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ALERT MEMORANDUM

January 28, 2016 clearygottlieb.com

Agencies Finalize Margin Rules for Non-Cleared Swaps and Security-Based Swaps

On October 22 and 30, 2015, the Prudential Regulators[1] adopted final rules (the "Bank Final Rules")[2] establishing margin requirements for non-cleared swaps and security-based swaps entered into by registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants ("Swap Entities") that are banks or otherwise subject to oversight by the Prudential Regulators ("Bank Swap Entities").[3]

On December 16, 2015, the Commodity Futures Trading Commission (the "CFTC" and together with the Prudential Regulators, the "Agencies") issued final rules (the "CFTC Final Rules," and together with the Bank Final Rules, the "Final Rules")[4] establishing margin requirements for non-cleared swaps entered into by registered swap dealers and major swap participants that do not have a Prudential Regulator ("Non-Bank Swap Entities").

The Final Rules conclude a more than four-year rulemaking process for the Agencies, including initial proposals in April and May 2011,[5] participation in the publication of an international framework in September 2013 (the "2013 International Framework")[6] and re-proposals in September 2014 (the "2014 Proposals").[7] The Final Rules will be followed by

[1] The Prudential Regulators are the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency (the "OCC"), the Federal Housing Finance Agency and the Farm Credit Administration.

[2] 80 Fed. Reg. 74840 (Nov. 30, 2015).

[3] The Bank Final Rules also impose capital requirements on Bank Swap Entities, which cross-reference existing capital standards already applicable to Bank Swap Entities as regulated financial institutions. Notably, the Bank Final Rules do not appear to establish capital requirements for Bank Swap Entities that are foreign banks that do not operate insured branches but are not "foreign banking organizations," as defined in the Board's Regulation K.

[4] 81 Fed. Reg. 636 (Jan. 6, 2016). Unless otherwise specified, references in this memorandum to "Swap Entities" refer to those Swap Entities subject to the Final Rules, which excludes security-based swap dealers and major security-based swap participants that do not have a Prudential Regulator and are not registered as swap dealers or major swap participants.

[5] 76 Fed. Reg. 23732 (Apr. 28, 2011) (CFTC's Proposal); 76 Fed. Reg. 27564 (May 11, 2011) (Prudential Regulators' Proposal).

[6] Basel Committee on Banking Supervision and International Organization of Securities Commissions, Margin requirements for non-centrally cleared derivatives (Sept. 2013). In addition, European supervisory agencies re-proposed their margin rules in June 2015. Second Consultation Paper regarding draft regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP (June 10, 2015).

[7] 79 Fed. Reg. 57348 (Sept. 24, 2014) (Prudential Regulators' re-proposal); 79 Fed. Reg. 59898 (Oct. 3, 2014) (CFTC's re-proposal).

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margin rules to be adopted by the Securities and Exchange Commission ("SEC") for non-cleared security-based swaps entered into by security-based swap dealers and major security-based swap participants that do not have a Prudential Regulator.[8] In addition, the CFTC indicated that it plans to adopt final rules for the cross-border application of its margin requirements in early 2016.

In several high-profile areas, the 2014 Proposals intentionally diverged from the 2013 International Framework and emerging EU framework. These included the proposed imposition of an initial margin ("IM") exchange obligation between affiliates, a proposed requirement that all variation margin ("VM") be posted in cash, and a significant reduction in the "material swaps exposure" threshold above which a financial end user would become subject to IM requirements. To a substantial degree, the Final Rules harmonized these requirements more closely with the 2013 International Framework and emerging EU framework. Even so, several differences between the Final Rules and margin requirements in other jurisdictions remain. These difference include the scope of covered transactions and covered entities, the scope of permitted netting sets, certain requirements for IM models and collateral haircuts.

Given the Agencies' extensive participation in the development of the 2013 International Framework, and the extraordinary degree of harmonization achieved across the Final Rules, the International Framework and EU implementation of the International Framework, one might have anticipated that the Bank Final Rules' cross-border framework would have included a robust substituted compliance regime. Such a regime would have avoided duplicative and potentially irreconcilable conflicts in margin requirements. It also would have mitigated the impact of disparities having the potential to distort competition and fragment markets.

Under the Bank Final Rules, however, U.S. margin requirements for Bank Swap Entities will apply extraterritorially to U.S.-based firms' foreign branches and foreign subsidiaries, with almost no meaningful opportunity to comply with comparable host country margin rules. This outcome is particularly disappointing because the remaining disparities between U.S margin requirements and international requirements would seem highly unlikely to pose any significant risk to the U.S. financial system or even individual Swap Entities. At the same time, the remaining differences are nonetheless sufficient to result in material competitive disparities and impediments to cross-border trading, resulting in market fragmentation and price skewing. These adverse consequences will be exacerbated significantly if the cross-border framework adopted by the CFTC mirrors that of the Bank Final Rules to any significant extent.

I. Overview; General Observations and Key Issues

Consistent with the 2013 International Framework and the 2014 Proposals, the Final Rules will require a Swap Entity to collect and post VM and IM for covered transactions[9]

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[8] The SEC's proposal pre-dated the 2013 International Framework and reflected many significant differences from that framework. *See* 77 Fed. Reg. 70214 (Nov. 23, 2012).

[9] The Bank Final Rules apply to all non-cleared swaps *and* non-cleared security-based swaps entered into by Bank Swap Entities. The CFTC Final Rules apply only to non-cleared swaps entered into by Non-Bank Swap Entities.

with another Swap Entity or a financial end user, subject to an exception from IM requirements for financial end users whose aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, foreign exchange ("FX") swaps and FX forwards does not exceed a specified level of "material swaps exposure."

The Final Rules also include eligibility requirements for the types of assets that can be posted as VM or IM, requirements for IM to be segregated in an account held at an unaffiliated third-party custodian, minimum standards for the internal models used to calculate IM requirements and documentation requirements. The Final Rules incorporate special margin requirements for inter-affiliate transactions, although the Prudential Regulators and the CFTC adopted significantly different approaches to such transactions. In addition, as noted above, the Bank Final Rules establish a highly complex framework for the cross-border and extraterritorial application of U.S. margin requirements.

The Agencies gave an uneven reception to the many practical and operational concerns expressed by industry participants with regard to the 2014 Proposals. For example:

- *Netting Sets*. The Agencies granted relief allowing Swap Entities to choose whether to apply the Final Rules to covered transactions entered into prior to the Final Rules' compliance date ("legacy covered transactions") that are governed by the same eligible master netting agreement ("EMNA") as covered transactions entered into after the compliance date. On the other hand, the Agencies rejected requests to afford the same treatment to FX forwards, FX swaps, non-cleared securities options and other derivatives transactions that likewise are governed by the same EMNA as new covered transactions. Instead, the Final Rules appear to require that Swap Entities exclude such transactions from the netting portfolios to which the new margin requirements apply, even though such transactions remain part of the same close-out netting set, are included in the same aggregate net exposure calculations for regulatory capital purposes, and, in other jurisdictions, will be subject to the same margin requirements, as covered transactions. This exclusionary treatment extends even to non-cleared security-based swaps entered into by Non-Bank Swap Entities, to which SEC (not CFTC) rules will eventually apply. The ensuing operational and documentation complexities associated with requiring some Swap Entities to manage upwards of four netting sets per counterparty pair will increase risks and foster competitive disparities and conflicts with foreign law that distort markets.

