

Client Alert

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CFTC Adopts Uncleared Swaps Margin Rules

By Julian Hammar

On December 16, 2015, the Commodity Futures Trading Commission (“CFTC” or “Commission”) adopted final rules to impose margin requirements on uncleared swaps entered into by swap dealers and major swap participants subject to CFTC regulation, referred to as “Covered Swap Entities” or “CSEs” in the rules. The CFTC also adopted an interim final rule to exclude from the requirements most uncleared swaps that swap entities enter into with commercial end users, financial institutions with \$10 billion or less in total assets, and certain other entities consistent with the requirements of the Business Risk Mitigation and Price Stabilization Act of 2015.

The CFTC’s regulations are largely the same as the rules and interim final rule adopted by the Prudential Regulators (the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Farm Credit Administration and the Federal Housing Finance Agency) in October 2015 for swap entities subject to their supervision, with a few important differences noted below. The CFTC’s and Prudential Regulators’ rules will significantly impact the economics of the swaps market. Both sets of rules become effective on April 1, 2016, with a compliance schedule discussed below. The CFTC’s final rules are available [here](#), while the Prudential Regulators’ final rules and interim final rule have been published in the Federal Register.¹

BACKGROUND

One of the criticisms of the swaps market in the wake of the 2008 financial crisis was that it did not require swaps counterparties to provide margin (that is, collateral) to secure their obligations to each other. In practice, in many cases before and (even more so) after the crisis, parties have provided collateral (“variation margin”) to cover the current (“mark-to-market”) value of their obligations to each other. Though less common, some parties have also provided upfront collateral (“initial margin”) to cover the potential for further changes in mark-to-market value that could occur over some period (such as 5 business days).

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)² requires the Prudential Regulators, the CFTC and the Securities and Exchange Commission (“SEC”) to draft rules requiring margin for bilateral swaps that will not be cleared at a clearinghouse (cleared swaps, in contrast, are subject to margin requirements imposed by clearinghouses and their members). In fulfillment of the statutory mandate, the CFTC and Prudential Regulators released in the fall of 2014 re-proposed rules for margin requirements for uncleared swap transactions subject to their regulation, which they first proposed in 2011. The re-proposed rules were issued in response to an international framework for uncleared swaps margin stated in a series of papers released by the Basel Committee on Banking Supervision and the Board of the International Organization of

¹ See Margin and Capital Requirements for Covered Swap Entities; Final Rule, 80 Fed. Reg. 74,839 (Nov. 30, 2015) and Interim Final Rule, 80 Fed. Reg. 74,915 (Nov. 30, 2015).

² Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Client Alert

Securities Commissions, the last of which was issued in September 2013 (the “BCBS/IOSCO Framework”). For more information on the Prudential Regulators’ and CFTC’s proposed rules, please see our alert [here](#).

FINAL RULES EXECUTIVE SUMMARY

Overview of the final rules

Like the Prudential Regulators’ final rules, the CFTC’s final rules in general would:

- Require Covered Swap Entities³ to bilaterally exchange, subject to a \$50 million threshold below which it need not be exchanged, “initial margin” with other swap entities and with a broad range of “financial end users,” whose use and affiliates’ use of uncleared swaps meet a notional amount-based exposure (“material swaps exposure”);
- Mandate that all such initial margin, which is intended to secure potential future exposure or adverse changes in value that may arise during the period of time when a swap is being closed out, must be segregated generally with a third-party custodian (not affiliated with either counterparty) and not subject to re-hypothecation or other use by the custodian;⁴
- Permit the calculation of initial margin by means of either a model-based method, subject to regulatory approval, or a table-based method provided for in the rules;
- Impose a significantly higher initial margin requirement on uncleared swaps as compared to cleared swaps by requiring that initial margin models use a 10 business day closeout horizon for most uncleared swaps as opposed to a 5 business day horizon for most cleared swaps; and
- Require swap entities to exchange “variation margin” with swap entities and with a broad array of financial end users without regard to the existence of material swaps exposure and without any threshold.

