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September 10, 2014

Proposed Margin Requirements for Uncleared Swaps Under Dodd-Frank

Federal Reserve Board, OCC, FDIC, Farm Credit Administration and Federal Housing Finance Agency Repropose Rules for Minimum Margin and Capital Requirements for Certain Dealers and Major Participants in Swaps and Security-Based Swaps

SUMMARY

On September 3, 2014, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency ("OCC"), the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "Prudential Regulators") issued a proposed rule to establish minimum initial and variation margin collection requirements for uncleared swaps entered into by certain swap dealers and major swap participants. The proposal supersedes the Prudential Regulators' previous proposal originally issued in April 2011 (the "2011 Proposal"), is intended to take into account the comments received by the Prudential Regulators in response to the 2011 Proposal and follows the promulgation of the international framework for margin requirements of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps finalized in September 2013 by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions. If adopted, the proposed rule would require that swap dealers and major swap participants subject to the jurisdiction of the Prudential Regulators collect and post minimum initial and variation margin amounts from and to certain swap counterparties, depending on the type of counterparty, in connection with swap transactions. Comments are due to the Prudential Regulators by sixty (60) days after publication in the Federal Register.

BACKGROUND

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires that, subject to certain exemptions, standardized swaps be cleared through a regulated clearing house that is registered under the Commodity Exchange Act ("CEA") as a Derivatives Clearing Organization ("DCO"). For uncleared swaps, *i.e.*, those swaps not cleared through a DCO, Dodd-Frank creates a new Section 4s of the CEA that requires the adoption of rules establishing initial margin, variation margin and capital requirements for swap dealers, major swap participants, security-based swap dealers and major security-based swap participants, as those terms have been defined by the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission ("CFTC") (collectively, "Swap Entities").[1] Swap Entities subject to regulation by a Prudential Regulator ("Covered Swap Entities") must meet the margin and capital requirements determined by the applicable Prudential Regulator. Swap Entities for which there is no Prudential Regulator must meet the margin and capital requirements imposed by the CFTC or the SEC, as applicable.

The term "Prudential Regulator" includes the Federal Reserve Board, the Office of the Comptroller of Currency ("OCC"), the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Authority. The Prudential Regulators are tasked with adopting margin requirements for federally insured deposit institutions, farm credit banks, federal home loan banks, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. The Federal Reserve Board is the Prudential Regulator not only for certain banks, but also for bank holding companies and any foreign banks treated as bank holding companies. The Federal Reserve Board is also the Prudential Regulator for subsidiaries of these bank holding companies and foreign banks, but excluding their nonbank subsidiaries that are required to be registered with the CFTC or the SEC as a Swap Entity.

The Prudential Regulators issued their initial proposed rule regarding margin and capital requirements related to swaps on April 12, 2011 (the "2011 Proposal").[2] In July of 2012, the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") issued a proposed framework for margin requirements of certain swaps with the goal of creating an international standard for margin requirements for such swaps (the "International Framework"). Following public comment on the proposal, the International Framework was finalized by

[1] For a more in-depth discussion of the definitions of swap dealer, security-based swap dealer, major swap participants and major security-based swap participant, please see the S&C publication "Proposed Swap Definitions Under Title VII of the Dodd-Frank Act," dated December 14, 2010, *available at* http://www.sullcrom.com/Proposed-Swap-Definitions-Under-Title-VII-of-the-Dodd-Frank-Act.

[2] *See* S&C publication "Proposed Margin Requirements for Uncleared Swaps Under Dodd-Frank", dated April 18, 2011, *available at* http://sullcrom.com/Proposed-Margin-Requirements-for-Uncleared-Swaps-under-Dodd-Frank.

BCBS and IOSCO in September 2013.[3] The Prudential Regulators reopened the comment period on the 2011 Proposal from October 2, 2012 to November 26, 2012;[4] in total the 2011 Proposal received over 100 comments from entities including banks, asset managers, commercial end users and trade associations. The reproposed rule disseminated by the Prudential Regulators on September 3, 2014 (the "Proposed Rule") endeavors to address the comments received regarding the 2011 Proposal and to be consistent with the International Framework. [5]

The CFTC issued its proposed rule regarding margin requirements for uncleared swaps applying to Swap Entities for which it is the regulator on April 14, 2011,[6] and the SEC issued its proposed rule for Swap Entities for which it is the regulator on October 18, 2012.[7] To date, neither entity has finalized these proposed rules or issued reproposed rules; however, the Prudential Regulators note they have "consulted with the staff of the CFTC and SEC in developing the [P]roposed [R]ule." The CFTC has scheduled a public meeting to consider further proposed margin rules for September 17, 2014.

THE PRUDENTIAL REGULATORS' PROPOSED RULE

Summary of Key Aspects of the Proposed Rule

The Proposed Rule includes a number of key provisions, certain of which reflect changes from the 2011 Proposal that were made in response to comments provided to the Prudential Regulators following the promulgation of the 2011 Proposal and the finalization of the International Framework. The key aspects of the Proposed Rule include the following (with the differences from the prior proposed rules discussed in greater detail below):

- ***Counterparties*.** The establishment of defined categories of counterparties (the definitions are addressed below), comprised of registered Swap Entities, Financial End Users With Material Swaps Exposure, Financial End Users Without Material Swaps Exposure and Other Counterparties. The proposal then distinguishes between those entities within and excluded from the definition of "Financial End User," which determines the level of margin required to be posted.
- ***Material Swaps Exposure*.** A provision distinguishing between financial end user entities with and without "material swaps exposure", where such term for an entity is defined to mean that the entity and its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for business days during June, July and August of the previous year that exceeds $3 billion.

