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June 8, 2016

UPDATED: Prudential Regulators and the CFTC Finalize Swap Margin Requirements and Cross-Border Rules

Key Takeaways:

- This is an updated Client Note to our March 2, 2016 Client Note. Included in this update are the CFTC's final cross-border rules, expanded discussions regarding minimum transfer amounts, the Legacy Swap Exemption, non-netting jurisdictions, non-segregation jurisdictions, the CFTC's treatment of affiliate transactions and the Prudential Regulator's cross-border rules, and an updated Conclusion to this Client Note.
- The Prudential Regulators and the CFTC approved final rules establishing minimum margin requirements for non-cleared swaps where one counterparty is a registered swap entity that will be phased in progressively through 2020.
- Both final rules cover minimum required amounts of initial and variation margin, eligible collateral, segregation, documentation and netting arrangements and the cross-border application of their respective requirements.
- The Prudential Regulators' and the CFTC's final rules apply to counterparties that are financial end users or registered swap entities, but not to entities specifically excluded from the definition of financial end user, such as sovereigns and multilateral development banks.
- The Prudential Regulators and the CFTC also issued interim final rules exempting the non-cleared swaps of financial end users eligible for the end-user clearing exceptions (such as certain small financial institutions, captive finance entities and treasury affiliates acting as agents).
- The Prudential Regulators' and the CFTC's final rules, including the cross-border application of such rules, are largely the same, with the exception of (i) the treatment of inter-affiliate trades and the definition of affiliates subject to such treatment, (ii) the approval process for using a bespoke margin model and (iii) the calculation of variation margin and related documentation requirements.

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> Market participants subject to the final rules will need to (i) implement compliant swap documentation, credit support annexes and custodial agreements, (ii) obtain necessary legal opinions and (iii) update internal policies and procedures to comply with new regulatory requirements, prior to the applicable compliance date.

Introduction

With the exception of the U.S. Securities and Exchange Commission, the U.S. regulators have finalized their respective versions of the margin requirement for swaps and security-based swaps not cleared through a clearinghouse ("**Non-Cleared Swaps**").[1] One final rule (the "**PR Rule**") was issued by the various U.S. bank regulators[2] (the "**Prudential Regulators**"). The other final rule (the "**CFTC Rule**", together with the PR Rule, the "**U.S. Margin Rules**") was issued by the U.S. Commodity Futures Trading Commission (the "**CFTC**", and together with the Prudential Regulators, the "**Agencies**").

In this Client Note, an entity subject to the U.S. Margin Rules is referred to as a "**Covered Swap Entity**" or "**CSE**".

The Agencies also issued interim final rules (the "**Interim Final Rules**")[3] providing that the margin requirements ***do not apply*** to a Non-Cleared Swap involving a counterparty that is not a swap entity[4] or a financial end user or, alternatively, to a Non-Cleared Swap that is eligible for certain exceptions/exemptions from clearing requirements (each such swap is an "**Exempted Swap**"). Most market participants that anticipate not being subject to the U.S. Margin Rules will rely on the fact that they are neither a swap entity nor a financial end user. However, some market participants such as certain treasury affiliates and small financial institutions do qualify as financial end users and therefore will need to rely on the Interim Final Rules. Specifically, initial and variation margin requirements will not apply to a Non-Cleared Swap[5] in which a counterparty (to a CSE) is: (i) a non-financial entity (including small financial institutions and captive finance companies) that qualifies for the end-user clearing exception; (ii) a cooperative entity that qualifies for an exemption from the

[1] When the CSE is a CSE 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.

[2] 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.

[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] "**Swap entity**" is the term used by the Agencies to refer collectively to swap dealers, major swap participants, security-based swap dealers and major security-based swap participants.

[5] Note that a derivative may be a Non-Cleared Swap either because (a) the particular derivative was subject to a mandatory clearing requirement, but was not cleared due to an exemption or exception from clearing or (b) the applicable derivative is not required to be cleared and was executed over-the-counter.

clearing requirements; or (iii) a treasury affiliate acting as agent[6] that satisfies the criteria for an exception from clearing in section 2(h)(7)(D) of the Commodity Exchange Act.[7]

Compliance with the Interim Final Rules and the U.S. Margin Rules will be phased in beginning September 2016 with the larger global swap entities having to begin the exchange of initial margin.[8]

This note summarizes what we consider to be the core aspects of the U.S. Margin Rules.

Who is a CSE under the PR Rule?

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. In addition, the requirements will apply to all of a CSE's swap and security-based swap activities without regard to whether the entity has registered as both a swap entity and a security-based swap entity.[9]

Who is a CSE under the CFTC Rule?

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.[10]

Who is a Financial End User under the U.S. Margin Rules?

The U.S. Margin Rules define "financial end user" by listing the various types of entities the Agencies intend to treat as such. 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. Pension funds and other employee benefit plans, including foreign non-ERISA plans, are also captured by the definition. The list also expressly includes certain asset management and securitization entities (*e.g.*, private funds, commodity pools and 3a-7 securitization vehicles). To address the risk that other investment vehicles may not have been expressly identified, the Agencies more generally defined "financial end user" to cover any entity that is, or holds itself out as, an entity

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[6] For those treasury affiliates that qualify for a clearing exemption as an "**eligible treasury affiliate**" as defined in the CFTC's No-Action Letter No. 13-22, the CFTC has included in the definition of "**financial end user**" a provision stating that the term shall not include an eligible treasury affiliate. The PR Rule does not include a similar provision, but the Prudential Regulators did provide that such eligible treasury affiliates would be excluded from the PR Rule. PR Rule § __.2 *See also* note 13.

[7] *See* 7 U.S.C. 2(h)(7)(D); 15 U.S.C. 78c-3(g)(4).

[8] PR Rule § __1; CFTC Rule § 23.161.

[9] For example, for an entity that is a swap dealer but not a security-based swap dealer or major security-based swap participant, the PR Rule's requirements would apply to all of that swap dealer's non-cleared swaps and non-cleared security-based swaps. PR Rule § __1.

[10] CFTC Rule § 23.151 (definition of "**covered swap 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.

The term "financial end user" generally does not include a counterparty that is:

> a sovereign entity;[11]

> a multilateral development bank;[12]

> The Bank for International Settlements;

> a captive finance company that qualifies for the appropriate CFTC clearing exemption;

> a treasury affiliate acting as an agent and eligible for the appropriate CFTC or SEC clearing exemption; or

> a treasury affiliate that qualifies for a clearing exemption as an "eligible treasury affiliate" as defined in the CFTC's No-Action Letter No. 13-22.[13]

Requirement to post Initial Margin and Variation Margin

The following table sets forth the basic requirements under the U.S. Margin Rules for CSEs to post and collect initial margin and variation margin to and from different types of counterparties with respect to Non-Cleared Swaps.

