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Margin Requirements for Uncleared Swaps

CFTC and Prudential Regulators Finalize Rules Imposing Minimum Margin and Capital Requirements on Covered Swap Entities

INTRODUCTION

On December 16, 2015, the Commodity Futures Trading Commission (“CFTC”) voted to adopt final rules (the “CFTC Final Rules”) to establish initial margin and variation margin requirements for uncleared swaps, *i.e.*, swaps that are not cleared by a derivatives clearing organization registered under the Commodity Exchange Act or by a clearing organization that the CFTC has exempted from registration. The CFTC Final Rules apply to swap dealers and major swap participants that are subject to the CFTC’s jurisdiction and are generally consistent with the final rules promulgated on October 22, 2015 by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the “Prudential Regulators”) establishing minimum initial margin and variation margin requirements for uncleared swaps and security-based swaps that are not cleared by a clearing agency (such swaps and security-based swaps, “Covered Swaps”)¹ entered into by swap dealers, major swap participants, security-based swap dealers and major security-based swap participants subject to the jurisdiction of one of the Prudential Regulators (the “Prudential Regulators’ Final Rules” and, together with the CFTC Final Rules, the “Final Rules”). In addition, the CFTC and the Prudential Regulators each adopted substantially similar interim final rules that exclude from the requirements of the Final Rules most Covered Swaps that a covered entity enters into with commercial end users and certain financial institutions with total assets of \$10 billion or less.

The Final Rules effect a fundamental shift in over-the-counter swap markets by requiring swap dealers, major swap participants, security-based swap dealers and major security-based swap participants to collect and post minimum initial and variation margin from and to certain swap counterparties, depending on the type of counterparty, in connection with certain non-centrally cleared derivative transactions.

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Compliance with the Final Rules will be required beginning as early as September 1, 2016 for certain covered entities.

The Final Rules issued by the CFTC and the Prudential Regulators are substantially similar, with some notable exceptions, most significantly in the treatment of swaps between affiliates and the requirements for calculating variation margin, as discussed below. This memorandum generally highlights the key components of the Final Rules together, noting significant differences between the CFTC Final Rules and Prudential Regulators' Final Rules where applicable.

BACKGROUND

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") provides that, subject to certain exemptions, standardized swaps and security-based swaps must be cleared through a derivatives clearing organization ("DCO") that is registered with the CFTC under the Commodity Exchange Act ("CEA") or a clearing agency registered with the Securities and Exchange Commission (the "SEC"), respectively. For other swaps, Sections 731 and 764 of Dodd-Frank created a new Section 4s of the CEA and a new Section 15F of the Securities Exchange Act of 1934 (the "Securities Exchange Act") that require the CFTC, the SEC and the Prudential Regulators to adopt 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 ("Covered Swap Entities"). Pursuant to these new provisions, Covered Swap Entities subject to regulation by one of the Prudential Regulators must meet the margin and capital requirements of the applicable Prudential Regulator, while Covered Swap Entities for which there is no Prudential Regulator must meet the margin and capital requirements imposed by the CFTC (for swap dealers and major swap participants) or the SEC (for security-based swap dealers and major security-based swap participants).

The Final Rules generally follow the approach of the international framework for margin requirements for Covered Swaps, foreign exchange forwards and foreign exchange swaps finalized in September 2013 (the "International Framework") by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions ("BCBS-IOSCO"). Unlike the International Framework, the Final Rules do not apply to physically settled foreign exchange forwards or foreign exchange swaps that are exempted from the definition of "swap" under the CEA by the Secretary of the U.S. Department of Treasury (such foreign exchange transactions, "Excluded FX Transactions").²

Each of the CFTC and the Prudential Regulators issued initial proposed rules in April 2011, and re-proposed rules following publications by BCBS-IOSCO. In particular, in July of 2012, BCBS-IOSCO issued a proposal for the International Framework. Following public comment on this proposal, the International Framework was finalized by BCBS-IOSCO in September 2013.³ The CFTC Final Rules finalized the CFTC's re-proposed rules issued on October 3, 2014 (the "CFTC Proposed Rules") and the Prudential Regulators' Final Rules finalized the re-proposed rules issued by the Prudential Regulators on

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September 3, 2014 (the “Prudential Regulators Proposed Rules” and, together with the CFTC Proposed Rules, the “Proposed Rules”).

The SEC issued its proposed rule for Covered Swap Entities for which it is the relevant regulator on October 18, 2012.⁴

THE FINAL RULES OF THE CFTC AND THE PRUDENTIAL REGULATORS

A. SUMMARY OF KEY ASPECTS OF FINAL RULES

Except as otherwise noted, the Final Rules are substantially similar to the Proposed Rules. The key aspects of the Prudential Regulators’ Final Rules and the CFTC Final Rules include the following:

- **Counterparties.** The Final Rules define categories of counterparties, comprised of registered Covered Swap Entities, financial end users with material swaps exposure, financial end users without material swaps exposure and other counterparties. The Final Rules impose margin obligations with respect to Covered Swaps entered into by Covered Swap Entities based on the status of the Covered Swap Entity’s counterparty. In addition, the Final Rules modified the definition of “affiliate” from the Proposed Rules to use a more objective standard based on financial accounting principles.
- **Material Swaps Exposure.** The Final Rules distinguish between financial end user entities with and without “material swaps exposure”. An entity has material swaps exposure if the entity, together with its affiliates, has an average daily aggregate notional amount of Covered Swaps with all counterparties on business days during June, July and August of the previous year that exceeds \$8 billion—an increased amount relative to the \$3 billion amount in the Proposed Rules and broadly consistent with the €8 billion threshold provided in the International Framework. In particular, the Final Rules require Covered Swap Entities to collect and post initial margin in respect of Covered Swaps entered into with a financial end user with material swaps exposure, but not in respect of Covered Swaps entered into with a financial end user without material swaps exposure.
- **Initial Margin Requirements.** The Final Rules require “two-way margining” (collecting and posting of initial margin) between a Covered Swap Entity and counterparties that are either swap entities or financial end users with material swaps exposure (other than most counterparties that are affiliates, as discussed below). The amount of initial margin that must be collected and posted can be calculated pursuant to a “look-up table” or an approved internal margin model that meets certain criteria enumerated in the Final Rules. The Final Rules also (i) permit a Covered Swap Entity to establish a maximum initial margin threshold amount of \$50 million (a decrease from the \$65 million threshold in the Proposed Rules), below which it does not need to collect or post initial margin from or to other counterparties that are swap entities or financial end users with material swaps exposures and (ii) specify that the first collection or posting of initial margin may be delayed for one day following the day the swap is executed. The Final Rules also cap the minimum transfer amount value that can be agreed to between a Covered Swap Entity and its counterparty at \$500,000, a decrease from the \$650,000 amount in the Proposed Rules, combining amounts for initial and variation margin.
- **Variation Margin Requirements.** The Final Rules require that Covered Swap Entities collect and post variation margin on their Covered Swaps with swap entities and with all financial end users (including financial end users without material swaps exposure) at least once every business day in an amount that is at least equal to the change in the value to the Covered Swap Entity of such swaps since the previous exchange of variation margin. In addition, a Covered Swap Entity may not agree to a threshold amount below which it need not collect or post variation margin on swaps with a swap entity or financial end user

counterparty. The variation margin requirements are subject to the minimum transfer amount value of \$500,000, combining amounts for initial and variation margin.

- **Inter-affiliate Swaps.** In an important departure from the Prudential Regulators' Final Rules, the CFTC Final Rules provide that a Covered Swap Entity generally is not required to collect initial margin from an affiliate if the Covered Swap Entity subjects these Covered Swaps to a risk management program and posts and collects variation margin other than from non-U.S. affiliate financial end users not subject to comparable initial margin collection requirements on their swaps with unaffiliated end users. In contrast, the Prudential Regulators' Final Rules require a Covered Swap Entity to collect initial margin from, but not to post initial margin to, an affiliate that is not itself a Covered Swap Entity subject to the Prudential Regulators' Final Rules, although such a Covered Swap Entity is required to calculate the amount of initial margin it otherwise would have been required to post to its affiliate under the Prudential Regulators' Final Rules and to provide documentation of such amount to each affiliate on a daily basis.⁵ The elimination of the initial margin requirement in the CFTC Final Rules is an important departure from the CFTC Proposed Rules, which provided no exception from the initial margin requirement for interaffiliate swaps.
- **Variation Margin Calculation and Control Criteria.** The CFTC Final Rules, but not the Prudential Regulators' Final Rules, specifically require Covered Swap Entities to rely on recently executed transactions, valuations provided by independent parties or other objective criteria to the maximum extent practicable in determining the quantum of variation margin for a Covered Swap and to implement and document certain controls regarding variation margin requirements.
- **Eligible Master Netting Agreements.** The Final Rules permit a Covered Swap Entity to (i) calculate initial margin requirements for Covered Swaps under an eligible master netting agreement ("EMNA") with the counterparty on a portfolio basis in certain circumstances, if it does so using an approved initial margin model, and (ii) calculate variation margin requirements on an aggregate, net basis under an EMNA with the counterparty.
- **Counterparty Risk Assessment.** The Prudential Regulators' Final Rules specifically require a Covered Swap Entity to collect (i) initial margin from counterparties other than swap entities and financial end users with material swaps exposure; and (ii) variation margin from counterparties other than swap entities and financial end users, at such times and in such forms and amounts (if any) that the Covered Swap Entity determines appropriately addresses the credit risk posed by the counterparty and the risks of such uncleared swaps with respect to Covered Swaps with counterparties that are not subject to established minimum margin requirements pursuant to the Prudential Regulators' Final Rules.
- **Eligible Collateral.** The Final Rules limit the types of eligible collateral that can be used as initial margin and variation margin. As discussed below, eligible collateral for variation margin is limited to immediately available cash funds denominated in certain specified currencies. Eligible collateral for initial margin includes immediately available cash funds denominated in certain specified currencies and certain other securities enumerated in the Final Rule, such as U.S. government and agency securities and publicly traded debt and equity securities that meet certain requirements. Depending on the type of eligible collateral, the Final Rules may require haircuts to be applied to the collateral.
- **Segregation Requirements.** The Final Rules require that a Covered Swap Entity ensure that any initial margin collateral be held by a custodian that is neither the Covered Swap Entity, the counterparty or any entity affiliated with the Covered Swap Entity or the counterparty. These requirements apply to all initial margin posted by the Covered Swap Entity (whether required by the Final Rules or otherwise) and to initial margin required to be collected by the Covered Swap Entity pursuant to the Final Rules (but not any margin collected beyond the required amount). The Final Rules further require that custodial agreements between the Covered Swap Entity and its counterparties prohibit the custodian from rehypothecating, repledging, reusing or otherwise transferring any funds or property held by it. The Prudential Regulators' Final Rules include new sections permitting a Covered