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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* 77 Fed. Reg. 60057 (Oct. 2, 2012).

5 *See* http://www.federalreserve.gov/newsevents/press/bcreg/20140903c.htm; Proposed Rules and comments available at http://www.regulations.gov (Docket No. OCC-2011-0008)

6 *See supra note 2.*

7 *See* S&C publication "Security-Based Swaps: Capital, Margin and Segregation Requirements", dated November 19, 2012, *available at* http://www.sullcrom.com/Publication_Proposed_Rules_on_Capital_Requirements_Margin_for_Security_Based_SDs_and_MSPs.

- ***Initial Margin Requirements.*** A requirement for "two-way margining" (collecting and posting of initial margin) between a Covered Swap Entity and certain of its counterparties, which can be calculated pursuant to a "look-up table" or approved internal margin model meeting certain criteria. The proposal also (i) would permit a Covered Swap Entity to adopt a maximum initial margin threshold amount of $65 million, below which it need not collect or post initial margin from or to other Swap Entities or financial end users with material swaps exposures; (ii) establishes that no specific numerical threshold need be set for other types of counterparties; and (iii) specifies that the first collection or posting of initial margin may be delayed for one day following the day the swap is executed. The proposal also would establish a minimum transfer amount value of $650,000.
- ***Variation Margin Requirements.*** A requirement that Covered Swap Entities transacting with Swaps Entities and with all types of financial end users collect and pay variation margin on at least a daily basis in an amount that is at least equal to the change in the value of such swaps since the previous exchange of variation margin. In addition, a Covered Swap Entity may not adopt a threshold amount below which it need not collect or pay variation margin on swaps with a Swap Entity or financial end user counterparty. The proposal also would establish a minimum transfer amount value of $650,000.
- ***Eligible Master Netting Agreements.*** A provision that a Covered Swap Entity may (i) calculate initial margin requirements for swaps under an Eligible Master Netting Agreement with the counterparty on a portfolio basis in certain circumstances, if it does so using an initial margin model, and (ii) calculate variation margin requirements under the proposed rule on an aggregate, net basis under an Eligible Master Netting Agreement with the counterparty.
- ***Counterparty Risk Assessment.*** A provision requiring a Covered Swap Entity to collect (i) initial margin from counterparties other than other Swap Entities and financial end users with material swaps exposure; and (ii) variation margin from counterparties other than other Swap Entities and financial end users, at such times and in such forms and amounts (if any) that the Covered Swap Entity determines appropriately address the credit risk posed by the counterparty and the risks of such uncleared swaps.
- ***Eligible Collateral.*** A provision limiting the types of eligible collateral that can be used for purposes of variation margin to cash, where such cash is denominated either in U.S. dollars or in the currency in which payment obligations under the swap are required to be settled. The rule as proposed also establishes a number of cash and non-cash eligible collateral categories that can be used for purposes of initial margin, subject to value "haircuts" to be applied to amounts collected in satisfaction of meeting the minimum margin requirements.
- ***Segregation Requirements.*** A requirement that a Covered Swap Entity ensure that any collateral other than variation margin be held by custodians unaffiliated with the Covered Swap Entity or the counterparty. This requirement would apply to all initial margin posted by the Covered Swap Entity (whether required by the Proposed Rule or otherwise) and to initial margin required to be collected by the Covered Swap Entity pursuant to the Proposed Rule (but not any margin collected beyond the required amount). The proposal would further require that the custodial agreements in place prohibit the custodian from rehypothecating, repledging, reusing or otherwise transferring any funds or property held by it.
- ***Application to Foreign Entities.*** A provision that the Proposed Rule would not apply to "foreign Covered Swap Entities", which are defined as Covered Swap Entities that are not (i) entities organized under U.S. or State law, including U.S. branches, agencies, or subsidiaries of a foreign bank; (ii) branches or offices of entities organized under U.S. or State law; or (iii) entities controlled by entities organized under U.S. or State law. The proposal would also allow for substituted compliance with margin rules of foreign jurisdictions by foreign entities if approved by the Prudential Regulators. At present, however, no such approvals have been granted.
- ***Capital Requirements.*** A provision incorporating the capital rules of the Prudential Regulators applicable to Covered Swap Entities.
- ***Compliance Dates and Costs.*** Provisions establishing the compliance date for all Covered Swap Entities as December 1, 2015 with respect to variation margin and requirements related thereto; with respect to initial margin and requirements related thereto, compliance dates are set between December 1, 2015 and December 1, 2019, depending on the average daily aggregate notional

amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps of the Covered Swap Entity and its counterparty for June, July and August of each year.

Categories of Counterparties

The 2011 Proposal would have imposed differing margin requirements, depending on the type of counterparty with which the Covered Swap Entity entered into transactions, and distinguished among four separate types of derivatives counterparties: Swap Entities (including swap dealers and major swap participants), "high-risk" and "low-risk" financial end users of derivatives and nonfinancial end users of derivatives. While the Proposed Rule retains four separate categories of counterparties, the categories have changed somewhat and the structure under the current proposal also modifies the margin requirements applicable to each category. The four categories under the Proposed Rule are the following:

- Swap Entities
- Financial End Users with Material Swaps Exposure
- Financial End Users without Material Swaps Exposure
- Other counterparties

Swap Entities

The Swap Entities category includes the same group of entities under both the 2011 Proposal and the Proposed Rules – registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants.

