

# Client Update

## CFTC Adopts Final Cross-Border Margin Rules for Non-Cleared Swaps

### NEW YORK

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On May 24, 2016, the Commodity Futures Trading Commission (the “CFTC”) adopted final rules (the “CFTC Final Rules”)<sup>1</sup> addressing the cross-border application of the CFTC’s margin rules (the “CFTC Margin Rules”)<sup>2</sup> for non-cleared swaps entered into by swap dealers and major swap participants (“Covered Swap Entities” or “CSEs”) for which no U.S. federal banking agency is a prudential regulator.<sup>3</sup>

The CFTC Final Rules are generally consistent, in substance, with the U.S. prudential regulators’ cross-border application of their own joint final margin rules (the “PR Margin Rules”)<sup>4</sup> for CSEs for which one of the U.S. federal banking agencies is a prudential regulator. A chart summarizing the application of the PR Margin Rules to various types of CSEs for which there is a prudential regulator is set forth in Appendix A to this client memorandum.

The CFTC Final Rules will become effective on August 1, 2016, and the applicable compliance dates are set forth in the CFTC Margin Rules.

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<sup>1</sup> The text of the CFTC Final Rules is available at: <http://www.cftc.gov/PressRoom/PressReleases/pr7370-16>.

<sup>2</sup> For additional information on the CFTC Margin Rules, please refer to our client memorandum, “CFTC Adopts Margin Rules for Non-Cleared Swaps,” dated December 30, 2015, available at: <http://www.debevoise.com/insights/publications/2015/12/cftc-adopts-margin-rules-for-non-cleared-swaps>.

<sup>3</sup> The prudential regulators are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Farm Credit Administration and the Office of the Comptroller of the Currency.

<sup>4</sup> For additional information on the PR Margin Rules, please refer to our client memorandum, “Bank Agencies Adopt Margin and Capital Rules for Non-Cleared Derivatives” (November 2, 2015), available at: <http://www.debevoise.com/insights/publications/2015/10/bank-agencies-adopt-margin-and-capital-rules>.

## CFTC FINAL RULES

The CFTC Final Rules divide CSEs into the following five categories, which determine the extent to which the CFTC Margin Rules apply and if substituted compliance is available:

- A CSE that is a U.S. person (a “U.S. CSE”);
- A non-U.S. CSE whose operating results, financial position and statement of cash flows are consolidated, in accordance with U.S. GAAP, with those of an ultimate parent entity that is a U.S. person (a “Foreign Consolidated Subsidiary” or “FCS”) and whose obligations are not guaranteed by a U.S. person (a “Non-Guaranteed FCS”);
- A non-U.S. CSE<sup>5</sup> whose obligations are guaranteed by a U.S. person (a “U.S. Guaranteed CSE”);
- A U.S. branch of a non-U.S. CSE whose obligations are not guaranteed by a U.S. person (a “Non-Guaranteed U.S. Branch”); and
- A non-U.S. CSE that is neither an FCS nor a U.S. branch and whose obligations are not guaranteed by a U.S. person (an “Excluded Non-U.S. CSE”).

A chart summarizing the application of the CFTC Margin Rules to various types of CSEs under the CFTC Final Rules is set forth in Appendix B to this client memorandum.

### **Treatment of Various Types of Covered Swap Entities**

#### *U.S. CSEs and U.S. Guaranteed CSEs*

Under the CFTC Final Rules, all non-cleared swaps of U.S. CSEs and U.S. Guaranteed CSEs are subject to the CFTC Margin Rules, regardless of the counterparty. However, U.S. CSEs and U.S. Guaranteed CSEs may rely on substituted compliance with respect to their initial margin posting obligations to (but not collecting obligations from) non-U.S. persons (including non-U.S. CSEs, U.S. branches of non-U.S. CSEs and FCSs) whose obligations are not guaranteed by a U.S. person.