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Swap Entity or an affiliate of a Covered Swap Entity to serve as custodian of non-cash collateral that a Covered Swap Entity collects from an affiliate.

- **Documentation Requirements.** The Final Rules require that a Covered Swap Entity execute trading documentation with each counterparty that is either a swap entity or a financial end user. The documentation must provide the Covered Swap Entity and its counterparty with the contractual right to collect and post initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by the Final Rules.
- **Application to Foreign Entities.** Under the Prudential Regulators' Final Rules, the margin requirements would not apply to certain swaps entered into by "foreign Covered Swap Entities" (defined below). The Prudential Regulators' Final Rules also allow for substituted compliance with the margin rules of foreign jurisdictions by foreign entities if the Prudential Regulators have made a substituted compliance determination with respect to that jurisdiction. The CFTC has indicated that it plans to address the cross-border application of the CFTC Final Rules in a separate rulemaking, with respect to which the CFTC has issued proposed rules.⁶
- **Compliance Dates.** Swap Entities must comply (a) with the variation margin requirements of the Final Rules as of either September 1, 2016 or March 1, 2017 depending on the average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions of both the Covered Swap Entity and its counterparty for March, April and May 2016; and (b) with the initial margin requirements of the Final Rules as of a date between September 1, 2016 and September 1, 2020, depending on the average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions of the Covered Swap Entity and its counterparty for March, April and May of each year.
- **Exemptions for Certain Entities.** The Final Rules were released alongside the interim final rules issued by each of the CFTC and the Prudential Regulators (together, the "Interim Final Rules"). The Interim Final Rules implement Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 ("TRIPRA"), which provided that the initial and variation margin requirements of Sections 731 and 764 of Dodd-Frank do not apply to certain transactions of non-financial entities and small banks that qualify for the end user exception to clearing.
- **Capital Requirements.** The CFTC Final Rules provide that the CFTC will address capital requirements for Covered Swap Entities in a separate rulemaking while the Prudential Regulators' Rules indicate that the capital rules that are otherwise applicable to entities regulated by the Prudential Regulators apply.

B. SUMMARY OF KEY DIFFERENCES BETWEEN THE CFTC FINAL RULES AND THE PRUDENTIAL REGULATORS' FINAL RULES

The following chart summarizes the key differences between the CFTC Final Rules and the Prudential Regulators' Final Rules. Each difference is described in greater detail in the following sections.

Provision	CFTC Final Rules	Prudential Regulators' Final Rules
Inter-affiliate swaps	Does <u>not</u> require a Covered Swap Entity to collect or post initial margin in respect of a Covered Swap entered into with an affiliate, subject to certain conditions.	Requires a Covered Swap Entity to collect but not to post initial margin in respect of a Covered Swap entered into with an affiliate that is not itself a Covered Swap Entity subject to the Prudential Regulators' Final Rules.

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Provision	CFTC Final Rules	Prudential Regulators' Final Rules
Definition of "financial end user"	Certain treasury affiliates are exempted from the definition of "financial end user".	Does <u>not</u> include this specific exemption from the definition of "financial end user". ⁷
Definition of "affiliate"	Does <u>not</u> permit the CFTC to designate any entity that provides significant support to, or is subject to the risks of, another company as an affiliate of that company (even if that entity is not otherwise covered by the definition of "affiliate"). ⁸	The relevant Prudential Regulator has the authority to designate any entity that provides significant support to, or is subject to the risks of, another company as an "affiliate" of that company (even if that entity is not otherwise covered by the definition).
Initial Margin Model Approval	Internal margin model approval may be delegated to the National Futures Association ("NFA").	Internal margin model must be approved by the appropriate Prudential Regulator for the Covered Swap Entity.
Variation Margin Calculation	Requires the calculation of the variation margin amount to reflect to the maximum extent practicable recently executed transactions and certain other objective criteria.	There are no specified requirements with respect to the methodology for calculating variation margin.

C. CATEGORIES OF COUNTERPARTIES

1. Swap Entities

Under the CFTC Final Rules, a swap entity means any person that is registered with the CFTC as a swap dealer or major swap participant pursuant to the CEA.⁹ Under the Prudential Regulators' Final Rules, a swap entity also includes a person that is registered with the SEC as a security-based swap dealer or a major security-based swap participant pursuant to the Securities Exchange Act.

2. Financial End Users

The definition of financial end user is substantially similar in both Final Rules. A financial end user under the Final Rules includes a counterparty that is not a swap entity (under the relevant set of Final Rules) but is any of the following:

- A bank holding company or an affiliate thereof; a savings and loan holding company; a U.S. intermediate holding company established or designated for purposes of compliance with 12 C.F.R. § 252.153; or a nonbank financial institution supervised by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") under Title I of Dodd-Frank;
- A depository institution; a foreign bank; a Federal credit union, U.S. state credit union as defined in section 2 of the Federal Credit Union Act; an institution that functions solely in a trust or fiduciary capacity as described in section 2(c)(2)(D) of the Bank Holding Company Act; an industrial loan company, an industrial bank or other similar institution described in section 2(c)(2)(H) of the Bank Holding Company Act;

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- An entity that is state-licensed or registered as a credit or lending entity, including a finance company; money lender; installment lender; consumer lender or lending company; mortgage lender, broker, or bank motor vehicle title pledge lender; payday or deferred deposit lender; premium finance company; commercial finance or lending company; or commercial mortgage company; but excluding entities registered or licensed solely on account of financing the entity's direct sales of goods or services to customers;
- A money services business, including a check casher; money transmitter; currency dealer or exchange; or money order or traveler's check issuer;
- A regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 or any entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator;
- Any institution chartered in accordance with the Farm Credit Act of 1971, as amended, that is regulated by the Farm Credit Administration;
- A securities holding company; a broker or dealer; an investment adviser as defined in section 202(a) of the Investment Advisers Act of 1940 (the "Investment Advisers Act"); an investment company registered with the SEC under the Investment Company Act of 1940 (the "Investment Company Act"); or a company that has elected to be regulated as a business development company pursuant to section 54(a) of the Investment Company Act of 1940;¹⁰
- A private fund as defined in section 202(a) of the Investment Advisers Act; an entity that would be an investment company under section 3 of the Investment Company Act but for section 3(c)(5)(C); or an entity that is deemed not to be an investment company under section 3 of the Investment Company Act pursuant to Investment Company Act Rule 3a-7;
- A commodity pool, a commodity pool operator or a commodity trading advisor as defined in, respectively, sections 1a(10), 1a(11) and 1a(12) of the CEA; a floor broker, a floor trader or introducing broker as defined, respectively, in sections 1a(22), 1a(23) and 1a(31) of the CEA; or a futures commission merchant as defined in section 1a(28) of the CEA;
- An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974;
- An entity that is organized as an insurance company, primarily engaged in writing insurance or reinsuring risks underwritten by insurance companies, or is subject to supervision as such by a U.S. state insurance regulator or foreign insurance regulator;
- An entity, person or arrangement that is, or holds itself out as being, an entity, person or arrangement that raises money from investors, accepts money from clients, or uses its own money primarily for the purpose of investing or trading or facilitating the investing or trading in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets; or
- An entity that would be a financial end user as described above or a swap entity, if it were organized under the laws of the United States or any U.S. state thereof.

The Final Rules explicitly exclude certain counterparties from the definition of financial end user. Specifically, the term does not generally include any counterparty that is: (i) a sovereign entity; (ii) a multilateral development bank; (iii) the Bank for International Settlements; (iv) a captive finance company that qualifies for the exemption from clearing under section 2(h)(7)(C)(iii) of the CEA and implementing regulations; or (v) a person that qualifies for the affiliate exemption from clearing pursuant to section 2(h)(7)(D) of the CEA or section 3C(g)(4) of the Securities Exchange Act and implementing regulations, which sections relate to certain affiliates acting on behalf of commercial end users and as agent.¹¹ The

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Final Rules further define a “sovereign entity” as “a central government (including the U.S. government) or an agency, department, or central bank of a central government”. The Prudential Regulators’ Final Rules specifically exclude the European Central Bank from the definition of financial end user. The Final Rules do not expressly include within the definition of “sovereign entity” other types of quasi-government and public sector entities, although certain such entities may be considered “sovereign entities” under the definitions in the Final Rules.¹² Further, the Final Rules note that U.S. states would not be excluded from the definition of financial end user but that the categorization of a U.S. state or particular part of a U.S. state as a financial end user depends on whether that part of the U.S. state is otherwise captured by the definition of financial end user.

