Client Update
CFTC Adopts Margin Rules for Non-Cleared Swaps

NEW YORK
Byungkwon Lim
blim@debevoise.com

Emilie T. Hsu
ehsu@debevoise.com

Peter Chen
pchen@debevoise.com

Aaron J. Levy
ajlevy@debevoise.com

On December 16, 2015, the Commodity Futures Trading Commission (the "CFTC") approved final rules (the "Final Rules") to establish margin requirements with respect to all non-cleared swaps (the "Covered Swaps") of registered swap dealers ("SDs") or major swap participants ("MSPs," together with SDs, the "Swap Entities") for which no U.S. federal banking agency is a prudential regulator.[1]

In October 2015, the U.S. federal banking agencies (collectively referred to as the "Banking Agencies") approved joint final rules (the "Banking Agencies Margin Rules") establishing minimum margin and capital requirements for SDs and MSPs whose prudential regulator is one of the Banking Agencies.[2]

When both the Final Rules and the Banking Agencies Margin Rules become effective, all swap activities of SDs and MSPs will be subject to regulatory margin requirements in the United States. Internationally, a framework of margin requirements has been issued in September 2013 by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, with the goal of establishing worldwide margin standard for uncleared derivatives. As indicated in Chairman Timothy Massad's statement on the adoption of the Final Rules, the CFTC intended the Final Rules to be "practically identical" to the Banking Agencies Margin Rules and

---

1 The prudential regulators are: the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), Federal Credit Administration (the "FCA"), Federal Deposit Insurance Corporation (the "FDIC"), Federal Housing Finance Agency (the "FHFA"), and Office of the Comptroller of the Currency (the "OCC").

2 For a discussion of the Banking Agencies Margin Rules, please refer to our client memorandum (the "Banking Agencies Rule Client Update"), "Bank Agencies Adopt Margin and Capital Rules for Non-Cleared Derivatives," dated November 2, 2015, *available at*: http://www.debevoise.com/insights/publications/2015/10/bank-agencies-adopt-margin-and-capital-rules.

"substantially similar to the international rules" on margin requirements for uncleared swaps.[3]

Together with the Final Rules, the CFTC also adopted interim final rules (the "Interim Margin Exemptions") to exempt from the margin requirements of the Final Rules certain Covered Swaps with nonfinancial end users and certain other counterparties that qualify for an exception or exemption from the clearing requirement for swaps in section 2(h)(1)(A) of the Commodity Exchange Act (the "CEA"). The comment period for the Interim Margin Exemptions will end on the 30th day after the day of the publication of the Interim Margin Exemptions in the Federal Register.

As of today, the Final Rules and the Interim Margin Exemptions have not yet been published in the Federal Register. Both the Final Rules and the Interim Margin Exemptions will become effective on April 1, 2016.[4]

As noted in the adopting release accompanying the Final Rules (the "Adopting Release"), the CFTC will address the cross-border application of the Final Rules in a separate rulemaking.

MARGIN REQUIREMENTS

Who Is Subject to the Final Rules?

The margin requirements in the Final Rules apply only to Covered Swaps entered into by Covered Swap Entities. A "Covered Swap Entity" is a Swap Entity for which none of the Banking Agencies is a prudential regulator; for example, nonbank SDs, nonbank subsidiary SDs of bank holding companies as well as certain foreign SDs and MSPs.

A Covered Swap Entity's counterparty to a Covered Swap is not directly subject to the margin requirements in the Final Rules if such counterparty is not itself a Covered Swap Entity. However, to the extent an entity enters into Covered Swaps with a Covered Swap Entity, it will be indirectly impacted by the margin requirements because the Covered Swap Entity will be required to collect margin from, and in certain situations, post margin to, its counterparty in the manner prescribed in the Final Rules.

---

[3] *Available at*: http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement121615d.

[4] The texts of the Final Rules and the Interim Margin Exemptions are *available at*: http://www.cftc.gov/PressRoom/PressReleases/pr7294-15.

Classification of Swap Counterparties

Generally

The Final Rules adopt the same approach as the Banking Agencies Margin Rules and divide a Covered Swap Entity's counterparties into the following four categories:

- Counterparties that are themselves Swap Entities;
- Counterparties that are financial end users with a material swaps exposure ("Material Financial End Users");
- Counterparties that are financial end users without a material swaps exposure ("Non-Material Financial End Users"); and
- Counterparties that are neither Swap Entities nor financial end users, including nonfinancial end users, sovereigns and multilateral development banks, to the extent their Covered Swaps do not qualify for an exemption under the Interim Margin Exemptions from the margin requirements in the Final Rules ("Other Counterparties").

Financial End Users and Eligible Treasury Affiliate

Under the Final Rules, a financial end user is an entity that is not a Swap Entity and is one of a number of enumerated types of entities,[5] including bank holding companies, savings and loan holding companies, depository institutions, foreign banks, federal and state credit unions, insurance companies, investment funds and nonbank financial institutions supervised by the Federal Reserve Board. The Final Rules also exclude certain enumerated entities (such as sovereign entities, multilateral development banks or the Bank for International Settlements) from the "financial end user" definition.