A non-U.S. branch of a U.S. CSE is part of the U.S. CSE, such that margin requirements and substituted compliance are applicable and available to the same

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<sup>5</sup> In this case, the non-U.S. CSE includes the U.S. branch of a non-U.S. CSE and a non-U.S. CSE that is an FCS.

extent described above for U.S. CSEs generally. Thus, a non-U.S. branch of a U.S. CSE, like a U.S. Guaranteed CSE, could be subject to two sets of initial margin collection and variation margin rules which may be inconsistent, without substituted compliance.

#### *Non-Guaranteed FCSs and Non-Guaranteed U.S. Branches*

The CFTC Final Rules subject a Non-Guaranteed FCS and a Non-Guaranteed U.S. Branch to the CFTC Margin Rules to the same extent as a U.S. CSE and a U.S. Guaranteed CSE (i.e., with respect to each non-cleared swap, regardless of counterparty).

However, the CFTC Final Rules permit a Non-Guaranteed FCS and a Non-Guaranteed U.S. Branch to rely on substituted compliance for all margin requirements, unless the counterparty is a U.S. CSE or U.S. Guaranteed CSE (in which case substituted compliance would only be available with respect to the initial margin collection requirements of the Non-Guaranteed FCS or Non-Guaranteed U.S. Branch).

#### *Excluded Non-U.S. Covered Swap Entities*

The CFTC Final Rules provide a limited exclusion from the CFTC Margin Rules (the “Exclusion”) for a swap between an Excluded Non-U.S. CSE and a non-U.S. person (including a non-U.S. CSE, other than an FCS or a U.S. branch of a non-U.S. CSE) whose obligations under the relevant swap are not guaranteed by a U.S. person.

With respect to non-cleared swaps with other types of entities, the CFTC Final Rules permit an Excluded Non-U.S. CSE, like a Non-Guaranteed FCS and a Non-Guaranteed U.S. Branch, to rely on substituted compliance with respect to all margin requirements, unless the counterparty is a U.S. CSE or U.S. Guaranteed CSE (in which case substituted compliance would only be available with respect to the Excluded Non-U.S. CSE’s initial margin collection requirements).

The Exclusion is not available if the swap is not covered by a CFTC comparability determination with respect to the initial margin collection requirements of the non-U.S. CSE’s home jurisdiction and any risk associated with the swap is transferred, directly or indirectly, through inter-affiliate transactions, to a U.S. CSE or a U.S. Guaranteed CSE.

A U.S. branch of a non-U.S. CSE is not eligible for the Exclusion.

### Guarantee Definition

The CFTC Final Rules define the term “guarantee” as an arrangement (whether written or not) pursuant to which a party to a non-cleared swap has legally enforceable rights of recourse against a guarantor with respect to its counterparty’s obligations under the swap (even where the guarantor is not affiliated with the guaranteed non-U.S. person counterparty and whether or not the rights of recourse are contingent upon such counterparty’s insolvency or failure to meet its obligations under the swap or upon the guaranteed party having first made a demand for payment or performance from the non-U.S. counterparty before proceeding against the guarantor).

### U.S. Person Definition

The CFTC Final Rules define “U.S. person” to mean:

- A natural person who is a U.S. resident and any estate of a decedent who was a U.S. resident at the time of death;
- A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any similar form of entity (other than a U.S. Pension Plan or a U.S. Trust) (a “Legal Entity”), in each case that is organized or incorporated under U.S. law or having its principal place of business in the United States,<sup>6</sup> including any branch of such legal entity (a “U.S. Legal Entity”);
- A pension plan for the employees, officers or principals of a U.S. Legal Entity that is not primarily for foreign employees of such entity (a “U.S. Pension Plan”);
- A trust governed by the laws of a state or other jurisdiction in the United States (if a court within the United States is able to exercise primary supervision over the administration of the trust) (a “U.S. Trust”);
- A Legal Entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) owned by one or more of the persons listed above and for

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<sup>6</sup> In general, the term “principal place of business” means the location from which the officers, partners or managers of a legal person primarily direct, control and coordinate the activities of the legal person. However, the principal place of business of an investment fund will generally be based on the location of the senior personnel responsible for either (1) the formation of the fund or (2) the implementation of the fund’s investment strategy, depending on the facts and circumstances relevant to the center of direction and control of the fund.

which such person(s) bear(s) unlimited responsibility for the obligations and liabilities of the Legal Entity, including any branch of the Legal Entity; and

- Any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners, for a joint account) is a person described above.