Counterparty	Margin Collection Requirement[14]
Financial end users with material swaps exposure[15]	Collect and post minimum initial and variation margin.[16]

[11] "**Sovereign entity**" is defined to mean a central government (including the U.S. government) or an agency, department or central bank of a central government. A sovereign entity would include the European Central Bank.

[12] "**Multilateral development bank**" is defined to mean the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank and any other entity that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member or which the relevant Agency determines poses comparable credit risk.

[13] CFTC No-Action Letter No. 13-22 (June 4, 2013), *available at* http://www.cftc.gov/LawRegulation/CFTCStaffLetters/13-22.

[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.

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.
Another CSE	Collect and post minimum initial and variation margin.[17]
Other counterparties[18]	Collect initial and variation 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.

Calculation of Initial Margin

Under the U.S. Margin Rules, a CSE transacting with a financial end user with material swaps exposure must:

> (1) calculate its initial margin collection amount using an approved internal model (an "**Approved Model**") or the standardized look-up table (the "**IM Table**");
>
> (2) collect an amount of initial margin that is at least as large as the initial margin collection amount less any permitted initial margin threshold amount (discussed more below); and
>
> (3) post at least as much initial margin to the financial end user with material swaps exposure as the CSE would be required to collect if it were in the place of the financial end user with material swaps exposure.[19]

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[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**"). *Infra* notes 26 and 27 (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).

[17] PR Rule §§ __.3(a) and (b), __.4(a); CFTC Rule §§ 23.152(a) and (b), 23.153(a). Because all swap entities will be subject to a Prudential Regulator, CFTC or SEC margin rule that requires them to collect initial and variation margin, the Rule will therefore also result in a collect-and-post system for all Non-Cleared Swaps between two swap entities.

[18] Other counterparties includes sovereigns, multilateral development bank, nonfinancial end users and financial entities specifically excluded from the definition of "financial end user". For more on these entities, see earlier part of this Client Note, *Who is a Financial End User under the U.S. Margin Rules?*; *see also* PR Rule § __.2 and CFTC Rule § 23.151 (definition of "financial end user").

[19] PR Rule §§ __.3 and __.8; CFTC Rules §§ 23.152 and 23.154.

A CSE may select one of two methods for calculating its initial margin requirements: the IM Table or an Approved Model (the selected method, the "**Elected IM Model**"), the implications of which are described in more detail in *Initial Margin Models and Standardized Amounts* below.

Calculation of Variation Margin

The U.S. Margin Rules require a CSE to collect or post (as applicable) variation margin on Non-Cleared Swaps in an amount that is at least equal to the increase or decrease (as applicable) in the value of such swaps since the previous exchange of variation margin.

The amount of variation margin to be collected or posted (as appropriate) by a CSE in respect of a Non-Cleared Swap can be calculated as:

$$MTM + X - Y = VM$$

> MTM is the cumulative mark-to-market change in value to such CSE of such Non-Cleared Swap as measured from the date it is entered into;

> X is the value of all variation margin previously posted by such CSE with respect to such Non-Cleared Swap; and

> Y is the value of all variation margin previously collected by such CSE.

The CSE must collect this amount if the amount is positive and post this amount if the amount is negative.

The 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.[20] Here, the CFTC Rule diverges from the PR Rule in one respect: the CFTC Rule requires that the calculation of variation margin utilize 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, and that such calculation method must be specified in the relevant margin documentation.[21]

As discussed below in *Minimum Transfer Amount*, netting across the portfolio of Non-Cleared Swaps may further impact variation margin requirements.

Initial Margin Threshold

There is a *de minimis* exception to the initial margin requirement. The U.S. Margin Rules do not require a CSE to collect or post initial margin to the extent that its aggregate un-margined exposure either to or from any particular counterparty remains below US$50 million.[22] Under the PR Rule, the

[20] Additionally, the Agencies note that the final margin requirements should be viewed as minimums. To the extent that two counterparties agree to transfer collateral in addition to the minimum amount required by the U.S. Margin Rules, and assuming that doing so would be consistent with safety and soundness, the U.S. Margin Rules will not impede them.

[21] *See* CFTC Rule §§ 23.155 and 23.158(b).

[22] PR Rule § __.3(a); CFTC Rule § 23.154(a)(3).

US$50 million threshold is measured as the amount of initial margin for the relevant portfolio of Non-Cleared Swaps and non-cleared security-based swaps, pursuant to the Elected IM Model used by the CSE.[23] Under the CFTC Rule, the US$50 million threshold measurement only accounts for Non-Cleared Swaps, so that any non-cleared security-based swaps are not included in the threshold analysis.[24]

Under the U.S. Margin Rules, the initial margin threshold applies on a consolidated entity level. It will therefore be calculated across all Non-Cleared Swaps between a CSE and its affiliates and the counterparty and the counterparty's affiliates that are not Exempted Swaps.[25] The requirement to apply the threshold on a fully consolidated basis applies to both the counterparty to which the threshold is being extended and the counterparty that is extending the threshold. The Agencies also noted that even in instances where a single entity has separate accounts, separate portfolios or otherwise segregated/independent managed accounts, such accounts/portfolios must be aggregated for purposes of calculating the threshold measurement.[26] Both 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 vehicle creating separate issuances of asset-backed securities, through the use of a series trust.[27]

Minimum Transfer Amount

The U.S. Margin Rules provide that transfers of initial margin and/or variation margin below a statutory minimum transfer amount are not required.[28] Transfers are only required if the exposure between the CSE and its counterparty is greater than US$500,000. This US$500,000 threshold is a gross analysis of both initial margin and variation margin obligation on any particular business day.[29] Although netting exposures is permitted within the calculation of initial margin obligations and variation margin obligations (as discussed below in *Netting Arrangements)*, netting is not permitted between the two obligations. In other words, a party collecting variation margin on any particular business day will not be permitted to net such collected amounts with any obligation to post initial margin.

