

## CFTC Uncleared Swap Margin Rules to Take Effect in September

***While the US gears up for compliance with uncleared swap margin rules, cross-border application of the CFTC rules remains unclear.***

The US Commodity Futures Trading Commission (the CFTC) finalized its margin requirements for uncleared swap transactions on December 16, 2015 (the CFTC Margin Rules).<sup>1</sup> The CFTC's adoption of the final rules comes on the tails of the Prudential Regulators<sup>2</sup>, who jointly finalized their uncleared swap margin rules in October 2015 (the PR Margin Rules).<sup>3</sup> Compliance with both sets of rules will be phased in over a period of time beginning in September 2016. The CFTC Margin Rules apply to swap dealers and major swap participants that are not subject to supervision by the Prudential Regulators (collectively referred to herein as CFTC Covered Swap Entities). The CFTC Margin Rules largely track the PR Margin Rules, except with respect to the treatment of certain affiliate-related issues, the proprietary margin model approval process and the calculation of variation margin. Though the finalization of the CFTC Margin Rules is a key piece of the puzzle with respect to the margin framework for uncleared swaps, market participants are still waiting for (i) the CFTC to finalize the rules addressing the cross-border application of the CFTC Margin Rules and (ii) European regulators and the US Securities and Exchange Commission (the SEC) to finalize their respective rules for uncleared derivative transactions.

For further discussion of the PR Margin Rules, please refer to our *Client Alert*: [Prudential Regulators Are First to Finalize Uncleared Swap Margin Rules](#).

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## I. Summary

### A. Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) directs the CFTC to adopt rules establishing minimum initial margin (IM) and variation margin (VM) requirements for CFTC Covered Swap Entities on all swaps that are not cleared by a registered derivatives clearing organization (DCO) (as used herein, uncleared swaps).<sup>4</sup> Though the CFTC initially proposed margin rules for public comment on April 28, 2011,<sup>5</sup> the CFTC repropose regulations to implement IM and VM requirements for uncleared swaps for CFTC Covered Swap Entities on October 3, 2014 (the CFTC Reproposed Margin Rules).<sup>6</sup>

The CFTC Reproposed Margin Rules followed the publication in September 2013 by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), at the direction of the Group of Twenty (G-20), of international standards for margin requirements for non-centrally cleared derivatives (the International Standards).<sup>7</sup> The International Standards were intended to reduce the opportunity for regulatory arbitrage by creating an international framework for uncleared swaps that regulators could use as a guide to frame their respective margin rules. European regulators also repropose their respective margin requirements for uncleared derivatives (the EMIR Proposed Margin Rules).<sup>8</sup> Prompted by market demand for more time and given the lack of finalized rules both in the United States and abroad, BCBS and IOSCO revised the compliance timeline under the International Standards to recommend delaying effectiveness of uncleared swap margin rules by nine months.<sup>9</sup>

### B. CFTC Margin Rules

Following the recommended timeline of BCBS and IOSCO, the CFTC Margin Rules (like the PR Margin Rules) will be phased in beginning on September 1, 2016, with the highest-volume dealers that are CFTC Covered Swap Entities becoming subject to IM and VM requirements first. All market participants, other than Exempted End-Users (defined below), will be required to post VM by March 2017. Market participants subject to IM requirements will become subject to the rules in phases, with the final phase requiring all covered market participants to post/collect IM under the CFTC Margin Rules by September 1, 2020.

The CFTC Margin Rules generally provide that:

- The term “CFTC Covered Swap Entity” captures Swap Entities (defined below) that are not prudentially regulated, including, *inter alia*, nonbank subsidiaries of bank holding companies and foreign Swap Entities not otherwise subject to prudential regulation.<sup>10</sup>
- CFTC Covered Swap Entities entering into uncleared swaps with a person registered with the CFTC as a swap dealer (SD) or a major swap participant (MSP) (SDs and MSPs collectively referred to herein as Swap Entities), or with Financial End-Users<sup>11</sup> with Material Swaps Exposure (defined below) (Financial End-Users with Material Swaps Exposure and Swap Entities collectively referred to herein as Covered Counterparties), must collect and post IM<sup>12</sup> and VM<sup>13</sup> on a daily basis.
- CFTC Covered Swap Entities entering into uncleared swaps with Financial End-Users that **do not** have Material Swaps Exposure must collect and post daily VM, but **will not** be required to post or collect IM.
- CFTC Covered Swap Entities **are not** required to post or collect IM or VM with respect to uncleared swap transactions entered into with Exempted End-Users.
- For purposes of portfolio margining, uncleared swap counterparties may enter into Eligible Master Netting Agreements that separately account for pre- and post-compliance date positions.
- CFTC Covered Swap Entities are generally not required to **collect** IM from their Margin Affiliates (defined below), **except** in the case of certain inter-affiliate swaps with certain foreign Margin Affiliates that are not subject to comparable IM collection requirements. CFTC Covered Swap Entities are also generally not required to **post** IM to their Margin Affiliates, **except** where such Margin Affiliate is a prudentially regulated Swap Entity (a PR Covered Swap Entity) subject to the PR Margin Rules.
- VM must be both collected and posted for uncleared swaps between a CFTC Covered Swap Entity and its Margin Affiliates.
- For purposes of the CFTC Margin Rules, “Margin Affiliate” is defined with a bright-line test, which provides greater legal certainty than under the CFTC Reproposed Margin Rules, in particular with respect to determining Material Swaps Exposure and IM Threshold Amount (defined below).
- IM must be segregated with independent, non-affiliate custodians.
- For purposes of calculating IM, CFTC Covered Swap Entities may use approved proprietary margin models instead of the standardized margin schedule provided by the CFTC in the CFTC Margin Rules.

We have used the term “uncleared swaps” herein to encompass swaps<sup>14</sup> that are not cleared by either a DCO<sup>15</sup> registered with the CFTC or by a clearing organization exempted from registration pursuant to the Commodity Exchange Act.<sup>16</sup>

### **Key Divergences from PR Margin Rules**

While largely mirroring the PR Margin Rules, the CFTC Margin Rules notably diverge from those finalized by the Prudential Regulators with respect to the:

- Treatment of certain treasury affiliates

- Exclusion of the Prudential Regulators' discretionary “anti-evasion” provision in the “Margin Affiliate” definition
- Proprietary IM model approval process
- Calculation of VM and related documentation requirements
- Treatment of certain inter-affiliate trades<sup>17</sup>

### C. Exempted End-Users

On January 12, 2015, the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA) was signed into law.<sup>18</sup> Title III of TRIPRA amends certain provisions of the Dodd-Frank Act to exempt certain counterparties from the IM and VM requirements for uncleared swaps. Specifically, TRIPRA prohibits applying any margin requirements promulgated under the Dodd-Frank Act to uncleared swaps with any of the following counterparties (collectively referred to herein as Exempted End-Users), so long as such counterparty is using the uncleared swaps to hedge commercial risk:

- Commercial end-users, including treasury affiliates (that do not otherwise qualify as Financial End-Users)<sup>19</sup> acting as agent
- Financial institutions (*i.e.*, small banks, savings associations, Farm Credit System institutions, credit unions) with total assets of **US\$10 billion** or less and certain financial cooperatives hedging the risks associated with originating loans for their members<sup>20</sup>
- Captive finance companies<sup>21</sup>

Pursuant to TRIPRA, the CFTC Margin Rules contained an interim final rule (the Interim Final Rule) exempting from the CFTC Margin Rules certain uncleared swaps entered into with Exempted End-Users using such uncleared swaps to hedge or mitigate commercial risk.<sup>22</sup> The Interim Final Rule is scheduled to go into effect with the CFTC Margin Rules on April 1, 2016. The comment period for the Interim Final Rule closed on February 5, 2016. We expect the Interim Final Rule to be finalized in substantially similar form.

