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THE FINAL MARGIN FRAMEWORK FOR UNCLEARED SWAP TRANSACTIONS

To Our Clients and Friends:

In December 2015, the Commodity Futures Trading Commission (CFTC) adopted its final rule on margin requirements for CFTC-regulated swap dealers (SDs) and major swap participants (MSPs) with respect to swaps that are not cleared with a derivatives clearing organization or clearing agency (CFTC Final Rule).[1] The CFTC's action follows on similar final action about two months earlier by the five so-called Prudential Regulators, the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency, Farm Credit Administration and Federal Housing Finance Agency (PR Final Rule).[2] These two final rules (together, the Final Margin Requirements) virtually complete the Dodd-Frank Act[3] regulatory framework for initial and variation margin requirements for uncleared swaps.[4]

The Final Margin Requirements govern the products and participants that are subject to initial margin (IM) and variation margin (VM) requirements, the nature and timing of the margin requirements, rules for calculating IM, rules for calculating VM, forms of eligible collateral, custodial arrangement requirements, special rules for inter-affiliate swaps, and the implementation schedule for compliance.

Although CFTC Chairman Massad helpfully noted at the CFTC's open hearing that the CFTC Final Rule is "practically identical" to the PR Final Rule, the CFTC Final Rule differs from the PR Final Rule in a few notable respects: (i) the treatment of certain treasury affiliates; (ii) anti-evasion provisions in the definition of "margin affiliate"; (iii) the treatment of inter-affiliate trades; (iv) the model approval process; and (v) the calculation of VM and related documentation requirements. In addition, whereas the PR Final Rule includes rules and guidance regarding its cross-border application, the CFTC refrained from finalizing the cross-border application of its rule, for which the agency had proposed a framework.[5]

Simultaneously with their issuance of the Final Margin Requirements, both the CFTC and Prudential Regulators issued interim final rules to implement the post-Dodd Frank statutory exemption from uncleared margin requirements for commercial end users and small financial institutions that qualify for an exemption or exception from clearing requirements.[6]

The significance of the Final Margin Requirements on the uncleared swaps markets should not be underestimated: all market participants engaging in uncleared swaps are likely to see the effects of the Final Margin Requirements in the form of increased costs, changes in market structure and liquidity, and operational and compliance burdens. This Alert summarizes the Final Margin Requirements, describes the differences between the CFTC Final Rule and the PR Final Rule, and highlights areas

where market participants are indirectly subject to the Final Margin Requirements. In addition, the Alert discusses the potential effects of the CFTC's pending regulations related to the cross-border application of the CFTC Final Rule and its harmonization with international regulations.

I. Jurisdiction Under the PR Final Rule and the CFTC Final Rule

Under the Dodd-Frank Act, jurisdiction over margin requirements for uncleared swaps is divided between the Prudential Regulators and the CFTC. The PR Final Rule thus establishes the requirements for CFTC-registered SDs and MSPs that are supervised by a Prudential Regulator. Such Prudential Regulator-supervised entities are:

- FDIC-insured depository institutions (banks and savings associations, state- and OCC-chartered);
- U.S. branches and agencies of non-U.S. banks;
- Bank holding companies and certain nonbank affiliates;
- Savings and loan holding companies and certain nonbank affiliates;
- Foreign banks treated as bank holding companies under the International Banking Act of 1978;
- Foreign banks that do not operate an insured branch;
- Edge and Agreement corporations;
- OCC-chartered national trust companies;
- Institutions chartered under the Farm Credit Act; and
- Fannie Mae and Freddie Mac.

The CFTC Final Rule establishes the requirements for SDs and MSPs that are not supervised by a Prudential Regulator. As a practical matter, the bifurcated regulations of the Prudential Regulators and CFTC are generally a matter of jurisdictional scope. The differences between the two regulatory regimes are not material, and rather, are intended to work together with the broader Basel Committee on Banking Supervision (BCBS) charge to harmonize uncleared swaps margin requirements at an international level.

II. Applicable Swaps and Market Participants

A. Swaps Subject to the Final Margin Requirements

Only "uncleared swaps" and "uncleared security-based swaps" executed after the applicable compliance dates are subject to the Final Margin Requirements. The CFTC Final Rule applies to swaps of SDs or MSPs for which there is no Prudential Regulator and that are "not cleared by a

registered derivatives clearing organization, or by a clearing organization that the Commission has exempted from registration."[7] The PR Final Rule applies to all uncleared swaps and uncleared security-based swaps of SDs or MSPs for which there is a Prudential Regulator.[8]

Foreign exchange swaps and foreign exchange forwards are excluded from the definition of swap, and thus are not subject to the Final Margin Requirements.[9] Certain foreign exchange transactions that are (1) fixed, (2) physically settled and (3) associated with the exchange of principal embedded in cross-currency swaps are also not subject to the Final Margin Requirements.[10] However, these excluded foreign exchange transactions, while not subject to the Final Margin Rules, are nonetheless included in the calculations to determine applicability and implementation of such rules as discussed below.

B. Types of Market Participants

The Final Margin Requirements are directly applicable to SDs and MSPs (collectively, covered swap entities, or CSEs); however, one must look to the status of a CSE's counterparty to determine the extent to which the Final Margin Requirements apply to a particular transaction. This result flows from Section 4s(e)(3)(A)(ii) of the Commodity Exchange Act (CEA), which mandates that margin requirements must be "appropriate to the risks associated" with uncleared swaps. Because risks will vary based on the CSE's counterparty, the Final Margin Requirements apply differently depending on whether the CSE's counterparty is (1) another CSE, (2) a financial end user, or (3) a non-financial end user.

1. Covered Swap Entities (CSEs)

CSEs are all SDs and MSPs subject to the Final Margin Requirements.[11]

2. Financial End Users

The Final Margin Requirements also apply to uncleared swaps between CSEs and "financial end users," a term that is defined broadly.[12] The expansive definition of a financial end user was implemented in an attempt "to capture all financial counterparties, without being overly broad and capturing commercial firms and sovereigns."[13] Pursuant to the Final Margin Requirements, a "financial end user" is a counterparty to a CSE that is not itself a CSE, and is one of the following entities:

- Bank holding companies or affiliates thereof;
- Savings and loan holding companies;
- U.S. intermediate holding companies established or designated under the Federal Reserve's Regulation YY;[14]
- Nonbank financial institutions supervised by the Federal Reserve;

- Depository institutions;
- Foreign banks;[15]
- Federal or state credit unions;
- Institutions that function solely in a trust or fiduciary capacity;[16]
- Industrial loan companies or industrial banks;[17]
- Entities that are state licensed or registered, except entities registered or licensed solely on account of financing the entities' direct sale of foods or services to customers, as:
    - a credit or lending entity;[18]
    - a money service business;[19]
- Regulated entities under Section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992;[20]
- Entities where the Federal Housing Finance Agency or its successor is the primary federal regulator;
- Securities holding companies;
- Brokers or dealers;
- Business development companies;
- Investment advisers and investment companies registered with the Securities and Exchange Commission;
- Entities defined under the Investment Company Act, including investment companies and private funds;
- Commodity pools, commodity pool operators, commodity trading advisors, futures commission merchants, floor traders or introducing brokers;
- Employee benefit plans defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. § 1002);
- Insurance companies; or
- Entities organized outside the United States that would be a financial end user under any of the above factors if they were organized in the United States.