Although this minimum transfer amount requirement provides a de facto *de minimis* exemption, if parties anticipate that they will have exposures exceeding US$500,000, then they may wish to consider minimum transfer amounts which

[23] PR Rule § __.2 (definition of "initial margin threshold amount") and PR Rule § __.3(a)(2).
[24] CFTC Rule § 23.151 (definition of "initial margin threshold amount").
[25] The threshold may be allocated among entities within the consolidated group, at the agreement of the CSE and the counterparties, but the total must remain below US$50 million on a combined basis. For an example illustrating allocations, *see* the 2014 proposal at 79 FR 57348, 57366 (Sept. 24, 2014). 80 FR 74863 (footnote 136); 81 FR 652 (footnote 154).
[26] 80 FR 74864; 81 FR 653.
[27] 80 FR 74864 (Footnotes 139 and 140); 81 FR 653 (Footnotes 156 and 157).
[28] CSEs, however, are not required to collect or post margin from or to any individual counterparty unless and until the combined amount of initial and variation margin that must be collected or posted under the PR Rule, but has not yet been exchanged with the counterparty, is greater than US$500,000. *See* § __.5 of the PR Rule and CFTC Rules §§ 23.152 and 23.153.
[29] PR Rule § __.5(b) and CFTC Rules §§ 23.152(b)(3) and 23.153(c).

are lower to avoid being over- or under-collateralized by amounts close to US$500,000. Lower thresholds may also be preferable if parties denominate the minimum transfer amount in a currency other than U.S. dollars, as discussed below in *U.S. Dollar Denominated Thresholds*.

Covered Swap Entities will also need to consider operations which can ensure any transfer amounts aggregate variation margin and initial margin obligations. In the past, initial margin and variation margin requirements were often agreed to in a single ISDA Credit Support Annex/Deed ("**CSA/CSD**"). However, the U.S. Margin Rules (and margin requirements in other jurisdictions) have resulted in parties finding certain efficiencies in preparing separate documentation sets, one set to address variation margin obligations and another to address initial margin obligations. While this may present various efficiencies, if the party calculating delivery obligations under one set of documents is not providing the same service under the other set, processes must exist to ensure minimum transfer amounts under the two sets of documentation aggregate across the sets, or otherwise have terms/processes to mitigate the risk of any failure to transfer margin when required under applicable law.[30] Such processes should also exist for instances where a single legal entity has multiple investment managers, accounts and/or separate issues of asset-backed securities, since the minimum transfer amount calculation should be on a legal entity basis, meaning threshold calculations must be aggregated across accounts/portfolios of a single legal entity.[31]

U.S. Dollar Denominated Thresholds

The U.S. Margin Rules' numerical amounts, such as the initial margin threshold and minimum transfer amount, are expressed in U.S. dollar terms. The Agencies and commenters to the proposed rules noted that this presents unique issues for market participants for whom the U.S. dollar is not the common or transacting currency. The Agencies, unfortunately, provided minimal guidance on the treatment of day-to-day calculations when dealing with other currencies. It appears that the Agencies are content with market participants having to account for day-to-day currency fluctuations and spot rates to determine whether a EUR480,000 exposure amount exceeds the U.S. dollar-based minimum transfer amount on any given valuation day. However, the Agencies did note they intend to "consider periodically the numerical amounts expressed in the [U.S. Margin Rules] and their relation to amounts denominated in other currencies in differing jurisdictions." [32] The applicable Agency will then propose adjustments, as appropriate, to these amounts.

The initial numerical amounts in the U.S. Margin Rules were based on a one-for-one exchange rate with the Euro.

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[30] If parties are not able to aggregate transfer amounts with a level of certainty to avoid regulatory risks associated with a failure to transfer required margin amounts, parties may wish to consider lower minimum transfer amounts in the respective documentation and/or providing excess margin under both sets of documentation.

[31] *Supra* notes 26 and 27.

[32] 80 FR 74852; 81 FR 677.

Timing of Collection and Posting of Initial and Variation Margin

Initial and variation margin with respect to a portfolio of Non-Cleared Swaps must be collected and posted with respect to each Non-Cleared Swap on each business day, beginning on or before the business day following the day of execution of the swap and ending on the date the swap is terminated or expires.[33]

Compliance Date Schedule[34]

The U.S. Margin Rules' margin requirements are being phased in over time with compliance dates which are consistent with the 2013 international framework for margin requirements on non-cleared derivatives, proposed by the Basel Committee on Banking Supervision ("**BCBS**") and the Board of the International Organization of Securities Commissions ("**IOSCO**").[35] As reflected in the table below, the compliance dates range from September 1, 2016 to September 1, 2020, in most cases depending on the average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange forwards and foreign exchange swaps ("**covered swaps**") of the CSE and its counterparty (accounting for their respective affiliates) for each business day in March, April and May of that year.[36, 37]

Compliance Date	Initial Margin Requirements
September 1, 2016	Initial and variation margin where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates (together, the "**Parties and Affiliates**") have an average daily aggregate notional amount of covered swaps (an "**AANA**") for March, April and May of 2016 that exceeds US$3 trillion.

[33] When a CSE and its counterparty are located in the same or adjacent time zones, this is a straightforward process. However, when the CSE is located in a distant time zone from the counterparty, or the two parties observe different sets of legal holidays, this can be less straightforward. The Agencies have added new provisions to the PR Rule to accommodate practical considerations that arise in these circumstances. PR Rule § __.2 and CFTC Rule § 23.1151 (definition of "day of execution").

[34] PR Rule § __.1(d); CFTC Rule § 23.161.

[35] *See* BCBS and IOSCO "Margin requirements for non-centrally cleared derivatives," (March 2015), *available at* https://www.bis.org/bcbs/publ/d317.htm (which extends the original compliance dates set out in the 2013 international framework by nine months).

[36] "**Foreign exchange forward**" and "**foreign exchange swap**" are defined to mean any foreign exchange forward, as that term is defined in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)), and foreign exchange swap, as that term is defined in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25)).

[37] Once a CSE and its counterparty become subject to the margin requirements based on the compliance dates, the CSE and its counterparty shall remain subject to the U.S. Margin Rules from that point forward. *See* PR Rule § __.1(f) and CFTC Rule §23.161(b). In the event a counterparty changes its status after the compliance date, such that a non-cleared swap or non-cleared security-based swap with that counterparty becomes subject to stricter margin requirements, then the CSE shall comply with the stricter margin requirements for any non-cleared swap or non-cleared security-based swap entered into after the counterparty's change in status. Less strict requirements may be observed for applicable swaps if a change in the counterparty's status results in less strict margin requirements.
See PR Rule § __.1(g) and CFTC Rule §23.161(c).

March 1, 2017	Variation margin for any other CSE with respect to covered swaps with any other counterparty.
September 1, 2017	Initial margin where the Parties and Affiliates have an AANA for March, April and May of 2017 that exceeds US$2.25 trillion.
September 1, 2018	Initial margin where Parties and Affiliates have an AANA for March, April and May of 2018 that exceeds US$1.5 trillion.
September 1, 2019	Initial margin where Parties and Affiliates have an AANA for March, April and May of 2019 that exceeds US$0.75 trillion.
September 1, 2020	Initial margin for any other CSE with respect to covered swaps with any other financial end user with material swaps exposure.