One significant difference between the two Final Rules is that the CFTC Final Rules exclude an “eligible treasury affiliate” from the financial end user category if the CFTC exempts the treasury affiliate from the margin requirements by rule.¹³ The CFTC staff has issued no-action relief from the clearing requirement with respect to certain treasury affiliates acting as principal, subject to certain conditions.¹⁴ In adopting the CFTC Final Rules, Commissioner Giancarlo recognized that the Prudential Regulators were unwilling to recognize the no-action relief for treasury affiliates acting as principal for commercial end users in the Prudential Regulators’ Final Rules, but have indicated that if the CFTC excludes these treasury affiliates by rule, such treasury affiliates would also be excluded from the Prudential Regulators’ Final Rules.¹⁵ As of the date of this memorandum, the CFTC has not yet codified its no-action relief for treasury affiliates acting as principal in a final rule.

3. Material Swaps Exposure

The Final Rules apply to counterparties of Covered Swap Entities depending upon each counterparty’s swap activities. In particular, the Final Rules apply differently to counterparties that are financial end users with material swaps exposure, as compared to their application to counterparties that are financial end users without material swaps exposure. “Material swaps exposure” for an entity is defined in the Final Rules to mean that the entity, together with its affiliates, has a consolidated average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions with all counterparties for June, July and August of the previous calendar year that exceeds \$8 billion,¹⁶ where such amount is calculated only for business days.¹⁷ The Final Rules increased the threshold for the definition of “material swaps exposure” from \$3 billion in the Proposed Rules to \$8 billion, which is broadly consistent with the €8 billion threshold provided in the International Framework. For purposes of this calculation, the Final Rules provide that Covered Swaps with an affiliate of the Covered Swap Entity are counted only once, and swaps that are exempted from the requirements of the Final Rules pursuant to the Interim Final Rules are not counted. The preambles to the Prudential Regulators’ Final Rules and to the CFTC Final Rules both state that it would be reasonable for a Covered Swap Entity to rely on good faith representations of its counterparty in making a determination regarding material swaps exposure.¹⁸

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4. Definition of Affiliates

The Proposed Rules defined “affiliate” by reference to a “control” test that defined control as a 25% voting or equity stake or the power to elect a majority of the directors or trustees of an entity.¹⁹ In contrast, the Final Rules align the definition of “affiliate” with established accounting standards rather than relying on a “control” test. The Final Rules specify that a company is an affiliate of another company if “(1) either company consolidates the other on financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles (“U.S. GAAP”), the International Financial Reporting Standards, or other similar standards; (2) both companies are consolidated with a third company on a financial statement prepared in accordance with such principles or standards; or (3) for a company that is not subject to such principles or standards, if consolidation as described in paragraph (1) or (2) of this definition would have occurred if such principles or standards had applied”. Additionally, under the Prudential Regulators’ Final Rules, but not the CFTC Final Rules, the relevant Prudential Regulator has the authority to designate any entity that provides significant support to, or is subject to the risks of, another company as an “affiliate” of that company for purposes of the Prudential Regulators’ Final Rules (even if that entity is not otherwise covered by the definition).

5. The Interim Final Rules

The Prudential Regulators and the CFTC each issued Interim Final Rules that implement Title III of TRIPRA, which provided that the initial and variation margin requirements of Sections 731 and 764 of Dodd-Frank do not apply to certain transactions of specified counterparties that qualify for an exemption or exception from clearing.

The first category of entities that are exempt from the initial and variation margin requirements under the Interim Final Rules are certain non-financial entities that qualify for the end user clearing exception under section 2(h)(7)(A) of the CEA (and under section 3C(g)(1) of the Securities Exchange Act with respect to security-based swaps). These sections provide an exception from the requirement to clear swaps or security-based swaps where one of the counterparties is not a “financial entity” and is using the swap to hedge commercial risk. Under this exception, the initial and variation margin requirements do not apply to any of the following entities when they use Covered Swaps to hedge or mitigate commercial risk:

- End-users that are not financial entities under the statutory definitions;²⁰
- Certain small banks, savings associations, Farm Credit System institutions and credit unions with total assets of \$10 billion or less that are exempted from the definition of “financial entity” in section 2(h)(7)(C)(ii) of the CEA from initial and variation margin requirements;²¹ and
- Captive finance companies²² that are exempted from the definition of “financial entity” in section 2(h)(7)(C) of the CEA.

The second category of entities that is exempt from the initial and variation margin requirements issued under the Interim Final Rules are cooperative entities that qualify for an exemption from the clearing requirements under section 4(c)(1) of the CEA.²³

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The final category of entities that is exempt from the initial and variation margin requirements under the Interim Final Rules are certain treasury affiliates acting as agents for their affiliates that satisfy the criteria for an exception from clearing in section 2(h)(7)(D) of the CEA (and in section 3C(g)(4) of the Securities Exchange Act, under the interim final rules promulgated by the Prudential Regulators). These sections provide that, where a person qualifies for an exception from the clearing requirements, an affiliate may qualify for the exception as well, but only if the affiliate is acting as an agent on behalf of that person, and the affiliate uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.²⁴

D. INITIAL MARGIN REQUIREMENTS

The Final Rules specify that “two-way margining” (*i.e.*, collecting and posting) is required between a Covered Swap Entity and certain counterparties in respect of a Covered Swap. Specifically, when a Covered Swap Entity enters into a transaction with another swap entity or a financial end user with material swaps exposure, both entities will be required to collect and post a minimum amount of initial margin and to maintain that minimum amount of initial margin until the Covered Swap expires or is terminated. In addition, a Covered Swap Entity must post or collect initial margin on each business day in response to changes in the required initial margin amounts that are caused by changes in portfolio composition or any other factors that result in a change in the required initial margin amounts.

With respect to the methodology for calculating initial margin requirements, the Final Rules permit a Covered Swap Entity to select from two alternatives to calculate its initial margin requirements, (i) a “look-up” table and (ii) an internal margin model.

1. “Look-Up” Table

Under the Final Rules, a Covered Swap Entity may calculate its initial margin requirements for a Covered Swap using a standard “look-up” table that specifies the minimum quantum of initial margin that must be collected, expressed as a percentage of the notional amount of the swap. Pursuant to this look-up table, the minimum initial margin amount varies depending on the broad asset class of the swap. The initial margin amount applicable to multiple uncleared swaps subject to an EMNA (discussed in more detail below) pursuant to the look-up table must be computed in accordance with a formula that recognizes netting benefits only to a limited extent.²⁵

2. Internal Margin Model

The Final Rules allow a Covered Swap Entity to calculate its minimum initial margin requirements using an internal margin model satisfying specified criteria. Under the CFTC Final Rules, the internal margin model can be approved by either the CFTC or the NFA (which operates as the industry self-regulatory organization, under delegated authority from the CFTC), whereas under the Prudential Regulators’ Final Rules, the internal margin model must be approved by the appropriate Prudential Regulator. Any internal initial margin model must meet the following requirements:

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- the model must calculate an amount of initial margin that is equal to the potential future exposure of the swap;²⁶
- all data used to calibrate the model must be based on an equally weighted historical observation period of at least one year and not more than five years and must incorporate a period of significant financial stress for each broad asset class that is appropriate to the uncleared swaps to which the initial margin model is applied;
- the model must use risk factors sufficient to measure all material price risks inherent in the swap transaction, which must include foreign exchange and interest rate risk, credit risk, equity risk and commodity risk, as appropriate;
- in the case of a cross-currency swap that is a Covered Swap, the model need not recognize any risks or risk factors associated with the fixed, physically settled foreign exchange transaction associated with the exchange of principal embedded in the uncleared cross-currency swap; but must recognize all material risks and risk factors associated with all other payments and cash flows that occur during the life of the uncleared cross-currency swap;
- the model may calculate initial margin for a portfolio of swaps and reflect offsetting exposures, diversification and other hedging benefits for swaps that are governed by the same EMNA within, but not across, specified risk categories (agricultural commodities, energy commodities, metal commodities, other commodities, credit, equity, and foreign exchange and interest rates (as a single asset class));
- if the initial margin model does not explicitly reflect offsetting exposures, diversification and hedging benefits within a broad risk category, the Covered Swap Entity must calculate an amount of initial margin separately for each subset within which such relationships are explicitly recognized by the model;
- the sum of the initial margin amounts calculated for each broad risk category will be used to determine the aggregate initial margin due from each counterparty (e.g., no netting across the broad risk categories);
- the model may not permit the calculation of any initial margin collection amount to be subject to offset by any initial margin that may be owed or otherwise payable by the Covered Swap Entity to the counterparty;
- the model must include all material risks arising from the nonlinear price characteristics of options positions and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates, prices or other material risk factors;
- the Covered Swap Entity may not omit any risk factor from the calculation of its initial margin that the Covered Swap Entity uses in its model unless it has previously demonstrated to its Prudential Regulator or the CFTC, as applicable, that such omission is appropriate;
- the Covered Swap Entity may not incorporate any proxy or approximation to capture the risks of the Covered Swap Entity's actual swap transactions unless it has previously demonstrated that such approximation is appropriate;
- the Covered Swap Entity must have a rigorous and well-defined process for re-estimating, re-evaluating and updating its model to ensure continued applicability and relevance;
- the model must be recalibrated at least annually; and
- the level of sophistication of the model must be commensurate with the complexity of the swap.