Relief provided from the re-proposals in the final rules

Also like the Prudential Regulators’ rules, the CFTC’s rules provide some relief from the re-proposal in certain areas, as well as some harmonization with the BCBS-IOSCO Framework. Specifically, the Prudential Regulators’ and CFTC’s rules, as discussed in more detail below, would:

- Increase the material swaps exposure amount for financial end users from \$3 billion to \$8 billion of average daily aggregate notional amount of swaps activity over a three-month period, thereby decreasing the number of entities from and to which Covered Swap Entities must post and collect initial margin and aligning the amount with the BCBS/IOSCO Framework;

³ Under the CFTC’s rules, Covered Swap Entities are swap dealers and major swap participants for which there is no Prudential Regulator, while under the Prudential Regulators’ rules, Covered Swap Entities include swap dealers, major swap participants, security-based swap dealers and major security-based swap participants that are regulated by a Prudential Regulator.

⁴ However, the Prudential Regulators and the CFTC clarify that cash collateral may be held in a general deposit account with the custodian if the funds in the account are used to purchase other forms of eligible collateral, such eligible non-cash collateral is segregated, and the purchase of which takes place within a time period reasonably necessary to consummate such purchase after the cash collateral is posted as initial margin. See 17 C.F.R. 23.157(c) and Prudential Regulators Rule __.7(c).

Client Alert

- Harmonize dollar amounts for the initial margin threshold and minimum transfer amount with the BCBS-IOSCO Framework in light of changed exchange rates;
- Revise the definition of affiliate to eliminate a test of affiliation based on “control” in favor of consolidation under accounting rules, which should make certain calculations easier, such as for material swaps exposure, required by the rules;
- Expand the eligible collateral for initial and variation margin by permitting redeemable securities in certain money market mutual funds for initial margin and providing that variation margin collateral, which under the re-proposals could only be in cash, may be in any form that is eligible for initial margin for swaps between CSEs and financial end users;
- Modify treatment of pre- and post-compliance date swaps under “eligible master netting agreements” (agreements meeting certain requirements under which variation margin can be calculated on a net basis and risk offsets recognized for calculating initial margin); and
- Amend the phased-in compliance schedule for the rules in accordance with delay of the schedule announced by BCBS and IOSCO earlier this year by 9 months.

Notable differences between the CFTC’s and Prudential Regulators’ rules

The CFTC’s final rules have a few notable differences from the Prudential Regulators’ rules, including:

- Providing for a broader exemption from swaps between Covered Swap Entities and their affiliates than the more limited exemption provided by the Prudential Regulators, but with an anti-evasion provision;
- Delegating authority to the National Futures Association (“NFA”), the self-regulatory organization in the futures and swaps industry, to approve initial margin models, which could also be approved by the CFTC (the Prudential Regulators would undertake their own approvals);
- Excluding from the financial end user definition treasury affiliates that qualify for an exemption from mandatory clearing that the CFTC has exempted by rule (the Prudential Regulators have stated that they will include this provision if the CFTC acts to exempt such entities, which currently qualify for an exemption under CFTC staff no-action letters, by rule);
- Requiring that the variation margin calculation use methods, procedures, rules, and inputs that, to the maximum extent practicable rely on recently executed transactions, valuations provided by independent third parties, and other objective criteria (the Prudential Regulators’ rules do not contain this provision); and
- Not addressing cross-border application of the rules, which are being considered by the CFTC in a separate proposal.

Even with the relief provided for in the CFTC’s and the Prudential Regulators’ rules, however, the obligations of the rules represent a significant regulatory burden and cost on the OTC swaps market that did not exist before. It remains to be seen how the swaps market will respond to these requirements.