### D. Cross-Border Application

On June 29, 2015, the CFTC proposed regulations that would frame the reach of the CFTC Margin Rules in cross-border swap transactions (the CFTC Proposed Cross-Border Margin Rules).<sup>23</sup> The CFTC Proposed Cross-Border Margin Rules would subject all uncleared swap transactions entered into by US CFTC Covered Swap Entities to the CFTC Margin Rules, as well as certain uncleared swaps entered into by non-US CFTC Covered Swap Entities where the risk flows back to a US entity. Though the CFTC declined to finalize a definitive cross-border framework concurrently with the CFTC Margin Rules, the CFTC has indicated that it anticipates finalizing such cross-border rules in the near future,<sup>24</sup> which should close the loop on the cross-border application of the CFTC Margin Rules.

## II. Margin Requirements

A CFTC Covered Swap Entity must post and/or collect (as applicable) IM and VM daily under the CFTC Margin Rules, for the life of the uncleared swap.<sup>25</sup>

### A. Minimum Transfer Amount

The minimum transfer amount below which a CFTC Covered Swap Entity need not collect or post margin pursuant to the CFTC Margin Rules with respect to a particular counterparty has been set at **US\$500,000**

(calculated in the aggregate taking into account all IM and VM required under the CFTC Margin Rules with respect to such counterparty). This amount has been lowered from US\$650,000, the amount repropounded by the CFTC in October 2014.<sup>26</sup>

## **B. Initial Margin Requirements**

### **1. Posting and Collecting Initial Margin**

The CFTC Margin Rules require that a CFTC Covered Swap Entity collect IM, with respect to any uncleared swap, from a Covered Counterparty on a daily basis, in an amount no less than the IM amount calculated in accordance with the CFTC Margin Rules (discussed further below), less the IM Threshold Amount (not including any portion of the IM Threshold Amount already applied by the CFTC Covered Swap Entity or its Margin Affiliates to other uncleared swaps with such Covered Counterparty or its Margin Affiliates), as applicable.<sup>27</sup>

Further, the CFTC Margin Rules require that a CFTC Covered Swap Entity post IM with respect to any uncleared swap with a counterparty that is a Financial End-User with Material Swaps Exposure, in an amount at least as large as what the CFTC Covered Swap Entity would be required to collect under the CFTC Margin Rules — note that the CFTC Covered Swap Entity would also be required to post this amount to a counterparty that is also a CFTC Covered Swap Entity, to satisfy such CFTC Covered Swap Entity counterparty's own IM collection obligations under the CFTC Margin Rules. The CFTC Covered Swap Entity must also post IM to any counterparty that is a Swap Entity, though the amount would be determined under the margin regime applicable to such Swap Entity.<sup>28</sup>

**Material Swaps Exposure.** Under the CFTC Margin Rules, a Financial End-User has “Material Swaps Exposure” if such entity and its Margin Affiliates, in the aggregate, have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange (FX) forwards<sup>29</sup> and FX swaps<sup>30</sup> with all counterparties for June, July and August of the previous calendar year that exceeds **US\$8 billion** (calculated only for business days). The CFTC Repropounded Margin Rules originally provided for a Material Swaps Exposure threshold amount of US\$3 billion. The increase in the threshold for Material Swaps Exposure further aligns with the recommended threshold of €8 billion under the International Standards<sup>31</sup> and the US\$8 billion threshold for Material Swaps Exposure under the PR Margin Rules. The CFTC Margin Rules provide for the following adjustments in calculating a Financial End-User's Material Swaps Exposure:

- Transactions between a CFTC Covered Swap Entity and a Margin Affiliate need only be counted once.
- Swaps exempt from the CFTC Margin Rules by virtue of the Interim Final Rule (*i.e.*, uncleared swaps with Exempted End-Users entering into such transactions to hedge or mitigate their commercial risk) **would not** be included in the calculation.
- Security-based swaps that (i) are exempt pursuant to the SEC clearing exemption for affiliates of end-users or (ii) satisfy the criteria for the SEC's end-user exception for clearing **would not** be included in the calculation.<sup>32</sup>

The CFTC has confirmed a CFTC Covered Swap Entity may rely on a Financial End-User counterparty's good-faith representations in determining whether such Financial End-User has Material Swaps Exposure.<sup>33</sup> Additionally, in response to market concerns, the CFTC has included a new provision in the CFTC Margin Rules to clarify what happens when a Financial End-User counterparty's exposure moves

above or below the Material Swaps Exposure threshold for a given calendar year (discussed further below).<sup>34</sup>

**Initial Margin Threshold Amount.** Rather than the US\$65 million proposed in the CFTC Reproposed Margin Rules, the CFTC has lowered the IM Threshold Amount under the CFTC Margin Rules to an aggregate credit exposure of **US\$50 million** resulting from all uncleared swaps between (i) a CFTC Covered Swap Entity or any of its Margin Affiliates **and** (ii) a Covered Counterparty or any of its Margin Affiliates. Uncleared swaps entered into with Exempted End-Users are **excluded** from this calculation under the Interim Final Rule. The reduction in the IM Threshold Amount is consistent with the International Standards and the PR Margin Rules. The IM Threshold Amount may be allocated among entities within a consolidated group at the agreement of the CFTC Covered Swap Entity and its counterparties, but the total must remain below US\$50 million on a combined basis.<sup>35</sup>

**Margin Affiliates.** The CFTC (like the Prudential Regulators in the PR Margin Rules) has applied a bright-line test to the definition of “Margin Affiliate,”<sup>36</sup> abandoning the control-based approach taken under the proposal. A company is considered a “Margin Affiliate” of another company under any of the following conditions:

- Either company consolidates the other on financial statements prepared in accordance with US Generally Accepted Accounting Principles, the International Financial Reporting Standards or other similar standards (referred to collectively herein as Accounting Standards).
- Both companies are consolidated with a third company on a financial statement prepared in accordance with Accounting Standards.
- For a company that is not subject to Accounting Standards, such consolidation would have occurred if such Accounting Standards had applied.

Notably, however, while the Prudential Regulators gave themselves leeway to otherwise determine that a company is an “affiliate” of another for purposes of the PR Margin Rules (based on the applicable Prudential Regulator's conclusion that either company provides significant support to, or is materially subject to the risks or losses of, the other company), the CFTC expressly declined to include a parallel provision in the CFTC Margin Rules.<sup>37</sup>

The “Margin Affiliate” concept is present throughout the CFTC Margin Rules, including with respect to IM Threshold Amount, Material Swaps Exposure and special considerations for inter-affiliate uncleared swaps. Abandoning the proposed control test for this bright-line accounting-based approach eliminates legal uncertainty regarding the calculation of IM Threshold Amount and Material Swaps Exposure on an aggregate basis under the CFTC Margin Rules.

