CFTC Proposed Margin Requirements for Uncleared Swaps Under Dodd-Frank

The CFTC Reproposes Rules for Minimum Margin Requirements for Swap Dealers and Major Swap Participants, Largely Aligned with Prudential Regulators’ Recent Reproposed Rules

SUMMARY
On September 23, 2014, the Commodity Futures Trading Commission (“CFTC”) issued a proposed rule to establish minimum initial and variation margin collection requirements for uncleared swaps entered into by certain swap dealers and major swap participants. With some exceptions, as discussed below, the proposal is substantially similar to the proposal promulgated collectively by the Federal Reserve Board, the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Authority on September 3, 2014 concerning swap margin and capital requirements. The CFTC’s reproposed rule supersedes the agency’s previous proposal originally issued in April 2011, is intended to take into account the comments received by the CFTC in response to the 2011 Proposal and follows the promulgation of the international framework for margin requirements of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps finalized in September 2013 by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions. If adopted, the proposed rule would require that swap dealers and major swap participants subject to the jurisdiction of the CFTC collect and post minimum initial and variation margin amounts from and to certain swap counterparties, depending on the type of counterparty, in connection with swap transactions. Comments are due to the CFTC by sixty (60) days after publication in the Federal Register.
BACKGROUND

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) requires that, subject to certain exemptions, standardized swaps be cleared through a regulated clearing house that is registered under the Commodity Exchange Act (“CEA”) as a Derivatives Clearing Organization (“DCO”). For uncleared swaps, i.e., those swaps not cleared through a DCO, Dodd-Frank creates a new Section 4s of the CEA that requires the adoption of rules establishing initial margin, variation margin and capital requirements for swap dealers, major swap participants, security-based swap dealers and major security-based swap participants, as those terms have been defined by the Securities and Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (“CFTC”) (collectively, “Swap Entities”).

Swap Entities subject to regulation by the Federal Reserve Board, the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Authority (collectively, the “Prudential Regulators”) must meet the margin and capital requirements determined by the applicable Prudential Regulator. Swap Entities for which there is no Prudential Regulator must meet the margin and capital requirements imposed by the CFTC or the SEC, as applicable.

The CFTC first issued its proposed rule regarding margin requirements for uncleared swaps applying to Swap Entities for which it is the regulator on April 14, 2011, and ultimately received 102 comments on the proposal from a variety of entities including financial services industry associations, agricultural industry associations, energy industry associations, insurance industry associations, banks, brokerage firms, investment managers, insurance companies, pension funds, commercial end users, law firms and public interest organizations. The Prudential Regulators issued their initial proposed rule regarding margin and capital requirements related to swaps on April 12, 2011, and the SEC issued its proposed rule for Swap Entities for which it is the regulator on October 18, 2012. In July of 2012, the Basel Committee on Banking Supervision (“BCBS”) and the Board of the International Organization of Securities Commissions (“IOSCO”) issued a proposed framework for margin requirements regarding certain swaps with the goal of

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3 Id.

creating an international standard for margin requirements for such swaps (the “International Framework”). Following public comment on the proposal, the International Framework was finalized by BCBS and IOSCO in September 2013.\(^5\) The reproposed rule disseminated by the CFTC on September 23, 2014 (the “CFTC’s Proposed Rule”)\(^6\) endeavors to address the comments received regarding the agency’s prior proposal and to be consistent with the International Framework, and, subject to the exceptions described herein, is substantially similar to the Prudential Regulators’ reproposed rule disseminated by the Prudential Regulators on September 3, 2014 (the “Prudential Regulators’ Proposed Rule”).\(^7\)

### THE CFTC’S PROPOSED RULE

The CFTC staff “worked closely with the staff of the Prudential Regulators,” in addition to consulting with the SEC, in developing the CFTC’s Proposed Rule, and, with some exceptions described below, the CFTC’s Proposed Rule and the Prudential Regulators’ Proposed Rule are substantially similar. For an in-depth discussion of the Prudential Regulators’ Proposed Rule, covering aspects of proposal including the scope of counterparties covered, requirements surrounding initial margin and variation margin, eligible collateral and segregation requirements, see our memo to clients entitled “Proposed Margin Requirements for Uncleared Swaps Under Dodd-Frank,” dated September 10, 2014.\(^8\)