In addition, the Covered 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 the Covered Swap Entity's initial margin model outputs (estimation of initial

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margin) with relevant alternative internal and external data sources to ensure that the initial margin required is not less than what a DCO or a clearing agency would require for similar cleared transactions. The Covered Swap Entity must review its initial margin model at least annually in light of developments in financial markets and modeling technologies and make enhancements as appropriate. Under both sets of Final Rules, the appropriate approving entity in its discretion could require a Covered Swap Entity to collect greater initial margin than the amount determined by its model. The preambles to the Prudential Regulators' Final Rules and to the CFTC Final Rules both note that, given the complexity and diverse nature of uncleared swaps, the Prudential Regulators and the CFTC expect that Covered Swap Entities may choose to make use of vendor-supplied products and services in developing their own initial margin models.

3. Initial Margin Threshold Amount

The Final Rules permit a Covered Swap Entity, using either alternative calculation method to determine initial margin requirements, to adopt a maximum initial margin threshold amount of \$50 million (a decrease from the \$65 million threshold amount in the Proposed Rules), below which it need not collect or post initial margin from or to swap entities or financial end users with material swaps exposures. The threshold applies on a consolidated or group basis and, therefore, applies across all Covered Swaps between a Covered Swap Entity and its affiliates and the counterparty and its affiliates. There is no cap on the threshold amount for initial margin requirements between a Covered Swap Entity and a counterparty that (i) qualifies as a nonfinancial end user; (ii) is exempt from the definition of financial end user; and (iii) is a financial end user without material swaps exposure. However, as discussed below, the Covered Swap Entity is specifically required under the Prudential Regulators' Final Rules to engage in an assessment of the overall risk of these counterparties to determine whether collection of initial margin is warranted.

The Final Rules also include a minimum transfer amount below which no transfer of initial or variation margin is necessary. A Covered Swap Entity is not required to collect or post initial or variation margin from or to any individual counterparty that is otherwise required by the Final Rules, unless and until the required cumulative amount of initial and variation margin resulting from all Covered Swaps between a Covered Swap Entity and its affiliates and a counterparty and its affiliates is greater than \$500,000.²⁷

The Prudential Regulators' Final Rules provide that a Covered Swap Entity may apply a \$20 million initial margin threshold in respect of inter-affiliate swaps to each of its affiliates. The CFTC Final Rules do not contain a similar initial margin threshold for inter-affiliate swaps; however, the CFTC Final Rules generally do not require Covered Swap Entities to post initial margin for inter-affiliate swaps, subject to certain conditions that are described below.

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E. VARIATION MARGIN REQUIREMENTS

Under the Final Rules, Covered Swap Entities transacting with swap entities and with all types of financial end users (including financial end users without a material swaps exposure) are required to collect and post variation margin with respect to Covered Swaps. The requirements to collect and post variation margin are broader than the initial margin requirements described above in that they apply to financial end users irrespective of whether the financial end user has material swaps exposure. Under the Prudential Regulators' Final Rules, a Covered Swap Entity is required to collect variation margin from other counterparties at such times and in such amounts as the Covered Swap Entity determines appropriate to address the credit risk posed by the counterparty and the risks of the Covered Swap. The Final Rules generally require a Covered Swap Entity to collect and post variation margin on Covered Swaps in an amount that is at least equal to the increase or decrease (as applicable) in the value of the Covered Swaps to the Covered Swap Entity since the previous exchange of variation margin. As noted above, a Covered Swap Entity is not required to collect or post initial or variation margin from or to any individual counterparty unless and until the required cumulative amount of initial and variation margin resulting from all Covered Swaps between a Covered Swap Entity and its affiliates, and a counterparty and its affiliates, is greater than the minimum transfer amount of \$500,000. Under the Final Rules, a Covered Swap Entity is required to collect or post variation margin with other Covered Swap Entities and financial end user counterparties no less frequently than once per business day.

The CFTC Final Rules provide more granular requirements on the calculation of variation margin amounts than the Prudential Regulators' Final Rules. In particular, the CFTC Final Rules specify that, on each business day, each Covered Swap Entity must calculate the amount of variation margin required to be paid by itself and by each counterparty that is a swap entity or a financial end user. The Covered Swap Entity is further required to 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". In addition, the CFTC Final Rules require a Covered Swap Entity to maintain documentation that describes its methodology with "sufficient specificity" to permit its counterparty, the CFTC, the NFA and any applicable Prudential Regulator to independently calculate a reasonable approximation of the variation margin requirement for the Covered Swap. The Covered Swap Entity must evaluate the reliability of its data sources for calculating variation margin at least annually.

F. TREATMENT OF SWAPS BETWEEN A COVERED SWAP ENTITY AND AN AFFILIATE

Requirements with respect to collecting and posting margin in connection with inter-affiliate swaps represent a key difference between the CFTC Final Rules and the Prudential Regulators' Final Rules.

The CFTC Final Rules generally do not require a Covered Swap Entity to collect or post initial margin with an affiliate with respect to a Covered Swap, subject to certain conditions.²⁸ Instead, the Covered Swap Entity must (i) subject the inter-affiliate swaps to a centralized risk management program that is reasonably designed to monitor and to manage risks associated with Covered Swaps entered into with

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affiliates, and (ii) exchange variation margin with affiliates in accordance with the requirements in the CFTC Final Rules, consistent with the treatment of non-affiliated counterparties. If a CFTC-regulated Covered Swap Entity enters into a Covered Swap with an affiliate that is a Covered Swap Entity subject to Prudential Regulators' Final Rules, the CFTC-regulated Covered Swap Entity must post initial margin to the affiliate in an amount equal to the amount that the Covered Swap Entity subject to the Prudential Regulators' Final Rules is required to collect from the CFTC-regulated Covered Swap Entity pursuant to the Prudential Regulators' Final Rules. Additionally, a Covered Swap Entity is required under the CFTC Final Rules to collect initial margin pursuant to the CFTC Final Rules from an affiliated non-U.S. financial end user that enters into swaps directly (or through an affiliate) with unaffiliated third parties to which the margin rules for uncleared swaps would apply if the affiliated non-U.S. financial end user were a Covered Swap Entity and is located in a jurisdiction that the CFTC has not found to be eligible for substituted compliance with respect to (and does not otherwise comply with) the requirements under the CFTC Final Rules. Similar to the Prudential Regulators' Final Rules, the CFTC Final Rules permit the Covered Swap Entity or one of its affiliates to serve as the custodian for initial margin collected pursuant to the inter-affiliate provisions of the CFTC Final Rules.

In contrast to the CFTC Final Rules (other than with respect to small end users that are exempted under the Interim Final Rules), the Prudential Regulators' Final Rules generally provide that a Covered Swap Entity is required to collect initial margin from an affiliate in connection with a Covered Swap, but is not required to post initial margin to the affiliate. The Covered Swap Entity is required to calculate the amount of initial margin it otherwise would have been required to post to its affiliate and to provide documentation of such amount to each affiliate on a daily basis. However, if the affiliate is itself a Covered Swap Entity that is also subject to the Prudential Regulators' Final Rules, and is therefore subject to an obligation to collect initial margin, then the relief from posting initial margin would not provide any practical relief.

Key elements of the Prudential Regulators' Final Rules including the following initial margin and variation margin requirements for inter-affiliate swaps:

- The amount of initial margin to be collected from affiliates under the Prudential Regulators' Final Rules must be calculated in the same manner as the amount for non-affiliate counterparties.²⁹
- The initial margin threshold is \$20 million, as opposed to the \$50 million threshold for swaps with non-affiliates; however, amounts under this threshold will be measured only with respect to Covered Swaps between the Covered Swap Entity and the relevant affiliate (rather than on a consolidated basis across the entire affiliated organization).
- For Covered Swaps with an affiliate that are exempt from a mandatory clearing determination solely by virtue of the CFTC's inter-affiliate swap exemption, the Prudential Regulators' Final Rules permit a Covered Swap Entity to calculate initial margin using a five-day hypothetical close-out period (rather than the generally applicable 10-day close-out period).³⁰
- A Covered Swap Entity must collect and post variation margin with respect to a Covered Swap with an affiliate, consistent with the treatment of swaps with non-affiliated

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counterparties. In addition, as noted above, the Prudential Regulators' Final Rules permit a Covered Swap Entity or an affiliate to serve as custodian of non-cash collateral that a Covered Swap Entity collects from an affiliate.