In addition, the Final Margin Requirements contain an expansive "catch-all" provision under which a financial end user includes any "entity, person or arrangement that is, or holds itself out as being, an entity, person, or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for the purpose of investing or trading or facilitating the investing or trading in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets."[21] As a result, the Final Margin Requirements do not contain, as was initially proposed, any discretionary authority for the CFTC or Prudential Regulators to determine whether other entities should be treated as financial end users.

The Final Margin Requirements also specifically ***exclude*** a subset of financial counterparties from the definition of financial end user:

- Sovereign entities;[22]
- Multilateral development banks;
- The Bank of International Settlements;
- Certain captive finance companies;[23]
- Agent affiliates;[24] and
- Eligible treasury affiliates that the CFTC may exempt by rule.[25]

Although an entity may meet the definition of a financial end user, the Final Margin Requirements establish margin thresholds that a financial end user must exceed before the Final Margin Requirements will apply. As discussed in greater detail below (*see* Section III.A), the classification of an entity as a financial end user will therefore require extensive transactional diligence to determine whether its uncleared swaps activities are subject to the Final Margin Requirements.

3. Non-Financial End Users

Serving as a catch-all for all other counterparties to an uncleared swap transaction, "non-financial end users"--counterparties that are neither CSEs nor financial end users--are specifically exempted from the CFTC Final Rule.[26] The PR Final Rule does not contain an explicit definition for a "non-financial end user," and instead only defines applicable entities subject to the PR Final Rule (*i.e.*, financial end users and CSEs). Although the PR Final Rule does not define "non-financial end users," it stands to reason that entities that are not financial end users or CSEs would not be subject to margin requirements pursuant to the rule. Notably, the PR Final Rule – unlike the CFTC Final Rule's specific exemption – requires CSEs to collect IM and VM "in such amounts (if any), that the [CSE] determines appropriately addresses the credit risk posed by the counterparty and the risks of" the swap.[27]

4. The Interim Final Rules and Further Exemptions

As noted, the CFTC and Prudential Regulators also issued Interim Final Rules that provide further exemptions for certain entities.[28] Specifically, the Interim Final Rules implement Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA), which amended the Dodd-Frank Act to exempt counterparties from the Final Margin Requirements when the counterparty: (1) qualifies for an exception under CEA Section 2(h)(7)(A); (2) qualifies for an exemption issued under CEA Section 4(c)(1) for cooperative entities as defined in such exemption; or (3) satisfies the criteria in CEA Section 2(h)(7)(D).[29]

CEA Section 2(h)(7)(A) exempts certain entities from clearing requirements when uncleared swaps are intended for hedging or other risk mitigation. As a natural outflow of the recognition of this clearing exemption, the CFTC and Prudential Regulators have also exempted these transactions from the Final Margin Requirements. The broadest of the three TRIPRA exemptions, CSEs transacting with counterparties that qualify for the CEA Section 2(h)(7)(A) clearing exception--such as non-financial end users, small banks and savings associations, Farm Credit System Institutions, credit unions, and captive finance companies--will not be subject to margin requirements under the Final Margin Requirements.[30]

The CFTC under its CEA Section 4(c)(1) powers exempts certain cooperative financial entities from clearing requirements when they (1) enter into uncleared swaps in connection with originating loans for their members or (2) hedge or mitigate commercial risks related to loans to members or swaps with non-financial entity members.[31] CSEs transacting with counterparties that qualify for a CEA Section 4(c)(1) clearing exception will not be subject to margin requirements under the Final Margin Requirements.

The last exemption of the Interim Final Rules has already been incorporated in to the Final Margin Requirements under an exception to the definition of a financial end user.[32] CEA Section 2(h)(7)(D) was recently amended by Title VII of the Consolidated Appropriations Act, 2016 and, exempts affiliates of an entity that otherwise qualifies for the clearing requirement under CEA Section 2(h)(7)(A) when certain conditions are met.[33] This exception is sometimes referred to as the "centralized treasury unit" exception, and does not apply to SDs, SBSDs, MSPs, MSBSPs, commodity pools, bank holding companies with over $50 billion in consolidated assets, or issuers that would qualify as an investment companies, private funds, employee benefit plans, insured depository institutions, farm credit system institutions, credit unions, nonbank financial companies supervised by the Federal Reserve or an entity engaged in the business of insurance and subject to capital requirements established by an insurance governmental authority of a state, territory of the U.S., District of Columbia, a foreign country or a political subdivision of a foreign country that is engaged in the supervision of insurance companies under insurance law.[34] CSEs transacting with counterparties that qualify for a CEA Section 2(h)(7)(D) clearing exception will not be subject to margin requirements under the Final Margin Requirements.

Although an entity may qualify as an SD, an MSP or a financial end user, such qualification, as discussed in greater detail below, is not dispositive as to whether the entity must post or collect IM

when entering into swaps with CSEs. Moreover, the Final Margin Requirements are fluid in their application and classification of counterparty entities. In the event a counterparty has a change in status where stricter rules will apply (*e.g.*, a financial end user gains material swaps exposure), the stricter Final Margin Requirements will apply to swaps entered into after the change in status.[35] Similarly, a counterparty that drops to a lower compliance status (*e.g.*, a financial end user drops below the material swaps exposure threshold), the less-strict requirements will apply to the CSE for all outstanding swaps with that counterparty.[36] Due to the fluidity of the Final Margin Requirements, market participants will need to actively account for the factors discussed below to determine whether compliance with the IM requirements of the Final Margin Requirements is necessary.

C. Special Rules for Inter-Affiliate Swaps

As explained by CFTC Chairman Massad, inter-affiliate swaps are "typically a means . . . to centrally manage risk related to the activities of multiple subsidiaries" and "are not outward facing and thus do not increase the overall risk exposure" of the entity to third parties.[37] As a result, these transactions are afforded special treatment under the Final Margin Requirements. In recognition of the beneficial and risk mitigating nature of these transactions, the Final Margin Requirements generally exempt consolidated affiliate swaps transactions from burdensome and costly two-way IM requirements.[38] Although the approaches taken under the CFTC Final Rule and the PR Final Rule vary, they are ultimately designed to work together.

1. Applicable Entities

The Final Margin Requirements exempt certain inter-affiliate transactions from IM requirements. A swap will qualify as an inter-affiliate transaction when the affiliate of a CSE is:

- consolidated with the CSE on a financial statement prepared in accordance with GAAP, IFRS, or other similar standard;
- consolidated with the CSE and a third company on a financial statement prepared in accordance with GAAP, IFRS, or other similar standard; or
- not consolidated, but otherwise would be consolidated if the affiliate were subject to GAAP, IFRS, or other similar standard.