Financial End Users

Under the 2011 Proposal, a "financial end user" was largely based on the definition of a "financial entity" that is ineligible for the exemption from the mandatory clearing requirements of sections 723 and 763 of Dodd-Frank, and was defined as any counterparty, other than a Swap Entity, that was: (i) a commodity pool (as defined in the Section 1a(5) of the CEA); (ii) a private fund (as defined in Section 202(a) of the Investment Advisors Act of 1940); (iii) an employee benefit plan (as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income and Security Act of 1974 ("ERISA")); (iv) a person that is predominantly engaged in activities that are in the business of banking, or in activities that are "financial" in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956; (v) a person that would be a commodity pool or private fund if it were organized under the laws of the United States; and (vi) any other person that one of the Prudential Regulators may designate with respect to Covered Swap Entities for which it is the Prudential Regulator. The term "financial end user" also referred to a non-U.S. sovereign counterparty.

In an effort to provide further certainty and clarity to counterparties as to whether they would be financial end users for purposes of this proposal, the financial end user definition in the Proposed Rule provides a list of the types of entities that would be considered financial end users as well as a list of the types of entities excluded from the definition. Under the Proposed Rule, a financial end user includes a counterparty that is not a Swap Entity but is any of the following:

- A bank holding company or an affiliate thereof; a savings and loan holding company; a nonbank financial institution supervised by the Board of Governors of the Federal Reserve System under Title I of Dodd-Frank;
- A depository institution; a foreign bank; a Federal credit union, 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;
- 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 and any entity for which the Federal Housing Finance Agency or its successor is the primary federal regulator;
- Any institution chartered and regulated by the Farm Credit Administration in accordance with the Farm Credit Act of 1971, as amended;
- 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;
- 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 of the SEC;
- 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; or a futures commission merchant;
- An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the ERISA;
- 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 State insurance regulator or foreign insurance regulator;
- An entity that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in loans, securities, swaps, funds or other assets for resale or other disposition or otherwise trading in loans, securities, swaps, funds or other assets;
- An entity that would be a financial end user as described above or a Covered Swap Entity, if it were organized under the laws of the United States or any State thereof; or
- Notwithstanding the specified exclusions described below, any other entity that a Prudential Regulator has determined should be treated as a financial end user.

Importantly, the Proposed Rule does not include the general catch-all from the definition of "financial entity" in the CEA for persons that are "predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature." Moreover, unlike the 2011 Proposal, the Proposed

Rule explicitly excludes 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. The Proposed Rule further defines a "sovereign entity" as "a central government (including the U.S. government) or an agency, department, or central bank of a central government", and in a footnote, explicitly includes the European Central Bank for purposes of the exclusion. The Proposed Rule does 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 definition in the Proposed Rule.[8] Further, the Prudential Regulators note that States would not be excluded from the definition of financial end user but that the categorization of a State or particular part of a State as a financial end user depends on whether that part of the State is otherwise captured by the definition of financial end user.

Material Swaps Exposure

In the 2011 Proposal, a "low-risk financial end user" was a financial end user that (i) did not have a "significant swap exposure"; (ii) predominantly used swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate or other risks arising from its business; and (iii) was subject to capital requirements established by a Prudential Regulator or state insurance regulator. "Significant swap exposure" was defined as swap positions that equal or exceed certain specified thresholds. A "high-risk financial end user" was a financial end user that did not fall under the definition of a low-risk financial end user. The 2011 Proposal would have imposed differential margin requirements on high-risk and low-risk financial end users.

The Proposed Rule distinguishes between swaps with financial end user counterparties that have a material swaps exposure and swaps with financial end user counterparties that do not have a material swaps exposure. "Material swaps exposure" for an entity is defined to mean that "the entity and its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps [("Covered Swaps")] with all counterparties for June, July and August of the previous year that exceeds $3 billion",[9] where such

8 In other contexts, the CFTC has specifically included certain of these quasi-government and public sector entities in exempting "foreign governments" from registration as regulated swap entities and determination to treat such parties as end users for purposes of the CFTC's clearing exemption. *See* 77 Fed. Reg. 30595, at 30692, n. 1178 (May 23, 2012); 77 Fed. Reg. 42560, at 42561, n. 12 (July 19, 2012).

9 An example of "material swaps exposure" is provided in the Proposed Rule: "[C]onsider a financial end user (together with its affiliates) with a portfolio consisting of two non-cleared swaps (for example,

(continued . . .)

amount is calculated only for business days during such months.[10] The effect of this limitation is that Covered Swaps Entities will not be required to collect margin even from certain counterparties that are financial end users if those entities do not exceed the "material swaps exposure" threshold. Notably, this amount is substantially below the similar threshold amount adopted in the International Framework, which defines smaller financial end users as those counterparties that have a gross aggregate amount of Covered Swaps below €8 billion, which is equal to approximately $11 billion.

Other Counterparties

Under the Proposed Rule, the fourth category of counterparties, "other counterparties" includes all swap counterparties that are not Swap Entities or financial end users. These counterparties include nonfinancial end users such as "commercial" end users which generally engage in swaps to hedge commercial risk, sovereigns (discussed above) and multilateral development banks.

Applicability to Affiliates

Finally, margin requirements under the Proposed Rule apply to uncleared swaps between a Covered Swap Entity and its counterparties, which also generally includes swaps between banks that are Covered Swap Entities and their affiliates that are financial end users, including subsidiaries of banks.[11]

Initial Margin Requirements

The 2011 Proposal specified, among other things, the manner in which a Covered Swap Entity must calculate the initial margin requirements applicable to its uncleared swaps. These initial margin requirements applied only to the amount of initial margin that a Covered Swap Entity would be required to collect from its counterparties. The 2011 Proposal did not address whether, or in what amounts, a Covered Swap Entity must post initial margin to a counterparty.