Although the CFTC Final Rules mitigate the impact that the Prudential Regulators' Final Rules might have had on affiliate Covered Swaps, the Prudential Regulators' Final Rules may still have significant implications for banking organizations, including the following:

- Covered Swaps between Covered Swap Entities in the bank chain (e.g., between a bank swap dealer and its subsidiary that also is a swap dealer) are subject to a two-way initial margin requirement under the Prudential Regulators' Final Rules because, as Covered Swap Entities subject to the Prudential Regulators' Final Rules, they both are required to collect initial margin. This is a change from existing market practice and a departure from the treatment of subsidiaries of a bank as part of the bank rather than as an affiliate of the bank for purposes of Sections 23A and 23B of the Federal Reserve Act, the key federal statutory provisions governing transactions between banks and their affiliates.
- The preamble to the Prudential Regulators' Final Rules makes clear that Sections 23A and 23B of the Federal Reserve Act are independent requirements that are unaffected by the Prudential Regulators' Final Rules. Because the Federal Reserve Board has not yet issued a rule defining "credit exposure" for inter-affiliate derivative exposures,³¹ it remains unknown what the Section 23A measure of credit exposure will be or how it will compare to the measure of exposure for purposes of the initial margin requirement in the Prudential Regulators' Final Rules. It is possible, therefore, that the Section 23A requirement will require banks to collect additional collateral from Section 23A affiliates, above what would be required under the Prudential Regulators' Final Rules, for the same uncleared swap transactions, or impose other obligations on such transactions. Furthermore, because the Prudential Regulators' Final Rules require that a Covered Swap Entity comply with the third-party custodial requirement with respect to cash initial margin even for cash collateral posted by the bank's affiliate, which prevents the bank from using that collateral for other purposes, a bank could not use that cash collateral to meet the terms of the exemption in Section 23A for transactions secured by cash or U.S. government securities, which requires that cash collateral be maintained in a segregated, earmarked deposit account with the bank.³² The Prudential Regulators' Final Rules should not, however, prevent the bank from using U.S. government securities that it custodies for its affiliate transactions to meet both the initial margin requirement and Section 23A.

G. ELIGIBLE MASTER NETTING AGREEMENTS

The Final Rules permit a Covered Swap Entity to (i) calculate initial margin requirements for Covered Swaps under an EMNA with the counterparty on a portfolio basis in certain circumstances, if the Covered Swap Entity calculates its initial margin requirements using an initial margin model, and (ii) calculate variation margin requirements on an aggregate, net basis across Covered Swaps with a particular counterparty that were executed under an EMNA.³³ 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 receivership, conservatorship, insolvency, liquidation or similar proceeding) provided that certain conditions are met. These conditions include requirements with respect to the Covered Swap Entity's right to terminate the agreement and liquidate collateral, and certain standards with respect to legal review of the agreement to ensure it meets the criteria in the definition. The legal review must be sufficient such that the Covered Swap Entity may

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conclude with a well-founded basis that, among other things, the agreement would be determined to be legal, binding and enforceable under the law of the relevant jurisdictions, and that the agreement otherwise meets the requirements of the EMNA definition (such as the absence of a walkaway clause).³⁴

The Final Rules address concerns raised by commenters in the Proposed Rules relating to the treatment of uncleared swaps entered into pursuant to an EMNA before the effective date of the rules, in which the Proposed Rules could have applied retroactively to uncleared swaps entered into before the effective date of the Proposed Rules under the EMNA. The Final Rules address this concern by permitting entities to carve out pre-compliance date Covered Swaps under an EMNA from the netting set of swaps entered into after the compliance date.

H. COUNTERPARTY RISK ASSESSMENT

With respect to Covered Swaps with counterparties that are not otherwise subject to the Prudential Regulators' Final Rules, the Prudential Regulators' Final Rules (but not the CFTC Final Rules) require a Covered Swap Entity to collect initial and variation margin from such counterparties at such times and in such forms and amounts (if any) that the Covered Swap Entity determines appropriately addresses the credit risk posed by the counterparty and the risks of such Covered Swaps. Under both sets of Final Rules, all financial end user counterparties are subject to the variation margin requirements, while only financial end user counterparties with material swaps exposure are subject to initial margin requirements. Therefore, financial end users *without* material swaps exposure may be subject to this counterparty risk assessment under the Prudential Regulators' Final Rules for purposes of determining any initial margin requirements, but not for purposes of determining variation margin requirements. In addition, under the Prudential Regulators' Final Rules, whether to apply any requirements relating to documentation, eligible collateral, segregation and rehypothecation, discussed in further detail below, is determined by Covered Swap Entities as part of this counterparty risk assessment.

I. SUMMARY OF INITIAL AND VARIATION MARGIN REQUIREMENTS BY COUNTERPARTY TYPE

1. Prudential Regulators' Final Rules

A summary of the initial and variation margin requirements under the Prudential Regulators' Final Rules by counterparty type follows.

Type of Counterparty to Covered Swap Entity	Initial Margin		Variation Margin
	IM Threshold	Amount Required	Amount Required
Swap Entities	\$50 million or below	Approved Internal Model or Standardized Minimum from "Look-Up" Table	Daily Market Value Change to the Covered Swap Entity
Financial End Users With Material (\$8B daily) Swaps Exposure	\$50 million or below	Approved Internal Model or Standardized Minimum from "Look-Up" Table	Daily Market Value Change to the Covered Swap Entity

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Type of Counterparty to Covered Swap Entity	Initial Margin		Variation Margin
	IM Threshold	Amount Required	Amount Required
Financial End Users Without Material Swaps Exposure	N/A	Judgment of the Covered Swap Entity	Daily Market Value Change to the Covered Swap Entity
Other Counterparties, Including Nonfinancial End Users	N/A	Judgment of the Covered Swap Entity	Judgment of the Covered Swap Entity
Affiliates	\$20 million	Must Collect Based on Internal Model or Standardized Minimum from "Look-Up" Table; Posting Not Required (unless the affiliate is itself a Covered Swap Entity subject to the Prudential Regulators' Final Rules)	Daily Market Value Change to the Covered Swap Entity
Entities Exempted Under the Interim Final Rules	N/A	No obligations	No obligations

2. CFTC Final Rules

A summary of the initial and variation margin requirements under the CFTC Final Rules by counterparty type follows.

Type of Counterparty to Covered Swap Entity	Initial Margin		Variation Margin
	IM Threshold	Amount Required	Amount Required
Swap Entities	\$50 million or below	Approved Internal Model or Standardized Minimum from "Look-Up" Table	Daily Market Value Change to the Covered Swap Entity (using certain objective criteria to the maximum extent practicable)
Financial End Users With Material (\$8B daily) Swaps Exposure	\$50 million or below	Approved Internal Model or Standardized Minimum from "Look-Up" Table	Daily Market Value Change to the Covered Swap Entity (using certain objective criteria to the maximum extent practicable)
Financial End Users Without Material Swaps Exposure	N/A	No Requirements	Daily Market Value Change to the Covered Swap Entity (using certain objective criteria to the maximum extent practicable)
Other Counterparties, Including Nonfinancial End Users	N/A	No Requirements	No Requirements
Affiliates	N/A	No Requirements (subject to certain conditions)	Daily Market Value Change to the Covered Swap Entity (using certain objective criteria to the maximum extent practicable)
Entities Exempted under the Interim Final Rules	N/A	No Requirements	No Requirements

J. ELIGIBLE COLLATERAL

The Final Rules are substantially similar with regard to provisions related to eligible collateral in respect of Covered Swaps. Both sets of Final Rules expand the categories of eligible margin collateral in comparison to the Proposed Rules.

1. Initial Margin – Collateral Requirements

With respect to initial margin, the Final Rules permit a Covered Swap Entity to collect initial margin related to Covered Swaps with either another swap entity or a financial end user solely in the form of:

- Immediately available cash funds that are denominated in U.S. dollars, another major currency, or the currency of settlement for the Covered Swap,³⁵
- A security that is issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of Treasury;
- A security that is issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, a U.S. government agency (other than the U.S. Department of Treasury) whose obligations are fully guaranteed by the full faith and credit of the United States government;
- A security that is 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 Covered Swap Entities as set forth in the Prudential Regulators' Final Rules;
- A publicly traded debt security issued by, or an asset-backed security fully guaranteed as to the payment of principal and interest by, a U.S. government-sponsored enterprise that is operating with capital support or another form of direct financial assistance received from the U.S. government that enables the repayments of the U.S. government-sponsored enterprise's eligible securities;
- A publicly traded debt security that meets certain terms and is issued by a U.S. government-sponsored enterprise not operating with capital support or another form of direct financial assistance from the U.S. government, and is not an asset-backed security;
- A security that is 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;
- A security solely in the form of: (i) publicly traded debt not otherwise described above that meets certain terms and is not an asset-backed security; or (ii) publicly traded common equity that is included in: (A) the Standard & Poor's Composite 1500 Index or any other similar index of liquid and readily marketable equity securities as determined by the relevant Prudential Regulator or the CFTC as appropriate; or (B) an index that a Covered Swap Entity's supervisor in a foreign jurisdiction recognizes for purposes of including publicly traded common equity as initial margin under applicable regulatory policy, if held in that foreign jurisdiction;
- Securities in the form of redeemable securities in a pooled investment fund representing the security-holder's proportional interest in the fund's net assets and that are issued and redeemed only on the basis of the market value of the fund's net assets prepared each business day after the security-holder makes its investment commitment or redemption request to the fund, if (i) the fund's investments are limited to the following: (A) securities that are issued by, or unconditionally guaranteed as to the timely payment of principal and interest

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by, the U.S. Department of Treasury, and immediately available cash funds denominated in U.S. dollars; or (B) securities denominated in a common currency and 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 Covered Swap Entities as set forth in the Prudential Regulators' Final Rules, and immediately available cash funds denominated in the same currency; and (ii) assets of the fund may not be transferred through securities lending, securities borrowing, repurchase agreements, reverse repurchase agreements or other means that involve the fund having rights to acquire the same or similar assets from the transferee; or

- Gold.