In addition, the Adopting Release specifically states that an eligible treasury affiliate that the CFTC has exempted from mandatory clearing requirement will be excluded from the definition of "financial end user," and that the CFTC will implement such exclusion either by rule or staff no-action letters. Further, we note that the Banking Agencies have stated in the release accompanying the adoption of the Banking Agencies Margin Rules that the Banking Agencies also exclude from their definition of "financial end user" an entity that the CFTC has exempted from clearing requirements. Therefore, a treasury affiliate, which is

[5] See Attachment 1 to this memorandum for a full list of the enumerated types of financial end users as well as a list of entities that are excluded from this category.

eligible for exemption from the clearing requirement, will not be treated as a 'financial end user' under either of the rules.

The Final Rules treat Material Financial End Users differently from Non-Material Financial End Users. A financial end user has a "material swaps exposure" if such entity and its affiliates have an average daily aggregate notional amount of Covered Swaps and foreign exchange forwards and swaps[6] 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. While the Final Rules impose margin requirements only on Covered Swaps (and not on foreign exchange forwards and swaps, which the Treasury Department has excluded from the definition of "swap"), the Final Rules provide that the determination of material swaps exposure must also include foreign exchange forwards and swaps. However, the calculation does not include a swap or security-based swap that is exempt pursuant to the Terrorism Risk Insurance Program Reauthorization Act of 2015 ("TRIPRA"), as such, swaps that are exempt from the Final Rules under the Interim Margin Exemptions will not be counted. Although the Final Rules do not explicitly provide how a Covered Swap Entity should determine whether its financial end user counterparty has a material swaps exposure, the CFTC believes that it would be reasonable for a Covered Swap Entity to rely in good faith on the reasonable representations of its counterparties as to their status.

A financial end user is required to count its Covered Swaps and foreign exchange forwards and swaps with all of its counterparties, including its affiliates. However, to avoid double-counting, the Final Rules clarify that inter-affiliate swaps should be counted only one time.

Additionally, an entity's designation as a Material Financial End User is not permanent; rather, the Final Rules permit an entity that is a Material Financial End User in one year (based on its swaps exposure in June, July and August of the prior year) to recalculate its swaps exposure in each successive year to determine whether its status has changed. Just like the Banking Agencies Margin Rules, if a Material Financial End User moves below the threshold for the current year and

---

[6] A "foreign exchange forward" and a "foreign exchange swap" refer to those foreign exchange products defined in Section 1a(24) and 1a(25), respectively, of the CEA, and which are those products that are excluded from the definition of "swap" by the determination of the Secretary of the Treasury. Please refer to our client memorandum, "Treasury Secretary Exempts Certain Foreign Exchange Swaps and Forwards from the Swap Definition," dated November 20, 2012, *available at*: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=2b8b2e69-ddd6-4731-8694-146012c12dc7.

ceases to be a Material Financial End User, the Covered Swap Entity is no longer obligated to exchange initial margin with that financial end user during that year and can return the initial margin previously collected. If a financial end user moves above the threshold for a particular year, only the new swaps entered into after its change of status to a Material Financial End User are subject to the additional margin requirements specific to Material Financial End Users.

Compliance Dates and Eligible Master Netting Agreements

Compliance Dates

As we describe in more detail at the end of this memorandum, the Final Rules set forth a number of different compliance dates by which Covered Swap Entities would be required to begin complying with the margin requirements. The compliance dates are the same as those set forth in the Banking Agencies Margin Rules.

Eligible Master Netting Agreement

The definition of "eligible master netting agreement" (an "EMNA") in the Final Rules is the same as the definition used in the Banking Agencies Margin Rules.

Similar to the Banking Agencies Margin Rules, the Final Rules also permit the establishment of separate netting portfolios for purposes of the rules (if each netting portfolio independently meets the requirement for close-out netting),[7] under a single EMNA, such that a Covered Swap Entity may avoid subjecting its pre-compliance date Covered Swaps to the margin requirements while still maintaining both its pre- and post-compliance date Covered Swaps under a single EMNA. A netting portfolio that contains only post-compliance date Covered Swaps will be subject to the margin requirements of the Final Rules, while a netting portfolio that contains only pre-compliance date Covered Swaps will not be subject to such requirements.

However, if a Covered Swap Entity cannot conclude after sufficient legal review with a well-founded basis that a netting agreement (including a netting agreement with two separate netting sets) meets the requirements for an "eligible master netting agreement," the Covered Swap Entity must treat the Covered Swaps covered by the agreement on a gross basis for the purposes of

[7] This refers to the requirement that an EMNA (or, in this case, a netting portfolio covered by an EMNA) must create a single legal obligation for all individual transactions covered by the relevant agreement (or all transactions within the netting portfolio) upon an event of default, including insolvency.

calculating and complying with the margin collection requirements in the Final Rules, but the Covered Swap Entity would still be permitted to net such Covered Swaps for purposes of its margin posting requirements.