## **2. Calculating Initial Margin**

A CFTC Covered Swap Entity may calculate its minimum IM amount under the CFTC Margin Rules in one of two ways: (i) by using a standardized margin schedule (as set out in Rule 23.154(c) of the CFTC Margin Rules and reproduced below), which allows for certain types of netting and offsetting of exposures; or (ii) by using an internal IM model that satisfies the CFTC Margin Rules criteria and that has been approved by the CFTC or a registered futures association (*i.e.*, the National Futures Association (the NFA)) (an approved proprietary IM model). In an effort to disincentivize “cherry picking” the method that produces the “most favorable” IM results, the CFTC has stated that it would expect a CFTC Covered Swap Entity switching between the two IM calculation options to provide the CFTC upon request with a rationale for changing methodologies.<sup>38</sup>

**Standardized Initial Margin Schedule.** The CFTC has adopted as proposed the following standardized minimum gross IM requirements for uncleared swaps, as divided by swap asset class:<sup>39</sup>

Asset Class		Gross IM (% of Notional Exposure)
Credit	0-2 year duration	2
	2-5 year duration	5
	5+ year duration	10
Commodity		15
Equity		15
FX/Currency		6
Cross-Currency Swaps <sup>40</sup>	0-2 year duration	1
	2-5 year duration	2
	5+ year duration	4
Interest Rate	0-2 year duration	1
	2-5 year duration	2
	5+ year duration	4
Other		15

- **Eligible Master Netting Agreements.** If the standardized margin schedule is being used to calculate IM for multiple uncleared swaps that are subject to an Eligible Master Netting Agreement (defined below), the amount of IM that the CFTC Covered Swap Entity must collect or post (as applicable) under the CFTC Margin Rules is determined according to the following calculation:

$$\text{IM} = ( 0.4 \times \text{Gross IM} ) + ( 0.6 \times \text{Net-to-Gross Ratio} \times \text{Gross IM} )^{41}$$

**Approved Proprietary Initial Margin Models.** The CFTC Margin Rules permit a CFTC Covered Swap Entity to calculate IM using a proprietary IM model that captures all of the material risks that affect an uncleared swap (including material non-linear price characteristics of such swap), so long as the CFTC or the NFA has granted prior written approval to use the model.<sup>42</sup> Such approval (which may be revoked) is premised on the model satisfying certain qualitative criteria and minimum control, oversight and validation mechanisms (which the CFTC adopted substantially as proposed in the CFTC Reproposed Margin Rules), including, *inter alia*:

- The model must determine the potential future exposure of an uncleared swap (or applicable netting portfolio (discussed further below)), where “potential future exposure” is an estimate of the one-tailed 99% confidence interval for an increase in the value of such uncleared swap (or applicable netting portfolio) over a period equal to the shorter of 10 business days or the maturity of such uncleared swap (or applicable netting portfolio) (referred to as a holding period). Note that (i) this 10-day holding period is longer than the holding period (*i.e.*, three to five days) that central counterparties typically require and, (ii) unlike under bank regulatory capital rules, the CFTC Margin Rules **do not** permit, under any circumstances, a CFTC Covered Swap Entity using an approved proprietary IM model to indirectly compute the 10-day horizon by making an IM calculation over a shorter horizon and then scaling such IM calculation to the required 10-day horizon. The CFTC Margin Rules instead require that such CFTC Covered Swap Entity’s IM calculation be performed directly over the 10-day close-out period.<sup>43</sup>
- If the model reflects offsetting exposures, diversification and other hedging benefits for uncleared swaps that are executed under the same Eligible Master Netting Agreement, the CFTC Covered

Swap Entity must demonstrate the reasonableness for modeling and measuring such hedging benefits.<sup>44</sup>

- With respect to an uncleared cross-currency swap, the model need not recognize risks or risk factors associated with the embedded FX swap (*i.e.*, the fixed, physically-settled exchange of principal), but must recognize all material risks associated with all other payments and cash flows under such uncleared cross-currency swap.<sup>45</sup>
- The CFTC Margin Rules also impose various annual assessment requirements on CFTC Covered Swap Entities that calculate IM pursuant to an approved proprietary IM model.<sup>46</sup>

We have set forth below a number of additional considerations related to a CFTC Covered Swap Entity's use of an approved proprietary IM model.

- Risk Categories. The CFTC Margin Rules require that an approved proprietary IM model assign each derivative contract to a single asset class or broad risk category (*i.e.*, FX and interest rates (considered together as a single asset class), credit, equity, commodities) and that the IM calculations for each broad risk category be performed separately. In a departure from the CFTC Reproposed Margin Rules, the finalized CFTC Margin Rules no longer divide commodities into smaller asset classes.<sup>47</sup>
- Eligible Master Netting Agreements. A CFTC Covered Swap Entity that uses an approved proprietary IM model to calculate IM under an Eligible Master Netting Agreement may only offset an uncleared swap against other uncleared swaps within the same asset class under such Eligible Master Netting Agreement when calculating IM.<sup>48</sup>
- Previously Approved Proprietary IM Models. Recognizing that CFTC Covered Swap Entities may employ vendor-supplied IM models, the CFTC has stated that it (or the NFA) may approve, on a case-by-case basis, such vendor-supplied models and model-related inputs, which the CFTC or the NFA have previously approved for one CFTC Covered Swap Entity, for use by **other** CFTC Covered Swap Entities (*i.e.*, a vendor-supplied proprietary IM model that the CFTC or the NFA has approved for use by a CFTC Covered Swap Entity may also be approved for another CFTC Covered Swap Entity's use). The CFTC Margin Rules also provide for coordination with the Prudential Regulators, the SEC or foreign regulators, as applicable, to facilitate expedited approval for proprietary IM models that have previously obtained the requisite approval by such regulator (*e.g.*, a proprietary IM model the Prudential Regulators have approved under the PR Margin Rules for use by a CFTC Covered Swap Entity's prudentially regulated Margin Affiliate).<sup>49</sup>
- Inter-Affiliate Swaps. Unlike under the PR Margin Rules,<sup>50</sup> the CFTC Margin Rules provide for no special treatment of inter-affiliate swaps when it comes to calculating IM amount.

### **C. Variation Margin Requirements**

The CFTC Margin Rules require that a CFTC Covered Swap Entity collect and post (as applicable) VM in accordance with the CFTC Margin Rules after such CFTC Covered Swap Entity has entered into an uncleared swap with a Swap Entity or a Financial End-User (regardless of whether such Financial End-User has Material Swaps Exposure), including any Margin Affiliates of such CFTC Covered Swap Entity.<sup>51</sup>



## Calculating Variation Margin

Like the PR Margin Rules, the CFTC Margin Rules define “VM amount” as the cumulative mark-to-market change in value to a CFTC Covered Swap Entity of an uncleared swap, as measured from the date such uncleared swap is entered into, less the value of all VM previously collected, plus the value of all VM previously posted with respect to such uncleared swap.<sup>52</sup> The CFTC Margin Rules do, however, go into further detail with respect to VM calculation, requiring that a CFTC Covered Swap Entity 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.<sup>53</sup>

## D. Inter-Affiliate Swaps

### 1. Variation Margin

Similar to the PR Margin Rules, the CFTC Margin Rules require that a CFTC Covered Swap Entity post and collect VM on inter-affiliate swaps entered into with each Margin Affiliate that is a Swap Entity or a Financial End-User.<sup>54</sup> Note that there is no comparable requirement under the current version of the EMIR Proposed Margin Rules to exchange VM with respect to uncleared swaps among affiliates.<sup>55</sup>

### 2. Initial Margin

**Collecting Initial Margin.** A CFTC Covered Swap Entity is **not** required to collect IM from a Margin Affiliate under the CFTC Margin Rules if each of the following conditions are met:

- The uncleared swaps entered into between such CFTC Covered Swap Entity and such Margin Affiliate are subject to a centralized risk-management program that is reasonably designed to monitor and manage the risks associated with such inter-affiliate swap(s)
- Such CFTC Covered Swap Entity exchanges VM with such Margin Affiliate in accordance with the CFTC Margin Rules<sup>56</sup>

The CFTC Margin Rules **do**, however, require CFTC Covered Swap Entities to **collect** IM from foreign Margin Affiliates that (i) are Financial End-Users and (ii) are not subject to comparable IM collection requirements on their own outward-facing swaps with Financial End-Users. Such Margin Affiliates would generally include Financial End-Users located in jurisdictions for which substituted compliance has not been granted with respect to the collection of IM, but would also apply in the case of a series of uncleared swap transactions involving, directly or indirectly, a Margin Affiliate that is not subject to comparable IM collection requirements (e.g., the CFTC Covered Swap Entity is facing a Margin Affiliate that is subject to such requirements, but such Margin Affiliate is, directly or indirectly, transacting with another Margin Affiliate that **is not** subject to such requirements). The CFTC has referred to this collection requirement as “an important anti-evasion measure,” as it is concerned with the potential incentive to use Margin Affiliates to avoid collecting IM from third parties.<sup>57</sup>