To help capture entities that hold majority interests in another entity, but do not consolidate, the PR Final Rule reserves additional discretionary authority that allows a Prudential Regulator to find an otherwise qualifying affiliate relationship when "either company provides significant support to, or is materially subject to the risks or losses of, the other company."[39] The CFTC did not incorporate a similar provision, nor did it elucidate its reasoning on the subject, only noting that it "has determined not to include this provision at this time."[40] Entities that do not qualify as an affiliate are treated as third parties entering uncleared swaps.[41]

2. IM Collection and Posting Requirements

The Final Margin Requirements' treatment of inter-affiliate swaps differs in approach by the CFTC and Prudential Regulators. Under the CFTC Final Rule, inter-affiliate transactions are generally exempt from IM requirements.[42] The PR Final Rule, however, establishes a one-way requirement for inter-affiliate transactions.[43]

The CFTC stated that it concurred with the position of the BCBS that "the exchange of initial . . . margin by affiliated parties 'is not customary' and that IM in particular 'would likely create additional liquidity demands'" and that "requiring the posting and collection of IM for inter-affiliate swaps would be likely to put CSEs at a competitive disadvantage to firms in other jurisdictions."[44] Under the CFTC Final Rule, therefore, CSEs are exempt from collecting IM from their affiliates when:

- the parties are affiliates, as defined by the test above;
- the swap is subject to a centralized risk management program that is "reasonably designed" to monitor and manage inter-affiliate risks; and
- the CSE-affiliate exchanges VM in accordance with the CFTC Final Rule.[45]

The PR Final Rule explicitly exempts CSEs from posting IM to their inter-affiliate counterparties, without imposing a similar CFTC required centralized risk management anti-evasion requirement.[46] The PR Final Rule, however, does require CSEs to calculate the amount of IM they would be required to post to all financial end user affiliates with material swaps exposures.[47] With regard to inter-affiliate IM collection requirements, the PR Final Rule does not provide an exemption and instead requires CSEs to collect IM from their affiliate counterparties subject to the Final Margin Requirements' general IM collection thresholds discussed below in Section III.A.[48] Additionally, the PR Final Rule establishes an affiliate-specific exemption threshold when the aggregate credit exposure of all uncleared swaps between the affiliates is below a $20 million threshold.[49]

To reconcile differences between inter-affiliate exemptions across the Final Margin Requirements, the CFTC Final Rule requires that a CSE post IM to any affiliate that is an SD or MSP subject to the rules of a Prudential Regulator.[50]

3. VM Collection and Posting Requirements

Generally, CSEs engaged in inter-affiliate transactions are required to exchange VM. The CFTC Final Rule requires that CSEs exchange VM only with affiliate CSE and financial end user counterparties.[51] In contrast, the PR Final Rule requires the exchange of VM for all inter-affiliate counterparties, including transactions with their non-financial end user affiliates.[52] The PR Final Rule required exchange of VM from all inter-affiliate counterparties is a slight departure from its outward facing counterpart, which only requires the exchange of VM for transactions with CSEs and financial end users.[53]

4. Transacting with Foreign Affiliates

The CFTC Final Rule also imposes another anti-evasion provision designed to curtail the potential use of affiliates to avoid collecting IM from third parties.[54] These anti-evasion rules, as noted by Chairman Massad, are designed to address the potential misuse of foreign affiliates--which are not currently subject to margin requirements--as a mechanism for engaging in margin-free outward facing uncleared swaps.[55] To reduce the risk of passing these exposures to CFTC regulated CSEs, in instances where a CSE transacts with its foreign affiliate, the CSE is required to collect IM when its foreign affiliate is a financial end user that is not subject to comparable IM requirements on its outward-facing swaps with financial end-users (*e.g.*, the foreign jurisdiction in which it is located in a jurisdiction for which substituted compliance has not been granted with respect to IM).[56]

The CFTC Final Rule explains that this requirement also applies in the case of a series of transactions involving, directly or indirectly, an affiliate that is not subject to comparable IM requirements. Notably, the CFTC stated that "even if the CSE is only in privity of contract with an affiliate who is subject to such requirements, but that affiliate, directly or indirectly, is transacting with another affiliate who is not subject to such requirements, the CSE would be required to collect initial margin."[57] Concerned with a similar outcome, the PR Final Rule, pursuant to its finalized cross-border requirements, extends margin requirements[58] to all CSE transactions with foreign "subsidiaries" of a U.S. entity, including transactions with foreign affiliates of a CSE.[59] Determination of a subsidiary is practically identical to the tests used to determine an "affiliate" under the Final Margin Requirements, as it examines whether the entity is consolidated or would be consolidated with the balance sheet of a U.S. entity.[60]

III. Margin: Calculation, Form, and Timing

Once designated as a CSE or financial end user, an entity may be subject (directly or indirectly) to IM and VM requirements under the Final Margin Requirements, and thus will need to examine, on an enterprise-wide scale, the totality of its uncleared swaps activities. Although the Final Margin Requirements place much of the financial and regulatory burden on CSEs, financial end users are indirectly subject to margin requirements if they do business with a CSE. In contrast, financial end user transactions that do not involve a CSE counterparty will be exempt from the Final Margin Requirements.

The extent of compliance is modeled on a risk-based approach, where compliance obligations are determined in large part by notional exposures of both the CSE and its counterparty. As a result, IM and VM requirements will vary based on a CSE's activities with a particular counterparty.

A. Initial Margin

1. Application of IM Requirements

CSEs are subject to a two-way IM requirement, requiring CSEs both to collect and post IM, with the notable exception of CSE inter-affiliate transactions as discussed above.[61] This two-way IM requirement applies not only to transactions between CSEs and an SD or MSP, but also between CSEs

and financial end users with material swaps exposure. A financial end user has a material swaps exposure when it, including its affiliates, has an aggregate gross notional exposure in uncleared swaps and excluded foreign exchange transactions that exceeds $8 billion.[62] Appendix A to this Alert provides more information on exposures that are excluded from the calculation of material swaps exposure.

CSE transactions with financial end users without material swaps exposure and other entities, including non-financial end users, are generally exempt from IM requirements under the Final Margin Requirements. For CSEs subject to the PR Final Rule, however, there is an additional requirement that CSEs examine the credit risk of such transactions. Under this requirement, the CSE is directed to collect IM "in such amounts (if any), that the [CSE] determines appropriately addresses the credit risk posed by the counterparty and the risks of" the swap.[63] CSEs subject to the CFTC Final Rule are not subject to a similar requirement.

2. IM Threshold Requirements

Should a CSE transact with a counterparty for which IM is required under the Final Margin Requirements, the CSE must then consider whether the uncleared swap or parties' exposures exceed the requisite threshold values. The Final Margin Requirements do not require CSEs to collect and post IM in instances where the aggregate exposures between affiliates and counterparties do not exceed an exposure threshold or where the swap's minimum transfer amount is below the value threshold. Market participants that have engaged in credit support documentation for their uncleared derivatives will be familiar with these threshold amount and minimum transfer amount concepts.

1. *IM Exposure Threshold*: CSEs are not required to collect or post IM from or to CSE or financial end user counterparties when the aggregate unmargined exposure of each counterparty is less than $50 million.[64] The CFTC and Prudential Regulators, however, expect CSEs to "make their own internal credit assessments when making determinations as to the credit and other risks presented by their specific counterparties."[65] This will require a CSE to calculate, on a consolidated basis, the non-exempted uncleared swaps between the CSE and its affiliates and also calculate the threshold across all non-exempted uncleared swaps between the counterparty and its affiliates. As a result, CSEs and their counterparties cannot reduce their IM obligations by creating separate legal entities and netting sets that have no economic basis. For more information on what is exempt from the threshold calculation, please see Appendix A.