In addition, the Final Rules permit the establishment of separate netting portfolios for Covered Swaps entered into before and after a financial end user's change into a Material Financial End User. This addresses the possibility that a Covered Swap Entity might accumulate a portfolio of Covered Swaps with a Non-Material Financial End User, but which later becomes a Material Financial End User, such that only those additional Covered Swaps entered into after that change in the counterparty's status would be subject to both initial and variation margin requirements (while those Covered Swaps entered into prior to the status change would only be subject to variation margin requirements).

General Application of Initial and Variation Margin Requirements

Initial Margin Threshold

The Final Rules permit a Covered Swap Entity to adopt a maximum initial margin threshold amount of $50 million, below which it need not collect or post initial margin. The threshold will be applied on a consolidated basis with respect to both the Covered Swap Entity (and its affiliates) and its counterparty (and its affiliates).[8] This threshold applies only to initial margin and not to variation margin. As noted in the Adopting Release, the initial margin threshold does not prevent parties from contracting with each other to require the collection of initial margin under a threshold of less than $50 million.

Definition of "Margin Affiliate"

The Final Rules provide that a company is a "margin affiliate" of another company for purposes of the Final Rules[9] if:

---

[8] The CFTC declined to incorporate the suggestions of certain commenters to apply separate initial margin thresholds to each "separate account" of a single investment fund vehicle or pension plan despite the fact that separate managers acting for the same fund or plan do not currently take steps to inform the fund or plan of their Covered Swap exposures on behalf of their principal on a frequent basis.

[9] The definition of "margin affiliate" is relevant for purposes of applying the special margin requirements applicable to inter-affiliate swaps (discussed below), determining the applicable compliance date for the Final Rules with respect to a Covered Swap Entity, applying the initial margin threshold, and determining whether a financial end user has a material swaps exposure.

- either company consolidates the other on financial statements prepared in accordance with U.S. GAAP, International Financial Reporting Standards ("IFRS"), or similar standards;
- both companies are consolidated with a third company on a financial statement prepared in accordance with such principles or standards; or
- for a company that is not subject to such principles or standards, if consolidation as described in the foregoing items would have occurred if such principles or standards had applied.

The Final Rules' definition of "margin affiliate" slightly differs from the definition of "affiliate" in the Banking Agencies Margin Rules. The Banking Agencies Margin Rules include an anti-evasion provision reserving the right for the applicable prudential regulator for a company to determine that the company is an affiliate of another company, based on such regulator's conclusion that either company provides significant support to, or is materially subject to the risks of losses of, the other. The CFTC has determined not to include in the Final Rules such an anti-evasion provision at this time.

Timing of Compliance with Margin Requirements

In parallel with the Banking Agencies Margin Rules, a Covered Swap Entity must collect and post initial margin and variation margin on each business day, for a period beginning on or before the business day following the day of execution of the Covered Swap and ending on the date the Covered Swap terminates or expires. If each party is in a different calendar day at the time the parties enter into the Covered Swap, the day of execution is deemed to be the later of the two calendar dates. Additionally, if a Covered Swap is entered into after 4:00 p.m. in the location of a party or is entered into on a day that is not a business day in the location of a party, the Covered Swap is deemed to have been entered into on the immediately succeeding day that is a business day for both parties.

Application of Minimum Transfer Amount

Same as with the Banking Agencies Margin Rules, a Covered Swap Entity need not collect or post initial or variation margin from or to any single counterparty (for which such margin requirements would otherwise apply) unless and until the required cumulative amount of initial and variation margin transfer is greater than $500,000. Unlike the initial margin threshold, this minimum transfer amount applies to Covered Swaps with a single counterparty, rather than to a consolidated group of the counterparty and its affiliates. Therefore, a Covered Swap Entity will not have to pay or collect variation margin to or from a Non-

Material Financial End User until the cumulative variation margin exceeds $500,000.

Counterparty Refusal to Post or Collect Margin

A Covered Swap Entity is not deemed to have violated its obligations to post or collect initial or variation margin from or to a counterparty where its counterparty has refused or otherwise failed to provide or accept the required margin to or from the Covered Swap Entity, if the Covered Swap Entity has (1) made the necessary efforts to collect or post the required margin (including the timely initiation and continued pursuit of formal dispute resolution mechanism) or has otherwise demonstrated upon request to the satisfaction of the CFTC that it has made appropriate efforts to collect or post the required margin, or (2) commenced termination of the Covered Swap with the counterparty promptly following the applicable cure period and notification requirements.

Application of Margin Requirements to Transactions with Different Types of Counterparties

Transactions with Swap Entities

Initial Margin. A Covered Swap Entity that enters into a Covered Swap with another Swap Entity must collect initial margin for such Covered Swap in an amount that is not less than the excess, if any, of (1) the initial margin collection amount for the Covered Swap over (2) the initial margin threshold amount (excluding any portion of the initial margin threshold already applied by the Covered Swap Entity or its affiliates to other Covered Swaps with the counterparty or its affiliates). The other Swap Entity will also be subject to initial margin collection requirements applicable to it under either the Final Rules or another regulatory regime applicable to it (*e.g.*, the Banking Agencies Margin Rules).

Variation Margin. A Covered Swap Entity that enters into a Covered Swap with another Swap Entity must post variation margin to or collect variation margin from such counterparty, as applicable, depending on the value of the Covered Swap.