This “U.S. person” definition is generally consistent with the definition in the CFTC’s 2013 cross-border guidance (the “CFTC Cross-Border Guidance”), with the following exceptions: (A) the definition in the CFTC Final Rules does not include collective investment vehicles that are not organized under U.S. laws or located in the United States but that are majority-owned by U.S. persons; and (B) the definition in the CFTC Final Rules is framed as an exhaustive list of the types of individuals and entities that are U.S. persons, whereas the list in the CFTC Cross-Border Guidance is framed as non-exhaustive.

### **Counterparty Representations**

The CFTC Final Rules permit a CSE to rely on its counterparty’s written representations as to its status as a U.S. person or FCS, and as to whether a non-U.S. counterparty’s obligations under a swap are guaranteed by a U.S. person, unless the CSE has information that would cause a reasonable person to question the accuracy of the representation.

### **Substituted Compliance**

In order for a CSE to rely on substituted compliance to the extent available (*i.e.*, to comply with a foreign jurisdiction’s margin requirements in lieu of complying with certain CFTC requirements), the CFTC must first issue a determination that the relevant margin requirement(s) of the foreign jurisdiction are comparable to the corresponding CFTC margin requirement(s) (a “comparability determination”).

Under the CFTC Final Rules, a comparability determination with respect to one or more of the CFTC’s margin requirements may be requested (either individually or collectively) by (1) a CSE (or CSEs) eligible for substituted compliance or (2) a foreign regulatory authority that has direct supervisory authority over one or more CSEs and that is responsible for administering the relevant foreign jurisdiction’s margin requirements.

The CFTC will conduct an “element-by-element” analysis of the CFTC and foreign margin rules in determining whether to grant comparability determinations, rather than assessing a foreign margin regime as a whole. Therefore, it is possible that a foreign margin system would be deemed

comparable (and substituted compliance would be available) with respect to some, but not all, elements of the CFTC's margin requirements, thereby potentially subjecting CSEs to a patchwork of U.S. and foreign margin rules.

### **Exception for Transactions with Counterparties in Certain Non-Segregation Jurisdictions**

The CFTC Final Rules provide a limited exception for a non-U.S. branch of a U.S. CSE and an FCS from the requirement to post initial margin to certain non-U.S. counterparties located in jurisdictions ("non-segregation jurisdictions") that do not have the legal or operational infrastructure to support the custodial segregation arrangements required under the CFTC Margin Rules (the "CFTC custodial requirements"), subject to certain conditions. In addition, where these conditions are met, such a non-U.S. branch or FCS would not be required to comply with the third-party custodial arrangement requirements for the segregation of initial margin collected by a CSE under the CFTC Margin Rules.

The exception is available only where the following conditions are met:

- Inherent limitations in the legal or operational infrastructure in the foreign jurisdiction make it impracticable for the parties to post any form of eligible initial margin (permitted under the CFTC Margin Rules) in compliance with the CFTC custodial requirements;
- The CSE is subject to foreign regulatory restrictions that require it to transact non-cleared swaps with the counterparty through an establishment within the foreign jurisdiction and do not accommodate the posting of collateral for such swap in compliance with the CFTC custodial requirements or comparable requirements of a foreign jurisdiction for which the CFTC has granted a comparability determination;
- The counterparty is a non-U.S. person and is not a CSE, and its obligations under the swap are not guaranteed by a U.S. person;
- The CSE collects initial margin for the swap in cash, and posts and collects variation margin in cash, in each case as required by the CFTC Margin Rules;
- The total outstanding notional value of all non-cleared swaps in each broad risk category for which the CSE relies on the exception (*i.e.*, foreign exchange or interest rate risk, credit risk, equity risk and commodity risk)<sup>7</sup>

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<sup>7</sup> The CFTC Margin Rules require that any internal model used by a CSE to calculate its initial margin requirements must use risk factors sufficient to measure all material price risks inherent in the relevant transactions, including the broad risk categories set forth above, and must use the sum of the initial margin calculated for each such category to determine the aggregate initial margin due from the counterparty.

does not exceed 5% of the total outstanding notional value of all of the CSE's non-cleared swaps in such risk category; and

- The CSE has policies and procedures ensuring that it is in compliance with the foregoing conditions and maintains books and records documenting such compliance.