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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 2015. Furthermore, suppose that a foreign exchange forward is added to the entity's portfolio at the end of the day on July 31, 2015, and that its notional value is $10 billion on every business day of August 2015. On each business day of June and July 2015, the aggregate notional amount of non-cleared swaps, security-based swaps and foreign exchange forwards and swaps is $30 billion. Beginning on August 1, 2015 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 2015 is then (22x$30 billion + 23x$30 billion + 21x$40 billion)/(22+23+21)=$33.18 billion, in which case this entity would be considered to have a material swaps exposure for every date in 2016."

10 Note that while, pursuant to a determination by the Secretary of the Treasury (77 Fed. Reg. 69694 (Nov. 20, 2012)), the margin requirements of the Proposed Rule do not apply to physically settled foreign exchange swaps and foreign exchange forwards, such foreign exchange swaps and foreign exchange forwards are used in calculating the material swaps exposure amounts and determining applicable compliance dates under the Proposed Rule.

11 The terms "affiliate", "subsidiary" and "control" are also defined in the Proposed Rule.

In contrast, the Proposed Rule specifies that "two-way margining" is required. Specifically, when a Covered Swap Entity enters into a transaction with another Swap Entity, both entities will be required to collect and post a minimum amount of initial margin. A Covered Swap Entity transacting with a financial end user with material swaps exposure must collect at least the amount of initial margin required by the Proposed Rule and must post at least the amount of initial margin that the Covered Swap Entity would be required to collect if the Covered Swap Entity were in the place of the counterparty. In addition, a Covered Swap Entity must post or collect initial margin on at least a daily basis in response to changes in the required initial margin amounts stemming from 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 Proposed Rule is similar to the 2011 Proposal in permitting a Covered Swap Entity to select from two alternatives to calculate its initial margin requirements, a "look-up" table and an internal margin model. Each of these is discussed in more detail below.

"Look-Up" Table

Under both the 2011 Proposal and the Proposed Rule, a Covered Swap Entity may calculate its initial margin requirements using a standard "look-up" table that specifies the minimum initial margin that must be collected, expressed as a percentage of the notional amount of the swap. Pursuant to the look-up table, the minimum initial margin varies depending on the broad asset class of the swap. The initial margin amount applicable to multiple uncleared swaps subject to an eligible master netting agreement ("EMNA", discussed in more detail below) pursuant to the lookup table must be computed in accordance with the following formula: Initial Margin= 0.4 x Gross Initial Margin + 0.6 x NGR x 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 uncleared swaps subject to the EMNA.

Internal Margin Model

Under the 2011 Proposal, a Covered Swap Entity could also calculate its minimum initial margin requirements using an internal margin model that met certain criteria and had been approved by the relevant Prudential Regulator. If approved, the Covered Swap Entity would then collect at least the amount of initial margin that was required under its internal model calculations, though a Prudential Regulator could require a Covered Swap Entity to collect greater initial margin than that determined by its model. The 2011 Proposal required that the Covered Swap Entity review its initial margin model at least annually in light of developments in financial markets and modeling technologies and make appropriate enhancements as appropriate.

The Proposed Rule similarly allows for a Covered Swap Entity to calculate its minimum initial margin requirements using an internal margin model meeting specific criteria which are substantially similar to the criteria of the 2011 Proposal, provided the model is approved by the Covered Swap Entity's Prudential Regulator. Any internal model must meet the following requirements:

- the model must calculate an amount of initial margin that is equal to the potential future exposure of the swap;[12]
- all data used to calibrate the initial margin 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. Such risk factors must include foreign exchange/interest rate risk, credit risk, equity risk and commodity risk, as appropriate;
- in the case of an uncleared cross-currency swap, the Covered Swap Entity's initial margin model need not recognize any risks or risk factors associated with the fixed, physically-settled foreign exchange transactions 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 eligible master netting agreement 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 of swaps for which offsetting exposures, diversification and other hedging benefits are explicitly recognized by the initial margin model;
- the sum of the initial margin calculated for each broad risk category will be used to determine the aggregate initial margin due from the counterparty;
- the initial margin 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 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;

[12] Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the non-cleared swap, non-cleared security-based swap or netting set of non-cleared swaps or non-cleared security-based 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 (10) business days or the maturity of the non-cleared swap or non-cleared security-based swap.

- the Covered Swap Entity must have a rigorous and well-defined process for re-estimating, re-evaluating, and updating its internal models to ensure continued applicability and relevance;
- the model must be recalibrated at least monthly; and
- the level of sophistication of the model must be commensurate with the complexity of the swap.

Similar to the 2011 Proposal, the Proposed Rule specifies that a Prudential Regulator can require a Covered Swap Entity to collect greater initial margin than that determined by its model. The Proposed Rule also requires that the Covered Swap Entity conduct a review of its initial margin model at least annually in light of developments in financial markets and modeling technologies and make appropriate enhancements. 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 margin) with relevant alternative internal and external data sources to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar cleared transactions.