**Posting Initial Margin.** The CFTC Margin Rules only require a CFTC Covered Swap Entity to **post** IM to those Margin Affiliates that are prudentially regulated Swap Entities (PR Covered Swap Entities), in an amount equal to the amount that any such PR Covered Swap Entity is required to collect from the CFTC Covered Swap Entity under the PR Margin Rules — CFTC Covered Swap Entities are otherwise not required to post IM with respect to any other inter-affiliate swaps. This posting requirement works in harmony with the PR Margin Rules, which require PR Covered Swap Entities to collect IM from affiliates that are Swap Entities or Financial End-Users.<sup>58</sup>

### III. Collateral

#### A. Market Value and Eligibility of Collateral

The CFTC Margin Rules require a CFTC Covered Swap Entity to monitor the market value and eligibility of all collateral collected and posted to satisfy the IM and VM requirements under the CFTC Margin Rules. Only certain types of assets satisfy these requirements, and the eligibility of the collateral differs based on the type of margin (*i.e.*, IM or VM) being posted and/or collected and, with respect to VM, the identity of the CFTC Covered Swap Entity's counterparty. To the extent that either (i) the market value of such collateral has declined or (ii) such collateral no longer qualifies as Eligible Collateral, CFTC Covered Swap Entities are required to collect or post (as applicable) sufficient collateral to remain compliant with the CFTC Margin Rules.<sup>59</sup>

#### Eligible Collateral

Similar to the PR Margin Rules, the CFTC Margin Rules expand the scope of collateral that CFTC Covered Swap Entities may post or collect (Eligible Collateral) beyond the original proposal.

**Eligible Collateral for Initial Margin.** CFTC Covered Swap Entities may post and collect the following types of collateral to satisfy their IM obligations under the CFTC Margin Rules:

- Immediately available cash funds denominated in (i) US dollars or another major currency<sup>60</sup> or (ii) the currency of settlement<sup>61</sup> under the uncleared swap (referred to herein as the settlement currency) (unless noted otherwise, such funds are referred to herein as cash collateral)
- Securities issued by or guaranteed by a US government agency, the European Central Bank (the ECB) or certain sovereign entities<sup>62</sup>
- Certain debt securities issued by, and asset-backed securities guaranteed by, US government-sponsored enterprises (GSEs)<sup>63</sup>
- Certain redeemable securities in pooled investment funds that invest in US government securities or securities issued by the ECB or certain sovereign entities (referred to herein as Eligible Investment Fund Interests)
- Certain corporate debt securities
- Securities issued or guaranteed by the Bank for International Settlements, the International Monetary Fund or a multilateral development bank<sup>64</sup>
- Certain listed equities
- Gold<sup>65</sup>

Many of these types of collateral are subject to significant Haircuts (defined below) to reflect their liquidity and market valuation risk.

**Eligible Collateral for Variation Margin.** As noted above, the scope of Eligible Collateral for VM under the CFTC Margin Rules varies depending on the identity of such CFTC Covered Swap Entity's counterparty:

- Swap Entity Counterparties. A CFTC Covered Swap Entity may only post and collect cash collateral to satisfy VM requirements imposed by the CFTC Margin Rules for uncleared swaps entered into with a Swap Entity counterparty.
- Financial End-User Counterparties. A CFTC Covered Swap Entity may post and collect the following forms of collateral to satisfy VM requirements under the CFTC Margin Rules for uncleared swaps entered into with a Financial End-User counterparty:
  - Cash collateral
  - Non-cash collateral that is eligible to satisfy the IM requirements (listed above)<sup>66</sup>

Note that the CFTC Margin Rules **do not** restrict the types of collateral a CFTC Covered Swap Entity may post and/or collect for bilaterally agreed amounts **above** the IM or VM amount required by the CFTC Margin Rules.<sup>67</sup>

**Ineligible Securities.** The following securities are specifically **excluded** from the Eligible Collateral definition under the CFTC Margin Rules:

- Securities issued by (i) the party pledging such collateral (the posting counterparty) or (ii) a Margin Affiliate of the posting counterparty
- Securities issued by a wide range of US and non-US financial entities and market intermediaries, including banks, bank holding companies, savings and loan holding companies and Margin Affiliates of the foregoing, and brokers, dealers, SDs and futures commission merchants<sup>68</sup>

## **B. Collateral Segregation**

The CFTC Margin Rules require that IM (but not VM) posted or collected by a CFTC Covered Swap Entity be segregated at one or more custodians that are not Margin Affiliates of either the CFTC Covered Swap Entity or its counterparty (such custodian is referred to as a third-party custodian).<sup>69</sup> These segregation rules are similar to the PR Margin Rules — however, unlike under the PR Margin Rules, any excess collateral posted above the IM amounts required by the CFTC Margin Rules **is not** subject to these segregation requirements.<sup>70</sup>

### **1. Custodial Agreement**

Any IM a CFTC Covered Swap Entity posts and/or collects under the CFTC Margin Rules must be subject to a custodial agreement that satisfies the following conditions:

- The custodial agreement is a legal, valid, binding and enforceable agreement under the laws of all relevant jurisdictions (including in the event of bankruptcy, insolvency or similar proceeding).
- The custodial agreement prohibits the third-party custodian from rehypothecating, repledging, reusing or otherwise transferring any of the collateral it holds, **except** that cash collateral may be held in a general deposit account with the third-party custodian if (i) such funds in the account are used to purchase an asset qualifying as Eligible Collateral, (ii) such Eligible Collateral is not otherwise rehypothecated, repledged or reused and (iii) such purchase takes place within a time period reasonably necessary to consummate such purchase after the cash collateral is posted as IM in satisfaction of the IM requirements under the CFTC Margin Rules.

- If the custodial agreement permits the posting party to substitute or direct any reinvestment of collateral held by the third-party custodian pursuant to the CFTC Margin Rules, the custodial agreement may only permit the substitution or reinvestment of such collateral in assets (i) that would qualify as Eligible Collateral and (ii) for which the amount net of applicable Haircuts would be sufficient to meet the IM requirements under the CFTC Margin Rules.<sup>71</sup>

## 2. Custody Arrangements for Inter-Affiliate Swaps

To the extent that a CFTC Covered Swap Entity collects Eligible Collateral from a Margin Affiliate to satisfy its IM collection requirements under the CFTC Margin Rules, the custodian for such Eligible Collateral may be such CFTC Covered Swap Entity or a Margin Affiliate thereof.<sup>72</sup>

## C. Collateral Valuation

The value of any Eligible Collateral is calculated as follows:

$$\text{Collateral Value} = \text{Eligible Collateral Market Value} \times (1 - \text{Applicable Haircut}),$$

with such value expressed in percentage terms (referred to herein as Collateral Value). The total value of all IM or VM collateral collected or posted pursuant to the CFTC Margin Rules is calculated as the sum of the Collateral Values of each item of Eligible Collateral.<sup>73</sup>

### Haircuts

The value of any Eligible Collateral collected or posted to satisfy the CFTC Margin Rules is subject to the sum of the following discounts (such discounts referred to herein as Haircuts):

Asset Class		Discount (%)
VM collateral denominated in a currency that is not the settlement currency (except for immediately available cash funds denominated in US dollars or another major currency)		8.0
IM collateral denominated in a currency that is not the settlement currency (except for Eligible Collateral denominated in a single termination currency designated as payable to the collecting counterparty under an Eligible Master Netting Agreement)		8.0
Cash in same currency as swap obligation		0.0
Eligible government and related debt	Residual maturity <1 year	0.5
	Residual maturity 1-5 years	2.0
	Residual maturity >5 years	4.0
Eligible corporate debt	Residual maturity <1 year	1.0
	Residual maturity 1-5 years	4.0
	Residual maturity >5 years	8.0
Equity included in the S&P 500 or a related index		15.0
Equity included in the S&P 1500 Composite or a related index (but not the S&P 500 or related index)		25.0
Gold		15.0
Additional (additive) haircut on asset in which the currency of the swap obligation differs from that of the collateral asset		8.0