**Documentation Requirements and Control Mechanisms**

Under the Prudential Regulators’ Proposed Rule, a Swap Entity subject to regulation by the Prudential Regulators is not required to collect initial margin with respect to uncleared swaps with a counterparty that is neither a financial end user with material swaps exposure nor another Swap Entity. A Prudential Regulator-regulated Swap Entity is also not required to collect variation margin with respect to uncleared swaps with a counterparty that is neither a financial end user nor another Swap Entity, but must collect such margin “at such times and in such forms and such amounts (if any), that the [Prudential Regulator-regulated Swap Entity] determines appropriately address the credit risk posed by the counterparty and the risks of such [uncleared] swaps.” Swap documentation by a Prudential Regulator-regulated Swap Entity with regard to margin must include trading documentation with each counterparty that is another Swap Entity and its counterparty with the contractual right to collect and post initial margin and variation margin

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in such amounts, in such form, and under such circumstances as are required by the margin rules; and (ii) specifies the methods, procedures, rules, and inputs for determining the value of each uncleared swap for purposes of calculating variation margin requirements, as well as the procedures by which any disputes concerning the valuation of uncleared swaps, or the valuation of assets collected or posted as initial margin or variation margin, may be resolved.

The CFTC’s Proposed Rule, in contrast, requires that a Swap Entity subject to regulation by the CFTC enter into documentation with all counterparties, including nonfinancial entities, to provide clarity about the parties’ respective rights and obligations. However, a CFTC-regulated Swap Entity would be free to set initial margin and variation margin requirements, if any, with nonfinancial entities in its discretion and any thresholds agreed upon by the parties would be permitted. Under the CFTC’s Proposed Rule, margin documentation must specify (i) the methodology and data sources to be used both to value uncleared swaps and collateral and to calculate initial margin as well as to value position and to calculate variation margin for uncleared swaps entered into between the Swap Entity and its counterparty; (ii) the procedures by which any disputes concerning the valuation of uncleared swaps, or the valuation of assets posted as initial margin or paid as variation margin, may be resolved; (iii) any thresholds below which initial margin need not be posted by the Swap Entity and/or its counterparty; and (iv) any thresholds below which variation margin need not be paid by the Swap Entity and/or its counterparty.

Each CFTC-regulated Swap Entity must also create and maintain documentation setting forth the variation margin methodology with sufficient specificity to allow the counterparty, the CFTC, and any applicable Prudential Regulator to calculate a reasonable approximation of the margin requirement independently. The CFTC-regulated Swap Entity must evaluate the reliability of the data sources used for its methodology at least annually and make appropriate adjustments based on such evaluation, and the CFTC reserves its right to require a Swap Entity to provide further data or analysis related to its methodology.

Under the Prudential Regulators’ Proposed Rule, a Swap Entity subject to regulation by the Prudential Regulators must conduct a review of its initial margin model at least annually in light of developments in financial markets and modeling technologies, and must make appropriate enhancements. In addition, a Prudential Regulator-regulated Swap Entity must comply with specific control, oversight and valuation mechanisms, including ongoing monitoring processes that are designed to verify internal processes and benchmarking by comparing such Swap Entity’s initial margin model outputs (estimation of initial margin) with relevant alternative internal and external data sources to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar cleared transactions.

The CFTC’s Proposed Rule includes requirements similar to those of the Prudential Regulators’ Proposed Rule with regard to control mechanisms for initial margin and also sets forth more detailed
requirements with regard to control mechanisms for variation margin. Under the CFTC’s Proposed Rule, a CFTC-regulated Swap Entity must calculate variation margin on a daily basis for itself and for each counterparty that is a Swap Entity or a financial end user, using a methodology and inputs that to the maximum extent practicable rely on recently executed transactions, valuations provided by independent third parties, or other objective criteria. The CFTC-regulated Swap Entity must also have alternative methods for determining the value of an uncleared swap in the event of the unavailability or other failure of any input required to value a swap.

In addition, in contrast to the Prudential Regulators’ Proposed Rule, under the CFTC’s Proposed Rule, a CFTC-regulated Swap Entity must calculate hypothetical initial and variation margin amounts each day for positions held by nonfinancial entities that have material swaps exposure to the CFTC-regulated Swap Entity – that is, the hypothetical calculations must be performed for each counterparty that has more than $3 billion in gross notional of uncleared swaps (as calculated under the CFTC’s Proposed Rule) with the CFTC-regulated Swap Entity. A CFTC-regulated Swap Entity must calculate what the margin amounts would be if this nonfinancial counterparty were instead another Swap Entity and compare these hypothetical amounts to any actual margin requirements for the positions. This requirement is cited by the CFTC as a risk management tool to assist the CFTC-regulated Swap Entities in measuring counterparty risk embedded in uncleared, un-margined trades and to assist the CFTC in conducting oversight of such entities.