- T+1 Margin Deadline. The Agencies clarified the definition of the "day of execution" for a covered transaction in order to address industry concerns that a T+1 margin collection deadline would not be achievable where parties located in distant time zones execute a transaction outside the business hours of one of the parties. The Agencies did not, however, expressly address the parallel time zone issue raised when a party makes a margin call outside the other party's business hours. In addition, the Agencies rejected requests to extend the T+1 deadline to accommodate collateral settlement mechanics for certain types of eligible margin.

- *Margin Haircuts*. The Agencies significantly narrowed the circumstances where a currency mismatch haircut will apply to margin, but they did not clarify how such a haircut is to be calculated when it does apply. The Agencies also did not accept requests to permit model-based haircuts or to recognize other relationships between credit exposure and margin assets.

- *Emerging Markets*. Commenters expressed concerns about the risks of requiring Swap Entities to post and collect margin on a gross basis or hold IM in third-party custodial accounts in jurisdictions that lack the legal framework or operational infrastructure to support enforceable netting or segregation arrangements. These commenters requested an exception when a Swap Entity trades in these jurisdictions, so long as the risks of such trading do not exceed a specified limit. Instead of adopting this proposal, the Prudential Regulators adopted limited exceptions from certain aspects of the Bank Final Rules that will, among other conditions, impose asymmetrically burdensome margin requirements on Swap Entities' counterparties. Affected counterparties are likely to find these conditions commercially unacceptable. The CFTC has not yet taken up this issue; if the CFTC ends up following the Prudential Regulators' approach, U.S. firms will find it very difficult to compete in emerging foreign markets, even through separately organized subsidiaries.

- *Pro-Cyclicality*. As has been proposed in the EU, Swap Entities will be required to revise the data used to calibrate IM models at least annually, instead of monthly, to incorporate a period of significant financial stress. Swap Entities will also, however, be required to revise such data more frequently as market conditions warrant. Unlike their EU counterparts, the Agencies did not take any specific steps to address industry concerns that such *ad hoc* adjustments to IM models' empirical inputs during periods of market stress could result in a pro-cyclical impact that would increase, rather than mitigate, market stress.

In contrast, the Agencies appear to have taken particular care to address industry concerns regarding the liquidity and other adverse consequences of the Agencies' proposed IM exchange obligation for inter-affiliate transactions. The Prudential Regulators did not accede to industry requests for an outright exception from IM requirements for inter-affiliate transactions. They did, however, make several modifications and clarifications intended to reduce the aggregate liquidity impact of such requirements and limit adverse effects on group-wide risk management. The CFTC adopted an exception from IM collection and posting requirements for inter-affiliate swaps, together with certain conditions designed to mitigate risk and avoid evasion of the CFTC Final Rules.

For covered transactions between the most significant market participants, both IM and VM requirements will come into effect on September 1, 2016. VM requirements will then come into effect for all other covered market participants on March 1, 2017. IM requirements will then be phased in for other covered market participants on an annual basis from September 1, 2017 through September 1, 2020. Only covered transactions entered into after the relevant compliance date will be subject to VM and/or IM requirements (as applicable). As noted above, the Final Rules include clarifications intended to permit a market participant to continue to

document post-compliance date covered transactions under the same EMNA as legacy covered transactions. The Agencies did not, however, grant industry requests to grandfather post-compliance date amendments to, or novations of, legacy covered transactions.

II. Covered Transactions

In General. The Bank Final Rules will cover all non-cleared swaps and security-based swaps entered into by Bank Swap Entities,[10] and the CFTC Final Rules will cover all non-cleared swaps (but not security-based swaps) entered into by Non-Bank Swap Entities, in each case after the relevant compliance date set forth in the Final Rules. Excluded from the rules' coverage are physically settled FX swaps and FX forwards that have been exempted by the Department of the Treasury,[11] as well as non-cleared derivatives (such as non-cleared securities options) that are not covered by the Agencies' margin authority under Title VII of Dodd-Frank. The Agencies also excluded from IM requirements the risks associated with the exchange of principal embedded in a non-cleared cross-currency swap.[12]

Limitations on Portfolio Margining.

The Final Rules do not permit portfolio margining across covered transactions and other transaction types (including, for example, exempt FX transactions, non-cleared securities options, etc.). These limitations raise several issues for Swap Entities. First, although a Bank Swap Entity can portfolio margin non-cleared swaps and security-based swaps, a Non-Bank Swap Entity cannot do so, even if the non-cleared swaps and security-based swaps are governed by the same EMNA. The CFTC did not adopt suggestions to allow Non-Bank Swap Entities that are dually registered with the CFTC and the SEC as swap dealers and security-based swap dealers to margin non-cleared swaps and security-based swaps together. Absent a clarification from the CFTC, Non-Bank Swap Entities will be required to margin non-cleared swaps and security-based swaps separately, potentially putting them at a disadvantage relative to Bank Swap Entities and creating significant obstacles to trading between Bank Swap Entities and Non-Bank Swap Entities.[13]

In addition, the Final Rules' exclusions differ from other jurisdictions' margin rules. For example, other jurisdictions—as well as the Prudential Regulators' own safety and

[10] A Bank Swap Entity that is solely registered as a swap dealer or major swap participant must still comply with the Bank Final Rules for its non-cleared security-based swaps, even if it is not registered as a security-based swap dealer or major security-based swap participant.

[11] These FX transactions remain subject to VM requirements in the case of certain large banking organizations subject to the Board supervisory guidance cited in Note 14 below.

[12] In drafting this exclusion, the Agencies do not appear to have taken into account reset features that commonly exist in cross-currency swaps.

[13] For example, in order to trade with each other, a Bank Swap Entity and a Non-Bank Swap Entity may need to exchange asymmetric amounts of IM.

soundness standards[14]—impose VM requirements on physically settled FX swaps and FX forwards. Other jurisdictions will also require VM and IM for non-cleared securities options. The Agencies did not, however, respond favorably to requests that they permit a Swap Entity to include these transaction types in a common netting set with non-cleared swaps and security-based swaps for purposes of calculating margin requirements.

Absent further clarification of the Agencies' position, Swap Entities may be forced to margin covered transactions separately from excluded transactions, leading to a multiplication of netting sets that does not correspond to risk.[15] This issue will impede the ability of U.S. Swap Entities to compete abroad, create significant operational and documentation burdens and, in the case of VM, unnecessarily increase settlement risk.

Application to Foreign Cleared Swaps. The Final Rules define whether a swap or security-based swap is "non-cleared" by reference to whether it is cleared by a derivatives clearing organization ("DCO") or clearing agency that is registered or exempt from registration with the CFTC or the SEC, respectively. As a result, the Final Rules would appear to apply to swaps and security-based swaps cleared by a foreign DCO or clearing agency whose activities do not subject it to U.S. registration requirements (or the need for other regulatory relief),[16] whether or not the DCO or clearing agency operates under home country requirements that are consistent with international clearing standards.