Client Alert

SCOPE OF THE FINAL RULES

Financial end users

Under both the CFTC's and Prudential Regulators' rules, a Covered Swap Entity will not be required to collect or post specified amounts of initial or variation margin on swaps with counterparties that are not swap entities or "financial end users." Such counterparties are described in the final rules as "other counterparties" by the Prudential Regulators and "non-financial end users" by the CFTC. The final rules retain the "financial end user" definition used in the re-proposal (a list of enumerated financial market status types under various U.S. statutes and regulations including banks, broker-dealers, investment companies, insurance companies, commodity pools and ERISA plans),⁵ which was intended to provide greater clarity than the "financial entity" definition used in the statutory exemption from mandatory clearing in the Commodity Exchange Act ("CEA"). Expressly excluded from the financial end user definition are sovereign entities (central governments or an agency or department thereof), the Bank for International Settlements, multilateral development banks,⁶ entities exempt from the definition of financial entity under section 2(h)(7)(C)(iii) or (D) of the CEA or section 3C(g)(4) of the Securities Exchange Act of 1934 ("Exchange Act"), and, as noted above, the CFTC's rules include an exclusion for treasury affiliates that qualify for an exemption from mandatory clearing that the CFTC has exempted by rule (currently exempted by staff no-action letters). The Prudential Regulators and the CFTC declined to exclude structured finance vehicles or covered bond issuers that had been requested by commenters.

Requirements for swaps with non-financial end users

Swaps with entities that are not financial end users are exempt from the margin requirements under both the CFTC's and the Prudential Regulators' rules, except under the Prudential Regulators' rules, a Covered Swap Entity must collect margin (if any) from such non-financial end users as the CSE determines is appropriate in its overall credit risk management of its exposure to the customer.⁷ CSEs must make this determination for entities that do not qualify for the separate interim final rule (e.g., a commercial end user that is not hedging or mitigating commercial risk), as well as with respect to initial margin for financial end users without material swaps exposure (who are not subject to the rule's initial margin requirements). The CFTC's release does not require this determination, and also removes the requirement contained in the CFTC's re-proposal that CSEs calculate

⁵ See 17 C.F.R. 23.151 and Prudential Regulators Rule __.2 (definition of financial end user). The Prudential Regulators and the CFTC added to the financial end user definition a U.S. intermediate holding company established or designated for purposes of compliance with the Federal Reserve Board's Regulation YY (12 C.F.R. 252.153), and three CFTC-registered entities to the enumerated list: floor brokers, floor traders, and introducing brokers. The CFTC also added business development companies to align its financial end user definition with that of the Prudential Regulators. Both sets of rules include a provision that would cover an entity, person, or arrangement that is, or holds itself out as, 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. See (xi) of the financial end user definition. The final rules also remove the provision contained in the re-proposals that would have included any other entity that the relevant agency determined should be treated as a financial end user.

⁶ Multilateral development banks are separately defined in the rule to include certain specified entities.

⁷ See 80 Fed. Reg. at 74,844.

Client Alert

hypothetical margin requirements for swaps with non-financial end users, citing the administrative burden and that other CFTC rules should address monitoring of risk exposures for these entities.⁸

Interim final rule exemption

The CFTC, like the Prudential Regulators, also adopted an interim final rule in accordance with the Business Risk Mitigation and Price Stabilization Act of 2015, which provides that the requirements of the uncleared swaps margin rules do not apply where the counterparty would be eligible for:

- An exemption from mandatory clearing under Section 2(h)(7)(A) of the CEA or Section 3C(g)(1) of the Exchange Act (i.e., a non-financial entity using the swap to hedge or mitigate commercial risk, certain small financial institutions and captive finance companies);
- An exemption under CEA Section 4(c)(1) for cooperative entities that would otherwise be subject to the requirement to clear; or
- The exemption for affiliates under CEA Section 2(h)(7)(D) or Exchange Act Section 3C(g)(4) (i.e., affiliates that act as an agent).⁹

KEY MODIFICATIONS TO THE RE-PROPOSALS IN THE FINAL RULES

The CFTC's and the Prudential Regulators' final rules make a number of modifications to the re-proposals, as noted above, which provide relief in some cases as well as some harmonization with the BCBS/IOSCO Framework. The discussion of these modifications below also highlights differences between the CFTC's and Prudential Regulators' rules.

Material swaps exposure

Under both the CFTC's and the Prudential Regulators' final rules, the threshold for determining whether a financial end user has "material swaps exposure" has been increased from \$3 billion to \$8 billion of average daily aggregate notional amount of swaps activity for June, July, and August of the previous calendar year (determined by reference to the swaps activity of the financial end user and its affiliate(s) on business days), which is more closely aligned with the BCBS-IOSCO Framework. This change will reduce the number of entities from which swap entities must post and collect initial margin, which is required under the rules for swaps between swap entities and financial end users with material swaps exposure, and level the playing field between swap entities subject to U.S. rules and those subject to rules of foreign jurisdictions, such as the European Union and Japan, which have more closely followed the BCBS-IOSCO Framework. Both sets of rules also clarify that swaps eligible for an exemption under the interim final rule do not count toward this threshold and that swaps entered into between an entity and its affiliate are counted only once to prevent double counting.

