the CSE counterparty to determine whether it wishes to collect margin. If swap dealers continue to use the market-standard process for swap transactions that hedge the risks of CFCs, the securitization and repack industry will undergo a divide of practices. While CFCs will continue to hedge utilizing swap contracts that adhere to current rating methodologies, other securitization and repack SPVs will reform their contractual and operational practices to comply with the U.S. Margin Rules. Rating methodologies will likely take into account the impacts from the two approaches, and the industry will have to assess the potential depreciation of securitized assets relative to rated liabilities.

Commenters to the proposed U.S. Margin Rules voiced the concern that subjecting securitization and repack SPVs to margin requirements would severely restrict the feasibility of securitization and repack transactions to hedge interest rate risk and currency risk, thereby increasing risk to investors who may have to retain unhedged risk. If investors are unable or unwilling to assume such additional risk, the U.S. Margin Rules may reduce the feasibility of securitizations and repackagings as a funding option for a variety of asset classes.

Moving forward, market participants will need to consider many new issues. Hopefully, industry groups and market participants can lobby for guidance or changes. The issues presented here may also reach beyond securitizations and repackaging transactions; certain project financing activities may also be captured by this unfortunate divergence by the United States from the rest of the world, with the result that Non-Cleared Swaps used to hedge and minimize risk will no longer be financially viable, jeopardizing the entire financing or resulting in unhedged risks to investors and other financing parties.

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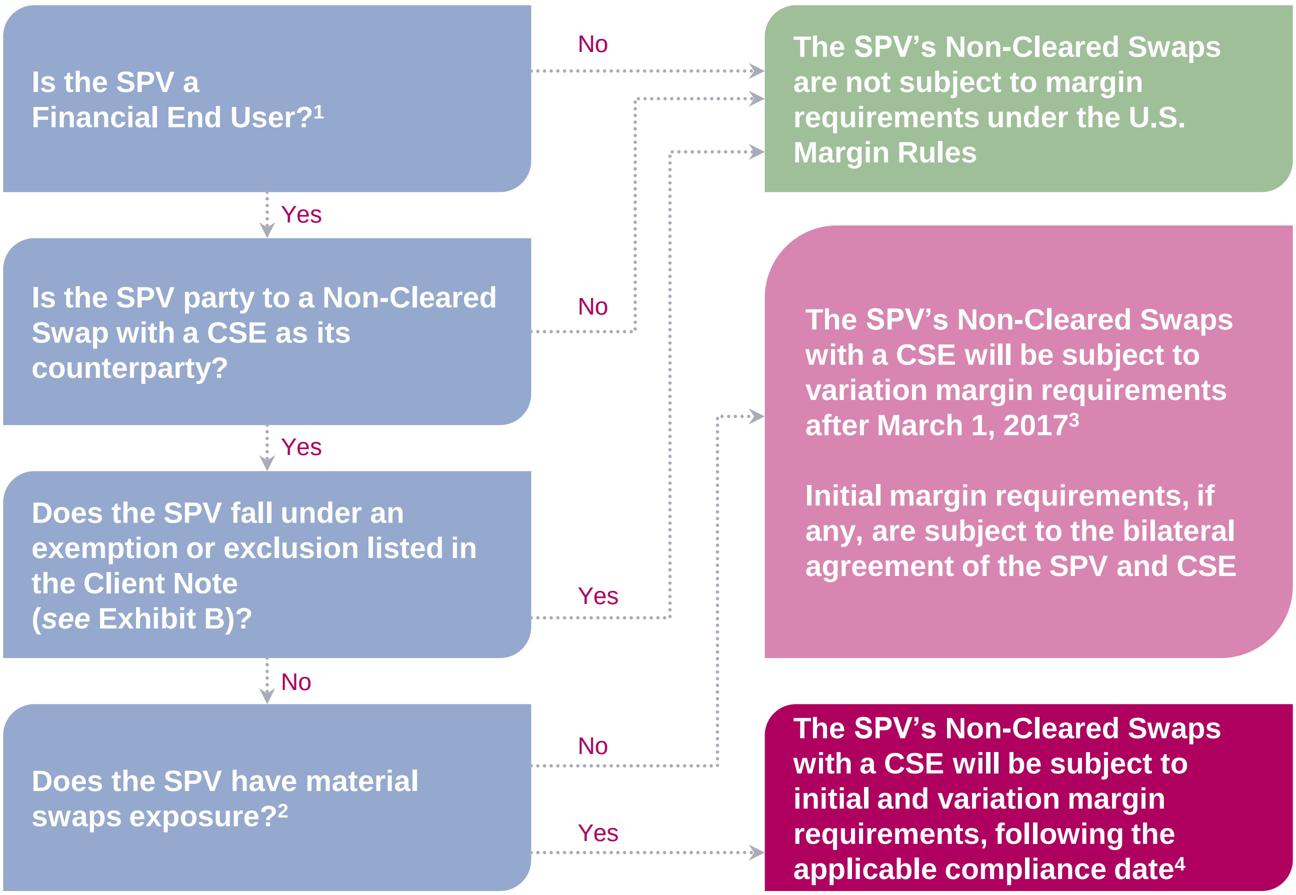
Exhibit A – Do the U.S. Margin Rules Apply to the SPV's Non-Cleared Swap?