### **Exception for Transactions with Counterparties in Certain Non-Netting Jurisdictions**

The CFTC Final Rules, like the PR Margin Rules, include a special provision permitting a CSE, for purposes of calculating its margin posting obligations, to net swaps with clients located in certain jurisdictions for which a netting opinion is not available ("non-netting jurisdictions"). A CSE that cannot conclude, with a well-founded basis, that the netting agreement with a non-U.S. counterparty meets the definition of an "eligible master netting agreement" in the CFTC Margin Rules may nonetheless net its swaps covered by such agreement in determining its initial and variation margin posting obligations (but must treat such swaps on a gross basis in determining its margin collection requirements).

In order to rely on this special provision, a CSE must have policies and procedures ensuring that it is in compliance with the special provision's requirements, and must maintain books and records documenting that all the requirements of the exception are satisfied.

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Please do not hesitate to contact us with any questions.

**Appendix A: Prudential Regulators' Cross-Border Approach**

The cross-border application of the PR Margin Rules is as follows (in this Appendix A, the term "CSE" refers to a CSE for which there is a prudential regulator):

- A U.S. CSE (including a CSE organized in the United States and any branch or office thereof) generally must collect margin from and post margin to its non-U.S. counterparties under the PR Margin Rules, except that the U.S. CSE may rely on substituted compliance to satisfy its initial margin posting obligation to a non-U.S. counterparty without a U.S. guarantee.
- A CSE that is a U.S. branch or agency of a non-U.S. bank with a U.S. guarantee is treated the same as a U.S. CSE.
- A CSE that is a U.S. branch or agency of a non-U.S. bank without a U.S. guarantee may rely on substituted compliance to satisfy both its initial and variation margin collection and posting obligations from and to U.S. and non-U.S. counterparties.
- A CSE that is not organized in the United States or any state thereof and is a subsidiary of a depository institution, Edge corporation or agreement corporation is treated the same as a U.S. CSE if it has a U.S. guarantee. If such a CSE does not have a U.S. guarantee, it may satisfy both its initial and variation margin collection and posting obligations from and to U.S. and non-U.S. counterparties by relying on a substituted compliance determination, if available, regardless of whether its counterparty has a U.S. guarantee.
- A foreign CSE will not be subject to the prudential regulators' margin requirements where neither the counterparty nor any guarantor (on either side) is (1) organized under the laws of the United States or any State (including a U.S. branch, agency or subsidiary of a non-U.S. bank) or a natural person that is a U.S. resident, (2) a branch or office of an entity organized under the laws of the United States or any State or (3) a Swap Entity that is a subsidiary of an entity organized under the laws of the United States or any State.
- A foreign CSE will be subject to prudential regulators' margin requirements with respect to transactions with (1) a U.S. counterparty or (2) a non-U.S. counterparty where one of the parties is guaranteed by a U.S. person. However, a foreign CSE may rely on substituted compliance:
  - where the foreign CSE does not have a U.S. guarantee, with respect to both its initial and variation margin collection and posting obligations to U.S. counterparties and to non-U.S. counterparties with a U.S. guarantee; and
  - where the foreign CSE does have a U.S. guarantee, only with respect to its initial margin posting obligation to non-U.S. counterparties without a U.S. guarantee.

A "foreign CSE" or a "Foreign Covered Swap Entity" is any CSE that is not:

- Organized under the laws of the United States or any State (including a branch, agency or subsidiary of a non-U.S. bank);
- A branch or office of an entity organized under the laws of the United States or any State; or
- A subsidiary of an entity organized under the laws of the United States or any State.