Requiring a foreign DCO or clearing agency to post IM would be fundamentally inconsistent with basic central counterparty risk management protocols. The adopted definition, absent clarification, could prevent many Swap Entities from accessing foreign DCOs and clearing agencies or force such DCOs or clearing agencies to register or seek an exemption from registration with the CFTC or the SEC, even though they do not engage in any U.S. activity.

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[14] *See, e.g.*, Managing Foreign Exchange Settlement Risks for Physically Settled Transactions, SR 13-24 (Dec. 23, 2013).

[15] For example, a Non-Bank Swap Entity trading with a Bank Swap Entity in a foreign jurisdiction where local margin rules apply could be forced to manage at least four netting sets: (1) a netting set for legacy transactions; (2) a netting set for new non-cleared swaps; (3) a netting set for new non-cleared security-based swaps; and (4) a netting set for new transactions that are excluded from the Final Rules but covered by local margin rules (such as non-cleared securities options). To the extent that some transactions are subject to VM requirements but not IM requirements (for example, as a result of the Final Rules' phase-in schedule or otherwise), the number of netting sets could increase.

[16] For example, the Bank Final Rules will apply to a Bank Swap Entity organized abroad in connection with non-cleared swaps guaranteed by a U.S. company, and such a Bank Swap Entity will not be eligible for substituted compliance. A foreign DCO accepting such a Bank Swap Entity as a clearing member would not, however, be required to register with the CFTC or obtain an exemption from registration. In the context of security-based swaps, even a U.S. Bank Swap Entity could clear at a foreign clearing agency indirectly through a local, non-U.S. clearing member without subjecting that clearing agency to registration with the SEC.

III. Covered Entities

In General. The Final Rules divide market participants into several categories, with different IM and VM requirements applicable to a Swap Entity depending on the category of its counterparty:

- For covered transactions with (i) other Swap Entities and (ii) "financial end users" with "material swaps exposure" (definitions discussed below), a Swap Entity is required to post and collect IM and VM;[17]

- For covered transactions with financial end users that do not have a material swaps exposure, Swap Entities must collect and post VM but not IM;

- Swap Entities do not have any minimum IM or VM requirements with respect to counterparties that are not Swap Entities or financial end users. These other counterparties include commercial end users, certain sovereigns, multilateral development banks and counterparties that qualify for certain exemptions from Dodd-Frank's mandatory clearing requirement (*e.g.*, captive finance companies and corporate treasury affiliates).[18]

"Financial End User" Definition. The Final Rules define "financial end user" broadly to encompass a wide range of entities who engage in financial activities that would give rise to Federal or State registration or chartering requirements or who otherwise engage predominantly in investing or trading activities.[19] The Final Rules expanded the definition from the 2014 Proposals to include certain additional entities, such as proprietary trading firms, and removed a provision that would have allowed the Agencies to designate additional parties as financial end users at their discretion.

- Application to Securitization Vehicles. The Final Rules will apply to securitization vehicles. Because securitization vehicles do not have excess liquidity,

[17] As a technical matter, a Swap Entity does not have a margin posting obligation to a Swap Entity counterparty. It is effectively required to post IM to a Swap Entity counterparty, however, because of the Swap Entity counterparty's reciprocal IM collection obligation.

[18] The Bank Final Rules only exclude treasury affiliates acting as agent, but the preamble indicates that the Prudential Regulators will exclude treasury affiliates acting as principal so long as the CFTC codifies its no-action relief from application of the clearing requirement to treasury affiliates that act as principal. *See* CFTC No-Action Letter No. 14-144 (Nov. 26, 2014). The CFTC Final Rules' definition of "financial end user," in turn, includes a provision that excludes treasury affiliates acting as principal that the CFTC has excluded by rule.

[19] The Bank Final Rules define security-based swap dealers and major security-based swap participants as Swap Entities, while the CFTC Final Rules define such persons as financial end users. As a result, a Non-Bank Swap Entity will not be required to collect or post IM from or to a non-bank security-based swap dealer or major security-based swap participant in connection with non-cleared swaps unless such counterparty has a material swaps exposure or is dually registered as a swap dealer or major swap participant.

they will need to find alternative means to fund their VM obligations,[20] which will increase the costs of securitizations and possibly necessitate changes in securitization structures. In contrast, certain other jurisdictions, such as the EU, appear inclined to exclude certain securitization and covered bond vehicles from many aspects of margin requirements based on the alternative risk mitigants built into such securitization arrangements.

- Foreign Financial End Users. The Final Rules retain a provision that includes as a financial end user any foreign entity that would be a financial end user if it was organized in the United States. This prong could result in the imposition of U.S. margin requirements on foreign entities that would be exempt from margin requirements under their home country regimes. This prong will often require analysis of a foreign counterparty's activities under a wide variety of Federal and State regulatory regimes, even for foreign counterparties that appear to be predominantly engaged in non-financial activities. Swap Entities will frequently not be in a position to engage in such an analysis due to its fact-intensive nature. Foreign counterparties, in turn, will often be reluctant to engage U.S. legal counsel simply to undertake this potentially complex U.S. legal analysis, particularly when such analysis can be avoided by transacting with a counterparty not subject to the U.S. rules.

"Material Swaps Exposure" Definition. Under the Final Rules, an entity has a material swaps exposure if the entity, together with its affiliates[21] had an average daily aggregate notional amount of non-cleared swaps, non-cleared security-based swaps, FX forwards and FX swaps with all counterparties for June, July and August of the previous year that equaled or exceeded $8 billion. The Agencies raised the threshold for material swaps exposure from $3 billion in the 2014 Proposals in order to align with the 2013 International Framework and the EU's proposed margin rules.

The calculation of material swaps exposure excludes swaps covered by TRIPRA (as defined below), and inter-affiliate transactions are only counted once. This calculation is different from the analogous calculation in the 2013 International Framework, which consists of a slightly different range of derivatives and is based on month-end measurements, rather than daily measurements.

TRIPRA. In addition to the Final Rules, the Agencies adopted interim final rules implementing Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 ("TRIPRA"). TRIPRA exempts from Dodd-Frank's margin requirements any non-cleared swaps and security-based swaps with respect to which a counterparty qualifies for certain exemptions from Dodd-Frank's clearing requirement, including the clearing exemption for swaps and

[20] Certain securitization structures, such as master trusts, may also exceed the material swaps exposure threshold and thereby become subject to IM requirements. In this regard, the Agencies stated that different series of a series trust must aggregate their positions together for purposes of calculating their material swaps exposure.

[21] The Final Rules define "affiliate" as any entity that is consolidated with another on financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles, International Financial Reporting Standards or other similar standards. This is a change from the definition in the 2014 Proposals, which included a lower, 25 percent common ownership threshold for "affiliate" status.

security-based swaps entered into by a U.S. depository institution with total assets of $10 billion or less for the purpose of hedging or mitigating commercial risk.