2. *Minimum Transfer Amount*: CSEs are exempt from IM requirements when the combined IM and VM transfer amount of the swap does not exceed $500,000, regardless of whether the aggregate exposures meet the $50 million threshold.[66] This threshold, however, only affects the timing of collection, and does not change the amount of margin that must be collected once the $500,000 threshold is crossed. For example, if the amount of IM due from a counterparty increased from $400,000 to $900,000, the CSE would be required to collect the entire $900,000.

3. IM Calculation

IM requirements for CSEs' uncleared swaps transactions must be calculated using either an approved internal model or a standardized table-based method.[67] CSEs are not required to adopt only one model, but may instead adopt a mix of internal models and standardized approaches in calculating IM for various counterparties; however, to avoid cherry-picking, the CFTC and Prudential Regulators "expect[] CSEs to provide a rationale for changing methodologies" if requested.[68]

Approval of internal models, however, varies slightly between the CFTC Final Rule and PR Final Rule. Under the CFTC Final Rule, prior to implementation, all internal models must be approved by a registered futures association (RFA) or the CFTC.[69] This approach differs from the Prudential Regulators in that the CFTC, in recognition of the "number . . . and complexity of the models," has allowed for third-party verification, rather than relying purely on governmental resources.[70] To combat CFTC shortcomings, RFAs are required to establish minimum standards of approval *at least as stringent as* those imposed by the CFTC.[71] Currently, the National Futures Association is the only RFA.

Generally, an internal model must calculate IM based on the aggregate of five broad risk categories (*i.e.*, asset classes): commodities, credit, equity, foreign exchange and interest rates.[72] Approval of an internal model requires that the model satisfy the following basic conditions:

1. *10-Day Closeout*. The model must calculate IM based on the assumption of a "holding period" of 10 business days with a one-tailed 99% confidence interval.[73]

2. *Portfolio Offsets*. IM models may reflect offsetting exposures, diversification, and other hedging benefits for uncleared swaps governed by the same eligible master netting agreement (EMNA), so long as the model incorporates empirical correlations within the risk categories and the CSE validates and can demonstrate its reasonableness. This may only be used for four broad risk categories: credit, equity, foreign exchange, and interest rates. Commodities are also included when calculating IM for a specific counterparty when executed under the same EMNA.[74]

3. *Data Quality*. Data used to calibrate IM models must be based on equally weighted historical observation periods of 1-5 years. Additionally, the model must incorporate a period of "significant financial stress for each broad asset class" appropriate to the unclear swap.[75]

4. *Risk Factors*. IM models must measure all material price risks inherent in uncleared swaps. Models must include, at a minimum foreign exchange risk, interest rate risk, credit risk, equity risk, and commodity risk, as necessary and appropriate. In instances where there are material currency exposures, models must capture spread and basis risk in a manner sufficient to capture its volatility.[76] It is the sum of these risk categories that will dictate the aggregate amount of IM to be collected from a counterparty.[77]

5. *Stress Calibration and Non-Linear Price Characteristics*. Except for cross-currency swaps,[78] the model must "capture all of the material risks that affect the uncleared swap

including material non-linear price characteristics of the swap."[79] For example, the calculation of IM for a credit-default swap must account for material non-linearities that stem from changes in the price of the underlying asset or its volatility.

6. *Calculation Frequency*. Margin must be calculated and adjusted on a daily basis. Data used to calibrate IM must be reviewed and revised on at least an annual basis.[80]

7. *Benchmarking*. Models must be periodically benchmarked against comparable and observable margin standards to ensure that IM is not less than what a central clearing party would require for similar transactions.[81]

CSEs may also elect to calculate IM using a standardized table that specifies the minimum IM amount that must be collected and posted as a percentage of an uncleared swap's notional amount.[82] The Final Margin Requirements adopt a standardized approach for calculating IM;[83] however, it was noted that this standardized table could change depending on certain capital rules relating to counterparty credit risk exposurs.[84]

Standardized Margin Table	
Asset Class	**Gross IM (% of notional exposure)**
Credit	
a. 0-2 year duration	2
b. 2-5 year duration	5
c. 5+ year duration	10
Cross-Currency Swaps	
a. 0-2 year duration	1
b. 2-5 year duration	2
c. 5+ year duration	4
Interest Rate	
a. 0-2 year duration	1
b. 2-5 year duration	2
c. 5+ year duration	4
Commodity	15
Equity	15
Foreign Exchange/Currency	6
Other	15

In light of the lack of asset class granularity of the Final Margin Requirements, CSEs are allowed to develop standardized margin schedules with greater granularity provided that the resulting amounts of IM in all circumstances will be at least as large as those required by the standardized table.[85]

4. Forms of Eligible IM

The Final Margin Requirements limit collateral that CSEs may collect or post to satisfy their IM requirements.[86] The Final Margin Requirements define which types of collateral are permissible for purposes of collecting and posting IM, so a CSE and its counterparties should be cognizant of the types of eligible collateral, which includes assets described in the table below. CSEs, however, may not collect or post as IM any asset that is a security issued by:

- the CSE or its affiliates;
- banking institutions with average total consolidated assets greater than $10 billion (*i.e.*, institutions subject to compliance with 12 C.F.R. § 252.153) or their affiliates;[87] or
- other nonbank financial institutions supervised by the Federal Reserve System.[88]

IM assets are not treated equally under the Final Margin Requirements and are subject to a standardized haircut based on asset class.[89]

Standardized IM Haircuts	
Asset	**Haircut (%)**
Cash in same currency as swap obligation	0
Eligible government and related debt (*e.g.*, central bank, multilateral development bank, eligible GSE securities) with residual maturity:	
a. less than one-year	0.5
b. between one and five years	2.0
c. greater than five years	4.0
Eligible corporate debt (including eligible GSE debt securities with residual maturity:	
a. less than one-year	1.0
b. between one and five years	4.0
c. greater than five years	8.0

Standardized IM Haircuts	
Asset	**Haircut (%)**
Equities included in S&P 500 or related index	15.0
Equities included in the S&P 1500 Composite or related index but not the S&P 500 or related index	25.0
Gold	15.0
Additional haircut on asset in which the currency of the swap obligation differs from that of the collateral asset	8.0

5. IM Timing of Payment/Collection

Regardless of the counterparty, CSEs have a daily obligation to calculate, collect and post IM beginning on the end of the business day after execution for each swap with that counterparty until the swap terminates or expires.[90] A departure from standard market practice to calculate IM on a monthly basis, the Final Margin Requirements impose a daily calculation requirement, "as any further timing delay will result in an increased margin period of risk."[91] In practice, as the CSE and counterparty enter into new swaps, the CSE will typically add these swaps to an existing portfolio which will incorporate the new swaps into the CSE's calculation of posted and collected IM on a daily cycle.