Initial Margin Threshold Amounts

Under the 2011 Proposal, for counterparties that were low-risk financial end users or nonfinancial end users, both alternatives for calculating initial margin requirements permitted Covered Swap Entities to establish a credit exposure threshold below which it need not collect initial margin. This credit exposure threshold was referred to as the "initial margin threshold amount." The maximum initial margin threshold amount that a Covered Swap Entity could establish under the 2011 Proposal varied based on the counterparty type. For counterparties that were low-risk financial end users, the 2011 Proposal limited the maximum initial margin threshold amount to the lower of (i) a range of $15 to $45 million or (ii) a range of 0.1 to 0.3 percent of the Covered Swap Entity's tier 1 capital. For counterparties that were nonfinancial end users, the 2011 Proposal did not place a specific limit on the maximum initial margin threshold amount. However, it did require that any initial margin threshold amount (i) appropriately take into account and address the credit risk posed by the counterparty and the risks of such swaps and security-based swaps and (ii) be reviewed, monitored and approved in accordance with the swap entity's credit processes. Further, the 2011 Proposal required that, even where an initial margin threshold amount was established, the Covered Swap Entity would still have to calculate the initial margin amount for the counterparty under one of the two calculation alternatives and, to the extent that the initial margin amount exceeded the initial margin threshold amount that had been established, collect initial margin equal to the excess amount. Under the 2011 Proposal, a Covered Swap Entity was not required to collect margin from any individual counterparty otherwise required under the rule until the required cumulative amount was $100,000 or more (the "minimum transfer amount"). Also, a Covered Swap Entity was required to collect initial margin on or before the date it entered into an uncleared swap. Finally, under the 2011 Proposal, a Covered Swap Entity was not permitted to establish an initial margin threshold amount for a counterparty that was either (i) a Covered Swap Entity itself or (ii) a high-risk financial end user, and as such, would always have to collect the full amount of required initial margin from such counterparty.

The Proposed Rule permits a Covered Swap Entity, using either alternative calculation method to determine initial margin requirements, to adopt a maximum initial margin threshold amount of $65 million, below which it need not collect or post initial margin from or to other Swap Entities or financial end users with material swaps exposures. The threshold would be applied on a consolidated/group basis; therefore, the threshold would apply across all uncleared swaps between a Covered Swap Entity and its affiliates and the counterparty and its affiliates. No specific numerical threshold related to initial margin need be set by the Covered Swap Entity for its transactions with parties (i) qualifying as nonfinancial end users; (ii) exempt from the definition of financial end user; and (iii) financial end users without material swaps exposure. However, as discussed below, the Covered Swap Entity must engage in an assessment of the overall risk of these counterparties to determine whether margin collection is warranted. Under the Proposed Rule, a Covered Swap Entity must, on a daily basis, comply with the initial margin requirements for uncleared swaps to which it is party for a period beginning on or before the business day following the day it enters into the transaction and ending on the date the non-cleared swap is terminated or expires. However, a Covered Swap Entity need not collect or post initial or variation margin from or to any individual counterparty otherwise required unless and until the required cumulative amount of initial and variation margin is greater than $650,000 (the "minimum transfer amount").

Variation Margin Requirements

Under the 2011 Proposal, a Covered Swap Entity was generally required to collect variation margin periodically and at different times depending on the type of counterparty, with the specific amount required to be collected being equal to or greater than (i) the cumulative mark-to-market change in value to the Covered Swap Entity of a swap less (ii) the value of all variation margin previously collected but not returned by the Covered Swap Entity with respect to such swap. The 2011 Proposal did not address whether, or in what amounts, a Covered Swap Entity would be required to post variation margin to a counterparty. As with the treatment of initial margin under the 2011 Proposal, a Covered Swap Entity could adopt a threshold amount below which it need not collect variation margin from counterparties that were low-risk financial end users or nonfinancial end users, and could not establish a variation margin threshold amount for counterparties that were themselves Swap Entities or high-risk end users. The variation margin threshold amount that a Covered Swap Entity could establish for low-risk financial end users was subject to the same maximum amount that governed initial margin threshold amounts for low-risk financial end users.

Under the Proposed Rule and consistent with proposed treatment of initial margin requirements, Covered Swap Entities transacting with Swaps Entities and with all types of financial end users are required to collect and pay[13] variation margin with respect to uncleared swaps. The variation margin collection and payment requirements differ from the initial margin requirements in that they apply to financial end users regardless of whether the financial end user has material swaps exposure. The Proposed Rule generally requires a Covered Swap Entity to collect and pay variation margin on uncleared swaps in an amount that is at least equal to the increase or decrease (as applicable) in the value of such swaps since the previous exchange of variation margin. Unlike the 2011 Proposal and the treatment of initial margin requirements in the Proposed Rule, a Covered Swap Entity may not adopt a threshold amount below which it need not collect or pay variation margin on swaps with a Swap Entity or financial end user counterparty (although transfers below the minimum transfer amount of $650,000 would not be required, as discussed above). Under the Proposed Rule, a Covered Swap Entity must collect or pay variation margin with other Covered Swap Entities and financial end user counterparties no less frequently than once per business day, and must collect variation margin from other counterparties if such variation margin is deemed appropriate in accordance with the Covered Swap Entity's counterparty risk assessment, discussed below.

Eligible Master Netting Agreements

The 2011 Proposal permitted a Covered Swap Entity to (i) calculate initial margin requirements for swaps and security-based swaps under a qualifying master netting agreement with the counterparty on a portfolio basis in certain circumstances, if it was using an initial margin model to do so, and (ii) calculate variation margin requirements under the proposed rule on an aggregate basis across all swap or security-based swap transactions with a particular counterparty that were executed under a qualifying master netting agreement. A qualifying master netting agreement was defined as a legally enforceable agreement to offset positive and negative mark-to-market values of one or more swaps or security-based swaps that meet a number of specific criteria designed to ensure that these offset rights are fully enforceable, documented and monitored by the Covered Swap Entity. Applying the margin rules in this way would, in some cases, have had the effect of applying the margin rules retroactively to pre-effective-date swaps under the master agreement.