Transactions with Financial End Users

Initial Margin. For a Covered Swap between a Covered Swap Entity and a Material Financial End User, the minimum amount of initial margin that must be collected by the Covered Swap Entity is the same as the minimum required

collection amount for its transactions with another Swap Entity. In addition, a Covered Swap Entity must post initial margin to the Material Financial End User in at least the same amount that the Covered Swap Entity would be required to collect (under the Final Rules) if the Covered Swap Entity were in the place of the Material Financial End User counterparty.

A Covered Swaps Entity transacting with a Non-Material Financial End User is not subject to the initial margin requirements in the Final Rules, and is only required to collect the amount of initial margin that it determines to be appropriate to address the credit risk posed by such financial end user and the risk of the transaction.

Variation Margin. A Covered Swap Entity that enters into a Covered Swap with any financial end user (whether or not a Material Financial End User) must post variation margin to or collect variation margin from such counterparty, as applicable (depending on the value of the Covered Swap).

Transactions with Other Counterparties

The Final Rules neither provide a general exemption for transactions between a Covered Swap Entity and an Other Counterparty from the CFTC's mandatory initial and variation margin requirements (except as provided in the Interim Margin Exemptions), nor set any specific numerical requirements for initial or variation margin with respect to such transactions. Instead, a Covered Swap Entity must collect initial or variation margin as it determines appropriate to address the credit risk posed by such Other Counterparty and the risks of such transactions.

Segregation of Initial Margin

In parallel with the Banking Agencies Margin Rules, the Final Rules impose margin segregation requirements with respect to initial margin, but not to variation margin. A Covered Swap Entity that posts any collateral (other than variation margin) for a Covered Swap must require its counterparty to segregate all such funds or other property at one or more independent third-party custodians. This applies not only to the minimum initial margin that the Covered Swap Entity is required to post under the Final Rules, but also to any collateral (other than variation margin) posted for other reasons, including as a result of negotiations between the parties, that is in excess of or in addition to what is required under the Final Rules (such as initial margin posted to a Non-Material Financial End User or to another Covered Swap Entity where the exposure is below the $50 million initial margin threshold amount).

Additionally, a Covered Swap Entity that collects initial margin amounts required under the Final Rules for a Covered Swap must hold such initial margin at one or more independent third-party custodians. This segregation requirement, unlike the margin posting requirement, applies only to the minimum initial margin that the Covered Swap Entity is required to collect under the Final Rules (*i.e.*, any additional margin collected by a Covered Swap Entity does not have to be segregated).

An independent third-party custodian must act pursuant to a custody agreement that prohibits the custodian from rehypothecating, re-pledging, reusing, or otherwise transferring (through securities lending, repurchase agreement or other means) any initial margin it holds, except that cash collateral may be held in a general deposit account with the custodian provided that the funds in the account must be used to purchase other forms of eligible collateral, such eligible noncash collateral must be segregated in compliance with the Final Rules, and such purchase must take place within a time period reasonably necessary to consummate such purchase after the cash collateral is posted.

A custody agreement may permit the posting party to substitute or direct any reinvestment of posted collateral held by the custodian so long as, with respect to the minimum initial margin that is required to be posted or collected by a Covered Swap Entity, the agreement requires the posting party to:

- substitute only funds or other property that would qualify as eligible collateral and for which the amount (net of applicable haircuts) would be sufficient to meet the initial margin posting requirements; and
- direct reinvestment of funds only in assets that would qualify as eligible collateral and for which the amount (net of applicable haircuts) would be sufficient to meet the initial margin posting requirements.

The restrictions on the substitution of collateral described above apply only to the initial margin that is required to be posted or collected pursuant to the Final Rules and do not apply to any collateral that has been posted in excess of or in addition to the required initial margin minimum amounts.

INITIAL MARGIN CALCULATION

Similar to the Banking Agencies Margin Rules, the Final Rules permit a Covered Swap Entity to select from two alternative methods to calculate its initial margin requirements on a daily basis. First, the Covered Swap Entity may calculate its initial margin using a standardized look-up table specifying the minimum initial margin requirement, expressed as a percentage of the notional amount of the

Covered Swap. The standardized look-up table set forth in the Final Rules is the same as the one in the Banking Agencies Margin Rules.

Alternatively, the Covered Swap Entity may calculate its minimum initial margin requirement using an internal model, so long as the internal model satisfies certain criteria[10] on an ongoing basis and is approved in advance by the CFTC or the National Futures Association (the "NFA"), in contrast, the Banking Agencies Margin Rules require approval of the internal model by a prudential regulator. In certain cases, the CFTC expects that a Covered Swap Entity whose initial margin model is subject to approval by the CFTC or NFA may be an affiliate of other SDs or MSPs that are prudentially-regulated and whose models are subject to approval of one of the prudential regulators. In those cases, the CFTC or NFA will coordinate with the prudential regulators to avoid duplicative efforts and to provide expedited approval of models that have been approved by a prudential regulator. Similarly, the CFTC or NFA will also coordinate with the Securities and Exchange Commission (the "SEC") for Swap Entities that are dually-registered and with foreign regulators for Swap Entities that are subject to the jurisdiction of foreign regulators.