IM obligations are required to be determined, subject to the following accommodations:

- in instances where counterparties are located across time zones, the day of execution is the later of the two calendar days in which the swap is executed;
- swaps entered into between 4:00 PM and midnight for any counterparty will be treated as having been entered into on the following business day;
- swaps entered into on non-business days of both parties will be treated as having been entered into on the immediately following business day.[92]

6. Custodial Arrangements for IM

Generally, IM collateral posted and collected under the Final Margin Requirements must be held by one or more custodians, not by the CSE or the counterparty, nor their affiliates.[93] This measure is directed at reducing the risk of collateral reallocation, and thus, as part of the custodial relationship, the CSE must ensure that the segregated collateral cannot be rehypothecated, repledged, reused, substituted or otherwise transferred. In instances where cash collateral is posted or collected, the Final Margin Requirements allow for the purchase of other eligible non-cash collateral with cash collateral, so long as the new collateral is segregated and sufficient to meet IM requirements (including haircuts).[94]

CSEs, however, may act as custodians for foreign inter-affiliate transactions. The PR Final Rule restricts CSE inter-affiliate custodial arrangements to non-cash collateral[95]; whereas the CFTC Final Rule allows the CSE to act as a custodian for all qualifying collateral used in foreign inter-affiliate transactions.[96]

B. Variation Margin

Unlike the nuances and exceptions prevalent in the IM requirements, VM requirements under the Final Margin Requirements are fairly uniform, generally applying to all uncleared swaps between applicable counterparties.

1. Application

CSEs will be required to collect and post VM for each counterparty that is an SD or MSP or financial end user, including inter-affiliate transactions. Unlike the IM requirements, VM must be collected and posted for all financial end user transactions, regardless of whether there is a material swaps exposure.[97] Like the IM requirements, however, CSEs are exempt from VM requirements when the combined IM and VM transfer amount of the swap does not exceed $500,000.[98]

2. VM Timing of Collection/Posting

VM collection and posting timing requirements are identical to IM requirements and must be calculated and exchanged on a daily basis.[99]

3. VM Calculation

Each CSE is required to calculate VM for itself and each counterparty to the "maximum extent practicable."[100]

The PR Final Rule provides more flexibility, requiring that VM arrangements generally define contractual rights, specifically including provisions for VM methodologies and dispute resolutions.[101] Moreover, calculation requirements under the PR Final Rules parallels the ISDA Master Agreement's definition of "Market Quotation"[102]--which is intended to provide for calculations at one party's side of the market--requiring that CSE must calculate VM as an amount that is at least equal to the increase or decrease (as applicable) in the value to the CSE of the relevant swaps since the previous exchange of VM.[103]

The CFTC Final Rule instructs CSEs to document and calculate VM in accordance with existing 17 C.F.R. § 23.504(b)(4), which requires VM arrangements to account for recently executed transactions, valuations provided by independent third parties, and other objective criteria; however, it provides little guidance as to whether swaps are to be valued at one party's side of the market or, in accordance with typical practice in the uncleared market. Instead, CSEs are required to "create and maintain" documentation of their VM methodology that will allow the CFTC or Prudential Regulator to calculate a "reasonable approximation" of the margin requirement independently.[104] Similar to IM

verification requirements, and to ensure accuracy and compliance with the CFTC Final Rule, CSEs will be required to evaluate their VM data and methodologies on at least an annual basis.[105]

4. Forms of VM

Forms of VM are more restrictive than IM requirements for transactions between CSEs and SDs or MSPs; however, the eligible collateral is the same as the IM requirements for transactions between CSEs and financial end users.

CSE to SD or MSP transactions must post and collect VM in U.S. dollars, major currencies,[106] or the currency of settlement.[107]

Initially, CFTC and Prudential Regulators proposed that all CSE to financial end user transactions post and collect VM only in U.S. dollars or a currency in which obligations under the swap are required to be settled. The Final Margin Requirements expand the list of eligible collateral for transactions between CSEs and financial end users from the proposals (regardless of whether there is a material exposure) to all permissible forms of collateral allowed under IM requirements. Permissible collateral will remain subject to the same haircuts applicable to IM collateral.[108]

5. Custodial Arrangements for VM

Consistent with the PR Final Rule, the CFTC Final Rule does not impose any custodial arrangements for VM, nor does it subject such collateral to restrictions on rehypothecation or reuse.[109]

C. Netting

The Final Margin Requirements allow CSEs to calculate IM and VM on an aggregate net basis across uncleared swaps when they are executed pursuant to an EMNA.[110] The Final Margin Requirements define an EMNA as a written, legally enforceable agreement that, among other things:

1. creates a single legal obligation for all individual transactions covered by the agreement upon an event of default or stay; and

2. provides the CSE with the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default of the counterparty, subject to applicable law related to federal insolvency measures.[111]

Additional, CSEs relying on EMNAs are required to perform extensive diligence and institute compliance measures, including:

1. confirming that the EMNA does not contain a walkaway clause that would allow a non-defaulting counterparty to lower or excuse its payment obligations to a defaulting party;

2. confirming that the EMNA has been subject to a legal review and can conclude that it satisfies the Final Margin Requirements and that "in the event of a legal challenge [including a federal insolvency-related proceeding], would be ruled to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions"; and

3. establishing and maintaining written procedures to monitor the EMNA's compliance with applicable laws.[112]

Limitations to this provision prohibit IM and VM from being netted against each other. In addition, IM netting may only be used for the purposes of calculating the collection or post amount under an approved internal model.[113]

IV. Implementation

Consistent with the recent announcement of implementation delays of the proposal of BCBS and the International Organization of Securities Commission (IOSCO),[114] IM requirements will phase-in from September 1, 2016 through September 1, 2020, with compliance dates largely dependent on aggregate notional amounts of outstanding covered swaps. For more information on what is exempt from the phase-in threshold calculation, please see Appendix A to this Alert. The following table sets forth the compliance schedule for IM requirements:

IM Implementation	
Compliance Date	**IM Requirements**
	IM is required where both the CSE combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount of covered swaps and excluded foreign exchange transactions for March, April and May of the phase-in year that exceeds:
September 1, 2016	$3 trillion.
September 1, 2017	$2.25 trillion.
September 1, 2018	$1.5 trillion.
September 1, 2019	$750 billion.
September 1, 2020	IM is required for any other CSE with respect to covered swaps with any other counterparty.

VM requirements will have a two-tier phase-in schedule, with the largest participants with aggregate notional averages over $3 trillion having a compliance date of September 1, 2016 and remaining market participants subject to a March 1, 2017 compliance date. The following table sets forth the compliance schedule for VM requirements:

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

V. Cross-Border Implications

In October 2015, the Prudential Regulators unanimously approved the PR Final Rule, including rules on its cross-border application. Two months later, in December 2015, the CFTC approved its final rule, without rules or guidance on cross-border application of its margin requirements. The CFTC released its CFTC Cross-Border Margin Proposal on the cross-border application of its margin requirements in July 2015[115] and it is expected to finalize those rules sometime this year.[116]

The PR Final Rule does not apply to certain foreign uncleared swaps or foreign uncleared security-based swaps that are entered into by a foreign CSE. A foreign CSE includes any CSE that is not:

- An entity organized under the laws of the U.S. or any U.S. state, including a branch, agency or subsidiary of a foreign bank;
- A branch or office of an entity organized under the laws of the U.S. or any U.S. state; or
- An entity that is a subsidiary of an entity that is organized under the laws of the U.S.[117]

A foreign uncleared swap or foreign uncleared security-based swap is a swap in which neither counterparty to the foreign CSE nor any party that guarantees the uncleared swap is:

- 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 U.S. resident;
- A branch or office of an entity organized under the laws of the U.S. or any U.S. state; or
- An entity that is a subsidiary of an entity that is organized under the laws of the U.S. or any U.S. state.[118]