A new provision common to both the CFTC's and Prudential Regulators' rules not contained in the re-proposals clarifies the consequences of a change in a counterparty's status. Under the new provision, if a change would

⁸ See CFTC Final Rule Release at 48.

⁹ 17 C.F.R. 23.150; Prudential Regulators Interim Final Rule.

Client Alert

make the rules stricter, such as when a financial end user becomes a financial end user with material swaps exposure, the stricter rules would apply for new swaps entered into after the change. Where a change would make the rules less strict (such as when the exposure of a financial end user with material swaps exposure falls below the \$8 billion threshold), the swap entity may comply with less strict requirements for all outstanding swaps. Accordingly, initial margin, which is not required for swaps with financial end users that do not have material swaps exposure, would no longer be required with respect to all swaps under this provision if a financial end user drops below the \$8 billion threshold.¹⁰

Changes to other numerical amounts

In addition to the modification to the material swaps exposure amount, both the CFTC's and the Prudential Regulators' rules modify other numerical amounts contained in the re-proposals to take into account changed exchange rates that have occurred since the re-proposals were issued. Specifically, the initial margin threshold amount—i.e., the amount under which initial margin need not be collected—has been reduced from \$65 million in the re-proposals to \$50 million in the final rules due to changed exchange rates.¹¹ Similarly, the minimum transfer amount across initial and variation margin—or the amount below which initial and variation margin need not be exchanged until it is exceeded—has been reduced from \$650,000 to \$500,000 in the final rules.¹²

Definition of affiliate

Under both the CFTC's and the Prudential Regulators' final rules, the definition of "affiliate" ("margin affiliate" in the CFTC's rules) has been aligned with established accounting standards rather than relying on the "control" test contained in their re-proposals. The re-proposals contained a low level of control for affiliation to exist—only 25 percent (not 50 percent or more) of the ownership or control, directly or indirectly, of a class of voting securities or total equity. The final rules provide that affiliation exists if a company consolidates the other (or both companies are consolidated with a third company) on financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles, the International Financial Reporting Standards, or other similar standards.¹³ The change may make it easier for companies to determine whether, for example, a financial end user has "material swaps exposure" (which must be calculated to include the exposures of its affiliates), as well as determine compliance deadlines under the phased-in compliance schedule discussed below. The CFTC did not include in its affiliate definition a provision included in the Prudential Regulators' definition of the term "affiliate" pursuant to which the relevant Prudential Regulator may determine that a company is an affiliate of another company based on the regulator's conclusion that either company provides significant support to, or is materially subject to the risk of losses of, the other company.

¹⁰ See 17 C.F.R. 23.161(c) and Prudential Regulators Rule __.1(g).

¹¹ See 17 C.F.R. 23.151 and Prudential Regulators Rule __.2 (definition of initial margin threshold amount).

¹² See 17 C.F.R. 23.151 and Prudential Regulators Rule __.2 (definition of minimum transfer amount). In addition to these modifications, the CFTC's and Prudential Regulators' rules provide clarification about when margin must be collected, when counterparties are in different time zones or observe different legal holidays. See CFTC Final Rule Release at 54-57 and 80 Fed. Reg. at 74864- 65.

¹³ See 17 C.F.R. 23.151 (definition of "margin affiliate") and Prudential Regulators Rule __.2 (definition of affiliate).