The Final Rules allow for the recognition of portfolio effects and offsetting exposures within a portfolio of swaps with a counterparty under both approaches.

It is worth noting that because a Covered Swap Entity is permitted to use its own internal model in determining the initial margin amount for a Covered Swap, a valuation dispute on the initial margin amount of a Covered Swap entered into between two Covered Swap Entities may occur as the parties may not be using the exact same internal model. The Final Rules leave the resolution of any such dispute to the parties (based on the terms of the parties' required trading documentation regarding procedures for resolving such disputes).

The CFTC acknowledges that it is appropriate under certain circumstances for a Covered Swap Entity to employ a mix of internal model-based and standardized approach to calculating initial margins. However, the CFTC stresses that it would not be appropriate for a Covered Swap Entity to cherry-pick by choosing whichever approach produces the lowest margin requirement (based on differences between the two approaches across different types of swaps); rather, the choice of which method to use should be based on fundamental

[10] The CFTC notes that the modeling standards for internal models under the Final Rules are broadly similar to the modeling standards that are currently used for calculating bank regulatory capital and value at risk.

considerations apart from which produces the more favorable result. Furthermore, since the CFTC does not anticipate a need for Covered Swap Entities to switch between the two approaches for a particular counterparty absent a significant change in the nature of the entity's swap activities, a Covered Swap Entity must provide a rationale for changing methodologies if so requested by the CFTC.

VARIATION MARGIN CALCULATION

A Covered Swap Entity transacting with another Swap Entity or with a financial end user must collect and post daily variation margin on a Covered Swap in an amount that is at least equal to the cumulative mark-to-market change in value (to the Covered Swap Entity) of the Covered Swap, as measured from the date it is entered into (or, in the case of a Covered Swap that has a positive or negative value on the date it is entered into, such positive or negative value *plus* any cumulative mark-to-market change in value of the Covered Swap after such date), *less* the value of all variation margin previously collected, *plus* the value of all variation margin previously posted with respect to the Covered Swap.

A Covered Swap Entity may calculate variation margin requirements on an aggregate net basis across all Covered Swaps with a counterparty that are executed under a single EMNA (or, where an EMNA includes multiple netting sets, across only those Covered Swaps within a single netting set, separate from and exclusive of any other swaps covered by the EMNA).

The Final Rules are consistent with the Banking Agencies Margin Rules but differs in certain respects. First, the CFTC Final Rules are more detailed in one respect: they require that variation margin calculations use 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. In addition, the Final Rules require a Covered Swap Entity to have in place alternative methods for determining the value of a Covered Swap in the event of the unavailability or other failure of any input required to value a swap.

The Final Rules further require a Covered Swap Entity to create and maintain documentation in a manner sufficient to allow the Covered Swap Entity's counterparty, the CFTC, the NFA, and any applicable prudential regulator to calculate a reasonable approximation of the margin requirement independently. The Final Rules provide that a Covered Swap Entity must evaluate the reliability of its data sources at least annually and make adjustments as appropriate. Finally,

the Covered Swap Entity must be ready to provide further data or analysis[11] concerning its variation margin calculation methodology or a data source upon request by the CFTC or the NFA.

TRANSACTIONS WITH AFFILIATES

The CFTC has generally determined not to impose initial margin requirement under the Final Rules on inter-affiliate swaps of a Covered Swap Entity if the following conditions are satisfied: (1) 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 (2) the Covered Swap Entity exchanges variation margin with the margin affiliate (such conditions, the "Excluded Affiliate Swap Margin Conditions").

Initial Margin

Collection of Initial Margin

Subject to the collection requirement for trades with foreign affiliates discussed below, the CFTC provides that a Covered Swap Entity is not required to collect initial margin from an affiliate as long as the Excluded Affiliate Swap Margin Conditions are satisfied. The Final Rules differ from the Banking Agencies Margin Rules, which do not exclude inter-affiliate swaps from the margin collection requirements.

The CFTC does require Covered Swap Entities to collect initial margin from non-U.S. affiliates that are not subject to comparable initial margin collection requirements on their own outward-facing swaps with financial entities. In other words, these non-U.S. affiliates would be generally located in jurisdictions for which substituted compliance has not been granted with regard to the collection of initial margin. The initial margin collection requirement also applies in the case of a series of transactions involving, directly or indirectly, an affiliate that is not subject to comparable initial margin collection requirements; for instance, a Covered Swap Entity that enters into a swap with an affiliate that is subject to comparable margin requirements, but which affiliate in turn enters into a series of swaps with affiliates that are not subject to comparable margin requirements. This provision, as the Adopting Release notes, is an anti-evasion measure

[11] Data or analysis concerning the Covered Swap Entity's variation margin calculation methodology or a data source that may be requested by the CFTC or the NFA include: (1) an explanation of the manner in which the methodology meets the requirements of the Final Rules; (2) a description of the mechanics of the methodology; (3) the conceptual basis of the methodology; (4) the empirical support for the methodology; and (5) the empirical support for the assessment of the data sources.

designed to prevent the use of affiliates to avoid collecting initial margin from third parties that are in jurisdictions that do not have comparable initial margin requirements to those in the United States.