In calculating the AANA as set forth in the table above, the U.S. Margin Rules provide that a CSE shall count the average daily aggregate notional amount of a non-cleared swap, a non-cleared security-based swap, a foreign exchange forward or a foreign exchange swap between the entity and an affiliate only one time, and shall not count those Exempted Swaps eligible under the Interim Final Rule.[38]

Legacy Swap Exemption

The U.S. Margin Rules' margin requirements only apply to Non-Cleared Swaps entered into on or after the applicable compliance date (swaps entered into prior to the compliance date, "**Legacy Swaps**", and their exclusion from the U.S. Margin Rules, the "**Legacy Swap Exemption**"). 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.[39] Unlike other jurisdictions which provide that their respective Legacy Swap Exemption permits certain immaterial amendments, the U.S. Margin Rules provided no such qualifications. As a result, CSE's subject to the U.S. Margin Rules will need to carefully track their Legacy Swaps and have processes to readily identify when modifications occur and an OTC swap is no longer eligible for the Legacy Swap Exemption.

[38] PR Rule § __.2 and CFTC Rule §23.151 (definition of "**material swaps exposure**").

[39] Commenters to the various proposals requested such transactions 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.

Netting Arrangements

The U.S. Margin Rules permit a CSE to calculate initial margin[40] and variation margin on an aggregate net basis with a counterparty. However, such netting is only permitted when the Non-Cleared Swaps are executed under an "eligible master netting agreement" ("**EMNA**"). Initial margin and variation margin amounts may not be netted against each other under the U.S. Margin Rules. In addition, initial margin netting is only for the purposes of calculating the collection amount or post amount under an Approved Model, and not for actual netting against each other. In order to allow parties to document separate netting portfolios for Non-Cleared Swaps that are and are not subject to the U.S. Margin Rules' margin requirements, the U.S. Margin Rules allow for an EMNA to identify multiple separate netting portfolios that independently meet the requirement for close-out netting.[41] Under such an EMNA with multiple netting portfolios, the collection and posting of margin applies on an aggregate net basis separate from and exclusive of any other Non-Cleared Swaps covered by the EMNA under another netting portfolio. For example, a netting portfolio that contains only Legacy Swaps is not subject to the requirements of the U.S. Margin Rules. The Agencies also noted that when separate portfolios exist, such separate portfolios are commonly covered by separate credit support annexes to the EMNA.[42]

Under the various netting arrangements, some market participants may opt to leave existing documentation in place, but identify non-Legacy Swaps as being part of a separate netting portfolio (*e.g.*, expressly providing for this in the applicable trade confirmation). However, even for those trade relationships with an existing CSA/CSD already in place, a new CSA/CSD will likely need to be agreed to that is in compliance with the applicable U.S. Margin Rules.[43] Alternatively, CSEs may find that executing entirely new ISDA Master Agreements, Schedules and applicable credit support documentation for Non-Legacy Swaps is the preferable path forward.

The rule does not prohibit the parties from including one or more Legacy Swaps in the netting portfolio of Non-Cleared Swaps subject to the applicable U.S. Margin Rules, however such Legacy Swaps will thereby become subject to the U.S. Margin Rules' margin requirements, as part of the netting portfolio. Similarly, any netting portfolio that contains any Non-Cleared Swap entered into after the applicable compliance date will subject the entire netting portfolio to the requirements of the U.S. Margin Rules. Under the U.S. Margin Rules, Legacy Swaps in the same EMNA as post-compliance date swaps would be subject to the requirements of the U.S. Margin Rules unless they are treated under the

[40] When using an internal margin model.
[41] *See* PR Rule § __.2 and CFTC Rule §23.151 (paragraph 1 of the definition of "**eligible master netting agreement**").
[42] PR Rule § __.5; CFTC Rule §§ 23.152(c) and 23.153(d).
[43] It should also be noted that if a new Credit Support Annex (NY Law) is to apply to trades under an already existing ISDA Schedule, such Schedule will also likely need to be amended to account for the new Credit Support Annex (NY Law) as another Credit Support Document.

EMNA as a separately identified netting portfolio.[44] To mitigate the risk of such Legacy Swaps being subject to the margin requirements, CSEs may either (i) have new EMNAs for all Non-Legacy Swaps or (ii) under a single EMNA, provide separate netting pools for Legacy Swaps and Non-Legacy Swaps.

Jurisdictions Where Netting is Unavailable

The U.S. Margin Rules provide that CSEs which cannot conclude that the netting agreement with a counterparty in a foreign jurisdiction meets the definition of an EMNA may nevertheless net uncleared trades in determining the amount of margin that they ***post***, provided that certain conditions are met.[45] In order to avail itself of this special provision, the CSE must treat the uncleared trades covered by the agreement on a gross basis in determining the amount of initial and variation margin that it must ***collect***, but may net those uncleared trades in determining the amount of initial and variation margin it must ***post*** to the counterparty, in accordance with the netting provisions of the applicable U.S. Margin Rules.[46]

Eligible Collateral

The U.S. Margin Rules limit the types of collateral that are eligible to be used to satisfy both the initial and variation margin requirements. Eligible collateral is generally limited to high-quality, liquid assets that are expected to remain liquid and retain their value, after accounting for an appropriate risk-based "haircut" or "discount". These haircuts are applied to account for risk associated with a particular asset class and are also applied in certain cross-currency scenarios. Where posted margin is not cash in a major currency[47] and is denominated in a different currency than the currency of settlement[48] or (for initial margin only) the termination currency of the posting party for the Non-Cleared Swap, such collateral will generally be subject to a cross-currency haircut of 8%.[49]

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[44] Id.

[45] *See* PR Rule § __.5(a)(4) and CFTC Rule § 23.160(d).

[46] The CFTC's margin requirements also require that the Covered Swap Entity have policies and procedures ensuring that it is in compliance with the special provisions applicable to the non-netting jurisdiction's uncleared trades, and maintain books and records properly documenting that all requirements of such provisions have been met. *See* CFTC Rule § 23.160(d).

[47] Infra note 50.

[48] "**Currency of settlement**" means a currency in which a party has agreed to discharge payment obligations related to a Non-Cleared Swap or a group of Non-Cleared Swaps, subject to a master agreement at the regularly occurring dates on which such payments are due in the ordinary course. PR Rule § __.2 and CFTC Rule § 23.151 (definition of "currency of settlement"). An agreed to termination currency would not generally qualify as the "Currency of Settlement", since the termination currency refers to one single payment on the termination of a Non-Cleared Swap. The regulatory definition of "Currency of Settlement" refers to the currency of the payment obligations which occur at "regularly occurring dates…" and based on the Agencies' guidance, which independently discusses termination currencies and settlement currencies, the Agencies' introduce a distinct and intentional difference between the "Currency of Settlement" and the termination currency.