The PR Final Rule also permits certain CSEs to comply with a foreign regulatory framework for uncleared swaps, instead of complying with the PR Final Rule, if the Prudential Regulators grant substituted compliance.[119] The Prudential Regulators have not made any substituted compliance determinations to date, and it is expected that such determinations would be nuanced based on the

particular rules of a jurisdiction. Notably, the PR Final Rule does not apply segregation requirements to foreign branches of CSEs and foreign CSEs where:

- Inherent limitations in the legal or operational infrastructure of the foreign jurisdiction make it impracticable for the CSE and the counterparty to post any form of eligible IM;
- The CSE is subject to foreign regulatory restrictions that require the CSE to transact in the uncleared swap through an establishment within the foreign jurisdiction and do not accommodate the posting of collateral for uncleared swaps outside the jurisdiction;
- The counterparty to the uncleared swap is not guaranteed by, and the counterparty's obligations under the uncleared swap do not have a guarantee from, certain U.S.-based entities;
- The CSE collects IM for the uncleared swap in accordance with the PR Final Rule in the form of cash and posts VM in accordance with the PR Final Rule in the form of cash; and
- The relevant Prudential Regulator of the CSE provides the CSE with prior written approval for the CSE's reliance on this exception from the segregation requirements.[120]

The CFTC Cross-Border Margin Proposal, if finalized, would adopt a hybrid of the entity-level and transaction-level approaches taken by the Prudential Regulators. Under the CFTC Cross-Border Margin Proposal, transactions between foreign CSEs and non-U.S. persons not guaranteed by a U.S. entity would not be subject to be subject to the CFTC Final Rule in most circumstances; however, it would change the CFTC's Cross-Border Guidance by applying margin requirements even when there is no U.S. guarantee if the U.S. parent has a controlling financial interest and includes the financial results and positions of the CSE on its consolidated financial statements.[121] This new category of "foreign consolidated subsidiaries" is effectively treated as U.S. persons in many contexts and has been described as an attempt to address de-guaranteeing concerns.[122] Further, under the CFTC Cross-Border Margin Proposal, foreign CSEs that are guaranteed by U.S. persons are not eligible for substituted compliance, while swaps executed through a U.S. branch of a foreign CSE are subject to the CFTC Margin Rule with substituted compliance available. The CFTC's path to substituted compliance, as proposed, is rather complex and actually bifurcates the ability to benefit from substituted compliance based on which counterparty is collecting and which is posting IM.

It is expected that the CFTC's final rule relating to cross-border margin will resemble the CFTC Cross-Border Margin Proposal and be closer to the cross-border language in the PR Final Rule and will diverge from the transaction-level approach set forth in the CFTC's Cross-Border Guidance.[123]

VI. Conclusion

The Final Margin Requirements will lead to a significant shift in the way that market participants engage in uncleared swaps. As margin requirements on uncleared swaps become effective, costs for entering into uncleared swaps will likely increase significantly for market participants. Further, the uncleared swaps subject to margin requirements compared to cleared swaps or futures will be much more expensive (as the margin calculation for uncleared swaps is based off of a longer liquidation

timeframe than for cleared swaps or futures). These increased costs will likely lead to fewer counterparties, which can lead to a significant decrease in liquidity. Accordingly, margin requirements on uncleared swaps could have a substantial impact on the trading strategies, structure, operational and trading costs and counterparty selection.

Appendix A: Swaps and security-based swaps excluded from threshold calculations

		CFTC End-User Exemption [124]	CFTC Treasury Affiliate Exemption [125]	Exempt by CFTC Rule or Order[126]	SEC End-User Exception [127]	SEC Treasury Affiliate Exception [128]
Material Swaps Exposure ($8 billion)	CFTC Final Rule	✔	✔	✔	✔	✔
	PR Final Rule	✔	✔	✔	✔	✔
IM Exposure Threshold ($50 million)	CFTC Final Rule	✔	✔	✔		
	PR Final Rule	✔	✔	✔	✔	✔
Inter-affiliate IM Exposure Threshold ($20 million)	CFTC Final Rule	N/A	N/A	N/A	N/A	N/A
	PR Final Rule	✔	✔	✔	✔	✔
Compliance Phase-in Threshold	CFTC Final Rule	✔	✔	✔	✔	
	PR Final Rule	✔	✔	✔	✔	✔

[1] Final Rule, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 6, 2016).

[2] Final Rule, *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74840 (Nov. 30, 2015).

[3] *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Public Law 111-203, 124 Stat. 1376 (2010).

[4] The PR Final Rule applies not only to uncleared swaps, but also to uncleared security-based swaps executed by security-based swap dealers and major security-based swap participants under the Prudential Regulators' jurisdiction. Because the Securities and Exchange Commission (SEC) has not yet finalized its rules requiring registration of security-based swap dealers and major security-based swap participants, the PR Final Rule is not currently applicable in the security-based swap context. Further, the SEC has not yet finalized its rules relating to margin requirements on uncleared security-based swaps over which it has jurisdiction.

[5] Proposed Rule, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants--Cross-Border Application of the Margin Requirements*, 80 Fed. Reg. 41376 (July 15, 2015) (CFTC Cross-Border Margin Proposal).

[6] *See* Interim Final Rule and Request for Comment, *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74916 (Nov. 30, 2015) (CFTC Interim Final Rule); Interim Final Rule and Request for Comment, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 6, 2016) (PR Interim Final Rule, together with the CFTC Interim Final Rule, the Interim Final Rules).

[7] 17 C.F.R. § 23.151(2016). The CFTC may exempt a DCO from registration for the clearing of swaps, where the DCO is subject to "comparable, comprehensive supervision and regulation" by the appropriate government authorities in its home country. CEA Section 5b(h).

[8] 17 C.F.R. § 23.151. When the SEC finalizes its requirements for the registration of security-based swap dealers and major security-based swap participants, the PR Final Rule will also become applicable to SBSDs and MSBSPs subject to the jurisdiction of the Prudential Regulators.

[9] Pursuant to CEA Sections 1a(47)(E) and 1(b) the Secretary of the Treasury made a determination to exempt foreign exchange swaps and foreign exchange forwards from certain swap requirements, including margin requirements for uncleared swaps. *See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act*, 77 Fed. Reg. 69694 (Nov. 20, 2012).

[10] 17 C.F.R. § 23.154(b)(2)(iv); 12 C.F.R. § 237.8(d).

[11] 17 C.F.R. § 23.151; 12 C.F.R. § 237.2.

[12] *Id.*

[13] CFTC Final Rule at 640; PR Final Rule at 74853.

[14] "Pursuant to Regulation YY, a foreign banking organization with U.S. non-branch assets of $50 billion or more must establish a U.S. IHC and transfer its ownership interest in the majority of its U.S. subsidiaries to the IHC by July 1, 2016. As not all IHCs will be bank holding companies, the Commission is explicitly identifying IHCs in the list of financial end users to clarify that they are included." CFTC Final Rule at 641.

[15] "Foreign bank means an organization that is organized under the laws of a foreign country and that engages directly in the business of banking outside the United States." 17 C.F.R. § 23.151; 12 C.F.R. § 237.2.

[16] As defined under 12 U.S.C. § 1841(c)(2)(D) (2016).