The Final Rules provide that the custodian for initial margin collected from such non-U.S. affiliates may be the Covered Swap Entity or its affiliate.

Posting of Initial Margin

The Final Rules, like the Banking Agencies Margin Rules, generally do not require a Covered Swap Entity to post initial margin to its affiliates. However, to harmonize the Final Rules with the Banking Agencies Margin Rules, the CFTC requires a Covered Swap Entity to post initial margin to an affiliate that is a Swap Entity that has a prudential regulator in an amount equal to the amount that such prudentially-regulated affiliate is required to collect from the Covered Swap Entity under the Banking Agencies Margin Rules. As the Adopting Release explains, this provision imposes no additional burden on the Covered Swap Entity as the Covered Swap Entity is only posting initial margin to the extent that the affiliate is required under the Banking Agencies Margin Rules to collect it.

In contrast to the Banking Agencies Margin Rules, the CFTC does not require a Covered Swap Entity to disclose to an affiliate the amount of initial margin that would be otherwise required to be posted to the affiliate if there were no exemption for inter-affiliate swaps from the posting requirement.

Variation Margin

The variation margin requirements applicable to Covered Swaps between affiliates are the same as the variation margin requirements that apply to Covered Swaps between unaffiliated counterparties.

ELIGIBLE COLLATERAL

The Final Rules establish a list of eligible collateral that may be used to meet minimum initial and variation margin requirements, depending on the type of counterparty with which a Covered Swap Entity enters into a Covered Swap; we note that the list is essentially the same to the one set forth in the Banking Agencies Margin Rules. With respect to transactions and counterparties for which there is no minimum initial or variation margin requirement under the Final Rules, the Covered Swap Entity can accept any form of collateral that is agreed to with its counterparties.

Transactions with Swap Entities

A Covered Swap Entity that enters into a Covered Swap with another Swap Entity must collect variation margin solely in the form of immediately available cash (denominated either in U.S. dollars, another major currency, or in the currency of settlement).

However, with respect to initial margin that is required for Covered Swaps entered into between a Covered Swap Entity and a Swap Entity, the Final Rules permit the use of cash collateral (denominated either in U.S. dollars, another major currency,[12] or in the currency of settlement[13]) and the same assets that are permitted to be used as eligible collateral under the Banking Agencies Margin Rules.[14]

Transactions with Financial End Users

Under the Final Rules, assets that are eligible as initial margin for transactions where a Covered Swap Entity enters into a Covered Swap with a Swap Entity are also eligible as initial margin and variation margin for transactions where a Covered Swap Entity enters into a Covered Swap with a financial end user (with or without a material swap exposure).

Exceptions, Haircuts, and Other Issues

To avoid general "wrong way risk," the Final Rules restrict eligible collateral to exclude any securities issued by (1) the Covered Swap Entity or a margin affiliate of the Covered Swap Entity (in the case of posting) or the counterparty or any margin affiliate of the counterparty (in the case of collection); (2) a bank holding

---

12 The Final Rules define the following as a "major currency": United States Dollar, Canadian Dollar, Euro, United Kingdom Pound, Japanese Yen, Swiss Franc, New Zealand Dollar, Australian Dollar, Swedish Kronor, Danish Kroner, Norwegian Krone, and any other currency as determined by the prudential regulator of the covered swap entity.

13 The Final Rules define "currency of settlement" as a currency in which a party has agreed to discharge payment obligations related to a Covered Swap or a group of Covered Swaps subject to a master agreement at the regularly occurring dates on which such payments are due in the ordinary course. The CFTC notes that, in determining the currency of settlement, the CFTC will look to the contractual and operational practice of the parties in liquidating their periodic settlement obligations for a Covered Swap in the ordinary course, absent a default by either party.

14 Such assets include securities issued by the U.S. Department of Treasury, securities issued by the European Central Bank or a sovereign entity that is assigned no higher than a 20% risk weight under the capital rules applicable to prudentially-regulated SDs, certain publicly traded debt and common equity security. For a detailed list of the assets that are eligible collateral, see the Banking Agencies Rule Client Update.

company, a savings and loan holding company, a U.S. intermediate holding company established or designated for purposes of compliance with the Regulation YY of the Federal Reserve Board, 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 United States or any state thereof, or an affiliate of one of the foregoing; or (3) a nonbank systemically important financial institution designated by the Financial Stability Oversight Council.

A Covered Swap Entity must monitor the market value and eligibility of all collateral collected and posted to satisfy its minimum initial and variation margin requirements and to ensure that all applicable minimum margin requirements remain satisfied on a daily basis.