Because the TRIPRA exemption only applies to particular transactions that qualify for an exemption from the mandatory clearing requirement, Swap Entities will have to comply with the Final Rules, and maintain separate margin netting portfolios, with respect to covered transactions entered into by such counterparties that do not qualify for such exemptions, such as covered transactions that are entered into for the purpose of speculation or investment.

Change in Status. The Final Rules clarify that, if a counterparty's status changes so that it becomes subject to more strict IM or VM requirements (*e.g.,* if a financial end user crosses the material swaps exposure threshold), then the transacting Swap Entity would be required to comply with the additional requirements only in the case of covered transactions entered into after the point that the counterparty's status changes. On the other hand, if a counterparty's status changes so that it is subject to less strict requirements, then the Swap Entity would be permitted to comply with the less strict requirements with respect to all covered transactions with that counterparty (including those entered into prior to the counterparty's status change).[22]

IV. Variation Margin

The Final Rules require Swap Entities to exchange VM on a daily basis with other Swap Entities and all financial end users[23], subject to a $500,000 minimum transfer amount.[24] The VM requirements apply on the business day following the "day of execution" of a covered transaction and then each business day thereafter.[25] There is no minimum exposure threshold exchange applicable to VM.

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[22] The Final Rules differ from the EU proposal, which would seem to require counterparties to respond to changes in status only with respect to new covered transactions that are entered into starting in January after a change occurs.

[23] The preamble clarifies that VM should be calculated at mid-market if that is consistent with the parties' agreement. The CFTC Final Rules (but not the Bank Final Rules) additionally require (i) that VM 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 and (ii) a Non-Bank Swap Entity to maintain documentation setting forth its VM methodology with sufficient specificity to allow the counterparty, the CFTC, the National Futures Association ("NFA") and any applicable Prudential Regulator to calculate a reasonable approximation of the VM requirement independently. The CFTC does not appear to require this documentation to be agreed with the counterparty.

[24] The Final Rules' minimum transfer amount was reduced from the proposed $650,000 level, based on intervening changes in the USD-EUR exchange rate. The minimum transfer amount is a maximum level, but parties may bilaterally adopt a lower minimum transfer amount.

[25] See Section VII for additional discussion about margin deadlines.

V. Initial Margin

In General. As noted above, the Final Rules require Swap Entities to collect and post IM with (i) other Swap Entities and (ii) financial end users that have a material swaps exposure, subject in each case to a maximum $50 million threshold (calculated on a consolidated basis with respect to all covered transactions between the Swap Entity and its affiliates, on the one hand, and its counterparty and the counterparty's affiliates, on the other hand).[26] IM requirements are also subject to the $500,000 minimum transfer amount (calculated across both IM and VM). The Swap Entity must satisfy its post and collect obligations before the end of the business day after the day of execution of the covered transaction and daily thereafter with respect to any changes in the IM amount (in excess of the threshold and minimum transfer amount).

A Swap Entity can calculate its IM amount using either (1) a table in the Final Rules that contains standardized IM amounts based on the risk category and tenor of the covered transaction or (2) an internal model that has been approved by the Swap Entity's U.S. Agency.[27] An IM model must measure the potential future exposure of a portfolio of covered transactions based on a one-tailed 99% confidence level over a 10-day liquidation horizon using data from an equally weighted historical observation period of one to five years that incorporates a period of significant financial stress.[28]

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[26] This threshold was reduced from the proposed $65 million level, based on intervening changes in the USD-EUR exchange rate.

[27] The CFTC Final Rules provide that an IM model can be approved by the CFTC or a "registered futures association," which currently only includes the NFA. In the preamble to the CFTC Final Rules, the CFTC stated that it and the NFA would coordinate review of IM models with the Prudential Regulators in circumstances where the Non-Bank Swap Entity was using the same IM model as a Bank Swap Entity affiliate.

[28] The preambles to the Final Rules state that Swap Entities can make use of vendor-supplied products and services for internal models, including data feeds, computing environments or calculation engines. Approval is limited to the specific implementation of a vendor-supplied model used by a Swap Entity, rather than to the generic vendor-supplied model. In this regard, the Final Rules require Swap Entities to develop internal control procedures with respect to their IM models that include the following requirements: (i) maintaining a "control unit" that reports directly to senior management and is independent from business trading units and is responsible for validating the IM model; (ii) ongoing monitoring and benchmarking of outcomes of the model against alternative internal and external data sources or estimation techniques; (iii) back-testing of the model; (iv) maintaining an internal audit function that annually assesses the effectiveness and compliance of business-line management and the risk control unit with respect to the model, and must report findings to the Swap Entity's board of directors annually; (v) documenting all material aspects of the IM model, management, valuation, control, oversight and validation related thereto; and (vi) documenting internal authorization and escalation procedures.

In addition, the Final Rules allow a Swap Entity to use either the standardized or the internal model approach for different categories of covered transactions, but the preambles state that a Swap Entity should not cherry-pick between the two methods or switch the method with respect to a counterparty based on which method yields a more favorable IM amount. The preambles state that the Agencies will monitor selective application of the standardized or internal model method for evasion of this requirement.

Limited Recognition of Risk Offsets. Under the Final Rules, a Swap Entity must categorize each covered transaction into one of four risk categories – (i) commodities,[29] (ii) credit, (iii) equity and (iv) FX and interest rates. An internal model can recognize risk offsets within a single risk category, but not across risk categories. The Final Rules will not allow an internal model to recognize risk offsets between different product types even where these product types exhibit common risk factors (*e.g.*, a model may not recognize the extent to which FX transactions within a non-cleared swap portfolio offset the FX risk embedded in a "compo" equity swap held in the same portfolio). This aspect of the Final Rules is inconsistent with a clarification recently proposed by EU authorities in connection with their proposed margin rules.

Model Recalibration and Pro-Cyclicality. The Final Rules require a Swap Entity to review its internal IM model at least annually with respect to developments in financial markets and modeling technologies, as opposed to the monthly review cycle contained in the 2014 Proposals. This change aligns the Final Rules' model review cycle with the review cycle that has been proposed by EU authorities.[30]

However, the Final Rules continue to require a Swap Entity, on an *ad hoc* basis, as dictated by changing market conditions, to update the empirical data used by the model to incorporate historical data from a period of significant financial stress. These updates could result in pro-cyclical increases in IM requirements during periods of elevated financial stress. Unlike the EU authorities' proposal, the Final Rules would not allow additional time for parties to satisfy increased IM requirements due to changes to an internal IM model.

VI. Eligible Margin and Required Haircuts

Initial Margin. The Final Rules allow a broad range of collateral to satisfy IM requirements,[31] subject to standardized haircuts for non-cash collateral.[32] The requirement to

[29] The Final Rules combined the proposed risk categories for agricultural commodities, energy commodities, metal commodities and other commodities into a single "commodities" risk category, consistent with the International Framework.

[30] The Final Rules also require Swap Entities to benchmark their internal IM models so as to ensure that the IM that they require is not less than the amount a DCO or clearing agency would require for similar cleared transactions.