## IV. Netting Arrangements and Retroactive Application

As under the PR Margin Rules, the CFTC Margin Rules permit a CFTC Covered Swap Entity to net multiple uncleared swaps with a counterparty for purposes of calculating IM and VM amounts and of posting or collecting margin, so long as all uncleared swaps netted against each other have been executed pursuant to an Eligible Master Netting Agreement entered into as between such CFTC Covered Swap Entity and such counterparty. Note that IM amounts **may not** be netted against VM amounts (or vice versa) under the CFTC Margin Rules.<sup>74</sup>

### A. Eligible Master Netting Agreements

Further aligning with the PR Margin Rules, the CFTC Margin Rules define “Eligible Master Netting Agreement” to mean a legally enforceable agreement for which the following conditions are satisfied:

- Upon an event of default following any permitted stay (discussed below), the agreement creates a single legal obligation for all transactions entered into under such agreement.
- The agreement provides the CFTC Covered Swap Entity the right (i) to accelerate, terminate and close out on a net basis all transactions under such agreement and (ii) to liquidate or set off collateral promptly upon an event of default, including upon an event of receivership, conservatorship, insolvency, liquidation or similar proceeding, of the counterparty. Upon the occurrence of any such proceeding, the agreement shall provide that any exercise of rights under such agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, **except** under either of the following circumstances:
  - In receivership, conservatorship or resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended, or the Farm Credit Act of 1971, as amended, or laws of foreign jurisdictions that are substantially similar to the foregoing in order to facilitate the orderly resolution of the defaulting counterparty.
  - The agreement is subject by its terms to, or incorporates, any of the laws referenced above (any such stay referred to herein as a permitted stay).
- The agreement does not contain a walkaway clause (*i.e.*, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement).

A CFTC Covered Swap Entity that relies on an Eligible Master Netting Agreement to calculate the margin required under the CFTC Margin Rules must:

- Conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of such legal review) that each of the following conditions has been met:
  - The agreement satisfies the requirements of the “Eligible Master Netting Agreement” definition.
  - In the event of a legal challenge (including one resulting from default or from receivership, conservatorship, insolvency, liquidation or similar proceeding), the relevant court and administrative authorities would find the agreement to be legal, valid, binding and enforceable under the law of the relevant jurisdictions.

- Establish and maintain written procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of the “Eligible Master Netting Agreement” definition<sup>75</sup>

## **B. No Retroactive Application to Previously Executed Uncleared Swaps**

The CFTC Margin Rules permit a CFTC Covered Swap Entity to identify separate pre- and post-compliance date groups of uncleared swaps to be netted only against the other uncleared swaps in their respective group, even if two or more groups of uncleared swaps were executed pursuant to the same Eligible Master Netting Agreement. As a result, CFTC Covered Swap Entities may continue to use an existing Eligible Master Netting Agreement after the applicable compliance date(s) without subjecting the pre-compliance trades thereunder to the CFTC Margin Rules.<sup>76</sup> This flexibility aligns with the PR Margin Rules.

- For example, if the uncleared swaps under a particular Eligible Master Netting Agreement entered into between a CFTC Covered Swap Entity and a counterparty (that is a Swap Entity or a Financial End-User) is divided into two netting portfolios — (1) uncleared swaps entered into before the compliance date applicable to such CFTC Covered Swap Entity in respect of such counterparty (the pre-compliance portfolio) and (2) uncleared swaps entered into on or after the applicable compliance date (the post-compliance portfolio) — the CFTC Covered Swap Entity is permitted to net the uncleared swaps in the post-compliance portfolio against only other post-compliance uncleared swaps, and the uncleared swaps in the pre-compliance portfolio against only other pre-compliance uncleared swaps.

## **Legacy Swaps**

Like the Prudential Regulators, the CFTC expressly declined to exempt new swap transactions arising from amendments to, and novations or compressions of, uncleared swaps entered into prior to the applicable compliance date (legacy swaps) from the CFTC Margin Rules; accordingly (and absent further guidance from the CFTC to the contrary), the following transactions will be subject to the CFTC Margin Rules beginning on the applicable compliance date, despite their relationship to any legacy swap, to the extent such transactions give rise to a new swap transaction (note the list below is not necessarily exhaustive):

- Amendments to legacy swaps
- Novations of legacy swaps
- New derivatives resulting from portfolio compression of legacy swaps<sup>77</sup>

## **V. Documentation**

### **A. Swap Documentation**

Consistent with documentation standards under the Dodd-Frank Act, the CFTC Margin Rules require a CFTC Covered Swap Entity to document margin-related matters. Such documentation must satisfy the following requirements:

- Provide such CFTC Covered Swap Entity with the contractual right to exchange IM and VM in such amounts, in such form and under such circumstances as the CFTC Margin Rules require

- Specify the methods, procedures, rules, inputs and data sources to be used for (i) determining the value of each uncleared swap for purposes of calculating VM and (ii) calculating IM for uncleared swaps entered into between such CFTC Covered Swap Entity and its counterparty
- Specify the procedures by which any disputes may be resolved with respect to the valuation of (i) the uncleared swaps or (ii) any collateral collected or posted as IM or VM<sup>78</sup>

The CFTC has removed the documentation requirements with respect to non-financial end-users that had previously been included in the CFTC Reproposed Margin Rules.<sup>79</sup>

## B. Approved Proprietary Initial Margin Models

If a CFTC Covered Swap Entity calculates IM under the CFTC Margin Rules by using an approved proprietary IM model, then such CFTC Covered Swap Entity must adequately document the following additional items with respect to such model:

- All material aspects of such approved proprietary IM model, including (i) the management and valuation of the uncleared swaps to which the model applies, (ii) the control, oversight and validation of such model and (iii) any review processes and the results of such processes
- (i) Internal authorization procedures (including escalation procedures) that require review and approval of any change to the IM calculation under such approved proprietary IM model, (ii) demonstrable analysis that any basis for any such change is consistent with the CFTC Margin Rules and (iii) independent review of such demonstrable analysis and approval<sup>80</sup>

## VI. Phased-in Compliance Period

The phased-in compliance schedule, which is consistent with the International Standards and the PR Margin Rules, is set forth below. The compliance dates for the IM and VM requirements are determined by calculating the average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, FX forwards and FX swaps (computed for business days only) for both the CFTC Covered Swap Entity and its counterparty (with each including their respective Margin Affiliates). Where both the CFTC Covered Swap Entity and the respective counterparty exceed the relevant average daily aggregate notional amount listed below, such uncleared swap transactions will be subject to the CFTC Margin Rules.<sup>81</sup>

	Variation Margin Compliance Date	Initial Margin Compliance Date
<b>AVERAGE DAILY AGGREGATE NOTIONAL AMOUNT</b>		
Exceeding US\$3 trillion <sup>a</sup>	Sept. 1, 2016	Sept. 1, 2016
Exceeding US\$2.25 trillion <sup>b</sup>	March 1, 2017	Sept. 1, 2017
Exceeding US\$1.5 trillion <sup>c</sup>		Sept. 1, 2018
Exceeding US\$750 billion <sup>d</sup>		Sept. 1, 2019
Any amount		Sept. 1, 2020

<sup>a</sup> Calculated for March, April and May 2016

<sup>c</sup> Calculated for March, April and May 2018

<sup>b</sup> Calculated for March, April and May 2017

<sup>d</sup> Calculated for March, April and May 2019

Note that a CFTC Covered Swap Entity may be subject to multiple compliance dates for both the IM and the VM requirements under the CFTC Margin Rules, since the CFTC Covered Swap Entity will calculate separate average daily aggregate notional amounts under the CFTC Margin Rules with respect to each of its counterparties.<sup>82</sup>