	U.S. Counterparty (an entity organized in the U.S)	Non-U.S. Counterparty (an entity not organized in the U.S.) with U.S. guarantee	Non-U.S. Counterparty (an entity not organized in the U.S.) without U.S. guarantee
CSE is (i) an entity organized in the U.S. or (ii) any branch or office of an entity organized in the U.S.	PR Margin Rules apply	PR Margin Rules apply	PR Margin Rules apply, except the CSE may post Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination)
CSE is U.S. branch or agency of a foreign bank with U.S. guarantee	PR Margin Rules apply	PR Margin Rules apply	PR Margin Rules apply, except the CSE may post Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination)
CSE is U.S. branch or agency of a foreign bank without U.S. guarantee	Substituted Compliance may apply	Substituted Compliance may apply	Substituted Compliance may apply
CSE is an entity not organized in the U.S. and is a subsidiary of a depository institution, Edge corporation or agreement corporation with U.S. guarantee	PR Margin Rules apply	PR Margin Rules apply	PR Margin Rules apply, except the CSE may post Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination)
CSE is an entity not organized in the U.S. and is a subsidiary of a depository institution, Edge corporation or agreement corporation without U.S. guarantee	Substituted Compliance may apply	Substituted Compliance may apply	Substituted Compliance may apply
CSE is Foreign Covered Swap Entity with U.S. guarantee	PR Margin Rules apply	PR Margin Rules apply	PR Margin Rules apply, except the CSE may post Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination)
CSE is Foreign Covered Swap Entity without U.S. guarantee	Substituted Compliance may apply	Substituted Compliance may apply	PR Margin Rules do not apply

**Appendix B: CFTC’s Cross-Border Approach**

	U.S. Counterparty (an entity organized in the U.S)	Non-U.S. Counterparty (an entity not organized in the U.S.) with U.S. guarantee	Non-U.S. Counterparty (an entity not organized in the U.S.) without U.S. guarantee
U.S. CSE (including non-U.S. branches of a U.S. person)	CFTC Margin Rules apply	CFTC Margin Rules apply	CFTC Margin Rules apply, except the CSE may post Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination)
Non-U.S. CSE (including U.S. branch of a non-U.S. CSE and a FCS) with a U.S. guarantee	CFTC Margin Rules apply	CFTC Margin Rules apply	CFTC Margin Rules apply, except the CSE may post Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination)
FCS without a U.S. guarantee	Substitute Compliance may apply unless the U.S. Counterparty is a U.S. CSE.  If the U.S. Counterparty is a U.S. CSE, then CFTC Margin Rules apply, except the FCS may collect Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination).	Substituted Compliance may apply unless the Non-U.S. Counterparty is a CSE.  If the Non-U.S. Counterparty is a CSE, then CFTC Margin Rules apply, except the FCS may collect Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination).	Substitute Compliance may apply
U.S. branch of a non-U.S. CSE without a U.S. guarantee	Substitute Compliance may apply unless the U.S. Counterparty is a U.S. CSE.  If the U.S. Counterparty is a U.S. CSE, then CFTC Margin Rules apply, except the U.S. branch of the non-U.S. CSE may collect Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination).	Substituted Compliance may apply unless the Non-U.S. Counterparty is a CSE.  If the Non-U.S. Counterparty is a CSE, then CFTC Margin Rules apply, except the U.S. branch of the non-U.S. CSE may collect Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination).	Substitute Compliance may apply
Non-U.S. CSE (that is not an FCS or a U.S. branch of a non-U.S. CSE) without a U.S. guarantee	Substitute Compliance may apply unless the U.S. Counterparty is a U.S. CSE.  If the U.S. Counterparty is a U.S. CSE, then CFTC Margin Rules apply, except the Non-U.S. CSE may collect Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination).	Substitute Compliance may apply unless the Non-U.S. Counterparty is a CSE.  If the Non-U.S. Counterparty is a CSE, then CFTC Margin Rules apply, except the Non-U.S. CSE may collect Initial Margin required under the foreign regime (if foreign regime benefits from a comparability determination).	CFTC Margin Rules do not apply