2. Variation Margin – Collateral Requirements

With regard to variation margin for Covered Swaps with a swap entity, the Final Rules require the Covered Swap Entity to collect or post immediately available cash funds to satisfy the minimum variation margin requirements. Cash funds can be denominated in U.S. dollars, another major currency,³⁶ or in the currency of settlement for the Covered Swap for purposes of variation margin collection and posting by a Covered Swap Entity from another swap entity. Variation margin in these forms is not subject to any “haircuts”.

With regard to variation margin for Covered Swaps with a financial end user, the Final Rules require the Covered Swap Entity to collect and post variation margin solely in the form of eligible collateral that is listed above with respect to initial margin. These assets would be subject to certain “haircuts” as described below.

3. Haircuts and Other Eligible Collateral Requirements

Certain forms of collateral are subject to an additional value “haircut” when determining the collateral's value for purposes of satisfying the margin requirements of the Final Rules. An eight percent haircut is required for variation margin denominated in a currency that is not the currency of settlement for the Covered Swap, except for immediately available cash funds denominated in U.S. dollars or another “major currency”. An eight percent haircut is also required for initial margin collateral denominated in a currency that is not the currency of settlement for the Covered Swap, except for eligible types of collateral denominated in a single termination currency designated as payable to the non-posting counterparty as part of the EMNA.³⁷ Additionally, initial and variation margin non-cash collateral are subject to certain risk-based haircuts.

A Covered Swap Entity is required to monitor the market value and eligibility of all collateral collected and posted to satisfy the minimum initial margin and minimum variation margin requirements. If the market value of such collateral declines, or if such collateral is no longer eligible, the Covered Swap Entity is required to collect or post such additional eligible collateral as is necessary to maintain compliance.

Under the Final Rules, certain collateral does not constitute eligible collateral, including any security issued by: (i) the party or an affiliate of the party pledging such collateral; (ii) certain banking entities,

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including bank holding companies and insured depository institutions; and (iii) certain nonbank financial institutions supervised by the Federal Reserve Board.

K. SEGREGATION REQUIREMENTS

The Final Rules direct a Covered Swap Entity that posts or collects initial margin with respect to a Covered Swap to require that such collateral be held by one or more custodians that are not the Covered Swap Entity, its counterparty, or an affiliate of the Covered Swap Entity or the counterparty, other than excess initial margin collateral collected by a Covered Swap Entity. However, the Prudential Regulators' Final Rules provide for special rules for inter-affiliate Covered Swaps which permit a Covered Swap Entity or an affiliate of a Covered Swap Entity to serve as custodian of non-cash collateral that a Covered Swap Entity collects from an affiliate.

For all collateral posted and collected, the Final Rules require that the custodian act pursuant to an enforceable custodial agreement specifying that the custodian is prohibited from rehypothecating, pledging, reusing or otherwise transferring any funds or property held by it, except that cash collateral may be held in a general deposit account with the custodian if the funds in the account are used to purchase certain assets qualifying as eligible collateral and meeting other requirements. Notwithstanding such prohibition, the party posting the collateral is permitted to substitute or direct any reinvestment of collateral, including collateral required by the Final Rules if the posting party substitutes only funds or other property that qualifies as eligible collateral, and the amount substituted or reinvested otherwise satisfies the requirements of the Final Rules. Notably, this provision of the Final Rules is different from the parallel provision in the International Framework, which permits a limited degree of rehypothecation, pledging and reuse of initial margin collateral when a Covered Swap Entity is transacting with a financial end user if certain safeguards for protecting the financial end user's rights in such collateral are available under applicable law.

L. DOCUMENTATION REQUIREMENTS UNDER THE FINAL RULES

The Final Rules impose certain documentation requirements on Covered Swap Entities for each Covered Swap entered into by the Covered Swap Entity with certain counterparties. The Final Rules require a Covered Swap Entity to execute trading documentation with each counterparty that is either a swap entity or a financial end user, regarding credit support arrangements that provide the Covered Swap Entity and its counterparty with the contractual right to collect and post initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by the Final Rules. The documentation must also specify the methods, procedures, rules and inputs for determining the value of each Covered Swap for purposes of calculating variation margin requirements. Similarly, the documentation must describe the methods, procedures, rules and inputs used to calculate initial margin for Covered Swaps entered into by the Covered Swap Entity and each counterparty. The documentation must also specify the procedures by which disputes concerning the valuation of Covered Swaps or the valuation of assets collected or posted as initial margin or variation margin may be resolved.

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The CFTC Final Rules also specify that Covered Swap Entities subject to regulation by the CFTC must comply with the general documentation requirements imposed on swap dealers and major swap participants for certain uncleared swaps as set forth in CFTC Rule 23.504.³⁸

M. APPLICATION OF MARGIN REQUIREMENTS TO CERTAIN FOREIGN COVERED SWAP ENTITIES

The Prudential Regulators' Final Rules include a section addressing the cross-border application of the margin requirements. The CFTC Final Rules do not address cross-border issues; instead, the CFTC stated that it will address these issues through a separate rulemaking. The CFTC released its proposed rules for the cross-border application of the margin rules (the "CFTC Cross-Border Proposed Rules") on July 14, 2015.³⁹

The margin requirements under the Prudential Regulators' Final Rules do not apply to certain foreign uncleared swaps or foreign uncleared security-based swaps that are entered into by a "foreign Covered Swap Entity". Under the Prudential Regulators' Final Rules, a "foreign Covered Swap Entity" is any Covered Swap Entity that is not (i) an entity organized under the laws of the United States or any U.S. state, including a U.S. branch, agency or subsidiary of a foreign bank; (ii) a branch or office of an entity organized under the laws of the United States or any U.S. state; or (iii) an entity that is a subsidiary of an entity that is organized under the laws of the United States or any U.S. state.

An uncleared swap or uncleared security-based swap is a "foreign uncleared swap" or a "foreign uncleared security-based swap" if neither the counterparty to the foreign Covered Swap Entity nor any party that guarantees either party's obligations under the Covered Swap is (i) an entity organized under the laws of the United States or any U.S. state (including a U.S. branch, agency or subsidiary of a foreign bank) or a natural person who is a resident of the United States; (ii) a branch or office of an entity organized under the laws of the United States or any U.S. state; or (iii) a swap entity that is a subsidiary of an entity that is organized under the laws of the United States or any U.S. state.

In addition, the Prudential Regulators' Final Rules allow for certain Covered Swap Entities to comply with a foreign regulatory framework for uncleared swaps, in lieu of adhering to the U.S. framework promulgated by the Prudential Regulators, if the Covered Swap Entity meets certain requirements and the Prudential Regulators jointly determine, by public order, that substituted compliance for the relevant jurisdiction is appropriate because the foreign regulatory framework has comparable requirements that are appropriate for the safe and sound operation of the Covered Swap Entity. To rely on substituted compliance, the Covered Swap Entity (i) must not have a guarantee of its obligations from a natural person who is a resident of the United States or from an entity organized under the laws of the United States or any U.S. state, including a branch or office of an entity organized under the laws of the United States or any U.S. state (other than a U.S. branch or agency of a foreign bank) and (ii) must be either a foreign Covered Swap Entity, a U.S. branch or agency or a foreign bank or another specified foreign entity. The Prudential Regulators expect to make substituted compliance determinations on a jurisdiction-

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by-jurisdiction basis, and these determinations may be conditional or unconditional and may apply to all or some of the requirements of the Prudential Regulators' Final Rules.

The Prudential Regulators' Final Rules clarify that the segregation requirements of the Prudential Regulators' Final Rules do not apply to a Covered Swap entered into by certain foreign entities where: (i) inherent limitations in the legal or operational infrastructure in the foreign jurisdiction exist that make it impracticable for the Covered Swap Entity and the counterparty to post any form of eligible initial margin collateral in compliance with the segregation rules; (ii) the Covered Swap Entity is subject to foreign regulatory restrictions that require the Covered Swap Entity to transact in the Covered Swap with the counterparty through an establishment within the foreign jurisdiction and do not accommodate the posting of collateral for the Covered Swap outside the jurisdiction; (iii) the counterparty to the Covered Swap is not guaranteed by, and the counterparty's obligations under the Covered Swap do not have a guarantee from, certain types of entities; (iv) the Covered Swap Entity collects initial margin for the Covered Swap in accordance with the rules for collecting initial margin under the Prudential Regulators' Final Rules in the form of cash and posts and collects variation margin in accordance with the rules for collecting variation margin under the Prudential Regulators' Final Rules in the form of cash; and (v) the relevant Prudential Regulator provides the Covered Swap Entity with prior written approval.