[31] In an expansion from the 2014 Proposals, the Final Rules include as eligible collateral interests in investment funds that hold securities issued or guaranteed by the U.S. Treasury, the European Central Bank or another sovereign entity that is assigned no higher than a 20% risk weight under bank capital rules.

Other eligible non-cash margin assets include: (i) U.S. Treasury securities; (ii) certain other U.S. government agency securities; (iii) certain debt or asset-backed securities issued by U.S. government-sponsored enterprises which are operating with direct financial assistance from the U.S. government; (iv) securities issued by the European Central Bank and certain foreign sovereign securities (assigned no higher than 20% risk weight under bank capital rules); (v) securities issued or guaranteed by the Bank for International Settlements, the International Monetary Fund or a multilateral development bank; (vi) investment grade publicly traded debt securities (other than asset-backed securities); (vii) certain investment grade publicly traded common equity securities; and (ix) gold. In addition, the Final Rules have wrong-way risk requirements pursuant to which corporate debt and equity securities are not eligible if they are issued by: (i) the counterparty or any of its affiliates; (ii) a bank holding company; (iii) a savings and loan holding company; (iv) a foreign bank; (v) a depository institution; (vi) a securities holding company; (vii) a broker-dealer; (viii) a futures commission merchant; (ix) a swap dealer; (x) a security-based swap dealer; (xi) a company that would fall into one of those

apply standardized haircuts is inconsistent with the 2013 International Framework, which allows parties to apply model-based haircuts to eligible margin. In the case of non-cash IM, no allowance is made for risk correlations between collateral and underlying swap positions.

In addition to the standardized haircuts, the Final Rules also provide that an 8% haircut will apply to IM denominated in a currency other than the currency of settlement, except in the case of IM denominated in a single termination currency designated as payable to the non-posting counterparty as part of an EMNA.[33] The Final Rules define the "currency of settlement" as the currency in which a party has agreed to discharge payment obligations for covered transactions under an EMNA in the ordinary course.

Variation Margin. The Final Rules expanded the scope of collateral eligible to satisfy VM requirements. For covered transactions between two Swap Entities, eligible VM is limited to immediately available cash in any major currency or the currency of settlement of the relevant covered transaction. For covered transactions between a Swap Entity and a financial end user, VM may take the form of any IM eligible collateral, subject to the same standardized haircuts applicable for IM.

For VM, the 8% cross-currency haircut will apply with respect to collateral denominated in a currency other than the currency of settlement, except for IM in the form of immediately available cash funds in a major currency. The Agencies did not clarify how the "currency of settlement" definition is to apply in the context of multiple transactions entered into under a single EMNA but for which periodic payments (as opposed to termination payments) are denominated in different currencies. Given that VM is collateral for non-cleared transactions, not settlement of accrued periodic payment obligations, it is unclear why the Agencies defined "currency of settlement" in relation to periodic payment obligations instead of termination payments.

VII. Margin Deadlines, Dispute Resolution, Documentation and Netting Requirements

Margin Deadlines. As noted above, Swap Entities are required to collect and post IM and VM beginning on the business day following the day of execution for a covered transaction and thereafter on a daily basis.[34] The Agencies responded to requests for

categories if it was organized in the U.S. or an affiliate of any of those entities; and (xii) any non-bank Systemically Important Financial Institutions, as designated by the Financial Stability Oversight Council.

Immediately available cash funds denominated in U.S. dollars, specified major currencies or the currency of settlement will be eligible as IM, but must generally be re-invested in eligible non-cash IM.

32 These haircuts range from 0.5% of market value (for certain government debt with residual maturity of less than one year) to 25% (for certain equity securities).

33 Parties to a single EMNA could each have different termination currencies, but IM for covered transactions under such an EMNA would not qualify for the exclusion from the 8% cross-currency haircut.

34 Although a Swap Entity has a requirement to post IM and VM to a financial end user, the Final Rules do not (and cannot) impose requirements on the financial end user to issue a margin call to a Swap Entity. Swap Entities

clarification regarding the definition of the "day of execution" in the case of transactions between parties located in different time zones.[35] However, the Agencies did not expressly address timing delays associated with the calculation of and calls for margin. In addition, the Agencies rejected requests to align posting and collection deadlines with the settlement cycles applicable to eligible margin. The U.S. Agencies also did not address timing delays associated with the calculation of and calls for margin. . Instead, the Agencies suggested that parties pre-position eligible margin securities before executing a covered transaction or initially post more readily-transferable collateral (such as cash) on an interim basis pending receipt of other collateral.[36]

Dispute Resolution. The deadlines for posting and collecting margin under the Final Rules will require parties to settle disputes that arise in the calculation of margin after the undisputed amount of margin is posted and collected. The preambles to the Final Rules clarified that, if such a dispute arises, a Swap Entity will not be in violation of the Final Rules if the Swap Entity acts to resolve the dispute pursuant to the provisions of the relevant swap agreement and in the normal course of business, as adjustments to the original margin call.

Documentation. The Final Rules require Swap Entities to execute trading documentation regarding credit support arrangements with other Swap Entities and financial end users. This documentation must provide the Swap Entity the right to collect and post IM and VM as required by the Final Rules. The documentation must also specify the "methods, procedures, rules, and inputs" used for valuing covered transactions for purposes of VM and describe the "methods, procedures, rules, and inputs" used to calculate IM.[37] Finally, the documentation must outline dispute resolution procedures regarding the valuation of the covered transactions or assets posted as VM and IM.

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should consider including provisions in their documentation to address circumstances where a financial end user counterparty does not issue a timely margin call.

[35] Under the Final Rules:

- If at the time the parties enter into the covered transaction, it is a different calendar day at the location of each party, the day of execution is deemed to be the latter of the two calendar days;
- If a covered transaction is entered into between 4:00pm and midnight in the location of a party, then such covered transaction shall be deemed to have been entered into on the immediately succeeding day that is a business day for both parties; and
- If the day of execution determined under these principles is not a business day for both parties, the day of execution shall be deemed to be the immediately succeeding day that is a business day for both parties.

[36] The preambles indicated that IM and VM generally may not be netted against each other, but did not clarify if a Swap Entity can use a counterparty's excess IM to satisfy VM requirements.

[37] The CFTC Final Rules (but not the Bank Final Rules) also require the margin documentation to specify the data sources to be used for (i) valuing covered transactions for purposes of VM and (ii) calculating IM.

Netting. The Final Rules permit Swap Entities to calculate margin requirements on a net basis for all covered transactions under a single EMNA.[38] For counterparties with respect to which the Bank Swap Entity has not concluded that the netting provisions of their agreement would be enforced at a level of confidence sufficient to satisfy the EMNA definition, the Bank Final Rules allow the Bank Swap Entity to post margin on a net basis, but collect margin on a gross basis. This provision is a beneficial change from the 2014 Proposals, which would have required collection and posting on a gross basis. As a practical matter, however, the affected counterparties are unlikely to agree to post margin on a gross basis. The CFTC Final Rules did not include this provision, but the preamble to the CFTC Final Rules indicated that the CFTC will address the absence of netting in foreign jurisdictions as part of its forthcoming cross-border margin rulemaking.