[49] PR Rule § __.6 and CFTC Rule § 23.156. The 8% cross-currency haircut will apply whenever the eligible collateral posted is denominated in a currency other than the currency of settlement or (for initial margin only) the termination currency of the posting party for the Non-Cleared Swap under the applicable EMNA, except that variation margin in immediately available cash funds in any "major currency" is never subject to the haircut. 80 FR 74872; 81 FR 668; *see also* infra note 50.

Initial Margin

With respect to initial margin, the U.S. Margin Rules include a list of eligible collateral, which includes certain cash funds,[50] certain debt and equity securities (such as treasuries, other highly rated sovereign bonds, securities (including asset-backed securities) guaranteed by the U.S. government, investment-grade publicly traded debt and equities in the S&P Composite 1500 index) and gold.[51] The U.S. Margin Rules also provide prescribed haircuts for the valuation of the eligible collateral.[52]

The U.S. Margin Rules exclude from the list of eligible collateral (i) any securities issued by the counterparty or any of its affiliates, (ii) securities issued by a bank holding company, a savings and loan holding company, a foreign bank, a depository institution, a market intermediary, or any company that would be one of the foregoing if it were organized under the laws of the U.S. or any State, or an affiliate of one of the foregoing institutions and (iii) securities issued by a non-bank, systemically important financial institution designated by the Financial Stability Oversight Council.[53]

Some counterparties who do not regularly hold assets in the form of eligible collateral may consider entering into separate collateral transformation agreements (*e.g.*, repurchase agreements) pursuant to which non-eligible assets may be pledged/transferred to a party in return for cash or other eligible collateral which may be utilized to meet the minimum margin requirements.

Variation Margin

With the exception of variation margin exchanges between two CSEs, the U.S. Margin Rules provide that the initial margin-eligible assets are also eligible assets for variation margin, subject to the applicable haircuts.[54] When dealing with two CSEs, the variation margin exchanged ***must*** be in the form of either U.S. dollars, immediately available cash in a "major currency"[55] or the currency of settlement for the Non-Cleared Swap.

The 8% haircut is added to the haircuts provided for in the standardized haircut schedule included in the respective U.S. Margin Rules (*e.g.*, eligible government debt with residual maturity greater than five years, has a haircut of 12% (4% + 8%) when the cross-currency haircut applies).

[50] Cash funds must be in a "major currency". The U.S. Margin Rules define the following as a "major currency": U.S. Dollar (USD); Canadian Dollar (CAD); Euro (EUR); United Kingdom Pound (GBP); Japanese Yen (JPY); Swiss Franc (CHF); New Zealand Dollar (NZD); Australian Dollar (AUD); Swedish Kronor (SEK); Danish Kroner (DKK); Norwegian Krone (NOK); and any other currency as determined by the Agency regulating the applicable CSE.

[51] PR Rule § __.6; CFTC Rule § 23.156.

[52] These haircuts range from 0.5% for eligible short-term government securities to 25% for equities included in the S&P 1500 Composite or related index but not the S&P 500 or related index. Appendix B to the U.S. Margin Rules.

[53] PR Rule § __.6(d).

[54] Variation margin is never subject to the segregation requirements set forth in PR Rule § __.7 and CFTC Rule §23.157, regardless of whether it consists of cash or non-cash collateral.

[55] *Supra* note 50.

Segregation and Rehypothecation of Collateral

The U.S. Margin Rules' segregation requirements and restrictions on rehypothecation will cause significant changes to the Non-Cleared Swaps market.

The segregation provisions require the use of independent third-party custodians to hold initial margin posted in compliance with the U.S. Margin Rules. To be an eligible custodian, such custodian (1) cannot be a counterparty to the applicable Non-Cleared Swap or an affiliate of either counterparty and (2) must act pursuant to a custodial agreement meeting certain requirements provided for in the U.S. Margin Rules.[56] One significant requirement to note: the custodial agreement must prohibit the custodian from rehypothecating, repledging, reusing or otherwise transferring (through securities lending, securities borrowing, repurchase agreement, reverse repurchase agreement or other means) the funds or other property held by the custodian.

Jurisdictions Where Segregation is Unavailable

The U.S. Margin Rules provide an exception to the segregation requirements[57] for Non-Cleared Swaps executed in foreign jurisdictions where inherent limitations in the legal or operational infrastructure in such foreign jurisdiction make it impracticable for the ***eligible CSE*** and the counterparty[58] to post any form of eligible initial margin in compliance with the U.S. Margin Rules' segregation requirements ("**non-segregation jurisdictions**").[59]

The exception available to Non-Cleared Swaps executed in non-segregation jurisdictions does not apply if the CSE, which is subject to the foreign regulatory restrictions, is permitted to post collateral for the Non-Cleared Swaps in the United States (or a jurisdiction for which the applicable Agency has issued a comparability determination), and the posting in such jurisdiction may be done in a manner compliant with the custodial arrangements requirements.[60]

Non-segregation jurisdictions and the PR Rules

Under the PR Rules, the only CSEs eligible to utilize the PR Rule's segregation exception for non-segregation jurisdictions are either (i) a foreign branch of a U.S. depository institution or (ii) a foreign subsidiary of a U.S. depository institution, Edge Act Corporation or Agreement Act Corporation. For such eligible CSEs to be able to utilize the exception, it must obtain prior written approval from its

[56] PR Rule § __.7(c); CFTC Rule § 23.157(c).
[57] We also note that this exception comes with modified requirements related to the posting of margin. Specifically, the eligible CSE must collect initial margin on a gross basis, and post and collect variation margin in cash, in accordance with the applicable U.S. Margin Rules.
[58] For this exception to be available, there are also limitations on the counterparty. Under the CFTC Rule, the counterparty must be a non-U.S. person that is not a CSE and the counterparty's obligations cannot be guaranteed by a U.S. person. Under the PR Rule, the counterparty cannot be an entity organized under the laws of the U.S. or any State (including a U.S. branch, agency or subsidiary of a foreign bank) or a natural person who is resident of the U.S. or a branch or office of an entity organized under the laws of the U.S. or any State.
[59] PR Rule § __.9(f)(2)(i); CFTC Rule § 23.160(e).
[60] *See* PR Rule § __.9(f)(2)(i) and (ii); CFTC Rule §§ 23.160(e)(1) and (2) (while the language between the PR Rule and CFTC Rule in these cited provisions do not match, the practical application appears to be the same),

Prudential Regulator before executing any Non-Cleared Swaps and relying on the available exception.