The CFTC Cross-Border Proposed Rules generally require Covered Swap Entities that are organized under U.S. law or whose obligations are guaranteed by a U.S. person to comply with the CFTC Final Rules. Under the CFTC Cross-Border Proposed Rules, a non-U.S. Covered Swap Entity would not be required to comply with the CFTC Final Rules if: (A) the obligations of the non-U.S. Covered Swap Entity under the relevant Covered Swap are not guaranteed by a U.S. person; (B) the non-U.S. Covered Swap Entity is not a U.S. branch of a non-U.S. Covered Swap Entity; and (C) the non-U.S. Covered Swap Entity is not a "Foreign Consolidated Subsidiary" of a non-U.S. person counterparty (excluding a Foreign Consolidated Subsidiary or the U.S. branch of a non-U.S. Covered Swap Entity), whose obligations under the relevant swap are not guaranteed by a U.S. person. A "Foreign Consolidated Subsidiary" is a non-U.S. Covered Swap Entity in which an ultimate parent entity that is a U.S. person has a controlling financial interest, in accordance with U.S. GAAP, such that the U.S. ultimate parent entity includes the non-U.S. Covered Swap Entity's operating results, financial position and statement of cash flows in the U.S. ultimate parent entity's consolidated financial statements, in accordance with U.S. GAAP. Substituted compliance may be available under the CFTC Cross-Border Proposed Rules with respect to:

- Covered Swaps entered into between a U.S. Covered Swap Entity or a non-U.S. Covered Swap Entity whose obligations under the swap are guaranteed by a U.S. person and a counterparty that is neither a U.S. person nor a non-U.S. person whose obligations under the relevant Covered Swap are guaranteed by a U.S. person; so long as the non-U.S. counterparty is subject to, and complies with, the margin requirements of the relevant foreign jurisdiction;
- Covered Swaps entered into between a non-U.S. Covered Swap Entity whose obligations are not guaranteed by a U.S. person and a counterparty other than a U.S. Covered Swap Entity

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- or a non-U.S. Covered Swap Entity whose obligations under the relevant Covered Swap are guaranteed by a U.S. person; and
- Covered Swaps entered into between a non-U.S. Covered Swap Entity whose obligations under the relevant Covered Swap are not guaranteed by a U.S. person with a counterparty that is a U.S. Covered Swap Entity or a non-U.S. Covered Swap Entity whose obligations under the relevant swap are guaranteed by a U.S. person.⁴⁰

In each case, the non-U.S. Covered Swap Entity must be subject to, and comply with, the relevant home country margin requirements, and the CFTC must issue a comparability determination with respect to such requirements. The CFTC will issue a comparability determination if it determines that the relevant foreign jurisdiction's margin requirements are comparable to the CFTC Final Rules. In determining whether the requirements are comparable, the CFTC will consider: (i) the scope and objectives of the relevant foreign jurisdiction's margin requirements; (ii) how the relevant foreign jurisdiction's margin requirements compare to the International Standards; (iii) whether the relevant foreign jurisdiction's margin requirements achieve comparable outcomes to the CFTC Final Rules; and (iv) the ability of the relevant regulatory authority or authorities to supervise and enforce compliance with the relevant foreign jurisdiction's margin requirements, among other factors.

N. COMPLIANCE DATES

The compliance dates are identical under both Final Rules. For the variation margin requirements, the compliance date is September 1, 2016 for Covered Swaps between a Covered Swap Entity and a counterparty where each of the Covered Swap Entity (combined with its affiliates) and the relevant counterparty (combined with its affiliates) has a consolidated average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions for March, April and May of 2016 that exceeds \$3 trillion, where such amounts are calculated only for business days.

For all other Covered Swaps with a Covered Swap Entity, the compliance date is March 1, 2017 with respect to the variation margin requirements. These dates are consistent with the International Framework.

With regard to initial margin, compliance dates range from September 1, 2016 to September 1, 2020, depending on the average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions of the Covered Swap Entity and its counterparty for March, April and May of the year indicated in the table below:

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Compliance Date	Covered Swap
September 1, 2016	Initial margin for Covered Swaps between a Covered Swap Entity and a counterparty where each of the Covered Swap Entity (combined with its affiliates) and the relevant counterparty (combined with its affiliates) has a consolidated average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions for March, April and May of 2016 that exceeds \$3 trillion, where such amounts are calculated only for business days. For purposes of this calculation, Covered Swaps and Excluded FX Transactions entered into by a Covered Swap Entity with an affiliate are only counted once, and Covered Swaps exempt pursuant to the Interim Final Rules are not counted.
September 1, 2017	Initial margin for Covered Swaps between a Covered Swap Entity and a counterparty where each of the Covered Swap Entity (combined with its affiliates) and the relevant counterparty (combined with its affiliates) has a consolidated average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions for March, April and May of 2017 that exceeds \$2.25 trillion. For purposes of this calculation, Covered Swaps and Excluded FX Transactions entered into by a Covered Swap Entity with an affiliate are only counted once, and Covered Swaps exempt pursuant to the Interim Final Rules are not counted.
September 1, 2018	Initial margin for Covered Swaps between a Covered Swap Entity and a counterparty where each of the Covered Swap Entity (combined with its affiliates) and the relevant counterparty (combined with its affiliates) has a consolidated average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions for March, April and May of 2018 that exceeds \$1.5 trillion. For purposes of this calculation, Covered Swaps and Excluded FX Transactions entered into by a Covered Swap Entity with an affiliate are only counted once, and Covered Swaps exempt pursuant to the Interim Final Rules are not counted.
September 1, 2019	Initial margin for Covered Swaps between a Covered Swap Entity and a counterparty where each of the Covered Swap Entity (combined with its affiliates) and the relevant counterparty (combined with its affiliates) has a consolidated average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions for March, April and May of 2019 that exceeds \$0.75 trillion. For purposes of this calculation, Covered Swaps and Excluded FX Transactions entered into by a Covered Swap Entity with an affiliate are only counted once, and Covered Swaps exempt pursuant to the Interim Final Rules are not counted.
September 1, 2020	Initial margin for any other Covered Swaps between a Covered Swap Entity and any other counterparty.

These dates are slightly behind the phased-in margin requirement compliance timeline of the International Framework, which ranges from December 2015 to December 2019.

Generally, the margin requirements would not be applied retroactively, and therefore, would not be imposed on Covered Swaps that are entered into prior to the relevant compliance date. However, if an EMNA covers Covered Swaps that are entered into both before and after the relevant compliance date, the initial and variation margin requirements of the Final Rules would apply to all Covered Swaps entered into pursuant to that EMNA, including those Covered Swaps entered into before the relevant compliance date. The Final Rules do provide a limited exception for pre-compliance date Covered Swaps entered into under an EMNA that also governs post-compliance date swaps. The counterparties can agree under the EMNA to identify one or more separate netting portfolios under an EMNA where the EMNA creates a single legal obligation for all individual Covered Swaps in that netting portfolio upon an event of default (subject to any applicable stay). The margin requirements of the Final Rules would apply only to a netting portfolio that includes post-compliance-date Covered Swaps.

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O. CAPITAL REQUIREMENTS

The Prudential Regulators' Final Rules require that a Covered Swap Entity comply with the regulatory capital rules already made applicable to that Covered Swap Entity by its Prudential Regulator. In the preamble to the Prudential Regulators' Final Rules, the Prudential Regulators noted that the current regulatory capital rules sufficiently take into account and address the risks associated with the swap positions of a Covered Swap Entity. As a result, the Prudential Regulators' Final Rules do not include separate capital requirements. The capital requirements for Covered Swap Entities regulated by the CFTC will be addressed in a separate rulemaking.

* * *

ENDNOTES

- ¹ In the context of the CFTC Final Rules, Covered Swaps refer only to uncleared swaps (and not to uncleared security-based swaps). The Securities and Exchange Commission will adopt rules governing margin on uncleared security-based swaps.
- ² See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (Nov. 20, 2012). The International Framework permitted national regulators to determine whether to apply margin requirements to foreign exchange transactions.
- ³ BCBS and IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives (Sept. 2013), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf>.
- ⁴ See S&C publication “Security-Based Swaps: Capital, Margin and Segregation Requirements”, dated November 19, 2012, available at https://www.sullcrom.com/Publication/Proposed_Rules_on_Capital_Requirements_Margin_for_Security_Based_SDs_and_MSPs.
- ⁵ See S&C publication “Prudential Regulators Capital and Margin Rules for Covered Swap Entities”, dated October 26, 2015, available at <https://www.sullcrom.com/prudential-regulators-capital-and-margin-rules-for-covered-swap-entities>.
- ⁶ See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 80 Fed. Reg. 41,374, 41,376 (July 14, 2015).
- ⁷ The preamble to the Prudential Regulators’ Final Rules noted that, to the extent the CFTC exempts these affiliates by rule, these entities would be excluded from the definition of financial end user for purposes of the Prudential Regulators’ Final Rules. See Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74839, 74,856 (Nov. 30, 2015).
- ⁸ The CFTC Final Rules use the term “margin affiliate” to describe entities that are considered affiliates pursuant to the CFTC Final Rules.
- ⁹ Under the CFTC Final Rules, the definition of “financial end user” includes security-based swap dealers and major security-based swap participants.
- ¹⁰ See n.9 above.
- ¹¹ 7 U.S.C. § 2(h)(7)(D); 15 U.S.C. § 78c-3(g)(4).
- ¹² In other contexts, the CFTC has specifically exempted certain of these quasi-governmental and public sector entities from regulatory requirements, such as exempting “foreign governments” from registration as regulated swap entities and treating these entities as end users for purposes of the CFTC’s end user exception from the clearing requirement. See Further Definition of “Swap Dealer”, “Security-Based Swap Dealer”, “Major Swap Participant”, “Major Security-Based Swap Participant” and “Eligible Contract Participant”, 77 Fed. Reg. 30,595, 30,692, n. 1178 (May 23, 2012); End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560, 42561, n. 12 (July 19, 2012).
- ¹³ The preamble to the CFTC Final Rules states that the CFTC has provided relief with respect to certain treasury affiliates acting as principal from the clearing requirement, provided that certain conditions are met, and that the CFTC will act to implement this approach by rule or staff no-action letter in a separate procedure. See CFTC No-Action Letter No. 13-22 (June 4, 2013); CFTC No-Action Letter No. 14-144 (Nov. 26, 2014).
- ¹⁴ CFTC No-Action Letter No. 13-22 (June 4, 2013); CFTC No-Action Letter No. 14-144 (Nov. 26, 2014).
- ¹⁵ Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 635, 708 (Jan. 6, 2016) (statement of Commissioner Giancarlo). As indicated below, each of the Interim Final Rules exempts certain treasury affiliates acting on behalf of commercial