[17] Or other similar institutions defined under 12 U.S.C. § 1841(c)(2)(H).

[18] This includes an entity that is: a finance company; money or installment lender; consumer lender or lending company; mortgage lender, broker or bank; motor vehicle title pledge lender; payday or deferred deposit lender; or a premium finance company.

[19] This includes an entity that is a check casher, money transmitter, currency dealer or exchange, or money order or traveler's check issuer.

[20] 12 U.S.C. § 4502(20).

[21] 17 C.F.R. § 23.151; 12 C.F.R. § 237.2.

[22] This term only includes central governments (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 for purposes of this exclusion. PR Final Rule at 74855. An entity "guaranteed by a sovereign entity is not explicitly excluded from the definition of financial end user … unless that entity qualifies as a central government agency, department, or central bank" and the existence of a "government guarantee" does not in and of itself exclude the entity from such definition. PR Final Rule at 74856. A State entity may be classified as a financial end user, subject to meeting one of the enumerated factors listed above. For example, the CFTC and Prudential Regulators Final Rules both note that "a State entity that is a 'governmental plan' under ERISA would meet the definition of financial end user." CFTC Final Rule at 643.

[23] Excluded from the definition of financial entity under CEA Section 2(h)(7)(C)(iii), captive finance companies are defined as "entit[ies] whose primary business is providing financing, and [that] use[] 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, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company." 7 U.S.C. § 2(h)(7)(C)(iii).

[24] 17 C.F.R. § 23.151; 12 C.F.R. § 237.2. Under CEA Section 2(h)(7)(D), "an affiliate of a person that qualifies for an exception under subparagraph (A) (including affiliate entities predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person) may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity."

[25] 17 C.F.R. § 23.151(2)(vi). This provision was drafted and finalized prior to the passage of H.R. 2029, an omnibus appropriations package, which amended and clarified CEA Section 2(h)(7)(D) to allow for centralized treasury units (CTU) to take advantage of the clearing exception. As a result of H.R. 2029, the Final Margin Requirements would exempt swaps that qualify for the exception under CEA Section 2(h)(7)(D) from such margin requirements. The PR Final Rule does not contain an explicit treasury affiliate provision the way the CFTC Final Rule does; however, the PR Final Rule noted that "to the extent the CFTC acts to exempt such entities from clearing by rule, these entities would also be excluded from the definition of financial end user for purposes of [the PR Final Rule]." PR Final Rule at 74856. As both the PR Final Rule and the CFTC Final Rule provide an exemption for affiliates that qualify pursuant to CEA Section 2(h)(7)(D), qualification under this section of the statute would also exempt such uncleared swaps from margin requirements.

[26] 17 C.F.R. § 23.151.

[27] 12 C.F.R. § 237.3(d) and 12 C.F.R. § 237.4(c).

[28] *See* Interim Final Rules, *supra*, fn. 6.

[29] CFTC Interim Final Rule at 678; PR Interim Final Rule at 74919.

[30] To qualify for the exemption, the CSE must not transact with small banks and savings associations, Farm Credit System Institutions, or credit unions with total assets exceeding $10,000,000,000. 7 U.S.C § 2(h)(7)(C)(ii).

[31] *See* 7 U.S.C. § 6(c)(1);17 C.F.R. § 50.51.

[32] 17 C.F.R. § 23.151; 12 C.F.R. § 237.2.

[33] *See* Section 705, H.R. 2029, Consolidated Appropriations Act, 2016.

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

[35] 17 C.F.R. § 23.161(b); 12 C.F.R. § 237.1(f).

[36] 17 C.F.R. § 23.161(c); 12 C.F.R. § 237.1(g).

[37] CFTC Final Rule, Statement of Chairman Massad, Appx. 2, at 705.

[38] One independent study, and consistent with CFTC supported findings, concluded that inter-affiliate swaps transactions posed an "excessively onerous" impact on the market without reducing systemic risk. *See Cost-Benefit Analysis of the CFTC's Proposed Margin Requirements for Uncleared Swaps*, NERA Economic Consulting (Dec. 2, 2014), *available at* http://www.nera.com/content/dam/nera/publications/2014/NERA_Margin_Requirements_Uncleared_Swaps.pdf.

[39] 12 C.F.R. § 237.2.

[40] CFTC Final Rule at 647.

[41] For example, if an SD transacts with a mutual fund managed by an affiliate, but is not consolidated, the swap would not be afforded an inter-affiliate exemption and would need to comply with the Final Margin Requirements.

[42] 17 C.F.R. § 23.159(a).

[43] 12 C.F.R. § 237.11(a).

[44] CFTC Final Rule at 674 *citing* (BCBS, *Margin requirements for non-centrally cleared derivatives*, Bank of International Settlements, 21 (Mar. 2015), *available at* http://www.bis.org/banking/index.htm.

[45] 17 C.F.R. § 23.159(a).

[46] 12 C.F.R. § 237.11(a).

[47] 12 C.F.R. § 237.11(a)(2). For more information on material swaps exposure, please see Section III.A below.

[48] 12 C.F.R. § 237.11(b)(2). As noted by Chairman Massad, "[t]his is similar to what federal law already requires, as Section 23A and 23B of the Federal Reserve Act impose requirements on inter-affiliate transactions by insured depository institutions." CFTC Final Rule, Statement of Chairman Massad, Appx. 2, at 706.

[49] 12 C.F.R. § 237.11(b)(2). For more information regarding the calculation of the Inter-affiliate IM Exposure Threshold, please see Appendix A.

[50] 17 C.F.R. § 23.159(a)(2)(i).

[51] 17 C.F.R. § 23.159(b).

[52] 12 C.F.R. § 237.11(c).

[53] *Compare* 12 C.F.R. § 237.11(c) *with* 12 C.F.R. § 237.4(a). Section 237.4(c) requires VM to be exchanged with "other counterparties"; however, this is a discretionary requirement based on the CSE's own determination of the credit risk posed.

[54] CFTC Final Rule at 674. The CFTC Final Rule provides the following hypothetical: A foreign affiliate of a CSE enters into a swap with a financial end user and does not collect IM because the foreign jurisdiction does not require IM – this risk would effectively be transferred to the CSE if the foreign affiliate then enters into a swap with the CSE.

[55] *Id.*

[56] 17 C.F.R. § 23.159(c)(2).

[57] CFTC Final Rule at 674.

[58] In these instances, either the PR Final Rule or foreign margin requirements will apply.

[59] *Cf.* 12 C.F.R. § 237.9(c)(3) (The PR Final Rule generally exempts foreign uncleared swaps of foreign parties, but excludes, among others, transactions with foreign subsidiaries of a U.S. entity).

[60] Compare "affiliate" and "subsidiary" definitions under 12 C.F.R. § 237.2.

[61] 17 C.F.R. § 23.152; 12 C.F.R. § 237.3.

[62] "Material swaps exposure" is defined as the average daily aggregate notional amount of uncleared swaps of the entity and its margin affiliates consisting of "uncleared 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 $8 billion, where such amount is calculated only for business days." 17 C.F.R. § 23.151; 12 C.F.R. § 237.2.

[63] 12 C.F.R. § 237.3(d) and § 237.4(c).

[64] 17 C.F.R. § 23.151; 12 C.F.R. § 237.2.