## A. Calculating Average Daily Aggregate Notional Amount

To determine the applicable compliance date, a CFTC Covered Swap Entity would take into account the average daily aggregate notional amounts of the following transactions of such CFTC Covered Swap Entity and its counterparty (accounting for their respective Margin Affiliates):

- Uncleared swaps
- Uncleared security-based swaps
- FX forwards
- FX swaps

Additionally, the CFTC Margin Rules provide for the following adjustments in calculating the average daily aggregate notional amounts:

- Transactions between a CFTC Covered Swap Entity and a Margin Affiliate (or between a counterparty and a Margin Affiliate) need only be counted once.
- Swaps exempt from the CFTC Margin Rules by virtue of the Interim Final Rule (*i.e.*, uncleared swaps entered into with Exempted End-Users) **would not** be included in the calculation.
- Security-based swaps that (i) are exempt pursuant to the SEC clearing exemption for affiliates of end-users or (ii) satisfy the criteria for the SEC's end-user exception for clearing **would not** be included in the calculation.<sup>83</sup>

## Divergence from International Standards

Note that the applicable compliance date under the CFTC Margin Rules is determined based on the average **daily** aggregate notional amount of uncleared swaps, whereas the International Standards proposed compliance dates determined by the average **month-end** aggregate notional amount of non-centrally cleared derivatives.

## B. Ongoing Compliance Obligations

Once a CFTC Covered Swap Entity is subject to the CFTC Margin Rules with respect to a particular counterparty by virtue of the above compliance schedule, such CFTC Covered Swap Entity will remain subject to the CFTC Margin Rules with respect to such counterparty, regardless of the average daily aggregate notional amount with respect to that particular counterparty or the CFTC Covered Swap Entity. However, in the event that a counterparty's status changes in a way that would subject any uncleared swaps entered into by the CFTC Covered Swap Entity with such counterparty to "less strict" margin requirements under the CFTC Margin Rules (*e.g.*, the counterparty is a Financial End-User that previously had, but no longer has, Material Swaps Exposure), then the CFTC Covered Swap Entity may comply with the "less strict" margin requirements for both: (i) any uncleared swaps entered into after such counterparty's status change and (ii) any outstanding uncleared swaps entered into after the applicable compliance date and before such counterparty changed its status. Note that the converse is also true — if a CFTC Covered Swap Entity's counterparty changes its status such that it would be subject to "stricter" margin rules, the CFTC Covered Swap Entity must comply with the "stricter" margin requirements for any uncleared swap entered into with that counterparty after the status change.<sup>84</sup>



## VII. Cross-Border Application

The CFTC Proposed Cross-Border Margin Rules were published on June 29, 2015 and, if finalized, would subject all uncleared swap transactions entered into by US CFTC Covered Swap Entities to the CFTC Margin Rules, as well as certain uncleared swaps entered into by non-US CFTC Covered Swap Entities where the risk flows back to a US entity.<sup>85</sup> Specifically, in the case of an uncleared swap transaction in which a non-US CFTC Covered Swap Entity is facing a counterparty that is a (i) non-US person whose relevant swap obligations are guaranteed by a US person, (ii) US branch of a foreign bank, (iii) foreign branch of a US CFTC Covered Swap Entity or (iv) non-US CFTC Covered Swap Entity whose financials are consolidated in the annual report of a US ultimate parent, such swap would be subject to the CFTC Margin Rules, though substituted compliance would be available in certain instances. The comment period for the CFTC Proposed Cross-Border Margin Rules closed on September 14, 2015, and the CFTC has indicated that it anticipates finalizing such cross-border rules in the near future,<sup>86</sup> which should close the loop on the cross-border application of the CFTC Margin Rules.

For further discussion of the CFTC Proposed Cross-Border Margin Rules, please refer to our *Client Alert: CFTC Proposes Cross-Border Application of Margin Requirements for Uncleared Swaps*.

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## Endnotes

- <sup>1</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) (to be codified at 17 C.F.R. pts. 23, 140), available at <https://www.gpo.gov/fdsys/pkg/FR-2016-01-06/pdf/2015-32320.pdf> (CFTC Margin Rules).
- <sup>2</sup> The term "Prudential Regulators" as used herein means the Office of the Comptroller of the Currency (Department of Treasury) (the OCC), the Board of Governors of the Federal Reserve System (the FRB), the Federal Deposit Insurance Corporation (the FDIC), the Farm Credit Administration (the FCA) and the Federal Housing Finance Agency (the FHFA). 7 U.S.C. § 1a(39).
- <sup>3</sup> Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840 (Nov. 30, 2015) (to be codified at 12 C.F.R. pts. 45, 237, 349, 624, 1221), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf> (PR Margin Rules). For further discussion, please refer to our *Client Alert* regarding the PR Margin Rules. Prudential Regulators Are First to Finalize Uncleared Swap Margin Rules, *Client Alert* No. 1896 (Nov. 20, 2015), available at <https://www.lw.com/thoughtLeadership/LW-prudential-regulators-finalize-uncleared-swap-margin-rules>.
- <sup>4</sup> 7 U.S.C. § 6s(e)(3)(D)(ii); see also 15 U.S.C. § 8302(a)(1). In accordance with a 2012 determination by the Secretary of the Treasury, the following transactions **will not** be subject to the CFTC Margin Rules: (i) FX swaps; (ii) FX forwards; and (iii) the fixed, physically-settled FX transactions associated with the exchange of principal in cross-currency swaps. See CFTC Margin Rules, 81 Fed. Reg. at 638; Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012), available at <https://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf>.
- <sup>5</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (proposed April 28, 2011) (proposing amendment of 17 C.F.R. pt. 23), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-04-28/pdf/2011-9598.pdf>. For further discussion, please refer to our publication regarding the CFTC's regulatory proposals to implement Title VII of the Dodd-Frank Act. Commodity Futures Trading Commission "Pro Forma" Proposed Rules July 2011 (July 6, 2011), available at <http://www.lw.com/thoughtLeadership/4233-CommodityFuturesTradingCommission-ProForma-ProposedRulesJuly2011>.
- <sup>6</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59897 (proposed Oct. 3, 2014) (proposing amendment of 17 C.F.R. pt. 23), available at <http://www.gpo.gov/fdsys/pkg/FR-2014-10-03/pdf/2014-22962.pdf> (CFTC Reproposed Margin Rules). For further discussion, please refer to our *Client Alert* on the CFTC Reproposed Margin Rules. UPDATE: Swap Dealers Will Face Significant Challenges from Reproposed Margin Rules for Uncleared Swaps, *Client Alert* No. 1792 (Jan. 26, 2015), available at <http://www.lw.com/thoughtLeadership/lw-dealers-margin-rules-for-uncleared-swaps>.
- <sup>7</sup> Margin Requirements for Non-Centrally Cleared Derivatives (updated March 2015), available at <http://www.bis.org/bcbs/publ/d317.pdf> (International Standards).
- <sup>8</sup> Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP Under Article 11(15) of Regulation (EU) No 648/2012 (proposed April 14, 2014), available at <https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf>; Second Consultation Paper: Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP Under Article 11(15) of Regulation (EU) No 648/2012 (proposed June 10, 2015), available at <https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf> (EMIR Proposed Margin Rules).
- <sup>9</sup> See International Standards.
- <sup>10</sup> See CFTC Margin Rules, 81 Fed. Reg. at 637.
- <sup>11</sup> The CFTC Margin Rules define "Financial End-User" to include the following counterparties:
  - Bank holding companies (or Margin Affiliates thereof)
  - Savings and loan holding companies