The eligible CSE meeting the PR Rules requirements does not have to comply with the segregation requirements or the requirement to post initial margin to the counterparty for those Non-Cleared Swaps executed in the applicable non-segregation jurisdiction.[61]

Non-segregation jurisdictions and the CFTC Rules

Under the CFTC Rules, the only CSEs eligible to utilize the CFTC's limited exception for non-segregation jurisdictions are either (i) a foreign branch of a "U.S. CSE" or (ii) an "FCS" (both terms, as defined below in *The CFTC Exclusion*).[62]In contrast to the PR Rules, the CFTC Rules do not require the eligible CSE to obtain prior approval from the CFTC, but such CSE will be subject to increased record keeping requirements, and the total outstanding notional value of all Non-Cleared Swaps relying on the exception cannot exceed 5% of such CSE's total outstanding notional amount of all Non-Cleared Swaps (*i.e.*, those relying on the exception and those which are not) in the same broad risk category identified in the CFTC's initial margin requirements.[63]

The CFTC's exception for non-segregation jurisdictions only provides relief from the custodial requirement in respect of initial margin ***collected*** by the CSE. Accordingly, FCSs and foreign branches of U.S. CSEs remain subject to the requirements to post initial margin and have such posting subject to a custodial arrangement that provides segregation and is otherwise compliant with the CFTC Rules. This appears to be a divergence from the PR Rule, since the language of the PR Rule's exception provides that it generally applies to the entirety of the custodial segregation requirements, while the CFTC Rule clearly only intended to provide an exception with respect to the CSE's collected initial margin. Ultimately, given the extremely narrow nature of both the CFTC Rule's and the PR Rule's exception, the exception may require too much in time and cost to be of any practical use to a CSE.

Initial Margin Models and Standardized Amounts

The U.S. Margin Rules adopt an approach whereby CSEs may calculate initial margin requirements using the IM Table or an Approved Model. All internal initial

[61] The Prudential Regulators expect that the counterparty here is a financial end user.

[62] The CFTC noted that it "would expect the CSE's counterparty to be a local financial end user that is required to comply with the foreign jurisdiction's laws and that is prevented by regulatory restrictions in the foreign jurisdiction from posting collateral for the uncleared swap in compliance with the custodial arrangements of Section 23.157 in the United States or a jurisdiction for which the CFTC has issued a comparability determination under the Final Rule, even using an affiliate." *See* Footnote 178 of the CFTC Rules Federal Register release. Interestingly, this is the first instance outside of certain inter-affiliate swaps that the CFTC would permit a swap counterparty to comply with margin posting requirements by having a third-party provide the margin on behalf of such swap counterparty.

[63] *See* CFTC Rule §§ 23.154(b)(2)(v) and 23.160(e). The four broad risk categories are credit, equity, foreign exchange and interest rates (considered together as a single asset class), and commodities.

margin models must be approved by a CSE's Prudential Regulator, or the CFTC in the case of CSEs subject to the CFTC Rule, and reviewed annually.[64] In the event that a CSE's proposed model is not approved, initial margin must be posted according to the IM Table.

In addition to regular review by the applicable Agency, the U.S. Margin Rules also require that robust oversight, control and validation mechanisms be in place to ensure the integrity and validity of the initial margin model and related processes.[65] CSEs that are either unable or unwilling to make the technology and related infrastructure investments necessary to maintain an initial margin model may elect to use the IM Table.

Some CSEs may choose to use both Approved Models and the IM Table to calculate initial margin requirements in different circumstances and for different counterparties. However, to guard against CSEs "cherry picking" between Approved Models and the IM Table, the Agencies have noted that (i) they do not anticipate a need for a CSE to switch between Elected IM Models for a particular counterparty (absent significant changes in such counterparty's activities) and (ii) they expect CSEs to provide a rationale for changing Elected IM Models if requested. Inappropriate switching between models will be subject to anti-evasion regulations.[66]

Cross-Border Application of U.S. Margin Rules

The U.S. Margin Rules set forth the extraterritorial application of its requirements. In cross-border transactions, particularly when between two non-U.S. entities, the threshold inquiry is generally whether or not the Non-Cleared Swap may be excluded from the PR Rule (the "**PR Exclusion**") or the CFTC Rule (the "**CFTC Exclusion**"), as applicable. To the extent a Non-Cleared Swap is not eligible for an exclusion, parties will need to consider whether a particular cross-border trade is eligible for full substituted compliance,[67] or instead only a more limited substituted compliance.

Substituted compliance is the mechanism by which an Agency will permit certain CSEs 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 Rules or CFTC Rules (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.

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[64] *See* PR Rule § __.8(c)(1) and CFTC Rule § 23.154(b)(1)(i).
[65] *See* PR Rule § __.8(f) and CFTC Rule § 23.154(b)(5).
[66] The Agencies discuss their approach to evasion in the introductory language of the final rules. PR Rule § __.8; CFTC Rule § 23.154.
[67] We note that the use of the term "**full substituted compliance**" refers more generally to the scope of substituted compliance the applicable Agency may generally permit under and subject to any substituted compliance determination, which may or may not encompass all margin requirements and/or may otherwise be conditioned by such Agency.

Cross-Border Exclusions from 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[68] on either side of the trade) when all such parties, including any guarantee (if applicable) are considered a "foreign covered swap entity" under the PR Rule, which includes ***any*** entity ***except*** those identified in the below table (which generally includes any entity incorporated in the United States).[69] If such requirements are met, then the swap at issue is eligible for the PR Exclusions 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.[70] Here, a subsidiary includes a company and its parent (or other company) which share a consolidated financial statement under appropriate accounting rules (or would have, if such principles/standards had applied).[71]

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[72] 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[73] by a U.S. person and

[68] 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).

[69] 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* infra note 74.

[70] PR Rule § __.9(b)(1).

[71] 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.

[72] Infra note 77.

[73] The CFTC Rule defines "guarantee" in a manner similar to the PR Rule. *See* CFTC Rule § 23.160(a)(2) and *supra* note 68.

neither counterparty is a Foreign Consolidated Subsidiary ("**FCS**"). Consistent with the PR Exclusion, the CFTC Exclusion does not apply if the counterparty is a U.S. branch of a non-U.S. CSE.

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 defines "**U.S. person**" and "**Foreign Consolidated Subsidiary**" as follows:

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[74] in the United States, including any branch of such legal entity[75] ("**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**").