The Final Rules also include a modification from the 2014 Proposals that allows a Swap Entity to identify and maintain multiple separate netting portfolios under a single EMNA, such as netting portfolios for legacy covered transactions that are not subject to the Final Rules, and a netting portfolio for new covered transactions. In order for the Swap Entity to identify two separate portfolios for margin purposes but still apply close-out netting across the portfolios, the Final Rules require that (i) each such portfolio "independently" satisfy the requirements for close-out netting[39] and (ii) the posting and collection of margin for each netting portfolio apply "separate and exclusive of" any other covered transactions documented under the EMNA.

If a new covered transaction is included in such a netting portfolio, then all the covered transactions included in that portfolio will become subject to the Final Rules, regardless of when they were executed. In this way, market participants will be able to elect which legacy covered transactions, if any, to subject to the Final Rules. As noted above, however, market participants will not be able to make the same election with respect to excluded transactions, such as non-cleared securities options, even when they are documented under the same EMNA as covered transactions.

[38] The Final Rules define an EMNA as any written, legally enforceable netting agreement that creates a single legal obligation for all individual transactions covered by the agreement upon an event of default (including conservatorship, receivership, insolvency, liquidation or similar proceeding), subject to certain conditions. The Final Rules modifies the definition of EMNA in the 2014 Proposals to align with the revised definition of "Qualified Master Netting Agreement" ("QMNA") for the Board's and OCC's risk based capital rules, which were adopted in an interim final rule of January 1, 2015. Specifically, the Final Rules removed a proposed limitation on clauses that allow a non-defaulting counterparty to "suspend or condition payment" from the limitation on walkaway clauses. This clarifies that Section 2(a)(3) of the standard 2002 ISDA Master Agreement and 1992 ISDA Master Agreement would not disqualify those agreements from being EMNAs. In addition, the Final Rules added language, in line with the revised QMNA definition, that an agreement would be an EMNA notwithstanding a stay on the exercise of termination rights in certain insolvency regimes, including (i) in receivership, conservatorship or resolution by an agency exercising its statutory authority, or substantially similar laws in foreign jurisdictions that provide for limited stays to facilitate the orderly resolution of financial institutions, or (ii) in an agreement subject by its terms to any of the foreign laws.

[39] The preamble to the Final Rules explains this change as responsive to commenters' objection to having to enter into new trading documentation to have separate netting portfolios and ensuing concerns about the loss of close-out netting. The text of the Final Rules leaves residual ambiguity, however, about how an individual netting portfolio can satisfy the close-out netting requirements of the Final Rules' EMNA definition "independently."

VIII. Segregation of Collateral

In General. Under the Final Rules, a Swap Entity must require that all IM that it posts (including IM posted voluntarily, *e.g.*, IM below the IM threshold) be held at an unaffiliated, third-party custodian. Similarly, a Swap Entity must hold all IM that the Final Rules require it to collect (except non-cash IM collected from an affiliate, as discussed below) at an unaffiliated, third-party custodian. The Final Rules require that any IM custodial arrangement prohibit the custodian from "rehypothecating, repledging, reusing or otherwise transferring" collateral held to satisfy IM requirements.[40]

Notwithstanding this provision, the Final Rules permit the posting party to substitute posted IM with, or reinvest posted IM in, other eligible collateral, so long as, in each case, the market value of the substituted or reinvested IM, less applicable haircuts, would be sufficient to satisfy the required minimum amount of IM.[41] Also, in response to comments from custodial banks about the application of the segregation requirement to cash IM, the Final Rules permit cash IM to be held in a general deposit account, so long as the cash IM is used to purchase eligible non-cash IM within a time period reasonably necessary to consummate such purchase and such purchased eligible non-cash IM is held in accordance with the rule.[42]

Interaction with SEC Proposal. Under proposed SEC capital rules, the Final Rules' segregation requirement would likely subject non-bank security-based swap dealers to a 100% capital charge for all IM they collect.[43] Without further clarification from the SEC, this requirement would significantly affect the competitive position of non-bank security-based swap dealers.

Interaction with Dodd-Frank Segregation Elections. The CFTC Final Rules amended the CFTC's pre-existing requirement that a Swap Entity segregate IM at a third-party custodian upon election by its counterparty. As amended, the elective segregation requirement applies only in those instances where segregation of IM is not required. However, this amendment only appears to apply to IM segregated under the CFTC Final Rules, but not the Bank Final Rules. The CFTC should clarify that its elective segregation requirements do not apply to IM segregated under the Bank Final Rules so that Bank Swap Entities are not arguably subject to two different segregation regimes.

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40 The Final Rules require that the custody agreement be "legal, valid, binding, and enforceable" in the jurisdiction of the custodian. Furthermore, a Swap Entity must ensure that, in the event that its counterparty is subject to an insolvency proceeding, the Swap Entity is able to set aside the custodial agreement and reclaim the relevant property under the law of the counterparty's jurisdiction.

41 The Final Rules do not address the timing or operational mechanics of substituting or reinvesting IM.

42 The Agencies rejected proposals to allow greater flexibility by allowing limited rehypothecation or alternative segregation arrangements.

43 *See* 77 Fed. Reg. 70214 at 70330 – 31 (SEC Proposal). Although it did not expressly address mandatory segregation requirements, such as those covered in the Final Rules, the SEC proposal would require a capital charge for any IM that a counterparty elects to segregate in an account at an independent third-party custodian. As noted above, the SEC proposal was released before the 2013 International Framework.

IX. Inter-Affiliate Transactions

The Final Rules include special provisions for IM requirements with respect to covered transactions between a Swap Entity and an affiliate. Under those provisions, VM requirements will apply to inter-affiliate covered transactions in the same manner as they apply to covered transactions with unaffiliated third parties.

IM Requirements for Inter-Affiliate Transactions Under the Bank Final Rules. Under the special IM provisions of the Bank Final Rules:

- Obligations to Collect but not Post. A Bank Swap Entity does not have an obligation to post IM with respect to inter-affiliate swaps or security-based swaps, but does have an obligation to collect IM. For swaps and security-based swaps between a Bank Swap Entity and a financial end user affiliate that has a material swap exposure, this results in a one-way IM obligation. Swaps and security-based swaps between a Bank Swap Entity and an affiliated Bank Swap Entity would be subject to reciprocal IM collection obligations.
- Posting by an Affiliated Holding Company. The preamble to the Bank Final Rules states that an affiliated holding company may provide IM required to be collected by the Bank Swap Entity from an affiliate so long as the Bank Swap Entity has the ability to apply this IM to the affiliate's obligations in the event of default, the IM does not secure any obligations of the holding company and the IM is held in a manner consistent with the Bank Final Rules' segregation requirements. These conditions do not appear to prohibit multiple affiliates from receiving a pledge of IM provided by an affiliated holding company, so long as relevant netting, credit support and other applicable documentation ensure that each Bank Swap Entity remains entitled to the required amount of IM.
- Segregation. Non-cash eligible IM collected from an affiliate can be custodied at the Bank Swap Entity or an affiliated custodian.
- Initial Margin Threshold. The Bank Final Rules provide an IM threshold of $20 million for each pair of affiliates, rather than the $50 million consolidated IM threshold applicable to third-party transactions.
- Five-Day Holding Period. For inter-affiliate swaps and security-based swaps that are not cleared due to an exemption from Dodd-Frank's clearing requirement, the Bank Final Rules provide that the Bank Swap Entity's internal IM model can use a holding period equal to the shorter of 5 days or the maturity of the swap, as opposed to the 10-day holding period requirement for third-party transactions, so long as the relevant inter-affiliate transactions are identified under a separate netting portfolio from other inter-affiliate transactions.