The Proposed Rule allows for the same master netting agreement-based calculations of initial and variation margin as in 2011 Proposal. However, the Proposed Rule uses the term eligible master netting agreement ("EMNA") to avoid confusion with and to distinguish the EMNA from the term "qualifying master netting agreement," as such term is used by the Federal banking agencies in their risk-based capital rules.[14] The Proposed Rule defines EMNA, similar to the definition of qualifying master netting

13 As noted in the Proposed Rule, the terms "pay" and "paid" are used with regard to variation margin with reference to the fact that the margin is being transferred in cash, and is "not intend[ed] to propose to mandate, as a legal matter, to alter current practices under which variation margin is characterized as being 'posted' pursuant to an agreement that establishes a security interest." The Prudential Regulators explicitly invite comment on the use of terminology in this context.

14 *See* 12 C.F.R. part 3.2, 12 C.F.R. part 217.2, and 12 C.F.R. part 324.2.

agreement in the 2011 Proposal, 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, insolvency, liquidation, or similar proceeding) provided that certain conditions are met.[15] Under the Proposed Rule, a Covered Swap Entity may (i) calculate initial margin requirements for swaps under an EMNA with the counterparty on a portfolio basis in certain circumstances, if it does so using an initial margin model, and (ii) calculate variation margin requirements under the proposed rule on an aggregate, net basis under an EMNA with the counterparty.

Counterparty Risk Assessment

The Proposed Rule requires a Covered Swap Entity to collect (i) initial margin from counterparties other than other Swap Entities and financial end users with material swaps exposure; and (ii) variation margin from counterparties other than other Swap Entities and financial end users, at such times and in such forms and amounts (if any) that the Covered Swap Entity determines appropriately address the credit risk posed by the counterparty and the risks of such uncleared swaps. However, the Proposed Rule does not impose any minimum margin requirements in such instances.

Notably, the Proposed Rule draws a distinction between the initial margin and variation margin requirements as applied to certain categories of counterparties of a Covered Swap Entity: 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. In other words, with regard to initial margin, financial end users without material swaps exposure can be evaluated under the counterparty risk assessment procedure, but cannot be evaluated under such procedure with regard to variation margin, and are instead subject to variation margin requirements.

The specific provisions of the Prudential Regulators' Proposed Rules on variation margin requirements, documentation, eligible collateral, segregation, and rehypothecation, discussed in further detail below, do not apply to swaps between Covered Swap Entities and these counterparties permitted to be evaluated pursuant to a counterparty risk assessment.

A summary of the initial and variation margin requirements by counterparty type follows.

15 These conditions include requirements with respect to the covered swap entity's right to terminate the contract 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 so that the covered swap entity may conclude with a well-founded basis that, among other things, the contract would be found legal, binding, and enforceable under the law of the relevant jurisdiction and that the contract meets the other requirements of the definition.

Type of Counterparty to Covered Swap Entity	Initial Margin		Variation Margin
	IM Threshold	**Amount Required**	**Amount Required**
Other Swap Entities	$65 million or below	Internal Model or Standardized Minimum from "Look-Up" Table	Daily Market Value Change
Financial End Users With Material ($3B) Swaps Exposure	$65 million or below	Internal Model or Standardized Minimum from "Look-Up" Table	Daily Market Value Change
Financial End Users Without Material Swaps Exposure	N/A	Judgment of the Covered Swap Entity	Daily Market Value Change
Other Counterparties, Including Nonfinancial End Users	N/A	Judgment of the Covered Swap Entity	Judgment of the Covered Swap Entity

Eligible Collateral

The 2011 Proposal specified certain types of collateral eligible to be collected to satisfy both initial and variation margin requirements. Eligible collateral was limited to: (i) immediately available cash; (ii) any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the United States; (iii) with respect to initial margin only, any senior debt obligations of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and Farmer Mac; and (iv) with respect to initial margin only, any obligation that is an "insured obligation" of the Farm Credit System banks, as that term is defined in 12 U.S.C. 2277a(3). Other than immediately available cash, all types of eligible collateral were subject to discounts or minimum "haircuts" for purposes of determining their value for margin purposes. Further, under the 2011 Proposal, Covered Swap Entities were required to monitor the value of non-cash collateral previously collected to satisfy margin requirements and, to the extent the value of such non-cash collateral has decreased, to collect additional collateral with a sufficient value to ensure that all applicable initial and variation margin requirements remain satisfied.

Variation Margin – Collateral Requirements

With regard to variation margin, the Proposed Rule requires the collection or payment of immediately available cash to satisfy the minimum variation margin requirements, where such cash can be denominated either in U.S. dollars or in the currency in which payment obligations under the swap are required to be settled.[16] These amounts are not subject to any value "haircuts."