[74] For purposes of this section, 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 legal person. 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." The CFTC also stated its interpretation of this prong in respect of an investment fund is consistent with its previous extraterritorial guidance so that in the case of a fund, the senior personnel that direct, control, and coordinate a fund's activities are generally the persons employed by the fund's investment adviser or the fund's promoter. Therefore, the CFTC would generally consider the principal place of business of a fund to be in the United States if the senior personnel responsible for either (1) the formation and promotion of the fund or (2) the implementation of the fund's investment strategy are located in the United States, depending on the facts and circumstances that are relevant to determining the center of direction, control and coordination of the fund. Whether a pool, fund or other collective investment vehicle is publicly offered only to non-U.S. persons and not offered to U.S. persons would not be relevant in the U.S. person analysis.

[75] 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.

What is a U.S. Person?

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[76] ("**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**"[77] 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[78] 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 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.

Consistent with existing market practice, the CFTC will permit CSEs to reasonably rely on written counterparty representations as to their status as a U.S. person, FCS and/or whether a party has any guarantees from a U.S. person, unless it has information that would cause a reasonable person to question the accuracy of the representation. Representations with respect to U.S. persons and any guarantees provided pursuant to the ISDA Cross-Border Representation Letter will largely match up with the status under the CFTC Rule.[79] To the extent parties need to confirm the FCS status of a counterparty, new representations or independent diligence efforts will be needed to confirm a non-FCS status.

[76] 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.

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

[78] 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.

[79] The "U.S. person" definition is almost the same word-for-word, except that in the CFTC Rule the term "U.S. person" does not include a U.S. majority-owned funds prong and removes the prefatory phrase "includes, but is not limited to" (which was included in the prior extraterritorial guidance) in order to provide legal certainty regarding the application of U.S. margin requirements to cross-border swaps.

Substituted Compliance Under the U.S. Margin Rules

The PR Rule's Substituted Compliance

Under the PR Rules, substituted compliance can either (i) provide full substituted compliance and permit the CSE to comply with its local margin requirements or (ii) permit a CSE to comply with a foreign jurisdictions posting requirements (though such CSE's collection requirements must still comply with the PR Rule).

Full substituted compliance is available for any CSE that does not have a guarantee from a U.S. entity[80] and is either:

> a foreign covered swap entity;

> a foreign bank's U.S. branches and agencies; or

> an entity that is not organized under U.S. Federal or State law and is a subsidiary of a depository institution, Edge Act Corporation or Agreement Act Corporation.

For a CSE that is otherwise subject to the PR Rule, but trades with a counterparty subject to a foreign regulatory framework for which the Prudential Regulators have made a substituted compliance determination, such CSE may comply with the posting requirement of the foreign counterparty's initial margin collection requirement (including amount, form and timing requirements),[81] provided that the foreign counterparty does not have a guarantee from a U.S. entity.

The CFTC Rule's Substituted Compliance

Under the CFTC Rule, non-U.S. CSEs (including FCSs) whose obligations under the relevant uncleared swap are not guaranteed by a U.S. person may avail themselves of full substituted compliance with respect to its Non-Cleared Swaps with any counterparty, other than a U.S. CSE or a U.S. Guaranteed CSE.[82] Similar to the PR Rule, there is also a more limited substituted compliance option for U.S. CSEs and U.S. Guaranteed CSEs.

U.S. CSEs and U.S. Guaranteed CSEs would be eligible for substituted compliance with respect to the requirement to post (but not the requirement to collect) initial margin provided that the counterparty is a non-U.S. person whose

[80] An entity organized under the laws of the U.S. or any State (including a U.S. branch, agency or subsidiary of a foreign bank) or a natural person who is resident of the U.S. or a branch or office of an entity organized under the laws of the U.S. or any State.

[81] For example, if a U.S. bank CSE 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 as 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.

[82] A non-U.S. CSE whose obligations in respect of the Non-Cleared Swap is guaranteed by a U.S. Person. "**U.S. Guaranteed CSEs**" are eligible for substituted compliance to the same extent as U.S. CSEs and are similarly ineligible for the Exclusion. Whether a non-U.S. CSE falls within the meaning of the term "U.S. Guaranteed CSE" varies on a swap-by-swap basis, such that a non-U.S. CSE may be considered a U.S. Guaranteed CSE for one swap and not another, depending on whether the non-U.S. CSE's obligations under such swap are guaranteed by a U.S. person.

obligations under the relevant swap are not guaranteed by a U.S. person. With respect to any foreign branches of a U.S. CSE, a foreign branch's Non-Cleared Swaps are treated the same as Non-Cleared Swaps of the U.S. CSE as a whole. Therefore, they may only be eligible for limited substituted compliance.

Documentation of Margin Agreements

Under the U.S. Margin Rules, a CSE must execute trading documentation regarding credit support arrangements which meet certain requirements set out in the U.S. Margin Rules with each counterparty that is a swap entity or a financial end user.[83] For example, the documentation must provide the CSE the contractual right and obligation to collect and post initial and variation margin as required by the U.S. Margin Rules, provide certain information used to determine the value of each Non-Cleared Swap and specify dispute resolution provisions related to valuations as well as describe how initial margin requirements are determined, amongst other required information.[84] The documentation between a CSE subject to the PR Rule and one subject to the CFTC Rule may be different due to the fact that the requirements related to the calculation of variation margin are slightly different under the CFTC Rule.[85]

Special Rules for Affiliates

PR Rule's Treatment of Affiliate Transactions

The requirements of the PR Rule generally apply to any Non-Cleared Swap with an affiliate unless the swap is an Exempted Swap or a "special rule" applies.[86] The "**special rule**" is the term used by the Prudential Regulators to refer to the PR Rule's provisions specific to affiliate transactions. The general idea being that an affiliate transaction would be treated in the same manner as a transaction with any other counterparty, unless otherwise provided for in the provisions specific to certain affiliate transactions – *i.e.*, the special rules. An entity is generally an "affiliate" of a CSE if the two entities share a consolidated financial statement under appropriate accounting rules.[87]

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[83] *See* PR Rule § __.10 and CFTC Rule § 23.158.
[84] PR Rule § __.10; CFTC Rule § 23.158.
[85] *Supra* Note 21.
[86] The CFTC Rule also has special rules for those swaps between a CSE and its affiliates. Generally, a CSE shall not be required to collect initial margin from a margin affiliate provided that the CSE meets the following conditions: (i) The swaps are subject to a centralized risk management program that is reasonably designed to monitor and to manage the risks associated with the inter-affiliate swaps; and (ii) The CSE exchanges variation margin with the margin affiliate in accordance with the applicable provisions of §§23.150 through 23.161. A CSE shall post initial margin to any margin affiliate that is a swap entity subject to the rules of a Prudential Regulator in an amount equal to the amount that the swap entity is required to collect from the CSE pursuant to the rules of the Prudential Regulator.
[87] The Prudential Regulators also included a provision aimed at mitigating the risk of evasion by providing that the term "affiliate" also includes an entity that a Prudential Regulator has determined to be an affiliate based on the conclusion that either entity provides significant support to, or is materially subject to the risk or losses of, the other company. *See* PR Rule § __.2 (definition of "affiliate").