Sections 23A and 23B. The preamble to the Bank Final Rules stated that compliance with the Bank Final Rules would not ensure compliance with regulatory requirements under Sections 23A and 23B of the Federal Reserve Act applicable to U.S.

insured depository institutions ("IDIs") in connection with inter-affiliate transactions.[44] The preamble did not, however, state that compliance with the Bank Final Rules' inter-affiliate provisions would be inconsistent with Sections 23A and 23B. Ultimately, the extent to which forthcoming regulations under Sections 23A and 23B will be consistent with the inter-affiliate provisions in the Bank Final Rules remains to be seen.

In addition, the Bank Final Rules will require a Bank Swap Entity to collect IM from its affiliates even in circumstances where Sections 23A and 23B do not apply (*e.g.*, in the case of non-cleared swaps between an IDI and its subsidiary).

IM Requirements for Inter-Affiliate Transactions Under the CFTC Final Rules. Under the special IM provisions of the CFTC Final Rules:

- Exception from IM Requirements. A Swap Entity is not required to collect or post IM in respect of non-cleared swaps entered into with affiliates so long as the Swap Entity is subject to a centralized risk management program that is reasonably designed to monitor and to manage the risks associated with the inter-affiliate swaps. For inter-affiliate swaps between a Non-Bank Swap Entity and a Bank Swap Entity affiliate, the Non-Bank Swap Entity must post an amount of IM to the Bank Swap Entity that the Bank Swap Entity is required to collect under the Bank Final Rules.

- Inter-Affiliate Swaps with Foreign Affiliates. The CFTC Final Rules include an anti-evasion provision designed to impose IM requirements on inter-affiliate swaps if a foreign affiliate of the Non-Bank Swap Entity enters into a corresponding outward-facing swap in respect of which IM is not collected. Under this provision, the CFTC's IM requirements will apply to inter-affiliate swaps entered into by the Non-Bank Swap Entity with an affiliate that (a) is a financial end user, (b) enters into swaps with third parties, or enters into swaps with other affiliates that, directly or indirectly (including through a series of transactions),[45] enter into swaps with third parties, in each case, where the CFTC Final Rules would apply if the outward-facing affiliate were a Swap Entity and (c) is located in a jurisdiction that the CFTC has not found to have a comparable margin regime for substituted compliance purposes and the outward-facing affiliate does not voluntarily collect IM in a manner that would comply with the CFTC Final Rules.

- Segregation. Any IM that is collected for inter-affiliate swaps can be custodied at the Non-Bank Swap Entity or an affiliated custodian.

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[44] Section 608 of Dodd-Frank amended Section 23A to require U.S. IDIs to collateralize inter-affiliate derivative transactions to the extent that the IDI incurs credit exposure to its affiliates under those transactions. These amendments have not yet been fully implemented.

[45] By including affiliates that "indirectly" enter into swaps with third parties "including through a series of transactions," the CFTC appears to have required some form of transaction-by-transaction tracking of inter-affiliate trading relationships.

X. Phase-In of Margin Requirements

Implementation Schedule. Under the Final Rules, IM and VM requirements will phase in through a staggered schedule, depending on whether both (i) the Swap Entity (and its affiliates) and (ii) the Swap Entity's counterparty (and the counterparty's affiliates) meet certain thresholds of average daily aggregate notional exposure to non-cleared swaps, non-cleared security-based swaps, FX forwards and FX swaps (excluding transactions exempted under TRIPRA) for March, April and May of the preceding calendar year:

- VM requirements will become effective September 1, 2016 for the most active market participants, and March 1, 2017 for all others.
- IM requirements will become effective in annual phases from September 1, 2016 through September 1, 2020, with the most active market participants being subject to IM requirements soonest.[46]

Legacy Transactions. The Final Rules only apply to covered transactions entered into on or after the applicable compliance date(s). A Swap Entity is able to maintain legacy covered transactions and new covered transactions under the same EMNA, but only if it identifies them as separate netting portfolios. A Swap Entity can also elect to subject some or all of its legacy covered transactions to the Final Rules, and thereby recognize offsets between those legacy covered transactions and new covered transactions, by including legacy covered transactions in a netting portfolio with new covered transactions. Covered transactions entered into prior to the applicable compliance date that are novated or amended subsequent to the compliance date will no longer be classified as legacy transactions and will instead be subject to the Final Rules as though they were executed after the relevant compliance dates.

XI. Cross-Border Application of Margin Requirements

Bank Final Rules

The Bank Final Rules' cross-border framework imposes requirements and allows substituted compliance in varying, but generally limited, degrees based on the categories of the transacting entities, as outlined below:

- U.S. Bank Swap Entities. A Bank Swap Entity that is organized under the laws of the U.S. or a U.S. State[47] will be subject to all requirements under the Bank Final

[46] The full phase-in schedule for IM requirements is as follows: (i) September 1, 2016 for covered transactions between market participants each (together with their affiliates) with average daily aggregate notional exposure exceeding $3 trillion; (ii) September 1, 2017 for covered transactions between market participants each (together with their affiliates) with average daily aggregate notional exposure exceeding $2.25 trillion; (iii) September 1, 2018 for covered transactions between market participants each (together with their affiliates) with average daily aggregate notional exposures exceeding $1.5 trillion; (iv) September 1, 2019 for covered transactions between market participants each (together with their affiliates) with average daily aggregate notional exposures exceeding $0.75 trillion; and (v) September 1, 2020 for all other market participants.

[47] The Prudential Regulators have not adopted either of the CFTC's definitions of "U.S. Person" (from the CFTC's July 2013 cross-border guidance or the CFTC's July 2015 cross-border margin proposal).

Rules for all non-cleared swaps and security-based swaps (regardless of a counterparty's U.S. or non-U.S. status) and will be eligible for substituted compliance only in connection with obligations to post IM to financial end users with a material swap exposure that are not guaranteed by (A) an entity organized under the laws of the U.S. or a U.S. State, (B) a branch or office of such an entity, (C) a U.S. branch or agency of a foreign bank or (D) a natural person who is a resident of the U.S. Substituted compliance will not be available in connection with VM requirements or requirements to collect IM.