16 Under the Proposed Rule, "[w]hen determining the currency in which payment obligations under the swap are required to be settled, a [C]overed [S]wap [E]ntity must consider the entirety of the contractual obligation. As an example, in cases where a number of swaps, each potentially *(continued . . .)*

Initial Margin – Collateral Requirements

With regard to initial margin, the Proposed Rule broadens the categories of eligible collateral which may be collected or posted in connection with the minimum margin requirements (such categories do not apply to collateral provided outside of collateral collected or posted in connection with meeting the minimum requirements, such as collateral collected from counterparties pursuant to a Covered Swap Entity's counterparty risk assessment or excess collateral that a counterparty elects to leave on deposit). The eligible collateral for purposes of collecting and posting required initial margin includes the following:

- Cash collateral denominated either in U.S. dollars or in the currency in which payment obligations under the swap are required to be settled (subject to the same requirements as variation margin described above and not subject to any value haircuts);
- a security that is issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the 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 the Treasury) whose obligations are fully guaranteed by the full faith and credit of the United States government;
- a publicly traded debt security issued by, or an asset-backed security fully guaranteed as to the timely 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;
- any major currency, regardless of whether it is the currency in which payment obligations under the swap are required to be settled (as described below, collateral denominated in non-U.S. currency or a currency other than the currency in which payment obligations under the swap are required to be settled would be subject to an additional value haircut);
- a security that is issued by the European Central Bank or by a sovereign entity that receives no higher than a 20 percent risk weight under subpart D of the Federal banking agencies' risk-based capital rules;[17]
- a security that is issued by or unconditionally guaranteed as to the timely payment of principal and interest by the Bank for International Settlements, the International Monetary Fund, or a multilateral development bank;
- a publicly traded debt security for which the issuer has adequate capacity to meet financial commitments (as defined by the appropriate Federal agency),102 including such a security issued by a U.S. Government-sponsored enterprise not covered in (3), above;

(. . . continued)

denominated in a different currency, are subject to a single master agreement that requires all swap cash flows to be settled in a single currency, such as the Euro, then that currency (Euro) may be considered the currency in which payment obligations are required to be settled." The Prudential Regulators have requested comment in the Proposed Rule as to "whether there are current market practices that would raise difficulties or concerns about identifying the appropriate settlement currency in applying this aspect of the proposed rule, from a contractual or other operational standpoint."

17 *See* 12 C.F.R. part 3, subpart D, 12 C.F.R. part 217, subpart D, and 12 C.F.R. part 324, subpart D.

- a publicly traded common equity security that is included in the Standard and Poor's Composite 1500 Index, an index that a Covered Swap Entity's supervisor in a foreign jurisdiction recognizes for the purposes of including publicly traded common equity as initial margin, or any other index for which the Covered Swap Entity can demonstrate that the equities represented are as liquid and readily marketable as those included in the Standard and Poor's Composite 1500 Index; and
- gold.

When determining the collateral's value for purposes of satisfying the Proposed Rule's margin requirements, non-cash collateral or cash collateral denominated in non-U.S. currency or a currency other than the currency in which payment obligations under the swap are required to be settled would be subject to an additional value "haircut." The haircuts only apply to satisfy the minimum margin requirements and would not apply to margin collected in excess of the margin requirements.

Segregation Requirements

The 2011 Proposal required that a Covered Swap Entity that entered into an uncleared swap with a counterparty that is itself a Swap Entity ensure that its counterparty segregate any funds or collateral that such Covered Swap Entity posts as initial margin. Under the 2011 Proposal, the initial margin would have been required to be segregated at an independent, third-party custodian that was prohibited by contract from (i) rehypothecating or otherwise transferring any initial margin it held and (ii) reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral for initial margin. The custodian would have been required to be located in a jurisdiction that applied the same insolvency regime to the custodian as would apply to the Covered Swap Entity. The segregation requirement of the 2011 Proposal only applied to initial margin and did not apply to any counterparty that was an end user of any type.

The Proposed Rule is similar to the 2011 Proposal with regard to segregation requirements to be applied to collateral other than variation margin. The Proposed Rule directs a Covered Swap Entity that posts any collateral other than variation margin (*i.e.*, all initial margin) with respect to an uncleared swap to require that such collateral be held by one or more custodians that are not affiliates of the Covered Swap Entity or the counterparty. This requirement would apply to initial margin posted by a Covered Swap Entity required to be posted under the rule, as well as initial margin that is not required by the rule but is posted by a Covered Swap Entity as a result of negotiations with its counterparty, such as initial margin posted to a financial end user that does not have material swaps exposure or initial margin posted to another Covered Swap Entity even though the amount was less than the $65 million initial margin threshold amount. With respect to initial margin required to be collected pursuant to the rule, the Covered Swap Entity must require that such initial margin collateral be held at one or more custodians that are not affiliates of either party. This requirement does not apply to initial margin collected in amounts above those required by the rule.

For all collateral posted and collected, the Proposed Rule requires that the custodian act pursuant to an enforceable custodial agreement and be prohibited from rehypothecating, repledging, reusing or otherwise transferring and funds or property held by it. Notwithstanding such prohibition, the party posting the collateral may substitute or direct any reinvestment of collateral, including, under certain conditions, collateral required to be collected or posted pursuant to the rule. Notably, this provision of the Proposed Rule is different from the International Framework, which allows for member countries to permit a limited degree of rehypothecation, repledging, and reuse of initial margin collateral when a Covered Swap Entity is dealing with a financial end user if certain safeguards for protecting the financial end user's rights in such collateral are available under applicable law.