Cross-Border Application of the Margin Rules
The CFTC’s Proposed Rule states that, “given the risk-mitigation function of the margin rules for uncleared swaps” the CFTC “believes that the rules should apply on a cross-border basis in a manner that effectively addresses risks” to the registered Swap Entities. However, the CFTC also states that “[a]t the same time, it may be appropriate, consistent with principles of international comity and statutory objectives underlying the margin requirements, to allow [Swap Entities] to satisfy the margin requirements by complying with a comparable regime in the relevant foreign jurisdiction, or to not apply the margin requirements under certain circumstances.” Although it is unclear how foreign branches of a U.S. bank that is a Swap Entity would be subject to CFTC’s margin rules, rather than the Prudential Regulators’ margin rules, the CFTC’s Proposed Rule includes such entities in describing three (3) alternative approaches to the cross-border applicability of its margin rules, as described below.

Cross-Border Guidance Approach
Under the Cross-Border Guidance Approach, the CFTC would apply the margin requirements consistent with the CFTC’s cross-border guidance (the “Cross-Border Guidance”). The margin requirements would

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CFTC, Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013). In this document, the CFTC addressed, among other things, how the swap provisions in Dodd-Frank (including the margin requirement for uncleared (continued . . . )
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apply to a U.S. CFTC-regulated Swap Entity (other than a foreign branch of a U.S. bank that is a CFTC-regulated Swap Entity) for all of its uncleared swaps (as applicable), irrespective of whether its counterparty is a U.S. person or not, without substituted compliance, but would only apply to a non-U.S. CFTC-regulated Swap Entity (whether or not it is a “guaranteed affiliate”\(^\text{10}\) or an “affiliate conduit”\(^\text{11}\)) only with respect to its uncleared swaps with a U.S. person counterparty (including a foreign branch of a U.S. bank that is a CFTC-regulated Swap Entity) and a non-U.S. counterparty that is guaranteed by U.S. person or is an affiliate conduit. Substituted compliance would be permitted where the counterparty is a guaranteed affiliate or an affiliate conduit pursuant to approval by the CFTC. For uncleared swap transactions between a non-U.S. CFTC-regulated Swap Entity (whether or not it is a guaranteed affiliate or an affiliate conduit) and a non-U.S. counterparty that is not a guaranteed affiliate or affiliate conduit, the margin requirements would not apply. Finally, for uncleared swap transactions between a foreign branch of a U.S. bank that is a CFTC-regulated Swap Entity, the margin requirements would apply to all such transactions with all counterparties, except that substituted compliance would be permitted, pursuant to CFTC approval, where the counterparty to the transaction is another foreign branch of a U.S. bank that is a CFTC-regulated Swap Entity or a non-U.S. person (whether or not it is a guaranteed affiliate or an affiliate conduit). A summary of the application of the margin requirements under the Cross-Border Guidance Approach, as provided in the CFTC’s Proposed Rule, follows:

\[\ldots\text{continued}\]

swaps) would apply on a cross-border basis. In this regard, the CFTC stated that as a general policy matter it would apply the margin requirement as a transaction-level requirement.

\(^{10}\) Under the Cross-Border Guidance, id. at 45318, the term “guaranteed affiliate” refers to a non-U.S. person that is an affiliate of a U.S. person and that is guaranteed by a U.S. person. The CFTC’s Proposed Rules note that “the scope of the term ‘guarantee’ under the Cross-Border Guidance Approach and the Entity-Level Approach would be the same as under note 267 of the [Cross-Border] Guidance and accompanying text.”

\(^{11}\) Under the Cross-Border Guidance, id. at 45359, the factors that are relevant to the consideration of whether a person is an “affiliate conduit” include whether: (i) the non-U.S. person is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. person controls, is controlled by, or is under common control with the U.S. person; (iii) the non-U.S. person, in the regular course of business, engages in swaps with non-U.S. third party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with such U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third-party(ies) to its U.S. affiliates; and (iv) the financial results of the non-U.S. person are included in the consolidated financial statements of the U.S. person. Other facts and circumstances also may be relevant.