The value of the eligible collateral posted to satisfy the initial margin or variation margin requirements is subject to certain haircuts that vary by asset class, as specified in the Final Rules. The haircuts required by the CFTC are the same as the ones specified in the Banking Agencies Margin Rules. In addition to the haircuts by asset class, the Final Rules also impose a further 8% discount to the value of any eligible collateral collected or posted to satisfy the margin requirements: (1) for variation margin collateral denominated in a currency that is not the currency of settlement for the Covered Swap, except when the collateral is immediately available cash denominated in U.S. dollars or another major currency; and (2) for initial margin collateral denominated in a currency that is not the currency of settlement for the Covered Swap, except for eligible types of collateral denominated in a single termination currency designated as payable to the non-posting counterparty as part of the EMNA.

TRADE DOCUMENTATION

The Final Rules require Covered Swap Entities to execute documentation with Swap Entities or financial end users regarding credit support arrangements; the requirements of the Final Rules are essentially identical to those contained in the Banking Agencies Margin Rules. However, the CFTC clarifies that compliance with the applicable CFTC swap trading documentation requirements[15] is not deemed to constitute compliance with the Final Rules' documentation requirements.

[15] For CFTC final rules, *see* Part 23, subpart I of the CFTC regulations; see also 77 Fed. Reg. 55903 (Sep. 11, 2012).

COMPLIANCE DATES

The dates on which a Covered Swap Entity must begin complying with the initial and variation margin requirements with respect to Covered Swaps entered into on or after such dates depend on the average daily aggregate notional amount of all outstanding Covered Swaps and foreign exchange forwards and swaps (such amount, the "Phase-In Trigger Amount") of the Covered Swap Entity (combined with its affiliates) and its counterparty (combined with its affiliates) over a specified three-month period. The CFTC compliance dates are the same as those set forth in the Banking Agencies Margin Rules, which are as follows:

- September 1, 2016, with respect to initial margin and variation margin where both (1) the Covered Swap Entity combined with all its affiliates and (2) the counterparty combined with all its affiliates have a Phase-In Trigger Amount for March, April, and May 2016 that exceeds $3 trillion;
- March 1, 2017, with respect to variation margin for any other Covered Swap Entity with respect to Covered Swaps entered into with any other counterparty;
- September 1, 2017, with respect to initial margin where both (1) the Covered Swap Entity combined with all its affiliates and (2) the counterparty combined with all its affiliates have a Phase-In Trigger Amount for March, April, and May 2017 that exceeds $2.25 trillion;
- September 1, 2018, with respect to initial margin where both (1) the Covered Swap Entity combined with all its affiliates and (2) the counterparty combined with all its affiliates have a Phase-In Trigger Amount for March, April, and May 2018 that exceeds $1.5 trillion;
- September 1, 2019, with respect to initial margin where both (1) the Covered Swap Entity combined with all its affiliates and (2) the counterparty combined with all its affiliates have a Phase-In Trigger Amount for March, April, and May 2019 that exceeds $0.75 trillion; and
- September 1, 2020, with respect to initial margin for any other Covered Swap Entity with respect to Covered Swaps entered into with any counterparty.

Once a Covered Swap Entity and its counterparty become subject to compliance with the margin requirements based on the foregoing timeline, both the Covered Swap Entity and its counterparty will remain subject to the margin requirements of the Final Rules regardless of subsequent decrease in derivatives activities.

INTERIM MARGIN EXEMPTIONS

The CFTC issued the Interim Margin Exemptions to exempt from the margin requirements of the Final Rules those swaps transactions in which a counterparty qualifies for an exemption or exception from clearing requirements, including commercial end users and certain financial institutions with $10 billion or less in total assets.

Specifically, the Interim Margin Exemptions, which add a new section to the Final Rules, adopt the exemptions and exceptions as required under TRIPRA, which provides that the initial and variation margin requirements of the Final Rules do not apply to the Covered Swaps with three types of counterparties, as discussed below. It is important to note that the exemptions granted under TRIPRA are transaction-based, not counterparty-based; for instance, a nonfinancial end user that enters into a swap with a Covered Swap Entity not for hedging purposes may be unable to benefit from this exemption, and the Covered Swap Entity will need to treat that swap as it would otherwise treat any swap with an Other Counterparty under the Final Rules.

Nonfinancial Entities

TRIPRA provides that the margin requirements do not apply to a Covered Swap in which a counterparty qualifies for an exception under section 2(h)(7)(A) of the CEA.[16] Section 2(h)(7)(A) excepts from clearing swaps where one of the counterparties is not a financial entity, is using the swap to hedge or mitigate commercial risk, and notifies the CFTC how it generally meets its financial obligations associated with entering into Covered Swaps.

- A counterparty that is not a "financial entity" (referred to as nonfinancial end users or commercial end users) that is using swaps to hedge or mitigate commercial risk generally would qualify for an exception from clearing under section 2(h)(7)(A) and thus from the margin requirements of the Final Rules.
- Small banks, savings associations, Farm Credit System institutions, and credit unions with total assets of $10 billion or less have been exempted by the CFTC from the CEA's definition of "financial entity." Thus, such small financial institutions that are using non-cleared swaps to hedge or mitigate commercial risk would qualify for the exemption from the margin requirements of the Final Rules.

[16] 7 U.S.C. 2(h)(7)(A).

- Certain captive finance companies are exempt from the definition of "financial entity" under the CEA.[17] Thus, when such entities use swaps to hedge or mitigate commercial risk, they are exempt from clearing under section 2(h)(7)(A) of the CEA and thus exempt from the margin requirements of the Final Rules.