Client Alert

Expansion of eligible collateral for initial and variation margin

The CFTC's and Prudential Regulators' rules also expand the types of eligible collateral for initial and variation margin. Eligible collateral types for initial margin include U.S. Treasury securities, government sponsored enterprise securities, securities issued or guaranteed by the Bank for International Settlements, the European Central Bank, the International Monetary Fund and multilateral development banks, publicly traded debt (other than asset-backed securities), publicly traded equities in certain indices and gold, but not securities issued by the pledgor or its affiliate or banks and similar entities. The final rules also permit collateral (not permitted in the re-proposals) of redeemable securities in certain money market mutual funds that meet specific requirements.¹⁴

The CFTC's and Prudential Regulators' final rules also provide that variation margin may include major currencies (defined in the final rules)¹⁵ in addition to U.S. dollars and the currency of settlement, while the re-proposals would not have permitted major currencies. An 8 percent cross-currency haircut applies if margin is denominated in a currency different from settlement currency, except that variation margin in immediately available cash funds in the major currencies is not subject to the haircut.

Both sets of final rules also permit non-cash collateral eligible to be used for initial margin to serve as variation margin for swaps between a Covered Swap Entity and a financial end user (but not for swaps with other swap entities), while the re-proposals only permitted cash collateral for variation margin for all counterparties.¹⁶ This change may be welcomed by certain financial entities, such as insurance companies, that hold significant reserves of bonds and other securities and commented that the restriction to cash-only variation margin would reduce their investment returns.

The CFTC's rules include a provision, not included in the Prudential Regulators' rules, that requires 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.¹⁷

Approval of initial margin models

The CFTC's and the Prudential Regulators' final rules differ in terms of the approval of initial margin models. Both sets of final rules, like the re-proposals, impose stringent regulatory requirements on initial margin models, including written approval of the relevant regulator for use of initial margin models, demonstration on an ongoing basis that the model satisfies all of the requirements under the rules, and prior notice to the relevant regulator before making changes to the model or its assumptions. However, the CFTC's final rules would provide a

¹⁴ See 17 C.F.R. 23.156 and Prudential Regulators Rule __.6.

¹⁵ The major currencies are 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 designated by the CFTC or relevant Prudential Regulator. See 17 C.F.R. 23.151 and Prudential Regulators Rule __.2 (definition of major currency).

¹⁶ See 17 C.F.R. 23.156(b)(1)(ii) and Prudential Regulators Rule __.6(b).

¹⁷ Both releases clarify, in response to comments that the re-proposals appeared to require calculation of variation margin based on the market value of the swap calculated from the Covered Swap Entity's perspective, that the market value used to determine the cumulative mark-to-market change will be mid-market prices, if that is consistent with the agreement of the parties. CFTC Final Rule Release at 114-15, 80 Fed. Reg. at 74,867.

Client Alert

registered futures association (the NFA is the only registered futures association) with authority to approve initial margin models in addition to the CFTC.¹⁸ The Prudential Regulators' final rules do not contain a similar provision; all approvals of initial margin models for Covered Swap Entities subject to their supervision will have to be approved by the relevant Prudential Regulator.¹⁹ The CFTC notes that it or the NFA will coordinate with the Prudential Regulators in order to avoid duplicative efforts and to provide expedited approval of Prudential Regulator-approved models.²⁰

Eligible master netting agreements

Relief was also provided by the CFTC and the Prudential Regulators from their re-proposals with respect to pre-compliance date and post-compliance date swaps subject to a single eligible master netting agreement ("EMNA"). For swaps subject to an EMNA, variation margin can be calculated on a net basis and risk offsets can be recognized within asset classes for calculating initial margin. Under the re-proposals, although the rules applied only to swaps entered into after the relevant compliance date, transactions subject to an EMNA applicable to pre-compliance date transactions would be subject to margin requirements for all swaps under the EMNA. Accordingly, without the relief provided for in the final rules, counterparties would have had to enter into a separate EMNA for new swaps, which received criticism from commenters who argued that this would reduce netting sets and thus increase systemic risk.

Both sets of final rules permit counterparties to document pre- and post-compliance date swaps as separate portfolios for netting purposes under the same EMNA covered by separate credit support annexes.²¹ Accordingly, netting portfolios that contain only uncleared swaps entered into before the applicable compliance date are not subject to the final rules. EMNAs, as provided under the re-proposals, are subject to a requirement that a swap entity conduct sufficient legal review to conclude with a well-founded basis that, among other things, the contract would be found legal, binding, and enforceable under the law of the relevant jurisdiction. Although unqualified legal opinions are not required, the legal review must be in writing.²² Also with regard to EMNAs, the definition of EMNA is amended in the final rules to provide that impermissible "walk away" clauses do not include clauses that only suspend payment obligations when a counterparty defaults.²³ A provision included in the Prudential Regulators' final rules that, if a netting agreement does not qualify as an EMNA, the Covered Swap Entity must collect variation margin on a gross basis but may post on a net basis, is not contained in the CFTC's final rules.