[65] CFTC Final Rule at 653; PR Final Rule at 74864.

[66] 17 C.F.R. § 23.152(b)(3); 12 C.F.R. § 237.5(b).

[67] 17 C.F.R. § 23.154(a); 12 C.F.R. § 237.8(a) and (b).

[68] CFTC Final Rule at 652; PR Final Rule at 74882.

[69] 17 C.F.R. § 23.154(b).

[70] 12 C.F.R. § 237.8(c).

[71] CFTC Final Rule at 654.

[72] *See* 17 C.F.R. § 23.154(b)(2)(vii); 12 C.F.R. § 237.8(d)(7).

[73] 17 C.F.R. § 23.154(b)(2)(i); 12 C.F.R. § 237.8(d)(1).

[74] 17 C.F.R. § 23.154(b)(2)(v) and (vi); 12 C.F.R. § 237.8(d)(5) and (6).

[75] 17 C.F.R. § 23.154(b)(2)(ii); 12 C.F.R. § 237.8(d)(2).

[76] 17 C.F.R. § 23.154(b)(2)(iii); 12 C.F.R. § 237.8(d)(3).

[77] 17 C.F.R. § 23.154(b)(2)(vii); 12 C.F.R. § 237.8(d)(7).

[78] Cross-currency swaps, however, will not need to recognize risk associated with the foreign transaction side of a fixed exchange of principal embedded in a cross-currency swap; however, the model must still recognize risks associated with other payments and cash flows. CFTC Final Rule at 653, fn. 159; PR Final Rule at 74880.

[79] CFTC Final Rule at 653; PR Final Rule at 74875-76; 17 C.F.R. § 23.154(b)(2)(ix); 12 C.F.R. § 237.8(d)(9).

[80] 17 C.F.R. § 23.154(b)(2)(xiii); 12 C.F.R. § 237.8(d)(13).

[81] 17 C.F.R. § 23.154(b)(5)(ii)(B); 12 C.F.R. § 237.8(f)(2)(ii).

[82] 17 C.F.R. § 23.154(a)(ii).

[83] *See* 17 C.F.R. § 23.154(c).

[84] CFTC Final Rule at 662; PR Final Rule at 74881.

[85] CFTC Final Rule at 662; PR Final Rule at 74881.

[86] 17 C.F.R. § 23.156(a)(1).

[87] Entities include "a bank holding company, a savings and loan holding company, a U.S. intermediate holding company established or designated for purposes of compliance with 12 C.F.R. § 252.153, a foreign bank, a depository institution, a market intermediary, a company that would be any of the foregoing if it were organized under the laws of the United States or any State, or a margin affiliate of any of the foregoing institutions." 17 C.F.R. § 23.156(a)(2)(ii); 12 C.F.R. § 237.6(d).

[88] 17 C.F.R. § 23.156(a)(2); 12 C.F.R. § 237.6(d).

[89] 17 C.F.R. § 23.156(a)(3)(B); 12 C.F.R. § 237.6(c)(1).

[90] 17 C.F.R. § 23.1532(b); 12 C.F.R. § 237.3(c).

[91] CFTC Final Rule at 650; *see also* PR Final Rule at 74880.

[92] *See* 17 C.F.R. § 23.151 definition of "Day of execution."

[93] 17 C.F.R. § 23.157; 12 C.F.R. § 237.7(a).

[94] 17 C.F.R. § 23.157(c)(2); 12 C.F.R. § 237.7(c).

[95] 12 C.F.R. § 237.11(d).

[96] 17 C.F.R. § 23.159(c)(3).

[97] *See* 17 C.F.R. § 23.153(a); 12 C.F.R. § 237.4(a).

[98] 17 C.F.R. § 23.152(b)(3); 12 C.F.R. § 237.5(b).

[99] 17 C.F.R. § 23.153; 12 C.F.R. § 237.4.

[100] *See* 7 U.S.C. § 6s(e)(2)(B); 15 U.S.C. § 78o–10(e)(2)(B).

[101] 12 C.F.R. § 237.10.

[102] *See* ISDA Master Agreement, Section 14 definition of "Market Quotation."

[103] 12 C.F.R. § 237.2.

[104] *See* CFTC Final Rule at 663; 17 C.F.R. § 23.155(b)(3)(i).

[105] 17 C.F.R. § 23.155(b)(2).

[106] The Final Margin Requirements defines the following as a "major currency": United States 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 a Prudential Regulator or the CFTC. 17 C.F.R. § 23.151; 12 C.F.R. § 237.2.

[107] 17 C.F.R. § 23.156(b)(1)(i).

[108] 17 C.F.R. § 23.156(b)(2)(ii); 12 C.F.R. § 237.5(a).

[109] *See* 17 C.F.R. § 23.157; 12 C.F.R. § 237.7(a).

[110] 17 C.F.R. § 23.152(c) and § 23.153(d); 12 C.F.R. § 237.5(a)(2).

[111] 17 C.F.R. § 23.151; 12 C.F.R. § 237.2.

[112] *Id.*

[113] *See* CFTC Final Release at 651, fn 136; PR Final Rule at 74869, fn. 153. These limitations will only apply to portfolios of swaps entered into after the compliance date.

[114] BCBS, *Margin requirements for non-centrally cleared derivatives*, Bank of International Settlements (Mar. 2015), *available at* http://www.bis.org/banking/index.htm.

[115] *See* CFTC Final Rule, Statement of Chairman Massad, Appx. 2, at 705 ("I hope that we can finalize that part of the rule early next year").

[116] *See* CFTC Cross-Border Margin Proposal, *supra*, fn. 5.

[117] 12 C.F.R. § 237.9(c).

[118] 12 C.F.R. § 237.9(b).

[119] 12 C.F.R. § 237.9(d). To rely on substituted compliance, the CSE (1) must not have a guarantee of its obligations from a natural person who is a resident of the United States or an entity organized under the laws of the United States or U.S. state (other than a U.S. branch or agency of a foreign bank) and (2) must be either a foreign CSE, a U.S. branch or agency of a foreign bank, or another specified foreign entity. 12 C.F.R. § 237.9(d)(3).

[120] 12 C.F.R. § 237.9(f).

[121] *See* CFTC Cross-Border Margin Proposal at 41402-03; Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013) (CFTC's Cross-Border Guidance).

[122] *See* CFTC Cross-Border Margin Proposal at 41385-86.

[123] The CFTC noted that the CFTC Final Rule and the finalization of the CFTC Cross-Border Margin Proposal are intended to further promote global harmonization of margin rules." *See* CFTC Final Rule at 662, fn. 357.

[124] 7 U.S.C § 2(h)(7)(A).

[125] 7 U.S.C. § 2(h)(7)(D).

[126] 7 U.S.C. § 6(c)(1); 17 C.F.R. § 50.51.

[127] SBS clearing exemption for a counterparty that is not a financial entity, using the SBS to hedge or mitigate risk, and notifies the SEC how the entity meets certain financial obligations. *See* 15 U.S.C. 78–c3(g)(1).

[128] SBS clearing exemption for affiliates of a person that qualifies for an SEC clearing exemption when the affiliate is "acting on behalf of the person and as an agent, uses the security-based swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity." *See* 15 US.C. 78c–3(g)(4).

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