Treasury Affiliates Acting as Agent

TRIPRA provides that the margin requirements do not apply to a Covered Swap in which a counterparty satisfies the criteria for an exception from clearing in section 2(h)(7)(D) of the CEA. This section provides that if a person qualifies for an exception from clearing, then an affiliate of that person also qualifies for an exception from clearing as long as the affiliate is acting on behalf of the qualifying person as an agent and uses the swap to hedge or mitigate the commercial risk of the qualifying person or other affiliate of the qualifying person that is not a financial entity. Such an affiliate acting as agent that meets the requirements for a clearing exemption is also exempt from the margin requirements of the Final Rules.

Certain Cooperative Entities

TRIPRA provides that the margin requirements do not apply to a Covered Swap in which a counterparty qualifies for an exemption issued under section 4(c)(1) of the CEA from the clearing requirement of the CEA that would otherwise apply to cooperative entities. The CFTC adopted a regulation that allows cooperatives that are financial entities to elect an exemption from mandatory clearing of swaps that: (1) they enter into in connection with originating loans for their members or (2) hedge or mitigate commercial risk related to loans to members or swaps with their members which are not financial entities or are exempt from the definition of a financial entity. Thus, the swaps of cooperatives that would qualify for an exemption from clearing would also qualify for an exemption from the margin requirements of the Final Rules.

* * *

Please feel free to contact us with any questions.

---

[17] Section 2(h)(7)(C) of the CEA provides that the definition of "financial entity" does not include an entity whose primary business is providing financing and uses derivatives for the purposes of hedging underlying commercial risks relating to interest rate and foreign exchange exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.

Attachment 1

List of Financial End Users

Under the Final Rules, a counterparty that is not a Swap Entity is a financial end user if it is:

- a bank holding company or an affiliate thereof, a savings and loan holding company, a U.S. intermediate holding company established or designated for purposes of compliance with the Federal Reserve Bank's Regulation YY, or a nonbank financial institution supervised by the Federal Reserve Bank under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act;
- a depository institution, a foreign bank, a federal credit union or state credit union as defined in section 2 of the Federal Credit Union Act, an institution that functions solely in a trust of fiduciary capacity as described in section 2(c)(2)(D) of the Bank Holding Company Act, an industrial loan company, an industrial bank, or other similar institution described in section 2(c)(2)(H) of the Bank Holding Company Act;
- an entity that is state-licensed or registered as: (1) a credit or lending entity, including a finance company, money lender, installment lender, consumer lender or lending company, mortgage lender, broker, or bank, motor vehicle title pledge lender, payday or deferred deposit lender, premium finance company, commercial finance or lending company, or commercial mortgage company, except entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers; or (2) a money services business, including a check casher, money transmitter, currency dealer or exchange, or money order or traveler's check issuer;
- a regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and any entity for which FHFA or its successor is the primary federal regulator;
- any institution chartered and regulated by the Farm Credit Administration in accordance with the Farm Credit Act of 1971;
- a securities holding company, a broker or dealer, an investment adviser as defined in section 202(a) of the Investment Advisers Act of 1940 ("Investment Advisers Act"), an investment company registered with the SEC under the Investment Company Act of 1940 (the "Investment Company Act"), or a company that has elected to be regulated as a business development company pursuant to section 54(a) of the Investment Company Act;

- a private fund as defined in section 202(a) of the Investment Advisers Act, an entity that would be an investment company under section 3 of the Investment Company Act but for section 3(c)(5)(C), or an entity that is deemed not to be an investment company under section 3 of the Investment Company Act pursuant to Rule 3a-7;
- a commodity pool, a commodity pool operator, or a commodity trading advisor as defined, respectively, in section 1a(10), 1a(11) and 1a(12) of the CEA; a floor broker, a floor trader, an introducing broker as defined, respectively, in section 1a(22), 1a(23) and 1a(31) of the CEA; or a futures commission merchant as defined in section 1a(28) of the CEA;
- an employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974;
- an entity that is organized as an insurance company, primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies, or is subject to supervision as such by a state insurance regulator or foreign insurance regulator;
- an entity, person, or arrangement that is, or holds itself out as being, an entity, person, or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for the purposes of investing or trading or facilitating the investing or trading in loans, securities, swaps, funds, or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets; or
- an entity that would be a financial end user described in the Final Rules, if it were organized under the laws of the United States or any state thereof.

Entities Excluded from Financial End User Definition

The Final Rules exclude the following entities from the definition of "financial end user":

- a sovereign entity;
- a multilateral development bank;
- the Bank for International Settlements;
- an entity that is exempt from the definition of financial entity pursuant to section 2(h)(7)(C)(iii) of the CEA and implementing regulations;
- an affiliate that qualifies for the exemption from clearing pursuant to section 2(h)(7)(D) of the CEA or section 3C(g)(4) of the Securities Exchange Act and implementing regulations; and

- an eligible treasury affiliate that the CFTC exempts from the requirements of the Final Rules by rule.