With respect to initial margin requirements, a CSE must (i) collect initial margin if the affiliate is a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant and also (ii) post a minimum amount of initial margin to such counterparty.[88] The CSE must also collect initial margin when the affiliate is a financial end user with a material swaps exposure.[89] When initial margin must be collected, the affiliate may be granted an initial margin threshold of US$20 million for purposes of calculating the amount of initial margin to be collected, and the CSE may utilize a 5-day margin period of risk instead of a 10-day margin period of risk when calculating the amount of initial margin.

To the extent that the CSE is required to collect initial margin from its affiliate in the form of collateral other than cash, the CSE may serve as the custodian for the non-cash collateral or have an affiliate serve as the custodian. Initial margin collateral that is cash would be subject to all of the requirements associated with collecting initial margin, including the required use of a third-party custodian that is not an affiliate of the CSE.

In regards to variation margin, a CSE must collect and post variation margin with respect to a Non-Cleared Swap with any affiliate-counterparty that is a swap dealer, major swap participant, security-based swap dealer, major security-based swap participant or financial end user.

CFTC Rule's Treatment of Affiliate Transactions

The CFTC Rule treats affiliate transactions differently than the PR Rule. As a threshold matter, the PR Rule's definition of "affiliate" includes anti-evasion language, which the CFTC opted not to include in its definition of "margin affiliate", but otherwise the two definitions are the same.[90] The more material difference is in the overall treatment of affiliate transactions, which is distinctly different under the CFTC Rule.

Under the CFTC Rule, a CSE generally does not have to post initial margin with a margin affiliate, provided that (1) the swaps are subject to an appropriate centralized risk management program, (2) the margin affiliate is not a CSE

[88] Initial margin is required even if the inter-affiliate swap was eligible for a clearing exemption for an inter-affiliate transaction.

[89] If the affiliate is a financial end user, the CSE would not need to post initial margin. However, the PR Rule requires that a CSE calculate the amount of initial margin that would be required to be posted to an affiliate that is a financial end user with material swaps exposure pursuant to § __.3(b) and provide documentation of such amount to each affiliate on a daily basis. An initial margin threshold of US$20 million should be used for purposes of calculating the amount of initial margin that would be required. Furthermore, to assist affiliates who may not have collateral on-hand to post, the PR Rule does not prohibit the margin from being supplied by the parent holding company, subject to certain requirements. Initial margin must be collected by the CSE even if the inter-affiliate swap was eligible for a clearing exemption for an inter-affiliate transaction.

[90] Because there are circumstances where an entity holds a majority ownership interest and would not consolidate financial statements, the Prudential Regulators reserved the right to include any other entity as an affiliate or 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 "margin affiliate" under the CFTC Rule. *Supra* note 87.

subject to the PR Rule[91] and (3) the margin affiliate is not a foreign affiliate entering into (directly or indirectly) outward-facing (*i.e.*, third-party) transactions and such margin affiliate is not in a jurisdiction the CFTC has deemed eligible for substituted compliance.[92] With respect to variation margin, the CFTC Rule does require the exchange of variation margin when the margin affiliate is a CSE or a financial end user.

The CFTC has also noted that in respect of affiliate transactions and availability of the CFTC Exclusion, the CFTC Exclusion is not available if the market-facing swap of the non-U.S. CSE (that is otherwise eligible for the CFTC Exclusion) is not subject to comparable initial margin collection requirements in the home jurisdiction and any of the risk associated with the Non-Cleared Swap is transferred, directly or indirectly, through inter-affiliate transactions, to a U.S. CSE or a U.S. Guaranteed CSE.[93]

Conclusion

Since the initial publication of our Client Note, ISDA has been supporting multiple working groups which are drafting updated CSAs/CSDs to address various documentation requirements. Other market participants are also working to provide collateral and custodial services that are not only compliant with multiple regulatory regimes, but should also hopefully assist market participants with valuation and margin exchange processes. While standardization may eventually be a common theme across various elements of margin documentation, some of the earliest examples of documentation still highlight the complexities that exist, particularly in the cross-border context. For example, parties will still have numerous "elections" to consider and review in an effort to ensure that the executed version of the common market documentation complies with applicable margin requirements.

In addition to new documentation, CSEs will need to make a number of operational and legal changes to their current swaps business operations in order to achieve compliance with the provisions of the applicable U.S. Margin Rules. ISDA is working on preparing a model (the "**ISDA SIMM Model**") that can assist in the valuation of Non-Cleared Swaps, but it is still too early to know how widely adopted this service will ultimately be, and if adopted, to what extent (if any) parties look to further modify the ISDA SIMM Model.

Another open item continues to be the obligation on CSEs to have to conduct a sufficient legal review to conclude with a well-founded basis that in the event of a legal challenge (including one resulting from default or from receivership, conservatorship, insolvency, liquidation or similar proceedings of the counterparty), the relevant court or administrative authorities would find their

[91] The CFTC Rule requires a CSE that enters into an inter-affiliate swap with a CSE that is subject to the PR Rules ("**PR-CSE**") to post initial margin with PR-CSE in an amount equal to the amount that the PR-CSE is required to collect under the PR Rule.
[92] CFTC Rule § 23.159.
[93] *Supra* note 82.

custodial agreement to be legal, valid, binding and enforceable by the CSE under the law applicable to the counterparty. This requirement is generally understood to mean that enforceability opinions will be required with respect to both trade counterparties and the custodian. Similar to the documentation exercises, market participants are working towards obtaining industry opinions to covered trade counterparties in various jurisdictions. With respect to custodians, there still seems to be some question around whether trade counterparties will obtain their own opinions in respect of the custodian utilized, or if the custodian will provide such opinions as part of the overall "suit of services" being offered to assist CSEs in complying with the global margin requirements.

Also since the initial publication of our original Client Note, CSEs have begun considering the U.S. Margin Rules within the broader context of other global margin requirements. For more information on this, a comparison of the U.S. Margin Rules against other jurisdictions' margin requirements, including the European Union, Hong Kong and Japan, and additional thoughts on documentation and substituted compliance, please see a recent article we published on this topic.[94]

[94] Global Margin Requirements for Non-Cleared Derivatives: Important Differences in the Margins, Futures & Derivatives Law Report (June 2016), http://linklaters.com/pdfs/mkt/newyork/GLFDLR.pdf.

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