- Certain US intermediate holding companies
- Certain nonbank financial institutions supervised by the FRB
- Depository institutions
- Foreign banks
- Federal or state credit unions
- Certain institutions functioning solely in a trust or fiduciary capacity
- Industrial loan companies, industrial banks or similar institutions
- State-licensed or registered credit or lending entities
- State-licensed or registered money services businesses
- Entities regulated by the FHFA
- Institutions regulated by the FCA
- Securities holding companies
- Brokers or dealers
- Investment advisers
- Registered investment companies, certain securitization vehicles or private real estate investment entities
- Registered security-based swap dealers or major security-based swap participants
- Business development companies
- Private funds relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act; mortgage-related funds (including some REITs) relying on Section 3(c)(5)(C) of the Investment Company Act; and issuers of asset-backed securities relying on Rule 3a-7 under the Investment Company Act
- Commodity pools, commodity pool operators or commodity trading advisors
- Floor brokers, floor traders or introducing brokers
- Futures commission merchants
- Employee benefit plans
- Insurance companies or other entities primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies or that are otherwise subject to supervision as an insurance company by an insurance regulator
- Entities, persons or arrangements that are, or hold themselves out as being, an entity, person or arrangement that raises money from investors, accepts money from clients or uses its own money primarily for purposes of investing or trading or facilitating the investing or trading in loans, securities, swaps, funds or other assets
- Foreign entities that would be considered Financial End-Users or Swap Entities if they were organized in the United States

The term Financial End-User expressly **excludes** any counterparty that is:

- A sovereign entity
- A multilateral development bank
- The Bank for International Settlements
- An entity that is exempt from the definition of “financial entity” under the Commodity Exchange Act
- An affiliate that qualifies for the inter-affiliate exemption from clearing
- An eligible treasury affiliate expressly exempted from the CFTC Margin Rules (*i.e.*, one qualifying under the Interim Final Rule) — note that the PR Margin Rules **do not** expressly exclude eligible treasury affiliates from the “Financial End-User” definition therein

17 C.F.R. 23.151; *see* 12 U.S.C. §§ 1752(1), (6), 1841(c)(2)(D), (c)(2)(H), 2001 *et seq.*, 4502(20), 5323; 15 U.S.C. §§ 78a *et seq.*, 80a-1 *et seq.*, 80a-3, 80a-53(a), 80b-2(a); 29 U.S.C. § 1002; 12 C.F.R. § 252.153; 17 C.F.R. § 270.3a-7.

<sup>12</sup> “Initial margin” is defined in the CFTC Margin Rules to mean collateral as calculated in accordance with a permitted IM margin model that is posted or collected in connection with one or more uncleared swaps. 17 C.F.R. § 23.151.

<sup>13</sup> “Variation margin” is defined in the CFTC Margin Rules to mean collateral provided by a party to its counterparty to meet the performance of its obligation under one or more uncleared swaps between the parties as a result of a change in value of such obligations since the trade was executed or the last time such collateral was provided. 17 C.F.R. § 23.151.

<sup>14</sup> *See* 7 U.S.C. § 1a(47).

<sup>15</sup> *See* 7 U.S.C. § 1a(15).

<sup>16</sup> 17 C.F.R. § 23.151; *see* 7 U.S.C. §§ 7a-1(a), (h).

<sup>17</sup> *See* CFTC Margin Rules, 81 Fed. Reg. at 638.

- <sup>18</sup> Terrorism Risk Insurance Program Reauthorization Act of 2015, Pub. L. No. 114-1 (2015) (TRIPRA).
- <sup>19</sup> The “treasury affiliate acting as agent” exception to the CFTC’s clearing mandate **does not** apply to a person that is a swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, an issuer that would be an investment company as defined in Section 3 of the Investment Company Act of 1940 but for Section 3(c)(1) or (7) of that Act, a commodity pool or a bank holding company with over US\$50 billion in consolidated assets. See CFTC Margin Rules, 81 Fed. Reg. at 679, n. 337; 7 U.S.C. § 2(h)(7)(D); 15 U.S.C. § 78c-3(g)(4); *see also* 15 U.S.C. § 80a-3.
- <sup>20</sup> Section 302 of TRIPRA specifically provides that the CFTC Margin Rules **shall not** apply to a swap in which a counterparty: (i) qualifies for an exemption under Section 2(h)(7)(A) of the Commodity Exchange Act; (ii) qualifies for an exemption issued under Section 4(c)(1) of the CEA for cooperative entities as defined in such exemption; or (iii) satisfies the criteria in Section 2(h)(7)(D) of the CEA. TRIPRA at § 302; *see* CFTC Margin Rules, 81 Fed. Reg. at 637-638, 678-679.
- <sup>21</sup> The term “captive finance company” describes an entity whose primary business is providing financing and uses derivatives for the purposes of hedging underlying commercial risks relating to interest rate and FX 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. See CFTC Margin Rules, 81 Fed. Reg. at 679; 7 U.S.C. § 2(h)(7)(C)(iii).
- <sup>22</sup> 17 C.F.R. § 23.150(b); *see* CFTC Margin Rules, 81 Fed. Reg. at 637-638, 678-679; TRIPRA at § 303.
- <sup>23</sup> Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 80 Fed. Reg. 41376 (proposed July 14, 2015) (proposing amendment of 17 C.F.R. pt. 23), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2015-07-14/pdf/2015-16718.pdf> (CFTC Proposed Cross-Border Margin Rules). For further discussion, please refer to our *Client Alert* regarding the CFTC Proposed Cross-Border Margin Rules. CFTC Proposes Cross-Border Application of Margin Requirements for Uncleared Swaps, *Client Alert* No. 1865 (Aug. 13, 2015), *available at* <https://www.lw.com/thoughtLeadership/lw-CFTC-Cross-Border-Application-Uncleared-Swaps>.
- <sup>24</sup> See Statement of Chairman Timothy Massad, Final Rule on Margin for Uncleared Swaps (Dec. 16, 2015), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement121615d>.
- <sup>25</sup> 17 C.F.R. § 23.153(b).
- <sup>26</sup> 17 C.F.R. §§ 23.151, 23.152(b)(3), 23.153(c); *see* CFTC Margin Rules, 81 Fed. Reg. at 652-653.
- <sup>27</sup> 17 C.F.R. §§ 23.152(a), 23.154.
- <sup>28</sup> See 17 C.F.R. §§ 23.152(b), 23.154.
- <sup>29</sup> See 7 U.S.C. § 1a(24).
- <sup>30</sup> See 7 U.S.C. § 1a(25).
- <sup>31</sup> See International Standards at 10, 25.
- <sup>32</sup> 17 C.F.R. § 23.151; *see* 15 U.S.C. §§ 78c-3(g)(1), (4).
- <sup>33</sup> CFTC Margin Rules, 81 Fed. Reg. at 645.
- <sup>34</sup> See 17 C.F.R. § 23.161(c); CFTC Margin Rules, 81 Fed. Reg. at 645-646, 676-677.
- <sup>35</sup> See CFTC Margin Rules, 81 Fed. Reg. at 652-653, n. 154.
- <sup>36</sup> The use of the term “Margin Affiliate” rather than “affiliate” was presumably meant to avoid confusion of the use of the term “affiliate” in other CFTC regulations.
- <sup>37</sup> CFTC Margin Rules, 81 Fed. Reg. at 647.
- <sup>38</sup> CFTC Margin Rules, 81 Fed. Reg. at 652.
- <sup>39</sup> 17 C.F.R. § 23.154(c)(1).
- <sup>40</sup> “Cross-currency swap” is defined in the CFTC Margin Rules to mean a swap in which one party exchanges with another party principal and interest rate payments in one currency for principal and interest rate payments in another currency, and the exchange of principal occurs on the date the swap is entered into, with a reversal of the exchange of principal at a later date that is agreed upon when the swap is entered into. 17 C.F.R. § 23.151.
- <sup>41</sup> “Gross IM” is equal to the sum of the product of each uncleared swap’s effective notional amount and the gross IM requirement for all uncleared swaps subject to the Eligible Master Netting Agreement; “Net-to-Gross Ratio” is the ratio of the net current replacement cost to the gross current replacement cost, where “net current replacement cost” equals the total replacement cost for all uncleared swaps subject to the Eligible Master Netting Agreement and “gross current replacement cost” equals the sum of the replacement cost for each uncleared swap subject to the Eligible Master Netting Agreement for which the cost is positive (except if the gross current replacement cost is zero, the Net-to-Gross Ratio should be set to 1.0). 17 C.F.R. § 23.154(c)(2).
- <sup>42</sup> 17 C.F.R. § 23.154(b); *see* CFTC Margin Rules, 81 Fed. Reg. at 653.
- <sup>43</sup> See 17 C.F.R. § 23.154(b)(2)(i); *see* CFTC Margin Rules, 81 Fed. Reg. at 656.
- <sup>44</sup> 17 C.F.R. § 23.154(b)(2)(v); *see* CFTC Margin Rules, 81 Fed. Reg. at 657.
- <sup>45</sup> 17 C.F.R. § 23.154(b)(2)(iv).
- <sup>46</sup> 17 C.F.R. §§ 23.154(b)(2)-(5).