¹⁸ See 17 C.F.R. 23.154(b).

¹⁹ See Prudential Regulators Rule __.8(c).

²⁰ See CFTC Final Rule Release at 74.

²¹ See CFTC Final Rule Release at 59-60 and 80 Fed. Reg. at 74,868.

²² See generally CFTC Final Rule Release at 79-80 and 80 Fed. Reg. at 74,862. A similar legal review requirement applies to custodial agreements with third party custodians for initial margin. The CFTC and Prudential Regulators provide guidance that, for that purpose, the relevant jurisdictions include that of the custodian as well as that of the Covered Swap Entity's counterparty. See CFTC Final Rule Release at 139 and 80 Fed. Reg. at 74,875.

²³ In this regard, the definition of EMNA has been modified to align it with the definition of qualifying master netting agreement in the risk-based capital rules that was modified earlier this year. See 80 Fed. Reg. at 74861-62.

Client Alert

Inter-affiliate swaps

Neither the CFTC's nor the Prudential Regulators' re-proposals contained an exemption from the margin requirements for swaps between a Covered Swap Entity and its affiliates. As mentioned above, the Prudential Regulators' and the CFTC's final rules differ on the treatment of such inter-affiliate swaps.

Under the Prudential Regulators' final rules, the margin requirements generally apply to swaps between a Covered Swap Entity and its affiliates (unless otherwise exempt), except that a Covered Swap Entity is not required to *post* initial margin to an affiliated counterparty.²⁴ The Covered Swap Entity is required to calculate the amount of initial margin that would be required to be posted under the rules to an affiliate (that is a financial end user with material swaps exposure) and provide documentation of such amount on a daily basis. The threshold for collecting initial margin from an affiliate that is a financial entity with material swaps exposure is \$20 million (rather than the generally applicable \$50 million threshold). The Prudential Regulators' rules do not provide relief from variation margin, which must be posted to and collected from financial end user affiliates by swap entities. Initial margin in the form of non-cash collateral for swaps between a swap entity and its affiliates may be held by a custodian that is an affiliate of the Covered Swap Entity or by the Covered Swap Entity itself (rather than an unaffiliated third party as required for uncleared swaps with non-affiliates). The Prudential Regulators' final rule allows a Covered Swap Entity to use a 5 business day close-out time horizon for modelling the initial margin requirement, rather than the generally applicable 10 business day horizon, for swaps that are required to be cleared but which are exempt because of a clearing exemption for inter-affiliate swaps. It should be noted that, if an affiliate of a swap entity is itself a swap entity, then the Prudential Regulators' rules require that both swap entities must collect margin, and thus there is no relief from the posting requirement.

Under the CFTC's final rules, a Covered Swap Entity is generally not required to collect initial margin from a margin affiliate (including another swap entity), provided that the CSE meets the following conditions:

- The swaps are subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with inter-affiliate swaps; and
- The CSE exchanges variation margin with the margin affiliate.²⁵

The CFTC's final rules provide, however, that a Covered Swap Entity must collect initial margin from non-U.S. affiliates that are financial end users that are not subject to comparable initial margin collection requirements on their own outward-facing swaps with financial end users. In addition, in order to facilitate compliance with the Prudential Regulators' rules, the CFTC's rules would require a Covered Swap Entity to post initial margin with a swap entity that is subject to the Prudential Regulators' rules (and required to collect initial margin from its affiliates). As is the case under the Prudential Regulators' rules, the CFTC's rules would require that variation margin be exchanged with respect to swaps between a Covered Swap Entity and its affiliates.

²⁴ See Prudential Regulators Rule __.11.

²⁵ See 17 C.F.R. 23.159.