Application of Margin Requirements to Certain Foreign Covered Swap Entities

With respect to U.S. Covered Swap Entities, the 2011 Proposal applied the margin requirements without regard to whether the counterparty was located inside or outside of the United States. With respect to foreign Covered Swap Entities, the 2011 Proposal excluded certain qualifying foreign derivative transactions of such entities from application of the margin requirements. Specifically, the margin requirements would not have applied to any "foreign non-cleared swap or foreign non-cleared security-based swap" of a "foreign Covered Swap Entity." A "foreign non-cleared swap or foreign non-cleared security-based swap" was defined as a non-cleared swap or non-cleared security-based swap with respect to which the counterparty was not organized under U.S. law or otherwise located in the United States, and no U.S. affiliate of the counterparty had guaranteed the counterparty's obligations under the transaction. A "foreign Covered Swap Entity" was a Covered Swap Entity that was not (i) a company organized under U.S. law; (ii) a branch or office of a company organized under U.S. law; (iii) a U.S. branch, agency or subsidiary of a foreign bank; and (iv) controlled, directly or indirectly, by a company that is organized under U.S. law.

The Proposed Rule modifies the exclusion of the 2011 Proposal described above slightly. The margin requirements under the Proposed Rule do not apply to any foreign non-cleared swap of a "foreign Covered Swap Entity." Similar to the 2011 Proposal, a "foreign Covered Swap Entity" is any Covered Swap Entity that is not (i) an entity organized under U.S. or State law, including a U.S. branch, agency, or subsidiary of a foreign bank; (ii) a branch or office of an entity organized under U.S. or State law; or (iii) an entity controlled by an entity organized under U.S. or State law. Under this definition, foreign swaps could include swaps with a foreign bank or with a foreign subsidiary of a U.S. bank or bank holding company, so long as that subsidiary is not itself a Covered Swap Entity.

In addition, the Proposed Rule allows for certain Covered Swap Entities to comply with a foreign regulatory framework for uncleared swaps in lieu of adherence to the U.S. framework if the Covered Swap Entity meets certain requirements and the Prudential Regulators determine such substituted compliance is appropriate. Such determinations would be made on a jurisdiction-by-jurisdiction basis, could be conditional or unconditional and could apply to all or some of the rule's requirements.

Capital Requirements

The 2011 Proposal required 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 Proposed Rule, the Prudential Regulators note that such capital rules, incorporated by reference into the Proposed Rule, have been strengthened since the issuance of the 2011 Proposal, and as noted in the Proposed Rule, the Prudential Regulators believe that the current regulatory capital rules sufficiently take into account and address the risks associated with the swaps positions of a Covered Swap Entity. As a result, the Proposed Rule does not include separate capital requirements.

Compliance Dates

Under the Proposed Rule, for variation margin, the compliance date is December 1, 2015 for all Covered Swap Entities with respect to Covered Swaps with any counterparty. With regard to initial margin, compliance dates range from December 1, 2015 to December 1, 2019, depending on the average daily aggregate notional amount of Covered Swaps of the Covered Swap Entity and its counterparty for June, July and August of the year indicated in the table below:

Compliance Date	Initial Margin
December 1, 2015	Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of Covered Swaps for June, July and August of 2015 that exceeds $4 trillion.
December 1, 2016	Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of Covered Swaps for June, July and August of 2016 that exceeds $3 trillion.
December 1, 2017	Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of Covered Swaps for June, July and August of 2017 that exceeds $2 trillion.
December 1, 2018	Initial margin where both the Covered Swap Entity combined with its affiliates and the counterparty combined with its affiliates have an average daily aggregate notional amount of Covered Swaps for June, July and August of 2018 that exceeds $1 trillion.
December 1, 2019	Initial margin for any other Covered Swap Entity with respect to Covered Swaps with any other counterparty.

These dates are generally in alignment with the phased-in margin requirement compliance timeline of the International Framework, which range from December 2015 and December 2019.

If an EMNA covers uncleared swaps that were entered into before the applicable compliance date, those swaps must be included in the aggregate for purposes of calculating the required variation margin. However, the margin requirements would not be applied retroactively, and therefore, no new initial margin or variation margin requirements would be imposed on uncleared swaps entered into prior to the relevant compliance date unless those transactions are rolled-over or renewed. The only requirements that would apply to a pre-compliance date transaction would be the initial margin and variation margin requirements to which the parties to the transaction had previously agreed by contract. However, if uncleared swaps that were entered into prior to the applicable compliance date were included in the EMNA, those swaps would be subject to the variation margin requirements. A Covered Swap Entity would need to establish a new EMNA to cover only swaps entered into after the compliance date in order not to subject pre-compliance date swaps to the variation margin requirements.

Estimated Compliance Costs Under the Proposed Rules

The OCC, which supervises institutions that account for about 80 percent of the swaps market, estimates that, if adopted as proposed, when the requirements are phased in entirely in 2019, they will require Swap Entities to post approximately $644 billion of initial margin for new swaps activity, estimated using current reported amounts of swap activity of FDIC-insured institutions.[18] Using the assumption that the opportunity cost of segregating initial margin into custodial accounts is between 45 and 100 basis points, the initial margin cost of the proposed rule is between $2.9 billion and $6.4 billion. The OCC further estimates that non-recurring compliance costs, including costs to related to recordkeeping, negotiating and executing new master netting agreements, establishing new third-party custodial accounts and modifying an existing internal margin model to comply with the Proposed Rule, in addition to general administrative costs, could be approximately $659 million, and that annual recurring (fully phased-in) compliance costs could be approximately $149 million.

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[18] OCC, Economic Impact Analysis for Swaps Margin Proposed Rule (Aug. 28, 2014), available at http://www.regulations.gov/contentStreamer?objectId=090000648185c55b&disposition=attachment&contentType=pdf. The OCC notes that while it expects that the proportion of cleared swaps to uncleared swaps will tend to increase as the Proposed Rule takes effect (decreasing initial margin requirements associated with the Proposed Rule), this change is not incorporated into the estimate of initial margin required.

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