ENDNOTES (CONTINUED)

- end users and as agent from the requirements of the Final Rules pursuant to CEA § 2(h)(7)(D) (and in section 3C(g)(4) of the Securities Exchange Act, under the interim final rules promulgated by the Prudential Regulators).
- ¹⁶ An example of “material swaps exposure” is provided in the Prudential Regulators’ Final Rules (with a substantially similar example also included in the CFTC Final Rules):
- “[C]onsider a U.S. based financial end user (together with its affiliates) with a portfolio consisting of two non-cleared swaps (for example, an equity swap, an interest rate swap) and one non-cleared security-based credit swap. Suppose that the notional value of each swap is exactly \$10 billion on each business day of June, July, and August of 2016. Furthermore, suppose that a foreign exchange forward is added to the entity’s portfolio at the end of the day on July 31, 2016, and that its notional value is \$10 billion on every business day of August 2016. On each business day of June and July 2016, the aggregate notional amount of non-cleared swaps, security-based swaps and foreign exchange forwards and swaps is \$30 billion. Beginning on August 1, 2016, the aggregate notional amount of non-cleared swaps, security-based swaps and foreign exchange forwards and swaps is \$40 billion. The daily average aggregate notional value for June, July and August of 2016 is then $(22 \times \$30 \text{ billion} + 20 \times \$30 \text{ billion} + 23 \times \$40 \text{ billion}) / (22 + 20 + 23) = \33.5 billion , in which case this entity would be considered to have a material swaps exposure for every date in 2017”.
- Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. at 74,857-58. For purposes of the material swaps exposure calculation, entities count the average daily aggregate notional amount of Covered Swaps and Excluded FX Transactions between the entity and an affiliate only one time.
- ¹⁷ Although the margin requirements of the Final Rules do not apply to physically settled foreign exchange swaps and foreign exchange forwards, pursuant to a determination by the Secretary of the Treasury (Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (Nov. 20, 2012)), such foreign exchange swaps and foreign exchange forwards are counted for purposes of calculating the material swaps exposure amounts and determining applicable compliance dates under the Final Rules.
- ¹⁸ Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. at 645; Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. at 74,858.
- ¹⁹ “Control” was defined in the Proposed Rules as (i) ownership, control, or power to vote 25 percent or more of a class of voting securities of the company, directly or indirectly or acting through one or more other persons; (ii) ownership or control of 25 percent or more of the total equity of the company, directly or indirectly or acting through one or more other persons; or (iii) control in any manner of the election of a majority of the directors or trustees of the company.
- ²⁰ CEA § 2(h)(7)(C); Securities Exchange Act § 3C(g)(3).
- ²¹ The CFTC exempts a cooperative that is a financial entity from mandatory clearing with respect to certain swaps that the cooperative enters into in connection with originating loans for its members or certain swaps with its members which are not financial entities. 7 U.S.C. § 2(h)(7)(C)(ii); 17 C.F.R. § 50.50; End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012) recodified by Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284 (Dec. 13, 2012).
- ²² A captive finance company includes an entity whose primary business is providing financing and uses derivatives for the purpose of hedging underlying commercial risks relating to interest rate and foreign exchange exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company. 7 U.S.C. § 2(h)(7)(C)(iii).
- ²³ 7 U.S.C. § 6(c)(1); 17 C.F.R. § 50.51.

ENDNOTES (CONTINUED)

²⁴ 7 U.S.C. § 2(h)(7)(D); 15 U.S.C. § 78c-3(g)(4). As noted above, this provision of the CEA exempts certain treasury affiliates from the clearing requirement when acting on behalf of and as agent for commercial end users. However, it is unclear how this exemption would apply given that any transaction with a treasury affiliate acting on behalf of a commercial end user as agent should result in the commercial end user being principal to the transaction.

²⁵ The formula for computing initial margin amounts for multiple uncleared swaps subject to an EMNA is:

$$\text{Initial Margin} = (0.4 \times \text{Gross Initial Margin}) + (0.6 \times \text{NGR} \times \text{Gross Initial Margin})$$

where Gross Initial Margin represents the sum of the product of each uncleared swap's effective notional amount and the gross initial margin requirement for all uncleared swaps subject to the EMNA, and NGR represents the net-to-gross ratio (that is, the ratio of the net current replacement cost to the gross current replacement cost). In calculating NGR, the gross current replacement cost equals the sum of the replacement cost for each uncleared swap subject to the EMNA for which the cost is positive. The net current replacement cost equals the total replacement cost for all Covered Swaps subject to the EMNA.

²⁶ Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the Covered Swap or netting set of Covered Swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates and spreads, over a holding period equal to the shorter of ten business days or the maturity of the Covered Swap.

²⁷ This figure is slightly lower than the minimum transfer amount of \$650,000 in the Proposed Rules.

²⁸ In determining to exempt certain affiliate Covered Swaps from the initial margin collection requirement, the CFTC noted that requiring Covered Swap Entities under the CFTC Final Rules to collect initial margin from swap entities under the Prudential Regulators' Final Rules would not result in two-way initial margin for these counterparties (which the Prudential Regulators specifically determined not to impose). In addition, the CFTC considered the "mission and overall regulatory framework" of the Prudential Regulators and CFTC. In particular, the CFTC noted that the Prudential Regulators' Final Rules are "similar to existing requirements of law, in that banks are subject to significant regulatory restrictions and requirements on inter-affiliate transactions under Sections 23A and 23B of the Federal Reserve Act." Margin and Capital Requirements for Covered Swap Entities, 81 Fed. Reg. at 674.

²⁹ The Covered Swap Entity must document this amount to its affiliate each business day.

³⁰ The mandatory clearing requirement currently applies only to certain standardized interest rate swaps and index credit default swaps.

³¹ The Dodd-Frank Act amended the definition of "covered transaction" in Section 23A specifically to include derivative transactions, thereby subjecting derivative transactions to the quantitative limits and collateral requirements of Section 23A. Prior to the amendment, the Federal Reserve Board's implementing regulation, Regulation W, required that such derivatives be on market terms and conducted pursuant to policies and procedures designed to ensure derivative transactions with affiliates are conducted on a safe and sound basis.

³² Section 23A(d)(4), implemented at 12 C.F.R. § 223.42(c), provides an exemption from the limits in Section 23A for derivative transactions fully secured by (i) obligations of the United States or its agencies; (ii) obligations fully guaranteed by the United States or its agencies as to principal and interest; or (iii) a segregated, earmarked deposit account with the bank.

³³ The Final Rules use the term "eligible master netting agreement" to avoid confusion with the term "qualifying master netting agreement", as such term is used by the Federal banking agencies in their risk-based regulatory capital rules. See 12 C.F.R. § 3.2, 12 C.F.R. § 217.2 and 12 C.F.R. § 324.2.

ENDNOTES (CONTINUED)

- ³⁴ A walkaway clause is defined in the Final Rules to mean a provision “that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement”. The definition of walkaway clause in the Final Rules changed from the Proposed Rules, which precluded an EMNA from including a clause that permits a non-defaulting counterparty to “suspend or condition payment” to a defaulter or the estate of a defaulter, in addition to including a clause that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement or no payment at all. The Prudential Regulators noted that this change would align the EMNA definition to the definition of “qualifying master netting agreement” as that term is used by the Federal banking agencies in their risk-based regulatory capital rules. See Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. at 74,861. The definition of walkaway clause in the Proposed Rules was similar to the applicable walkaway clause definitions in the Federal Deposit Insurance Act and Title II of Dodd-Frank, which prohibit any provision that “suspends” or “conditions” a payment obligation. See 12 U.S.C. § 1821(e)(8)(G)(iii); 12 U.S.C. § 5390(c)(8)(F)(iii).
- ³⁵ “Major currency” is defined in the Final Rules to include United States Dollar, Canadian Dollar, Euro, United Kingdom Pound, Japanese Yen, Swiss Franc, New Zealand Dollar, Australian Dollar, Swedish Kronor, Danish Kroner, Norwegian Krone or any other currency determined by the relevant Prudential Regulator or by the CFTC, as appropriate. The “currency of settlement” is defined as the currency in which a party has agreed to discharge a payment obligation related to Covered Swaps or a group of Covered Swaps subject to a master netting agreement at the regularly occurring dates on which such payments are due in the ordinary course.
- ³⁶ The ability to collect and post variation margin in the form of cash denominated in another “major currency” under the Final Rules is a departure from the Proposed Rules, which permitted variation margin only in the form of cash in U.S. dollars or the currency of settlement.
- ³⁷ A single “termination currency” is the currency in which termination and close-out amounts with respect to a Covered Swap will be paid in the event of an early termination.
- ³⁸ 17 C.F.R. § 23.504.
- ³⁹ See n.6 above.
- ⁴⁰ Substituted compliance would be available to a Foreign Consolidated Subsidiary as if it were a non-U.S. Covered Swap Entity.

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