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**Entity-Level Approach**

Under the Entity-Level Approach, the CFTC would treat the margin requirements as an entity-level requirement. Here, the CFTC would apply the margin requirements at the entity level, regardless of whether the counterparty to the swap is a U.S. person, but may allow substituted compliance in certain circumstances. As noted in the CFTC’s Proposed Rule, “this approach would be intended to address the concern that the source of the risk to a firm – given that the non-U.S. [Swap Entity] has sufficient contact with the United States to require registration as [a Swap Entity] – is not confined to its uncleared swaps with U.S. counterparties or to its uncleared swaps executed within the United States.” A summary of the application of the margin requirements under the Entity-Level Approach, as provided in the CFTC’s Proposed Rule, follows:
### Prudential Regulators’ Approach

Under the Prudential Regulators’ Approach, the CFTC would adopt the approach of the Prudential Regulators’ Proposed Rule. The Prudential Regulators propose not to assert authority over transactions between a non-U.S. Swap Entity that is not guaranteed by a U.S. person and either a (i) non-U.S. Swap Entity that is not guaranteed by a U.S. person or (ii) a non-U.S. person that is not guaranteed by a U.S. person. The Prudential Regulators’ Approach is generally consistent with the Entity-Level Approach described above, except with regard to the application of the margin requirements to certain non-U.S. Swap Entities. In addition, this approach is consistent with the Cross-Border Guidance Approach to margin requirements with respect to transactions between a non-U.S. Swap Entity and a non-U.S. person that is not guaranteed by a U.S. person. However, under the definition of “foreign covered swap entity” in the Prudential Regulators’ Proposed Rule, a non-U.S. Swap Entity controlled by a U.S. person would not be a foreign covered swap entity, and thus, would not qualify for the exclusion from the margin requirement. In addition, the Prudential Regulators’ Proposed Rule incorporates a “control” test for

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<td>U.S. Swap Entity</td>
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<tr>
<td>U.S. Swap Entity</td>
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<td>U.S. Margin Requirements (All)</td>
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<tr>
<td>Non-U.S. Swap Entity guaranteed by a U.S. Person</td>
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<td>U.S. Margin Requirements (All)</td>
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<td>Non-U.S. person guaranteed by a U.S. person</td>
<td>U.S. (Initial Margin collected by U.S. Swap Entity)</td>
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<td>Substituted Compliance (Initial Margin collected by non-U.S. person not guaranteed by a U.S. person)</td>
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<td>U.S. (Variation Margin)</td>
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<td>U.S. (Initial Margin collected by non-U.S. Swap Entity guaranteed by a U.S. person)</td>
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<td>Substituted Compliance Permitted (All)</td>
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purposes of determining whether a registered Swap Entity subject to regulation by the Prudential Regulators is not a “foreign” entity.

Prohibited Assets

Both the CFTC’s Proposed Rule and the Prudential Regulators’ Proposed Rule require that Swap Entities may not collect or post as initial margin any asset that is a security issued by (i) the party providing such asset or an affiliate of that party; or (ii) a bank holding company, a savings and loan holding company, a foreign bank, a depository institution, a market intermediary, a company that would be any of the foregoing if it were organized under the laws of the United States or any State, or an affiliate of any of the foregoing institutions. The CFTC’s Proposed Rule, however, further specifies that a CFTC-regulated Swap Entity also may not collect or post as initial margin any asset that is a security issued by “a U.S. government-sponsored enterprise after the termination of capital support or another form of direct financial assistance received from the U.S. government that enables the repayments of the government-sponsored enterprise’s eligible securities unless the security” is (i) issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of Treasury; (ii) issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to swap dealers subject to regulation by a prudential regulator; or (iii) issued by, or fully guaranteed as to the payment of principal and interest by, the Bank for International Settlements, the International Monetary Fund, or a multilateral development bank.

Coordination of Margin Model Approval

With regard to the approval of margin models, the CFTC’s Proposed Rule indicates that it will coordinate with the Prudential Regulators in order to avoid duplicate efforts and to provide expedited approval of margin models that a Prudential Regulator had already approved. For example, if a Prudential Regulator had approved the margin model of a depository institution registered as a Swap Entity, CFTC review of a comparable model used by a non-bank affiliate of the Swap Entity would be streamlined. Further, the CFTC would similarly coordinate with the SEC and foreign regulators with regard to margin model approval, and for CFTC-regulated Swap Entities seeking to use models not approved by these entities, the CFTC anticipates coordinating with the National Futures Association to facilitate approval.

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