- Foreign Branches of U.S. Bank Swap Entities. The Bank Final Rules treat the foreign branch of a U.S. Bank Swap Entity in the same manner as its U.S. head office, including by making substituted compliance available only in connection with obligations to post IM to financial end users with material swaps exposure that are not guaranteed by (A) an entity organized under the laws of the U.S. or a U.S. State, (B) a branch or office of such an entity, (C) a U.S. branch or agency of a foreign bank or (D) a natural person who is a resident of the U.S. This limitation on substituted compliance will likely lead to unintended legal conflicts and complexities for foreign branches, many of which will be subject to host country margin rules that do not permit substituted compliance with U.S. requirements in these circumstances.

- Guaranteed Non-U.S. Bank Swap Entities. A non-U.S. Bank Swap Entity that is guaranteed by an entity organized under the laws of the United States or a U.S. State, a branch or office of such an entity or a natural person who is a resident of the U.S. (a "Guaranteed Non-U.S. Bank Swap Entity") will be treated the same as a U.S. Bank Swap Entity. The "guarantee" definition will generally apply only where a particular counterparty has recourse to the U.S. third-party acting as a guarantor.[48] Guaranteed Non-U.S. Bank Swap Entities, like foreign branches of U.S. Bank Swap Entities, are also likely to face conflicts between U.S. and non-U.S. margin rules, which will create an incentive to ensure that covered transactions do not benefit from a guarantee from a U.S. person.

- Non-Guaranteed, Non-U.S. Consolidated Bank Swap Entities. A non-U.S. Bank Swap Entity that is a subsidiary[49] of an entity that is organized under the laws of the U.S. or any U.S. State but is not a Guaranteed Non-U.S. Bank Swap Entity will be subject to all requirements of the Bank Final Rules for all non-cleared swaps and

[48] The Bank Final Rules define a "guarantee" as an arrangement pursuant to which a party has a conditional or unconditional legally enforceable right to receive or otherwise collect payment from a third-party guarantor, in each case with respect to its counterparty's obligations under the non-cleared swap or security-based swap.

[49] The Bank Final Rules defines "subsidiary" as an entity that is consolidated by another company on financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles, International Financial Reporting Standards or other similar standards. The definition of subsidiary also includes a provision that will allow the Prudential Regulators to determine, in their discretion, that a company is a subsidiary of another company based on the conclusion that either company provides significant support to, or is materially subject to the risks of loss of, the other company. The Bank Final Rules do not clarify how parties would be informed of such a determination.

security-based swaps (regardless of a counterparty's U.S. or non-U.S. status), but it will be eligible for substituted compliance for all requirements of the Bank Final Rules (including in respect of its U.S.-facing transactions) if it is a subsidiary of a U.S. depository institution, Edge corporation or agreement corporation.

- U.S. Branches of Non-U.S. Bank Swap Entities. A Bank Swap Entity that is a U.S. branch or agency of a foreign bank[50] will be subject to all requirements of the Bank Final Rules for all non-cleared swaps and security-based swaps (regardless of a counterparty's U.S. or non-U.S. status), but it will be eligible for substituted compliance for all requirements of the Bank Final Rules (including in respect of its U.S.-facing transactions).

- Other Non-U.S. Bank Swap Entities. If a non-U.S. Bank Swap Entity is not (i) a U.S. branch or agency of a foreign bank, (ii) a subsidiary of an entity that is organized under the laws of the U.S. or a U.S. State or (iii) guaranteed by (A) an entity organized under the laws of the U.S. or a U.S. State, (B) a branch or office of such an entity, (C) a natural person who is a resident of the U.S., (D) a U.S. branch or agency of a foreign bank or (E) a Swap Entity that is a subsidiary of an entity that is organized under the laws of the U.S. or a U.S. State, such non-U.S. Bank Swap Entity will be subject to the Bank Final Rules only with respect to non-cleared swaps and security-based swaps entered into with a counterparty that is, or is guaranteed by, (A) an entity organized under the laws of the United States or a U.S. State, (B) a branch or office of such an entity, (C) a natural person who is a resident of the U.S., (D) a U.S. branch or agency of a foreign bank or (E) a Swap Entity that is a subsidiary of an entity that is organized under the laws of the U.S. or a U.S. State. With respect to such covered non-cleared swaps and security-based swaps, such a non-U.S. Bank Swap Entity will be eligible for substituted compliance for all requirements of the Bank Final Rules.

Jurisdictions where Segregation Is Unavailable. The Bank Final Rules include an exception from the requirement to post and segregate margin for non-cleared swaps and security-based swaps entered into by (i) foreign branches of Bank Swap Entities that are depository institutions and (ii) non-U.S. Bank Swap Entity subsidiaries of U.S. depository institutions, Edge corporations or agreement corporations if all of the following conditions are applicable with respect to the non-cleared swap or security-based swap:

- Limitations in the legal and operational infrastructure of the foreign jurisdiction make it impracticable for the Bank Swap Entity to satisfy the IM segregation requirements of the Bank Final Rules;

50 The Bank Final Rules do not include a conduct or personnel test for U.S. branches. Instead, the preamble states that the Prudential Regulators would consider the entity to which the non-cleared swap or security-based swap is "booked" as the counterparty for this purpose.

- The Bank Swap Entity is subject to regulatory restrictions that require transacting with the counterparty through an establishment within the foreign jurisdiction and do not accommodate posting collateral outside the jurisdiction;

- The counterparty is not, and its obligations under the non-cleared swap or security-based swap are not guaranteed by, (A) an entity organized under the laws of the U.S. or a U.S. State, (B) a branch or office of such an entity, (C) a U.S. branch or agency of a foreign bank or (D) a natural person who is a resident of the U.S.;

- The Bank Swap Entity collects IM in cash, and posts VM in cash; and

- The Bank Swap Entity has prior written approval from a relevant U.S. Prudential Regulator to rely on this exemption for the foreign jurisdiction.

Because the above conditions would require affected counterparties to transact with Bank Swap Entities on terms that differ from those offered by local banks, the exemption does not address the fundamental competitive imbalance created by the Bank Final Rules.

Substituted Compliance. The Prudential Regulators will allow entities to comply with some or all of the Final Rules on a substituted compliance basis, within the context of the framework outlined above, by complying with some or all of a foreign jurisdiction's margin rules, if the Prudential Regulators have made a comparability determination with respect to the margin rules of that jurisdiction.

The Prudential Regulators have said that, in making comparability determinations, they expect to take a "holistic view," evaluating whether the foreign regulatory framework will achieve a comparable outcome to the Final Rules. The Prudential Regulators would accept requests for comparability determinations from Bank Swap Entities, but not foreign regulators. Once the Prudential Regulators make a favorable determination for a foreign regulatory framework, any Bank Swap Entity that could comply with the foreign framework would be allowed to do so without submitting a specific request.

CFTC Final Rules. As noted above, the CFTC did not adopt final cross-border rules as part of the CFTC Final Rules, but indicated that it will do so early in 2016. Notably, however, the cross-border margin proposal published by the CFTC in July 2015 included several key differences from the framework adopted by the Prudential Regulators, including a significantly broader "U.S. person" definition, a much more granular (as opposed to holistic) approach to comparability determinations and additional limits on substituted compliance. If the CFTC does not address these differences, then Non-Bank Swap Entities will face further disadvantages relative to Bank Swap Entities.

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