1: For example, private funds (i.e., 3(c)(1) or 3(c)(7) entities), commodity pools and 3a-7 securitization SPVs. Typical repackaging vehicles are also caught. More broadly, any entity that is, or holds itself out as, an entity raising money from investors, accepting money from clients, or using 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. If the SPV is a Captive Finance Company, it is not a financial end user, but for simplicity of this analysis we capture this concept as an exemption or exclusion from the U.S. Margin Rules.

2: An entity has "material swaps exposure" if that entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, non cleared security based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds US$8 billion, where such amount is calculated only for business days. PR Rule § __.2 and CFTC Rule § 23.151 (definition of "material swaps exposure"). See also notes 26 and 27 of the MR Client Note (the Agencies provided that this calculation is a legal entity calculation that must aggregate separate accounts and portfolios of a single legal entity).

3: Program SPVs with multi-series issuances will need to aggregate exposures across all series with the same SPV when determining whether a transfer of variation margin is required due to exceeding the U.S. Margin Rules' US$500,000 maximum Minimum Transfer Amount.

4: Similar to the aggregation requirements noted in Footnote 3 above, for variation margin, threshold amounts associated with the initial margin requirements will also need to be aggregated across the same SPV, even if it is a program SPV with multi-series issuances.

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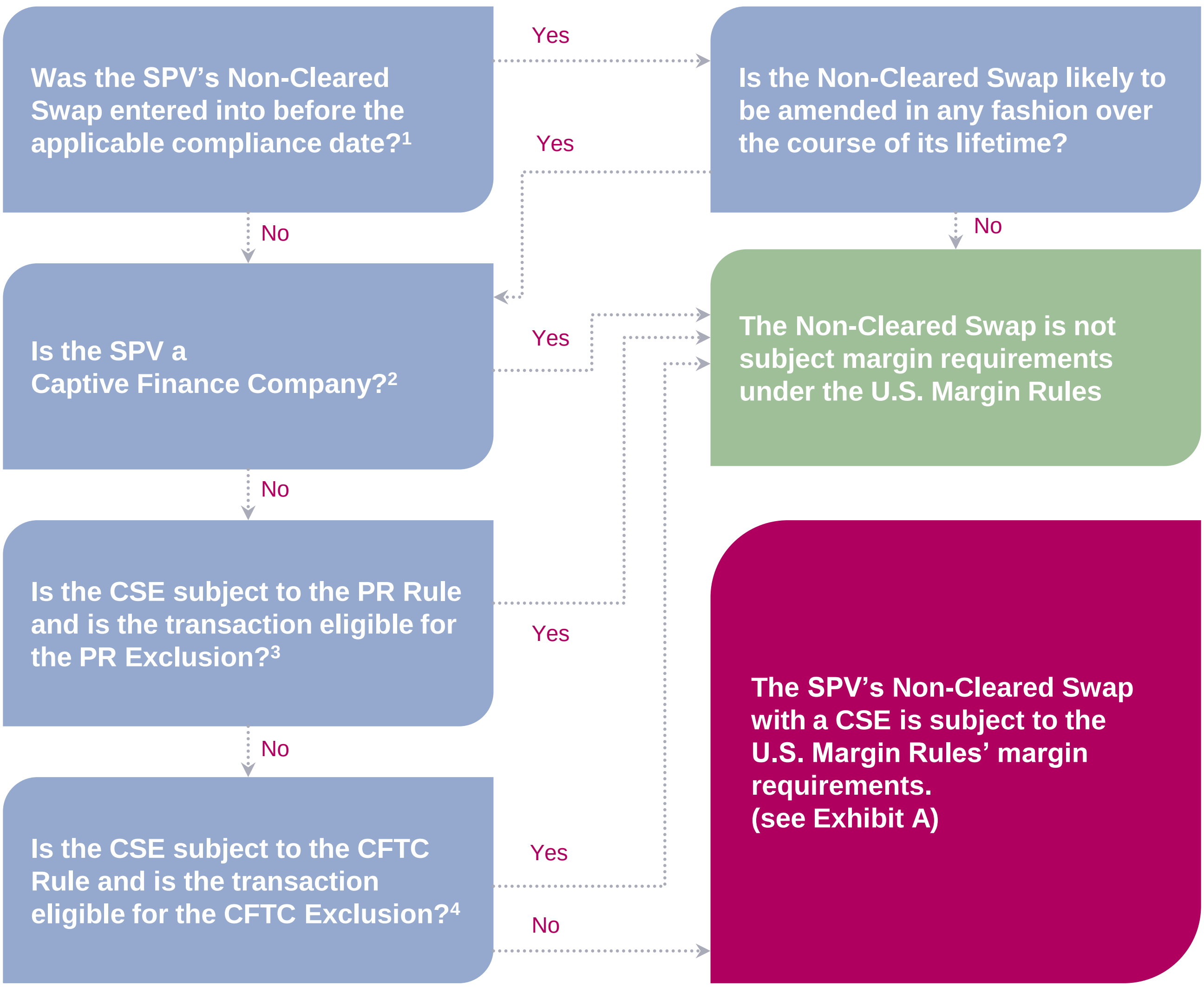
Exhibit B – Exemptions and Exclusions from Margin Requirements



1: For variation margin, March 1, 2017; for initial margin, September 1, 2020.

2: CFTC Letter No. 15-27, Interpretation of Section 2(h)(7)(C)(iii) of the Commodity Exchange Act –Captive Finance Companies (May 4, 2015), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-27.pdf.

3: The PR Exclusion applies to certain Non-Cleared Swaps between a non-U.S. CSE and its non-U.S. counterparty (and any guarantor on either side of the trade) when all such parties, including any guarantor (if applicable), are considered a "foreign covered swap entity" under the PR Rule. The PR Exclusion is unavailable for any foreign branch of a U.S. bank or a U.S. branch or U.S. subsidiary of a foreign bank. The PR Exclusion is also unavailable for any swap involving a counterparty or guarantor that is a "subsidiary" of an entity that is organized under U.S. Federal or State law.

4: The CFTC Exclusion applies to certain Non-Cleared Swaps between a non-U.S. CSE and a non-U.S. SPV, (and any guarantor on either side of the trade) when all such parties, including any guarantor (if applicable), are considered not a U.S. person, and the non-U.S. CSE is not a Foreign Consolidated Subsidiary.