Client Alert

Phased-in compliance schedule

Both the CFTC's and the Prudential Regulators' final rules adopt the phase-in schedule announced by BCBS/IOSCO in March 2015, which delays implementation of initial margin and variation margin requirements by nine months compared with the re-proposals, starting in September 1, 2016.²⁶ The compliance schedule is nonetheless aggressive in light of the legal, operational, and regulatory approval requirements imposed by the rules. The final rules provide for phased-in implementation for initial margin depending upon swaps exposure of the Covered Swap Entity and its affiliates and its counterparties and their affiliates starting from September 1, 2016 (for entities with the largest exposure) through September 1, 2020, after which swaps with all financial end users with material swaps exposure will be subject to the initial margin requirements.

The CFTC's and Prudential Regulators' final rules also provide for a delayed-implementation schedule with regard to variation margin for Covered Swap Entities belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives is less than \$3 trillion for March, April and May 2016, until March 1, 2017. For all other Covered Swap Entities, the compliance date for variation margin is September 1, 2016.

The final rules clarify that, once a CSE and its counterparty (and their affiliates) become subject to the margin requirements under the schedule, they remain subject to the requirements even if they have a change in status due to a reduction in notional exposure (this differs from the rule explained earlier when a financial end user with material swaps exposure changes status and the less strict margin requirements apply). The Prudential Regulators and the CFTC declined to provide guidance in response to commenters' requests that certain swaps be considered to be entered into before the applicable compliance date.

Cross-border application

The Prudential Regulators' final rules contain provisions governing the cross-border application of the margin rules, while the CFTC has proposed a separate rulemaking to address cross-border application, which has not yet been finalized.²⁷ The Prudential Regulators' final rules, as under the re-proposal, exempt foreign swap entities (but not their U.S. branches or agencies) with respect to the foreign non-cleared swaps from the margin requirements. The exemption is not available where the foreign counterparty is, or is guaranteed by, a U.S. entity, a U.S. branch or subsidiary of a foreign bank, or a foreign swap entity that is a subsidiary of a U.S. entity. Substituted compliance (i.e., compliance with non-U.S. rules rather than U.S. rules) may be available for a foreign bank, U.S. branch or agency of a foreign bank, or an entity that is a foreign subsidiary of a depository institution, Edge corporation or agreement corporation. However, substituted compliance would be available only if the Prudential Regulators have made a comparability determination for the jurisdiction the rules of which would apply to the uncleared swap. Moreover, substituted compliance would not be available if the swap is guaranteed by a U.S. entity.

²⁶ See 17 C.F.R. 23.161 and Prudential Regulators Rule __.1(e).

²⁷ See Prudential Regulators Rule __.9. For more information on the CFTC's proposed rules regarding cross-border application of the uncleared swaps margin requirements, please see our client alert [here](#).

Client Alert

All swap entities (including U.S. entities) under the Prudential Regulators' rules will be deemed to satisfy the initial margin posting requirement under the final rules if they post the amount of initial margin that each of their counterparties is required to collect under non-U.S. rules, provided that the Prudential Regulators have made a substituted compliance determination with respect to those rules and the swap is not subject to a guarantee from a U.S. entity. The Prudential Regulators' final rules also provide relief in certain circumstances from the segregation requirements to foreign branches and subsidiaries of U.S. banks and Edge corporations where inherent limitations in the legal or operational infrastructure in a foreign jurisdiction make it impracticable to segregate collateral.²⁸

CONCLUSION

The CFTC's and Prudential Regulators' final rules provide some welcome relief to market participants when compared with the re-proposals, and the harmonization efforts with non-U.S. regulators should help to create a more level playing field. Nonetheless, the margining requirements imposed by the rules represent a significant regulatory burden and cost on the OTC swaps market that did not exist before, in particular as it pertains to initial margin, which, due to the segregation and re-hypothecation restrictions, will impose a significant new cost for swap dealers and financial end users with material swaps exposure. Because of the 10 business day close-out requirement for calculating initial margin, this cost will be substantially higher than other derivative products, such as cleared swaps or futures. It remains to be seen how the swaps market will respond to these requirements and whether, as a result of their cost, the use of other derivative products, such as cleared swaps and futures, may be used in place of OTC swaps.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.

²⁸ See Prudential Regulators Rule __.9(f).