- 47 17 C.F.R. § 23.154(b)(2)(iii); see CFTC Margin Rules, 81 Fed. Reg. at 657.
- 48 17 C.F.R. § 23.154(b)(2)(v); see CFTC Margin Rules, 81 Fed. Reg. at 657-658.
- 49 See CFTC Margin Rules, 80 Fed. Reg. at 654-658.
- 50 See PR Margin Rules, 80 Fed. Reg. at 74887, 12 C.F.R. § \_\_.11(b)(1).
- 51 17 C.F.R. § 23.153(a)-(b).
- 52 In the case of an uncleared swap that has a positive or negative value to a CFTC Covered Swap Entity on the date it is entered into, "VM amount" means such positive or negative value, plus any cumulative mark-to-market change in value to the CFTC Covered Swap Entity, less the value of all VM previously collected, plus the value of all VM previously posted with respect to such uncleared swap. 17 C.F.R. § 23.151; see also PR Margin Rules, 12 C.F.R. § \_\_.2.
- 53 17 C.F.R. § 23.155(a)(1); see CFTC Margin Rules, 81 Fed. Reg. at 665; see also PR Margin Rules, 80 Fed. Reg. at 101-103; 12 C.F.R. §§ \_\_.2, \_\_.3(c), \_\_.4(b).
- 54 17 C.F.R. § 23.159(b).
- 55 See EMIR Proposed Margin Rules; see also International Standards at 21; CFTC Margin Rules, 81 Fed. Reg. at 674.
- 56 Note that these conditions largely mirror the requirements for qualifying for the CFTC's inter-affiliate exemption from the clearing mandate. See CFTC Margin Rules, 81 Fed. Reg. at 673; 17 C.F.R. § 50.52; Clearing Exemption for Swaps Between Certain Affiliated Entities, 78 Fed. Reg. 21750, 21760 (April 11, 2013) (amending 17 C.F.R. pt. 50), available at <https://www.gpo.gov/fdsys/pkg/FR-2013-04-11/pdf/2013-07970.pdf>.
- 57 17 C.F.R. § 23.159(c); see CFTC Margin Rules, 81 Fed. Reg. at 673-674.
- 58 17 C.F.R. § 23.159(a); see CFTC Margin Rules, 81 Fed. Reg. at 673; see also PR Margin Rules, 80 Fed. Reg. at 74888-74889.
- 59 17 C.F.R. § 23.156(c).
- 60 "Major currencies" is defined in the CFTC Margin Rules to mean (i) the United States Dollar (USD), (ii) Canadian Dollar (CAD), (iii) Euro (EUR), (iv) United Kingdom Pound (GBP), (v) Japanese Yen (JPY), (vi) Swiss Franc, (vii) New Zealand Dollar (NZD), (viii) Australian Dollar (AUD), (ix) Swedish Kronor (SEK), (x) Danish Kroner (DKK), (xi) Norwegian Krone (NOK) and any other currency designated by the CFTC. 17 C.F.R. § 23.151.
- 61 "Currency of settlement" is defined in the CFTC Margin Rules to mean a currency in which a party has agreed to discharge payment obligations related to an uncleared swap or a group of uncleared swaps subject to a master netting agreement at the regularly occurring dates on which such payments are due in the ordinary course. 17 C.F.R. § 23.151.
- 62 The CFTC Margin Rules define "sovereign entity" to mean a central government (including the US government) or an agency, department, ministry or central bank of a central government. 17 C.F.R. § 23.151.
- 63 The CFTC Margin Rules define "US government-sponsored enterprise" to mean an entity established or chartered by the US government to serve public purposes specified by federal statute but whose debt obligations are not explicitly guaranteed by the full faith and credit of the US government. 17 C.F.R. § 23.151.
- 64 The CFTC Margin Rules define "multilateral development bank" to include (i) the International Bank for Reconstruction and Development, (ii) the Multilateral Investment Guarantee Agency, (iii) the International Finance Corporation, (iv) the Inter-American Development Bank, (v) the Asian Development Bank, (vi) the African Development Bank, (vii) the European Bank for Reconstruction and Development, (viii) the European Investment Bank, (ix) the European Investment Fund, (x) the Nordic Investment Bank, (xi) the Caribbean Investment Bank, (xii) the Islamic Development Bank, (xiii) the Council of Europe Development Bank and (xiv) any other entity that provides financing for national or regional development in which the US government is a shareholder or contributing member or which the CFTC determines poses comparable credit risk. 17 C.F.R. § 23.151.
- 65 17 C.F.R. § 23.156(a)(1).
- 66 17 C.F.R. § 23.156(b)(1).
- 67 17 C.F.R. § 23.156(d); see CFTC Margin Rules, 81 Fed. Reg. at 667.
- 68 17 C.F.R. § 23.156(a)(2).
- 69 17 C.F.R. §§ 23.157(a)-(b).
- 70 See CFTC Margin Rules, 81 Fed. Reg. at 670-671; see also PR Margin Rules, 80 Fed. Reg. at 74873.
- 71 17 C.F.R. § 23.157(c).
- 72 17 C.F.R. § 23.159(a)(3).
- 73 17 C.F.R. §§ 23.156(a)(3), (b)(2).
- 74 17 C.F.R. §§ 23.152(c), 23.153(d).
- 75 17 C.F.R. § 23.151; see CFTC Margin Rules, 81 Fed. Reg. at 655-656; see also 12 U.S.C. §§ 1811 *et seq.*, 2183, 2279cc, 4617, 5381 *et seq.*
- 76 17 C.F.R. §§ 23.152(c), 153(d); see CFTC Margin Rules, 81 Fed. Reg. at 676-677.
- 77 See CFTC Margin Rules, 81 Fed. Reg. at 675; see also PR Margin Rules, 80 Fed. Reg. at 74851.

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- <sup>78</sup> 17 C.F.R. § 23.158.
- <sup>79</sup> See CFTC Margin Rules, 81 Fed. Reg. at 672.
- <sup>80</sup> 17 C.F.R. §§ 23.154(b)(6)-(7).
- <sup>81</sup> 17 C.F.R. § 23.161.
- <sup>82</sup> CFTC Margin Rules, 81 Fed. Reg. at 676.
- <sup>83</sup> 17 C.F.R. §§ 23.161(a)(1)(iii), (a)(3)(iii), (a)(4)(iii), (a)(5)(iii); see 15 U.S.C. §§ 78c-3(g)(1), (4), 78o-10(e).
- <sup>84</sup> 17 C.F.R. § 23.161(c).
- <sup>85</sup> See CFTC Proposed Cross-Border Margin Rules.
- <sup>86</sup> See Statement of Chairman Timothy Massad, Final Rule on Margin for Uncleared Swaps (Dec. 16, 2015), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement121615d>.